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## CORPORATIONS-THEORY OF ORGANIZATIONAL FRANCHISE TAXATION- MICHIGAN FRANCHISE TAX

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CORPORATIONS—THEORY OF ORGANIZATIONAL FRANCHISE TAXATION—MICHIGAN FRANCHISE TAX—The present inquiry, besides delving into the nature of corporate organizational franchise taxation,<sup>1</sup> will also seek to arrive at a logical theoretical basis for two of the more common types of such levies, and will conclude by examining the pertinent Michigan statutes in the light of such theories.

## I

Although the term, "corporate franchise tax" has been used to cover a number of different types of exactions,<sup>2</sup> it is generally applied to levies laid on either the privilege to be a corporation or on that of doing business in a corporate capacity.<sup>3</sup> A consideration of these measures necessarily requires a knowledge of the franchises upon which they are imposed. The franchise "to be" is the grant of corporate life from the state—the right merely to exist in corporate form.<sup>4</sup> On the other hand, the franchise "to do" represents that grant of power from the state which enables the recipient to conduct corporate business.<sup>5</sup> It should also be noted that although any functioning corporation must of necessity have been the recipient of both grants, the state need not tax both, but may choose either franchise as an object for its taxing power.<sup>6</sup>

Turning now to the development of a theory of corporate franchise taxation, an initial step to be taken is the assumption that the statute is

<sup>1</sup> This term will be used to denote franchise taxes which are basically laid as of the time of organization rather than periodic exactions.

<sup>2</sup> See 51 AM. JUR. §809 (1944).

<sup>3</sup> 14 FLETCHER, CYC. CORP. 645 (1945).

<sup>4</sup> *Id.* at 652; see also, *In re Detroit Properties Corp.*, 254 Mich. 523, 236 N.W. 850 (1931).

<sup>5</sup> 14 FLETCHER, CYC. CORP. 653 (1945).

<sup>6</sup> *Id.* at 648. That both franchises may be subject to taxation is likewise clear. *Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185, 17 S.Ct. 604 (1897).

to be designed solely for the purpose of raising revenue.<sup>7</sup> Next we must further assume that like economic interests should be treated alike.<sup>8</sup> This unfortunately poses the additional problem of choosing a system for measuring the values of the franchise interests.

Although the question of determining economic worth or value is one which has long perplexed economists, it is generally believed that the most useful general definition of the concept is the one which stresses the relative importance of the subject matter with regard to its capacity to perform services for particular persons.<sup>9</sup> Even doubting the usefulness of such a general definition, it would seem that for the

<sup>7</sup> An enactment which requires the payment of a sum in excess of the reasonable expenses of filing and of regulation is to be considered an exercise of the taxing power and hence a revenue measure. *Vernor v. Secretary of State*, 179 Mich. 157, 146 N.W. 338 (1914). See also *Union Steam Pump Sales Co. v. Secretary of State*, 216 Mich. 261, 185 N.W. 353 (1921) (necessarily implying that the Michigan organizational franchise fee is a tax, a result of which might well be reached under many statutes). However, it should be noted that the taxing power of the state can be used for regulation. *ROTTSCHAEFFER, CONSTITUTIONAL LAW* 624 (1939). In light of this fact, might not necessarily police power objectives operate to vitiate theories based on the assumption that the statute is to be designed strictly as a revenue measure? Not necessarily. It should first be noted that many regulatory objectives can be achieved within the frame-work of a corporate franchise taxation statute designed solely to raise revenue. Later in the comment, a flat sum tax on the franchise "to be" will be advocated as a revenue measure. This tax can serve as the necessary financial barrier to eliminate "random" incorporation. Again, strictly as a revenue measure, a tax on the franchise "to do" in proportion to the extent of prospective business activity will be proposed. Such a fund raising device can achieve the desirable end of inducing incorporators to reveal the facts as to their potential operations, thus curtailing investor deception. Secondly, even assuming police power objectives beyond those attainable under statutes designed purely for revenue, if revenue is one of the goals of the levy, knowledge of what standards are required for the equitable raising of funds will enable a more intelligent compromise to be reached between these standards and those which are required for the attainment of the other statutory aims. If, of course, revenue is not a legislative objective, then the theories to be evolved based on this assumption will be useless.

