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Taxation

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I. LEGISLATION

Although more than the usual number of interesting and challenging cases on the subject of taxation were presented to the South Carolina Supreme Court in the period under review, legislative developments deserve prior comment. The 1965 *Report of the Tax Study Commission to the General Assembly* makes three recommendations which deserve the careful attention of every tax practitioner. None of these recommendations were enacted during the 1965 session, but they are under study by committees of the general assembly.

The first proposal is to replace the present income tax,[1] with a statute under which taxable income would be calculated with reference to taxable income as defined in federal law, with appropriate adjustments to meet constitutional and other considerations. The general assembly would enact the rates and exemptions. The object is to simplify computation of taxes for taxpayer and tax administrators alike. "The South Carolina Income Tax return might then be reduced to a one-page flyer attached to a copy of an already prepared Federal income tax return."[2] This proposal is a bold and practical one. South Carolina's income tax statutes have a deceptive appearance of simplicity, but because of the few annotations and clarifying regulations thereunder, many questions are left unanswered. Since the tax practitioner must struggle with the federal materials anyway, the net result of conforming the two acts would be economy of time and effort for all. Many states have adopted such a system.[3]

A second proposal urges granting to the tax board of review jurisdiction over appeals from the tax commission, with further appeal permitted to the court of common pleas. It is proposed that the board be reduced to three commissioners. The purpose of the proposal to grant this additional jurisdiction to the board

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1. S.C. CODE ANN. §§ 65-201 to -367 (1962).

2. 1965 SOUTH CAROLINA TAX COMM'N SIXTH ANN. REP. 13-14.

3. *Id.* at 15. The report states that Alaska, Colorado, Connecticut, Delaware, Hawaii, Idaho, Indiana, Iowa, Kentucky, Massachusetts, Minnesota, Montana, New Jersey, New Mexico, New York, North Dakota, Pennsylvania, Rhode Island, Vermont and West Virginia employ this device.

is to provide a disinterested tribunal within the tax administrative system.[4]

The third proposal is that the general assembly enact a state gift tax law based on the federal gift tax, together with an estate tax credit.[5] Since South Carolina has adopted an estate tax law based on federal law,[6] the proposed additional legislation has the objective of protecting the estate tax.

In addition to these fundamental proposals for law revision, the tax study commission continues to survey the detailed tax law and to recommend technical amendments thereto to the general assembly. The work of the commission has been sound in tax philosophy and highly competent in execution. The commission has served the citizens of the state well over the six years of its existence, and its efforts deserve the informed support of the bar.

II. Judicial Decisions

A. Taxing South Carolina Portion of Nationwide Business—Apportionment Formulas.

In *Hertz Corp. v. South Carolina Tax Comm'n*[7] the taxpayer raised questions as to interpretation of provisions of the code prescribing formulas for apportioning the tax attributable to South Carolina activities, where a foreign corporation is engaged in activities throughout the United States. Beginning in 1958, South Carolina enacted a system of allocation of income, to subject such businesses to tax on income "upon a base which reasonably represents the proportion of the trade or business carried on within this State."[8] The statutory scheme provides that a taxpayer whose principal business in this state is (a) manufacturing, or analagous activities, or "(b) *selling*, distributing or *dealing* in tangible personal property within this State "(emphasis added)[9] shall compute net income based on the arithmeti-

4. *Id.* at 17. The proposal recommends the addition of one appointee to the present five member tax commission, and then designation of three of the six as tax commissioners and three as the tax board of review. The former would exercise administrative functions, the latter quasi-judicial functions.

5. Int. Rev. Code of 1954, §§ 2501-2524 contain the gift tax provisions, while § 2012 provides the gift tax credit on the federal estate tax law.

6. S.C. Code Ann. §§ 65-451 to -570 (1962).

7. 246 S.C. 92, 142 S.E.2d 445 (1965).

8. This language is found in the preamble to the acts, and is not found in the codification in S.C. Code Ann. §§ 65-279 to -279.11 (1962). S.C. Acts & J. Res. 1959, p. 363; S.C. Acts & J. Res. 1958, p. 1574.

