Wisconsin Privilege Dividend Tax

William Smith Malloy
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BY SECTION 3 of Chapter 305, Laws of 1935, the Wisconsin legislature enacted a corporate "privilege dividend tax." The measure, although originally designated as temporary, has been retained on the statute books, and decisions surrounding it have made it the seeming ultimate expression of the power of a state to tax without running afoul of constitutional restrictions. The law has continued to excite interest because entirely aside from questions of the substantive law of taxation, there are bound up in the interpretations which courts have placed on the law principles of constitutional law, canons of statutory construction, and political issues of states rights. The chronology of the litigation will contribute to an understanding of the problems presented to the supreme courts of the United States and of Wisconsin, and to that end it will be briefly summarized.

The issue of the constitutionality of the tax in its application to Wisconsin corporations was at an early date determined favorably. In its application to foreign corporations doing business within the state the question of constitutionality was presented in the leading case of J. C. Penny v. State of Wisconsin. Here funds earned from operations in the state were commingled with funds derived from other sources; and from these monies a dividend was declared and paid by the taxpayer, a Delaware corporation, by authority of a resolution of the board of directors meeting in New York City. The Wisconsin Supreme Court held the tax to be in nature an excise tax on the act of privilege of receiving a dividend. On the authority of a then recent

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1 The pertinent provisions of the act are: "(1) For the privilege of declaring and receiving dividends out of income derived from property located and business transacted in this state, there is hereby imposed a tax equal to three per cent of the amount of such dividends declared and paid by all corporations (foreign and local) ... Such tax shall be deducted and withheld from such dividends payable to residents and non residents by the payor corporation.

"(3) Every such corporation hereby made liable for such tax shall deduct the amount of such tax from the dividends so declared." 71.60(3) Wis. Statutes 1941.

2 Dowling, CASES ON CONSTITUTIONAL LAW p. 629 (1940).

3 State ex Rel Froedert Grain and Malt Company v. Tax Commission, 221 Wis. 225, 265 N.W. 672 (1936).

4 233 Wis. 286, 289 N.W. 677 (1940).
decision of the United States Supreme Court,\(^5\) it was decided that the act was invalid as violative of the due process clause of the Fourteenth Amendment in that it attempted to tax an act occurring outside of the taxing jurisdiction.

The United States Supreme Court took jurisdiction of the case upon certiorari at the petition of the state, and the majority decision in its language expressly disregarded the state court's characterization of the measure. The highest tribunal held five to four that the tax was essentially an additional income tax upon the corporation's income from Wisconsin sources; as such it was held valid, regardless of where the dividend was declared or the recipients resided.\(^6\) In effect the federal court looked upon the measure as an income tax, the incidence of which was postponed until distribution by the corporation to its stockholders. With this view of the nature of the measure, the Supreme Court of Wisconsin disagreed. On remander it took occasion to remark as follows:

"The only question presented by the record on appeal was whether the state had jurisdiction to levy the tax. The Supreme Court was not asked to construe the statute. That is a matter under the decisions of the Supreme Court which is clearly a function of this court, and we must assume that the Supreme Court of the United States made its decision in recognition of that fact. We are bound by its decision and we yield on no other."\(^7\)

The court then proceeded to express the opinion that the levy was not an income tax, nor even a tax born by the corporation, but was a tax payable by the stockholder upon the event of the declaration of the dividend.

The implication of the Wisconsin Supreme Courts' remarks is that the United States Supreme Court had extended its powers in a manner never foreseen by Justice Marshall when he wrote the opinion in Martin v. Hunter's Lessee,\(^8\) and in a manner not necessary to keep the Federal Constitution the supreme law of the land. The vigor of Justice Roberts' dissent, the number of cases involving every conceivable issue collateral to the measure which have since gone to the appellate courts, and the variety of rulings which these cases have called forth, are added indication that the bench and bar have remained in a quandary as to what questions have been finally passed on by the tribunals in which the ultimate question of interpretation can be raised. Hes-

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\(^7\) 238 Wis. 69, 298 N.W. 186 (1941).