<sup>8</sup> Under the Federal Constitution such a broad premise is not required. As long as the tax classification and the taxing bases set up by the statute are not purely arbitrary or capricious, the measure will be held to meet the equal protection requirement of the Fourteenth Amendment. Thus a franchise tax which imposed a levy of five cents on each one hundred dollars of authorized stock and which also set an arbitrary capitalization figure of one hundred dollars for each share of no-par stock, was held to be valid. *Roberts and Schaefer Co. v. Emmerson*, 271 U.S. 50, 46 S.Ct. 375 (1926); 40 HARV. L. REV. 139 (1926). For a view questioning the propriety of the theory of the case, see Wickersham, "Taxation of No Par Value Stock," 39 HARV. L. REV. 289 (1926). Despite the existence of a broad era for constitutionally permissible action, it would seem that except where the taxing power is being used for regulatory purposes or where such attempts would result in unworkably complex taxing statutes, legislation in this field should be aimed at burdening equal economic interests equally.

<sup>9</sup> "In economics, things are deemed to have value for their supposed capacity to perform services, and in that department of economics which is concerned with the value of *property*, things are assumed to have value for their capacity to perform services for those persons who can exploit them by exercising the powers of ownership." 1 BONBRIGHT, *THE VALUATION OF PROPERTY* 14 (1937). See also Commons, "Law and Economics," 34 YALE L.J. 371 at 377 (1925).

particular problem of taxation herein presented, this criterion is probably the best evidence of the economic power a given franchise represents. This is so since here resort to other commonly used evidence of value will prove fruitless. Market value cannot be utilized because the franchises under consideration are apparently inalienable.<sup>10</sup> Secondly, since the cost of the franchises is a purely arbitrary matter, depending solely upon what the state decides to charge (which assumedly ought to be determined by the value of the franchise), that standard is of no use. Proceeding then on the theory that here "value to the owner" is the best measure of economic worth, that value standard must be applied to the two specific kinds of franchises—"to be" and "to do." What then is the proper basis for taxing a franchise "to be"? It seems clear that the mere right to exist in corporate form is of equal value to all corporations. Since such a grant confers no power to act as a corporation the franchise is inherently solely capable of performing exactly the same service for any and all grantees regardless of their potential business activity. Proper taxation of this right would thus seem to require the levying of the same fixed sum thereon for all grantees. Of course, increases in the capital stock item should be treated as being of no moment for the purposes of this tax.

On the other hand, a franchise "to do" does confer the power to act as a corporate entity, which power is capable of being used to perform different services in the hands of different grantees. Thus, the proper measure of an organizational tax on such a franchise would seem to require its being couched in terms of the volume of the potential business activity of the grantee which in turn would be a measure of the services which the particular business unit would derive from the franchise, and hence of its value. As a practical matter, the determination of the potential business activity of a corporation prior to its entrance into business within the state might be extremely difficult.<sup>11</sup> In the light of this problem, a compromise may be required between theory and legislative convenience. To effect this balance, some states have

<sup>10</sup> This conclusion would seem to flow from the inherent nature of the franchise. The Michigan statute seems to bear out the inference. See 15 Mich. Stat. Ann. (1947 Cum. Supp.) §21.203. It would seem that whenever the exchange value is not equal to the use value of a commodity, market value is an inaccurate measure of its economic worth. Another example of such a situation is that of a peculiarly designed building such as the New York Stock Exchange, the market value of which is undoubtedly far less than the worth of the economic benefits it confers upon its present owners.