9. S.C. Code Ann. § 65-279.3 (1962); S.C. Code Ann. §§ 65-279.4 to -279.9 (1962).

cal average of three ratios, (1) property within the state compared with property everywhere, (2) payrolls within the state compared with payrolls everywhere, and (3) sales within the state compared with sales everywhere.[10] Some specified items of income are directly allocated to a particular state without using this formula. The arithmetical average of the three ratios is then multiplied by the remaining net income of the company. Taxpayers other than those described use a ratio of gross receipts in the state to gross receipts everywhere.[11]

Taxpayer Hertz was engaged in the business of renting or leasing motor vehicles throughout the United States, including South Carolina. Hertz argued that in computing its income, it was entitled to use the three ratio method.[12] It argued that the statute contained a definition of the word "sales" in describing the sales ratio, and that it should follow that the same definition, applicable by the particular section to the entire article in the code, should be utilized to define "selling" in section 65-279.3. The provision relating to the sales ratio contains the sentence, "The word 'sales' as used in this article shall be construed to include rentals of tangible personal property the rentals from which are not separately allocated under this article."[13] In the words of Circuit Judge Grimball, adopting this argument, "While the word 'sales' is used in Section 3 [Section 65-279.3], it would be reasonable to assume that the Legislature, having equated sales with rentals, meant that 'selling' be interpreted as [including] 'renting.' "[14]

Hertz further argued that it was included within the phrase "dealing in tangible personal property." The supreme court, affirming Circuit Judge Grimball, held that Hertz' income should be computed using the three ratio formula. Mr. Justice Brailsford said for the court:

> The nature of the taxpayer's business is entirely appropriate to the use of the three factor formula . . . . The Tax Commission's insistence that the words 'dealing in' are used in sub-division (b) of the classification, quoted above, as sy-

10. *Ibid.*

11. S.C. CODE ANN. § 65-279.10 (1962).

12. It should be noted that the method is not elective but mandatory, if a taxpayer falls within the classification in S.C. CODE ANN. § 65-279.3 (1962). Sections 65-279.7 to -279.9 permit some elective flexibility.

13. S.C. CODE ANN. § 65-279.6 (1962).

14. Order of Circuit Judge Grimball, Record, pp. 12, 14, Hertz Corp. v. South Carolina Tax Comm'n, 246 S.C. 92, 142 S.E.2d 445 (1965).

nonymous with selling and distributing is unnecessarily restrictive and is inconsistent with the legislative intention to obtain a broad coverage of businesses to which the three ratio formula is appropriate.[15]

This appears to be a wise resolution of the statutory problem. Although the Hertz activities are not technically "selling" activities, there appears no reason why the legislative scheme to allocate income fairly to business activities in the several states should not embrace this case, and no distortion of the statutory language is required to reach this result.

B. Net Operating Loss Carry-over; "New Business."

The state's income tax allows a taxpayer, who has established a new business or industry in the state, to utilize a net operating loss carry-over for the first three years of the operation of the new business or industry.[16] This provision was held in 1963 by the attorney general to be inapplicable to the continuation of an old, established business by a new owner.[17] In *Chronicle Publishers, Inc. v. South Carolina Tax Comm'n*[18] the problem came to the supreme court. Chronicle Publishers was chartered on March 1, 1956, and on March 3 it purchased all the assets of a corporation known as The Camden Chronicle, Inc. (Camden Chronicle). Camden Chronicle had been in the business of publishing a newspaper in the city of Camden, and in a printing business. Chronicle Publishers converted the newspaper after purchase from a bi-weekly to a tri-weekly publication, installed new equipment worth some 50,000 dollars and enlarged the printing business. There was no identity of officers or equity interest between the two, and in fact, the key personnel of Camden Chronicle left the company and established a rival paper, the Camden News. It is obvious that there were now two newspapers where formerly there was one, so that a "new business" had come to Camden. Chronicle Publishers had net operating losses, which it asserted could be carried over to later years under section 65-259(12). Reversing the trial court, the supreme court, in an opinion by Mr. Justice Brailsford, held that the statutory test

15. Hertz Corp. v. South Carolina Tax Comm'n, *supra* note 14.

16. S.C. CODE ANN. § 65-259(12) (1962).

17. OP. ATT'Y GEN. (1963). The brief for the attorney general appropriately omits citing this opinion, which is dated after payment of the tax under protest but before the filing of the complaint.

18. 244 S.C. 192, 136 S.E.2d 261 (1964).

was not met, and hence the net operating loss-carry-over was not available to Chronicle Publishers. The taxpayer had merely acquired and improved an existing business. The "business or industry" must be "new" to the state; the statute is not met simply because the business is new to the taxpayer.[19] The decision appears clearly correct in its finding that Chronicle Publishers was a continuation of the old business, and that a mere change of ownership is insufficient to meet the statutory provision.

