TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

HONOLULU

45

October 30, 1939

OPINION No. ~~1753~~ 1726

TAXATION: NET INCOME TAX.

A foreign corporation not doing business in the Territory is not liable to tax upon the interest from certificates of deposit issued by local banks merely because it has local officers to make deposits and withdrawals who determine how much money should be left in commercial accounts and how much placed at interest through the issuance of certificates of deposit.

SAME: SAME:

Under the facts stated it does not appear that such certificates of deposit have a business situs in the Territory.

SAME: SAME.

Mere local domicile of a debtor does not render the creditor liable to net income tax upon the interest paid by the debtor.

SAME: SAME.

The mere fact that a debtor is a domestic corporation does not render the creditor liable to net income tax upon the interest paid by such debtor.

WORDS AND PHRASES.

The expression “receiving or deriving income from sources within the Territory” in Section 2031, R. L. 1935 refers to sources of income within the Territory according to the constitutional taxing jurisdiction of the Territory.

Honorable William Borthwick,
Tax Commissioner,
Territory of Hawaii,
Honolulu, T. H.

Dear Sir:

You have referred to us correspondence and a taxpayer's memorandum, regarding the taxability of a certain foreign corporation under the net income tax law for the calendar years 1934 to 1938 inclusive, and after stating your conclusions have requested our opinion. We assume that the findings of facts, as furnished by your department, are correct and also include all material facts. The findings of fact so furnished are as follows:

"This corporation is a Philippine corporation with its office and place of business in the Philippine Islands where it is engaged in the business of operating a sugar central. All of its raw sugar sold in the United States is sold through a New York broker. All of its property is situated in the Phillippine Islands, unless bank deposits with banks in the Territory of Hawaii should be regarded as having a different situs. All of its directors and principal officers are residents of the Philippine Islands. Ninety per cent of the stock, however, is owned by Hawaii residents, notably Hawaiian sugar corporations who claim that the dividends received from this corporation are exempt from tax under Section 2033-2 (d), Revised Laws of Hawaii 1935, as amended.

"All monies received from the New York broker representing the proceeds of sugar manufactured in the Philippine Islands and marketed on the mainland of the United States are transmitted to Hawaii and deposited in two commercial accounts in the two principal banks here.

"From 1927 to 1934 the corporation had an assistant secretary and an assistant treasurer in Hawaii authorized to deposit and withdraw funds and since 1934, because of occasional temporary absence of these officers, there have been eight assistant treasurers, residents in Hawaii, any one of whom may deposit and any two of whom may withdraw funds. These funds are used to disburse dividends to local shareholders or remitted to the Philippines for current expenses.

"The surplus is kept in interest bearing certificates of deposit which are taken out from time to time, if it appears to the authorized officers in Hawaii that there is a surplus not needed to meet expected requirements.

"The question is whether or not this interest is subject to Territorial Net Income Tax for the calendar years 1934 to 1938, inclusive.

"The corporation was incorporated in the Philippine Islands in 1918. In 1929 the corporation applied for and obtained authority to do business in the Territory. The affairs of the company in the Territory have been the same throughout

the various years involved except that up until 1936 the Hawaiian Sugar Planters' Association acted as agent in the Territory for the company in connection with the transfer of stock and maintenance of certain accounts. The corporation paid the annual $100.00 license fee provided by section 6772, Revised Laws of Hawaii 1935, until 1936. As of October first, 1936, (the beginning of its new fiscal year) the corporation withdrew from the Territory and it ceased to employ the aforesaid agent. The corporation has not carried on any income producing business in the Territory during any part of the years involved."

You have concluded that the corporation was not taxable under the territorial net income tax law for the calendar years 1934 to 1938 inclusive. We agree with this conclusion for the following reasons:

By the Revenue Act of 1936 foreign corporations were divided into two classes, resident and non-resident (Sec. 231 (a) and (b), Revenue Act of 1936). Non-resident foreign corporations are those "not engaged in trade or business within the United States and not having an office or place of business therein." Such corporation are taxed only upon interest (except interest on bank deposits), dividends, rents, and certain other "fixed or determinable annual or periodical gains, profits, and income,"

but without the allowance of any deductions. Resident foreign corporations are those “engaged in trade or business within the United States or having an office or place of business therein.” Such corporations are taxed upon all income from sources within the United States, but are allowed deductions, the rate of tax, however, being higher than upon domestic corporations. (See G. C. M. 17014, C. B. XV-2, p. 317, 4 Paul and Mertens Law of Federal Income Taxation, 1938 Supp., Secs. 37.15H to 37.15K.)