<sup>11</sup> Even in the case of a foreign corporation, having a long history of out-of-state operation, since the commerce clause of the Federal Constitution requires that a tax such as the one under consideration be apportioned with regard to the intra-state activity of the corporation [Western Union Telegraph Co. v. Kansas, 216 U.S. 1, 30 S.Ct. 190 (1910)], the same problem of prior determination would exist.

chosen as a taxing basis the par value of the authorized capital stock,<sup>12</sup> or in the case of no-par stock, its initial selling price or initial book value.<sup>13</sup> Although it must be admitted that these measures do not accurately reflect prospective business activity, the capital stock item and analogous figures almost always give some indication of the extent of the use to which the franchise will be put, and in view of the relatively small sums which are usually involved, they may be sufficiently precise.<sup>14</sup>

One further theoretical question remains and that is whether a statute taxing only the franchise "to do" upon organization, and which in the case of par stock operates by imposition of the levy on the authorized capital stock, should be designed to tax increases in that capital stock. The answer would seem to be clearly in the negative. The organizational tax on the franchise "to do," since it is imposed only at the time of incorporation, must be designed to measure *prospective* business activity. Due to the difficulty of measuring this quantity, the capital stock item, though a crude index, may in the light of legislative convenience be sufficiently accurate. However, once the corporation begins to conduct business, not only can the worth of its franchise be more accurately measured by an easily determinable basis keyed to present activity, but the sole use of the capital stock figure for this purpose is completely deceptive.<sup>15</sup> Thus the organizational taxing statute on the franchise "to do" should not be used in theory to gain revenue from subsequent corporate operations by taxing increases in the capital stock item. Rather a separate statute taxing post-organizational activity should be framed.

## II

Approaching the Michigan statutes, the first step in analyzing the pertinent corporate franchise sections involves a determination of their nature. One section imposes an annual levy on the privilege of carrying

<sup>12</sup> Some states apparently more nearly measure prospective business activity by taxing on the basis of the stock actually issued and outstanding. <sup>14</sup> FLETCHER, *CYC. CORP.* §6963 (1945).

<sup>13</sup> See 14 FLETCHER, *CYC. CORP.* §§6963, 6964 (1945). Reference to §6964 will show that the bases for no-par taxation run the gamut, however.

<sup>14</sup> Under the rate laid down by the New York statute, 59 N.Y. Code Ann. (McKinney, 1943) §180, a corporation with an authorized capital stock item of \$100,000 would be required to pay a tax of \$50. The administrative expense in determining a more accurate measure of potential activity might exceed this sum.

<sup>15</sup> See Bonbright, "The Danger of Shares without Par Value," 24 *COL. L. REV.* 449 at 450 (1924), in which the author points out that the capital stock item of an operating corporation in no way represents its value.

on corporate activity.<sup>16</sup> Two sections deal with valuation,<sup>17</sup> and the final pertinent section imposes the organizational franchise tax<sup>18</sup> which will be hereafter considered. To treat the present provision properly, it is necessary to consider the law as it existed before 1921 when the current statute was enacted.<sup>19</sup> At that time, Michigan law required the payment of "a franchise fee of ½ of one mill upon each dollar of the authorized capital stock."<sup>20</sup> This statute was identical on the pertinent points with an earlier enactment<sup>21</sup> which had received interpretation in the case of *Coit and Co. v. Sutton*.<sup>22</sup> In this case, the court through dicta stated that the tax was on the "privilege of doing business,"<sup>23</sup> thus indicating that the statute taxed the franchise "to do." However, in 1921, after the legislature had recast the provisions into almost their present form,<sup>24</sup> the court was presented with a case which necessitated a decision as to the nature of the new enactments.<sup>25</sup> In this case, the court held first that the newly imposed annual privilege fee was laid on the franchise "to do," and second, that the organizational franchise tax, which was essentially like the pre-1921 law, was really on the franchise "to be."<sup>26</sup>

Noting, then, that the organizational tax is on the franchise "to be," it might be well to correlate its treatment under the Michigan statute

<sup>16</sup> 15 Mich. Stat. Ann. (1937) §21.205.