C. Tax Procedure—Necessity of Payment Under Protest.

In an age when federal income taxes loom so large in the total tax picture, and federal estate and gift taxes are of significant impact, tax counsel are apt to overlook principles that formerly were considered basic. One such principle is the rule that a taxpayer cannot sue a sovereign to recover a tax paid by him unless he paid the tax under protest. Federal law has removed this prerequisite for the income, estate and gift, and excess profit taxes. In other areas of taxation, including state taxation, tax counsel should consider whether pertinent law requires payment under protest as a condition for an action for refund. The basic provision permitting action to recover taxes wrongfully collected under South Carolina law[20] requires payment under protest and suit within thirty days against the appropriate defendant, the tax commission, the county treasurer, or the municipality.

City of Columbia v. Glens Falls Ins. Co.[21] involved the question of whether a statutory exception to this basic law applied to the particular facts. Glens Falls (and the South Carolina Insurance Company, whose action was consolidated with the Glens Falls case) paid business license taxes to the city of Columbia for the years 1959, 1960 and 1961. For the year 1962, Glens Falls paid its business license tax under protest, asserting that the payment was in excess of the legally collectible amount. This position was sustained by the South Carolina Supreme Court.[22] On December 13, 1962 Glens Falls filed its petition with the

19. The court found highly persuasive authority in the analogous situation of tax exemption for new manufacturing enterprises. Arkwright Mills v. Murph, 219 S.C. 438, 65 S.E.2d 665 (1951); *cf.* Duke Power Co. v. Bell, 156 S.C. 299, 152 S.E. 865 (1930).

20. S.C. CODE ANN. §§ 65-2661 to -2667 (1962).

21. 245 S.C. 119, 139 S.E.2d 529 (1964).

22. Glens Falls Ins. Co. v. City of Columbia, 242 S.C. 237, 130 S.E.2d 573 (1963).

South Carolina Tax Commission, asserting that the city likewise had exacted license fees for the three prior years in excess of the statutory maximum. Jurisdiction was based on special statutory exceptions to the general rule.[23] The tax commission held that it had jurisdiction, and ordered a refund by the city. Certiorari was granted by the circuit judge, Judge Grimball, who discharged the writ and affirmed the order of the tax commission. On appeal to the South Carolina Supreme Court the judgment was reversed; opinion by Mr. Justice Lewis. The court held that the sections invoked by the taxpayers applied only to rebate or refund of a property tax.[24]

D. Documentary Stamp Tax—Form Versus Substance

Tax counsel are constantly reminded of the importance, for tax purposes, of the form in which transactions are cast. Usually the taxpayer is bound by the form which he adopts; the taxing sovereign has been able, on occasion, to challenge the form and tax the transaction according to the asserted substantive reality.[25] Seldom is the taxpayer successful in asserting the latter argument. *Textron, Inc. v. Livingston*[26] involving the question of the applicability of the South Carolina documentary stamp tax to a conveyance of realty on which a factory had been constructed, was a case in which the taxpayer offered an appealing argument for disregarding the form of his transaction. Nonetheless, the court held that he was bound by the form in which his transaction was cast.

Textron desired in 1959 to negotiate a lease for a new factory to be constructed in South Carolina, but had not as yet made the necessary arrangements with a charitable foundation as lessor. Wishing to move ahead without delay, Textron executed an agreement with Daniel Construction Company whereby the latter would acquire a site for the factory, as trustee for Textron or its nominee, and commence erection of the plant. On January 5, 1959 this agreement was made, and on January 14 Daniel acquired a site of some fifty acres from one Few, taking title in

23. S.C. CODE ANN. §§ 65-2681 and -2682 (1962).

24. The supreme court has held that the basic rule is reasonable in that it provides to governmental officials information as to the collected tax moneys upon which they may rely in preparation of the operating expenses of government. Weathers v. City of Laurens, 187 S.C. 297, 197 S.E. 317 (1938).