\(^8\) Wheaton (U.S.) 304, 4 L.E. 97 (1816).
tancy to question a measure which the United States Supreme Court has held inoffensive to the Constitution has coacted with a belief that the Wisconsin and the federal tribunal approached the problem from different and irreconcilable viewpoints. The Supreme Court's decision in a matter in which the Wisconsin court's opinion should be final has produced an aura of indecision which only judicial redetermination of the validity of the law as a whole can remove.

It is submitted that the approach to the problem best calculated to dispel the mists is to determine what each court had the right to do, and what it assumed to do when the case was initially before it. In this connection, it is an over-simplification of the problem to say that the United States Supreme Court radically changed the right of the state to tax an incident outside of its borders, or that it disregarded established principles and went behind the interpretation which the state courts affixed to the law.

As the Wisconsin Supreme Court remarked, the construction of a state statute is normally a matter for the court of last resort of a state. The interpretation, when made, becomes part of the law and is binding on the federal courts to the extent that when a case involving the application of the law is before the federal courts, the law will be applied as interpreted by the state courts. Furthermore, if its constitutionality is assailed, the Supreme Court of the United States must look to the measure as interpreted, rather than appeal to consideration of what the law might be if the state court had decided otherwise. It is perhaps the normal situation that the highest tribunal is not afforded an opportunity to pass upon the constitutionality under the federal Constitution of an ambiguous measure until the ambiguities have been resolved by a decision in the state courts of last resort.

This need not, however, be the case. The United States Code provides six methods of bringing before the United States Supreme Court a state statute assailed as unconstitutional, and the remedy by appeal and certiorari from the state appellate tribunals are only two of the methods. Consequently, it is possible that a measure, even though ambiguous may finally reach the highest federal court neither extended or restricted by binding state court interpretations of the law. A third alternative is possible if the measure is unambiguous or if it is so considered by the state courts. In such a situation, an interpretation may be neither necessary or helpful. In the progress of litigation in courts inferior to the United States Supreme Court, the statute might be

10 Zalatuka v. Metropolitan Life Insurance Co., 90 F. (2d) 230 (C.C.A. 7th, from Wisconsin) ; 14 Am. Jurisprudence 314, and cases there cited.
11 28 U.S.C.A. 380; 28 U.S.C.A. 344 (a) and (b); 28 U.S.C.A. 347 (a) and (b); 28 U.S.C.A. 360.
merely characterized as a measure of a particular nature and hence held to be constitutional or unconstitutional. The mere fact that decisions have been rendered in the state courts in cases in which the measure was involved does not necessarily mean that the law has been interpreted.

When the Supreme Court declares unconstitutional (1) a law previously determined by the state courts to have a given meaning and then appealed on federal grounds, or (2) one which the state courts have not interpreted, and the Supreme Court holds it unconstitutional on its face, it is competent for the state courts on remand to save the law as constitutional by revising their earlier opinion in the light of the mandate. This power is hedged with restrictions: the interpretation of the United States Supreme Court mandate presents a federal question on which that tribunal may again pass, and the second guess of the state court is without prejudice to a subsequent review by the highest tribunal of the law as then in force. The rule is further subject to an exception in that it will not be applied in cases in which a law before the United States Supreme Court is declared constitutional only if interpreted in a given way.

Another principle which comes into play in a discussion of what the two courts assumed to do in the Penney case is the canon of construction that when a statute is ambiguous, the court interpreting it shall place upon the law an interpretation which will if possible save its constitutionality. This is upon the theory that the legislature intended to enact a valid law, and that a duty devolves upon the court to resolve all ambiguities in such way as to implement that intent. As witness to the fact that courts will be especially tender of a law before it when it is the unconstrued statute of another jurisdiction, following language from a case in the Federal courts is pertinent:

"In the absence of a construction of a statute by a state court, the Supreme Court of the United States, unless obliged to do so should not adopt the construction which might render the statute of doubtful validity, but should await a determination of the matter by the state court."