<sup>17</sup> 15 Mich. Stat. Ann. (1937) §21.204, §21.208.

<sup>18</sup> 15 Mich. Stat. Ann (1947 Cum. Supp.) §21.203.

<sup>19</sup> Mich. Pub. Acts (1921), Act No. 85, §3.

<sup>20</sup> Mich. Comp. Laws (1915) §11352 (1).

<sup>21</sup> Mich. Pub. Acts (1893), Act No. 79.

<sup>22</sup> 102 Mich. 324, 60 N.W. 690 (1894).

<sup>23</sup> Id. at 327.

<sup>24</sup> At this time, one of the no-par valuation sections [Mich. Stat. Ann. (1937) §21.204] had not been enacted, it having been originally added in 1925 (Act No. 223, P.A. 1925 as amended by Act No. 253, P.A. 1927).

<sup>25</sup> *Union Steam Pump Sales Co. v. Secretary of State*, 216 Mich. 261, 185 N.W. 353 (1921).

<sup>26</sup> The statements in the earlier case of *Coit and Co. v. Sutton*, 102 Mich. 324, 60 N.W. 690 (1894), were reconciled on apparently tenuous grounds. The court said that the franchise "to do" necessarily follows the franchise "to be," although the former may not be the subject of taxation. Thus, although the statement of the court in the prior case appeared to be in terms of the franchise "to do," the tax might have actually been imposed on the co-incident franchise "to be," which this court arbitrarily decreed to be the case, even though the statute stated that the levy was imposed "as an organization fee and for the *privilege* of exercising its franchise." 15 Mich. Stat. Ann. (1947 Cum. Supp.) §21.203. Although the formal logic of this position appears to be questionable, the result would appear to be desirable. It was apparently occasioned by a seemingly excessively restrictive provision of the Michigan Constitution [§1, Art. 10 (1908)], which stated that all subjects of taxation which were contributing to the primary school fund in 1908, should continue to so contribute. Since there had been a corporate franchise tax at this time, and secondly, since it would have been very difficult to construe the annual privilege fee as a tax on the franchise "to be," and, thirdly, since the primary school fund was already well financed, the court was constrained to consider the organizational tax as being upon the franchise "to be."

with our previously developed theory that taxation of this franchise should be in terms of a flat sum for all corporations.

The statute contains the following pertinent provisions:

Sec. 3: "Every domestic corporation hereafter organized for profit . . . shall at the time of filing its articles . . . pay to the Michigan Corporation and Securities Commission, as an organization fee and for the privilege of exercising its franchises within this state, a sum equal to  $\frac{1}{2}$  mill upon the dollar for each dollar of the authorized capital stock of such corporation: . . . And provided further, That every corporation heretofore or hereafter incorporated . . . which shall thereafter increase its authorized capital stock . . . shall pay a sum equal to  $\frac{1}{2}$  mill upon each dollar for each and any increase in its authorized capital stock."<sup>27</sup>

Sec. 3a: "The value placed upon each share of stock of no par value by a corporation for the purpose of sale, or for exchange for property, or other stock, or for any other purpose, shall be taken as the basis of the franchise fees required at the time of incorporation or upon the increase of capital of a corporation for profit. Such value for tax purposes and for computation of franchise fees shall be at least one (1) dollar. Where any shares of stock shall within one (1) year after incorporation or within one (1) year after an increase in capital be exchanged for property or for other stock at a price in excess of that stated in the articles of association, . . . there shall be paid to the Secretary of State [Michigan Corporation and Securities Commission] on account thereof an additional franchise fee, such fee to be computed at the same rate as in the case of original incorporation: *Provided*, That no additional franchise fee shall be required where the value placed upon such shares is based upon earnings of a corporation."<sup>28</sup>

Sec. 5: ". . . For the purpose of this act only, each share of no par value shall be deemed to have the value of at least one (1) dollar, or such value as shall have been fixed by the corporation for the sale of such stock, or the book value as determined by the secretary of state, whichever may be the higher."<sup>29</sup>

Clearly the statute in section 3 is not in accord with the previously developed theory both with respect to the designation of the capital stock item as the taxable basis and to the allowance of taxation on the increase thereof. Since this legislative pattern seems not to have been

<sup>27</sup> 15 Mich. Stat. Ann. (1947 Cum. Supp.) §21.203.