In addition to the distinction between the Federal income tax provisions applicable to a resident and a non-resident corporation, it further appears that a corporation which can be classified as a non-resident foreign corporation does not pay a capital stock tax. (G. C. M. 17014, supra).

Inasmuch as the corporation has no “fixed or determinable” income other than bank interest, as to which a foreign non-resident corporation is exempted, the corporation of course desired to qualify as a non-resident. It withdrew from the Territory as above noted and it has ceased to pay the Federal capital stock tax.

In my opinion the liability of this corporation to net income tax turns upon the question whether the certificates of deposit have a business situs in the Territory. I am of the

opinion that they do not.

All of the cases in which the court has attributed a business situs to intangibles are cases in which the intangibles were an integral part of some local business. They grew out of the business conducted within the state (New Orleans v. Stempel, 175 U. S. 309, 44 L. Ed. 174, Bristol v. Washington County, 177 U. S. 133, 44 L. Ed. 701, State Assessors v. Comptoir Nat. D'Escompte, 191 U. S. 388, 48 L. Ed. 232, Metropolitan Life Insurance Co. v. New Orleans, 205 U. S. 395, 51 L. Ed. 853, Liverpool end L. & G. Ins. Co. v. Board of Assessors, 221 U. S. 346, 55 L. Ed. 762, Wheeling Steel Corp. v. Fox, 298 U. S. 193, 80 L. Ed. 1143), or were used in the local business (First Bank Corp v. Minnesota, 301 U. S. 234, 81 L. Ed. 1061), or were of a peculiar nature which localized the intangible (New York ex rel Whitney v. Graves, 299 U. S. 366, 81 L. Ed. 285). See the analysis of the business situs cases in the opinion of Mr. Justice Reed in Newark Fire Insurance Co. v. State Board of Tax Appeals, U. S. Sup. Ct., May 22, 1939, 83 L. Ed. Adv. Sh. 889.

This Philippine Corporation has withdrawn from the Territory and its position with regard to the liability for the annual license fee due the Treasurer, also with regard to Federal income and capital stock tax, is that it has no office or place of business in the Territory and is not engaged in carrying on

any business in the Territory. The funds were derived from sales of sugar on the mainland and are kept in the Territory in order that they might be used in the payment of dividends to the shareholders and be forwarded to the Philippines if needed. Thus the use of the funds is controlled from the office in the Philippines, which is the only office the company has. The authority of the local officers is restricted to the withdrawal and deposit of funds and to the determination of how much of the funds should be left in commercial accounts and how much placed at interest, through certificates of deposit. This office already has determined that the mere maintenance of interest bearing funds in banks is not a business. Op. Letter, Att'y. Gen. (July 1, 1935) No. 1072. There is no case which holds that the mere handling of banks deposits in itself is a local business sufficient to localize the deposits away from the domicile of the owner.

In Wheeling Steel Corp. v. Fox, supra, a Delaware corporation had its general business office in West Virginia. Dividends were declared at meetings held at that office, but the dividends were paid through checks drawn and distributed by a dividend disbursing agent from funds deposited in New York. Bank deposits were maintained in other states as well, and although in most instances the checks on those banks were

drawn at the main office in West Virginia, the checks for payrolls of out of state plants and sales offices, and for incidental items of these units, were drawn by the out of state units. The deposits in other states were not due to the fact that the funds arose out of business there, but were maintained to meet expenditures controlled from the West Virginia office. It was held:

> "* * * In the light of this course of business as shown by the agreed statements of fact, we find no sufficient basis for concluding that the bank accounts thus maintained and controlled were properly attributable to the Corporation at any place other than at its general office at wheeling. If there were any special circumstances by which any of these deposits could be deemed to have been localized elsewhere, they do not appear upon the present record."

We are unable to see any distinction between that case and this one. The mere determination by the local officers as to the form of bank deposit, which determination is subordinate to the disbursements to be made as determined by the Philippines office, certainly does not divorce these funds from the Philippines office.

In Ewa Plantation v. Wilder, 26 Haw. 299, 304, aff'd. 289 Fed. 664, a Hawaiian sugar corporation had a sub-agent in San Francisco. The sugar was sold on the mainland and the proceeds of sale received by the sub-agent and deposited in Calif-

ornia banks. Against the credits thus created the Hawaiian corporation drew from time to time for expenses and dividends. The sub-agent bought bonds and notes with the surplus moneys and kept them until they were sold. It was held that these investments had not acquired a business situs apart from the principal office. That case is on all fours with the present one, except that in that case the authority as to the use of the funds at the place of receipt of the funds exceeded the authority here.