It is the thesis of this paper that there is common ground on which the present holdings of the state and Federal courts can be reconciled without violence to accepted principles governing the respective provinces of either court. This process of reconciliation must begin with a

careful delineation between "interpretation" of a state statute and mere "classification" or "characterization" of a measure. From the discussion above, it is apparent that the first function is the function of the state courts and as such is conclusive on the federal courts. But the same is not true of the latter function, if function it may be called. If it can be said that a court of last resort in a state was pursuing the latter course alone, its expression would not be treated as binding by the Supreme Court of the United States on appeal. It is submitted that the Wisconsin court's action fell in the latter class, thus leaving the United States Supreme Court free to perform the state court's function; and it devolved on the former tribunal to save the law by construction of the ambiguities if it could do so.

In this connection an examination of both the majority and minority opinions in the United States Supreme Court's handling of the Penney case at the very least permits an inference that the court placed the opinion of the state tribunals in the latter category. Such inference runs like a thread through both opinions but the following are indicative of the court's attitude.

From the majority opinion by Mr. Justice Frankfurter:

"Ascertainment of the scope of the exaction—what is included in it—is for the state court. But the descriptive pigeonhole into which a state court puts a tax is of no moment in determining the constitutional significance of the exaction."

and from the minority opinion by Mr. Justice Roberts:

"I concur . . . in the view that in testing the constitutionality of an exaction, this court examines for itself the nature and incidence of the tax and disregards mere names and distinctive epithets. With this principle, I have no quarrel . . ."

The language is more consistent with recognition of such a distinction than it is with the implied overruling of a long established rule of law. So it seems no wild assumption to say that neither the writer of the majority or of the dissenting opinion looked upon the action of the Wisconsin court as an interpretation of the tax legislation. That the right of the appellate court depended on the answer to a question of fact, and that much evidence supports a contrary view of which the Wisconsin court did not demand a contrary view.

Since the federal court took this view, and earlier remarks of the Wisconsin court were mere dicta on the subject of the applicability of the tax to foreign corporations it would seem that the federal court could actually fix an interpretation upon the law.

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Its function in such circumstances should be similar to those exercised by the state court. If the law could be saved by a constitutional interpretation it devolved upon the United States Supreme Court to so construe the ambiguities. That the law is ambiguous to the point where judicial clarification was needed is apparent from the fact that it lays a tax on "the privilege of declaring and receiving dividends ..."; and this concept involves not only two distinct acts, but the taxable acts are the acts of different parties. The majority opinion, that the tax was in nature an additional income tax, was intended neither as a usurpation of the state court's power to interpret the statute nor an extension of the power of the state to tax; and it entirely mooted the point of which Justice Rosenberry deemed it decisive. The right of the lower federal courts to do so when an interpretation is necessary to the decision of a federal question properly before it has since been expressly established in the recent case of Meredith v. Winter Haven, in which it was said with reference to a problem somewhat akin to those involved in the Penney case, that "the case of Erie Railroad Company v. Tomkins did not free the federal courts from the duty of deciding questions of state law. . . . Instead it placed on them a greater responsibility for determining and applying state law in all cases within their jurisdiction. Accepting this responsibility (as was its duty), this Court has not hesitated to decide questions of state law when necessary for the disposition of a case brought to it for decision, although the highest court of the state had not answered them, the answers were difficult, and the character of the answer which the highest state courts might ultimately give remained uncertain." No logical reason appears why the same language is not applicable to a case properly before the United States Supreme Court.

The facts on which the above decisions rest show that the Circuit Court of Appeals dismissed an appeal from the District Court for the Southern District of Florida in a diversity of citizenship case, the ground for dismissal being that the state law which the federal court was bound to apply was not clearly settled and stable. The language of the Supreme Court indicates that though spoken in a case involving citizens of various states, the same holding would a fortiori apply to cases in which a federal question was involved.