25. Leading federal decisions are National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949) and Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

26. 244 S.C. 380, 137 S.E.2d 267 (1964).

its own name, and paying approximately 25,000 dollars for the land. Proper documentary stamp taxes were affixed to this deed of transfer. Under the contract with Textron, Daniel was to build the plant, and would be paid a sum not in excess of 1,500,000 dollars, including the land cost. While Daniel was proceeding with the construction, Textron found a desirable lessor, the relief and annuity board of the Southern Baptist Convention (Convention). Textron entered into an agreement with Convention. Under this agreement, Convention would, upon completion of the plant, take title to the property and simultaneously lease it to Textron for a long term. Textron instructed Daniel to convey the completed plant to Convention, which Daniel did by deed dated July 31, 1959. Although the record does not clearly say, it is assumed that Convention paid the agreed consideration therefor. Pursuant to a ruling of the tax commission, Textron purchased under protest and affixed documentary stamp taxes in the amount of 3,077 dollars.

Section 65-689 of the code requires that a deed, whereby realty sold shall be transferred to the purchaser or to any other person by his direction, shall bear a tax stamp in the amount of one dollar per five dollars consideration. Textron argued that Daniel had taken title only as trustee for Textron, and had Daniel conveyed the property to Textron itself, no stamp tax would be payable. Further, had Textron entered the agreement with Convention at a stage whereby Convention was equitable owner of the site during construction, no stamp tax would be payable on transfer by Daniel to Convention. In neither case would the necessary antecedent to the statute, that realty be *sold*, be present. The instant events, it was argued, should be reviewed as a single transaction whereby Convention as cestui acquired the land and directed construction of the plant thereon. Unfortunately for this argument, for all the record shows, Textron was equitable owner of the property until July 31, 1959, the date of the deed, at which time there was a sale to Convention.

The decision of Circuit Judge Price below, affirmed by the supreme court, Mr. Justice Moss writing the opinion, appears correct. As Dean Griswold has written, "There is no use in thinking great thoughts about a tax problem unless the thoughts are firmly based on the controlling statute."[27] The result urged by the taxpayer, fair though it may be, seems to be beyond reach of the statute.

27. GRISWOLD, CASES AND MATERIALS ON FEDERAL TAXATION 15 (5th ed. 1960).

The court, in denying relief from the statute, held that liability is "as a general rule determinable from the form and face of the instrument in question."[28] The deed itself recited consideration in an amount in excess of 1,500,000 dollars. It is doubtful, however, had the deed recited no consideration, or a nominal consideration, that taxpayer could escape the tax by so simple an expedient as preparing a deed which concealed the true nature of the transaction.

E. Tax Accounting—Installment Method

In *Adams v. Burts*[29] the taxpayer sued to recover additional income taxes paid under protest for the tax years 1960, 1961, and 1962. The dispute concerned the proper method of reporting gain from a sale of timber from taxpayer's tract of land, the sale being completed in 1958. Payment was to be made in installments of 3,000 dollars in 1958, 12,767 dollars in 1959, and 15,750 dollars in each of the years 1960, 1961 and 1962 (a total of 63,017 dollars). Taxpayer was on a cash basis for tax purposes. In his returns for 1958 and 1959, taxpayer elected to return this transaction on an installment method of accounting. "The South Carolina Tax Commission acquiesced in and approved plaintiff's election of the installment method of reporting the profit on the sale of said timber."[30] For these years, taxpayer reported on all the profit of the 1958 and 1959 installments.

Effective January 1, 1960,[31] the income tax law was amended to permit a deduction of one-half of "gains . . . arising from the sale or exchange of capital assets, as defined in this chapter . . . ."[32]

28. Textron, Inc. v. Livingston, 244 S.C. 380, 386, 137 S.E.2d 267, 270 (1964).

29. 245 S.C. 339, 140 S.E.2d 586 (1965).

30. Stipulation and Agreement of Parties, Record, p. 8, Adams v. Burts, 245 S.C. 339, 140 S.E.2d 586 (1965). A complicating factor in the litigation was the fact that during 1958, 1959, and 1960, there was, as later held by the supreme court, no statutory authority for use of the installment method. See Heyward v. South Carolina Tax Comm'n, 240 S.C. 347, 126 S.E.2d 15 (1962). Mr. Justice Moss appropriately points out that this factor is "not in issue here", because of the tax commission's stipulation. Adams v. Burts, 245 S.C. 339, 343, 140 S.E.2d 586, 588 (1965).

31. "This act shall, upon approval of the Governor, be effective with respect to income earned on or after January 1, 1960." S.C. Acts & J. Res. 1960, p. 1655.

32. S.C. Code Ann. § 65-258(6) (1962). Section 65-258.1 defines capital assets. No specific provision relates to growing timber. *Cf.* Int. Rev. Code of 1954 § 631. No issue was raised as to qualifications of timber for capital asset treatment under the amendment; presumably it clearly qualifies unless excluded by S.C. Code Ann. § 65-258.1(1) (1962).