In Newark Fire lnsurance Company v. State Board of Tax Appeals, supra, U. S. Sup. Ct., May 22, 1939, four of the judges, through an opinion by Mr. Justice Reed, sustained the tax on intangibles at the place of incorporation on the ground that there was no other situs, while four, who also sustained the tax, did so on the ground it was unnecessary to determine whether there was any other situs, but did not in any way reflect on Mr. Justice Reed's opinion as to business situs. The case involved New Jersey corporations, which maintained in New Jersey only such offices as the law of New Jersey required. The executive offices were in New York and the general accounts of the companies were kept there. Practically all cash and securities were kept there or in states other than New Jersey. Although the court knew that the funds were kept in New York banks or at

other points outside New Jersey, and knew that these funds were handled at the executive offices in New York where accounts were payable (as appears as to at least two of the companies) this was not enough. The opinion of Mr. Justice Reed reads in part:

> "* * * To overcome the presumption of domiciliary location, the proof of business situs must definitely connect the intangibles as an integral part of the local activity. The facts presented by this record fall far short of this requirement.
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> "* * * We are not told where business is accepted, moneys collected or insurance contracts made. The securities may represent local loans or investments in New Jersey or elsewhere made from funds derived from similar insurance contracts with a business situs at those points. They may be the result of insurance activities of many kinds, taking place far from New York. If we were to assume that the intangibles of a corporation may have only one taxable situs, the mere fact that general affairs of a foreign corporation are conducted by general officers in New York without further evidence of the source and character of the intangibles does not destroy the taxability of a part of these intangibles by the state of the corporation's legal domicile. The presumption of a taxable situs solely in New Jersey is not overturned."

In Carter v. Hill, 31 Haw. 264, aff'd. 47 Fed.(2d) 869, a resident of Hawaii received certain securities under the will of her father, a resident of New York. She had a general agent in New York, who made investments, borrowed on the securities, collected the income for further investments,

and did everything necessary to build up a fund to meet estate and inheritance taxes. The owner received a monthly sum and also sums for specific purposes, such as charitable contributions, but she had no other business to which these funds were in any way ancillary. It was held that these securities were localized away from the domicile of the owner.

That the present matter resembles the Wheeling Steel Corp., Ewa Plantation, and Newark Fire Insurance Co. cases and not Carter v. Hill, is very clear in our opinion. As to the situation before 1936, while as previously pointed out the corporation had an agent to keep accounts and stock transfer records, the situation was not materially different so far as these certificates of deposit are concerned. They had no business situs in Hawaii before or after 1936.

The corporation contends that business situs is not material and that the interest is assessable merely on account of the domicile of the debtor (the bank). Consideration of the authorities convinces us that however desirable it might be to widen the application of the territorial income tax law to include all interest paid on debts owed by local residents, this position could not be maintained.

The corporation lays stress on the taxation of the net income of every corporation doing business in "or receiving

or deriving income from sources within the Territory" (Section 2031, R. L. 1935). It will be noted that this section does not cover income received or derived from persons within the Territory, but only from sources within the Territory, which clearly means "sources of income". What is a source of income within the Territory can only be determined according to the Constitutional taxing jurisdiction of the Territory. Thus, in Burnet v. Brooks, 288 U. S. 378, 77 L. Ed. 844, in interpreting a reference to the estate "situated in the United States" the court said:

> "* * * In interpreting this clause, regard must be had to the purpose in view. The Congress was exercising its taxing power. Defining the subject of its exercise, the Congress resorted to a general description referring to the situs of the property. The statute made no distinction between tangible and intangible property. It did not except intangibles. It did not except securities. Save as stated, it did not except debts due to a nonresident from resident debtors. As to tangibles and intangibles alike, it made the test one of situs, and we think it is clear that the reference is to property which, according to accepted principles, could be deemed to have a situs in this country for the purpose of the exertion of the Federal power of taxation. * * *"

The principle of the above ease that the words "situated in the United States" are to be interpreted in the light of the Federal power of taxation is applicable here, and leads to the conclusion that the words "sources within the Territory" must be interpreted in the light of the Terri-

tory's power of taxation. It should be noted, however, that what the Territory's power of taxation is cannot be determined upon the authority of Burnet v. Brooks, which recognizes the distinct sphere of jurisdiction of the United States on the one hand and the several states on the other. To the effect that the taxing jurisdiction of a state or territory is more limited than the federal power see Domenech v. United Porto Rican Sugar Co. 62 Fed. (2d) 552 (C. C. A. lst) cert. den. 289 U. S. 739, United States v. Bennett, 232 U. S. 299, Cook v. Tait, 265 U. S. 47.