<sup>28</sup> 15 Mich. Stat. Ann. (1937) §21.204.

<sup>29</sup> 15 Mich. Stat. Ann. (1937) §21.208.

dictated by any supervening police power objective,<sup>30</sup> it seems fair to discuss the statutes as revenue measures and to criticize them as such. Even assuming the law to remain unchanged, the theory may be of some value in the determination of ambiguities under the present provisions. A recent Michigan case illustrates the latter situation.<sup>31</sup> A corporation had begun business with 10,000 shares of no-par stock proposed to be sold at \$1 per share. Later it had increased its capitalization to 100,000 shares on the same basis. Then at a time when the book value of the shares was \$3.85, a certificate of decrease to 66,670 shares was filed. This reduction in the number of shares actually represented an increase in the book value of \$156,675.50, which for the purpose of the statute was to be treated as an increase in the capital stock item. The question presented to the court was whether this increase in capitalization could properly be taxed under the aforementioned statutes or, put another way, did the statute authorize taxation only of an increase in the number of shares or did it also authorize taxation on the increase of the capital stock item? On the basis of the statutory language, equally sound arguments could be made for both contentions.

The argument for taxability is that the language of section 3 places the initial levy "upon the dollar for each dollar of the authorized capital stock" and the additional levy "upon each dollar for each and any increase in its authorized capital stock." This language might be read placing emphasis on the former phrase, prompting the conclusion that the tax is in reality on the dollar value of the stock and the increase in that dollar value. The prohibition set out in section 3a against requiring an additional franchise fee where the value placed upon the shares is based upon earnings can be explained by saying that section 3a was passed to prevent a situation which could otherwise occur under section 5 whereby a corporation could take in just enough capital on incorporation or on an increase of its stock so as to allow it to set the value of its shares at the minimum figure of one dollar. Later, the stock could be exchanged for property in excess of the minimum figure and no additional tax could be collected. Section 3a prevents this if the latter transaction occurs within one year after incorporation or increase. The "earnings" proviso, so the argument goes, was inserted to exempt earn-

<sup>30</sup> Note the tenor of the opinion in *Union Steam Pump Sales Co. v. Secretary of State*, 216 Mich. 261, 185 N.W. 353 (1921).

<sup>31</sup> *Waterways Navigation Co. v. State*, 323 Mich. 153, 35 N.W. (2d) 227 (1948).

ings made within that period from the general treatment of section 3a and for no other purpose.<sup>32</sup>

The opposing position could be maintained by arguing that section 3 states definitely that the corporation "shall pay a sum equal to ½ mill upon each dollar for each and any 'increase' in its authorized capital stock." Moreover, the "earnings" proviso of section 3a is in no way limited by the prior language of that section, but rather it deals with all no-par valuation. This being so, "increase" must be interpreted to mean increase in the number of shares if any consistency between these provisions is to be attained. This was the view of the Michigan court. If the decision were rested on the competing contentions of statutory construction the result could not have been other than intuitive. However, viewed in the light of the afore-noted theory, the holding seems to be beneficial, since as previously pointed out, increases in the capital stock item should not afford a basis for the imposition of an additional tax on the franchise "to do," and the present case, by restricting taxation of such increase to the statutory minimum, would seem to have taken the proper course.

*Charles Hansen, S.Ed.*

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<sup>32</sup> See appellant's brief in *Waterways Navigation Company v. State*, 323 Mich. 153, 35 N.W. (2d) 227 (1948).