The circuit judge, Judge Grimball, referred the case to the master for Richland County, Judge Lightsey, who held in favor of the taxpayer. The essence of his decision is that the words "income earned" in the enacting provision are equivalent to the words "received or accrued" in tax accounting provisions of the tax law.[33] This decision was confirmed by the circuit judge on the report of the master. On appeal, the supreme court reversed, in an opinion by Mr. Justice Moss.

The court rejected the accounting approach adopted by the master in favor of a legal analysis predicated on when a "completed sale" had occurred.[34] "All events" constituting a completed sale had occurred in 1958, hence the sale was then consummated for tax purposes, and the income was then "earned." The court added, as an additional factor tending to this construction, the view that the legislature would not intend that cash method and accrual method taxpayers would be taxed at different rates on identical transactions taking place in the same year.

The difficulty arises from the necessity of filing annual returns, the requirement of "annualizing," in accounting parlance. To this problem much of the labors of accountants are devoted, and they have developed techniques and sophistication beyond the experience of most lawyers. If in 1960 the legislature had merely changed the rates in the tax law, then there would have been no denial that the taxpayer must follow the accounting method he had adopted. The accounting method alone would then result in different taxes between taxpayers on different accounting methods, whose transactions were otherwise identical. The instant case came to the court concerning a deduction section of the tax statute, rather than a simple rate change, but it would seem that the result should be the same. In an accounting sense, the income was "earned" in installments; when income is earned,

33. S.C. CODE ANN. §§ 65-251, 65-202(11), and 65-281 (1962) provide that income shall be computed in accordance with taxpayer's regular method of accounting, unless such method does not clearly reflect the income.

34. The court cited Johnson v. South Carolina Tax Comm'n, 235 S.C. 155, 110 S.E.2d 173 (1959). That case held that a taxpayer could not defer income where installment obligations had been received from purchasers of cars and had been discounted by a finance company, which held a portion thereof in a reserve account. The amount in the reserve account was held to be income to the auto dealer in the year of the sale, although if a purchaser failed to carry out his installment obligations, the finance company could use the reserve to protect itself against loss. In *Johnson* the court followed Commissioner v. Hansen, 360 U.S. 446 (1959). The instant case could be distinguished from these authorities since taxpayer here was using the installment method; taxpayers in *Hansen* and *Johnson* were on the accrual method. The lower court did not cite the *Johnson* case, but it was cited in the briefs for appellants.

it is based on the accounting convention that the taxpayer adopts. In the instant case, despite the lack of authority in the law for taxpayer's returning the income in installments, the stipulation was made that the treatment was proper. The problem is not easy of solution, but with due deference to the court's approach, it would seem that the ruling of the master and the circuit judge was sound.[35]

F. Tax Procedure—Standing to Sue for Recovery of Wrongfully Collected Taxes

In *Furman Univ. v. Livingston*,[36] the university had collected admissions taxes[37] on tickets sold at its 1960 football games, and had paid the taxes under protest. The university then sued for a refund. The supreme court held that only the *taxpayer* had standing to sue for refund.[38] In this case the court said that the taxpayer, was the purchaser of the ticket, not the university, which was merely a collecting agent for the state.[39]

35. It must be admitted that further support for the position of the supreme court, though not directly in point, may be found in Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); and Automobile Club v. United States, 353 U.S. 180 (1957).

36. 244 S.C. 200, 136 S.E.2d 254 (1964).

37. S.C. CODE ANN. § 65-801 (1962) levies the admissions tax; section 65-801(4) exempts admissions charged by eleemosynary or non-profit entities.

38. S.C. CODE ANN. § 65-2686 (1962).

39. This problem of standing to sue led the University of Georgia to follow the procedure of asking injunctive relief when it asserted that a federal admissions tax on admissions to athletic contests under the auspices of the state was unconstitutional. Allen v. Regents of the Univ. Sys., 304 U.S. 439 (1938) held that the remedy of injunctive relief was available despite the predecessor of INT. REV. CODE OF 1954 § 7421(a). The court then found that the tax was constitutional as applied to the University's athletic contests. South Carolina has a statutory provision, S.C. CODE ANN. § 65-2651 (1962), similar to the cited federal provision; no indication has been found in state decisions as to whether an exception to withholding injunctive relief would be made where the remedy of action for refund was inadequate.