If Wisconsin had not interpreted the law, the United States Supreme Court was free to do so, and it did. The logical question is what effect the decision in the United States Supreme Court must be given. To this, Meredith v. Winter Haven, above cited, supplies an answer which does not, however, coincide with the conclusions which

19 See footnote 7.
20 88 L.Ed. 1 (Advance Sheets Nov. 22, 1943).
21 304 U.S. 64, 58 S. Ct. 817, 82 L.Ed. 1188 (1938).
the Wisconsin Supreme Court reached in its opinion on the remand of the case. The decision of the Supreme Court of the United States operated as an adjudication of the respective rights of the litigants before it and became the law of the case; but it had no effect whatsoever on the final meaning assigned by the state courts to the statute.

The basis of the Wisconsin Court's opinion was that the United States Supreme Court's holding finally determined the constitutionality of the measure though its incidence were declared to be on the out-of-state receiver of dividends. The writer regards the federal decision as merely adjudicating the rights of the parties and expressing the thought of the majority that the measure could be so construed that the Fourteenth Amendment to the Federal Constitution would not be violated. It neither constrains the state court to adopt the interpretation nor precludes the federal court from again inquiring into the interpretation which the state did adopt, when the latter question is properly raised.

In the three and one-half years which have elapsed since the Penney Company decision, authority in both the state and federal courts have grown up around the problem.

In the state court, it has been held squarely that the tax is one upon the stockholder receiving dividends and not upon the corporation paying them;22 that the stockholder may not sue to collect from the corporation the amount of the tax withheld from the dividend;23 and that, the exaction being upon the stockholder, the corporation can not deduct the amount thereof as an expense of doing business on its Wisconsin tax return.24 The federal District Court for the Eastern District of Wisconsin held the tax to be a tax on the corporation25 but its holding was reversed in the Seventh Circuit Court of Appeals,26 in an opinion which relied on the Wisconsin court's interpretation in Blied v. Wisconsin Foundry and Machine Company. Finally the Tax Court of the United States reversed the Commissioner of Internal Revenue and held the Wisconsin tax, if paid by the corporation, deductible as a business expense in filing a federal tax return.27 In effect, this amounts to a holding that the tax is a tax on the corporation and deductible as such. Since appeal from the Tax court lies to the Circuit Court of Appeals

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22 International Harvester v. Wisconsin Department of Taxation, Wis. Supreme Ct. June 16, 1943, (C.C.H. Tax Service par. 19-052) which should also be consulted for its statement of the present position of the Wisconsin Court.
23 Blied v. Wisconsin Foundry and Machine Co., 243 Wis. 221, 10 N.W. (2d) 142 (1943).
24 Wisconsin Gas and Electric Co., et al. v. Wisconsin Department of Taxation, 243 Wis. 216, 10 N.W. (2d) 140 (1943).
27 Montreal Mining Co. v. Commissioner 2 T. C., No. 85 (Sept. 16, 1943).
of the Circuit in which lies the office of the Collector with whom the return was filed, unless both parties stipulate otherwise, it seems certain that appeal will result in reversal of the Tax Court's holding as well.

By its own statement in *International Harvester Company v. Department of Taxation*, supra, the Wisconsin court deems the issue of constitutionality closed, and all issues decided in favor of a widened power of the states to tax transactions beyond their borders. The character of the tax is now fixed by the state court; the error, if error was made, was in deeming that the Supreme Court had passed upon the constitutionality of the measure as now interpreted. Rectification can only be made by the Supreme Court of the United States by a decision on the constitutionality of the measure as interpreted. It would seem that certainty in the law would demand submission of the question at as early a date as possible. The quickest method of obtaining review would be by suit to enjoin enforcement of the statute before a three-judge federal district court, with immediate and direct appeal from the District court to the Supreme Court.29

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