The corporation also quotes the definition of "gross receipts in the Territory" in Section 2030, R. L. 1935. This expression is used only in Section 2035, R. L. 1935, relating to the allocation of income where a business is conducted both within and without the Territory, and hence has no bearing.

The corporation calls attention to the fact that Section 2031, R. L. 1935, refers to "receiving" as well as "deriving". Whether received or derived the income, to be taxable, must be from a source of income within the Territory in a constitutional sense.

In Shaffer v. Carter, 252 U. S. 37, 64 L. Ed. 445, the court defined a state's income tax jurisdiction as follows:

"And we deem it clear, upon principle as well as

well as authority, that just as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein; enforcing payment, so far as it can, by the exercise of a just control over persons and property within its borders. * * *" (p. 52)

* * *

"As to non-residents, the jurisdiction extends only to their property owned within the State and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources." (p. 57)

Commenting on this case the Supreme Court of Wisconsin in Newport Co. v. Wisconsin Tax Commission, 219 Wis. 293, 261 N. W. 884, cert. den. 297 U. S. 720, a case involving the taxability by Wisconsin of a profit made by a Delaware corporation the sale of stock of a Wisconsin corporation, said:

"With respect to income taxes, it was held in Shaffer v. Carter, 252 U. S. 37, 40 S. Ct. 221, 64 L. Ed. 445, that a state may tax a nonresident on income derived from property or business located within the state. While it is not so held, it appears to be implied that that is the limit of its jurisdiction with respect to income taxes. * * *

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"* * * So far as the cases leave the subject, the state of Delaware may tax this taxpayer upon its entire income. Wisconsin may tax it upon income

> derived from property located within the state. To this extent multiple taxation is permitted, but this represents the limits so far established. * * *"

In New York ex rel Whitney v. Graves, supra, the only question discussed is business situs and the court seems to have assumed that such business situs was essential in order to tax a non-resident upon the profit from the sale of an intangible.

These certificates of deposit are not property owned in the Territory; the owner is not domiciled here nor do these deposits have a business situs here. Nor was the interest derived from any business conducted in the Territory. We need not go so far as to suggest, like the Wisconsin court, that the sum total of income tax jurisdiction with respect to non-residents is property owned or business carried on in the Territory. It is sufficient that mere domicile of the debtor does not subject the income therefrom to state taxation in the hands of the recipient, according to all the authorities.

In State ex rel Manitowoc Gas Co. v. Wisconsin Tax Commission, 161 Wis. 111, 152 N. W. 848, there was involved an income tax on bondholders of a Wisconsin corporation. The statute levied an income tax upon income received "by every other non-resident of the state upon such income as is derived from sources within the state or within its jurisdiction." The

court held:

> "* * * The law levying an income tax upon non-residents, 'upon such income as is derived from sources within the state or within its jurisdiction,' must be construed to mean such income as issues directly from property or business located within the state, and not income from loans made therein, though, as here, secured by a trust deed upon property situated within the state.* * *
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> "The result arrived at is that as to the non-resident bondholders the income sought to be taxed was not derived from sources within the state within the meaning of the income tax law of 1911.* * *"

In State Tax on Foreign-Held Bonds, 15 Wall 300, 21 L. Ed. 179, a Pennsylvania tax on the interest paid to non-residents by a Pennsylvania railroad corporation, required to be withheld by the corporation, was held invalid on the ground of lack of taxing jurisdiction.

In Domenech v. United Porto Rican Sugar Co., supra, 62 Fed.(2d) 552 (C. C. A. lst), cert. den. 289 U. S. 739, a statute of Puerto Rico imposed an income tax on non-resident creditors measured by the interest received from local debtors, who were required to withhold the tax. This tax was held invalid and the decision plainly shows that the mere domicile of the debtor is not sufficient to sustain such a tax. We have already considered the possibilities of business situs as a ground of jurisdiction, and what the court said in the above case, in pointing out that the interest was earned in

a transaction outside Puerto Rico, merely negatives the business situs in that case without suggesting that the mere maintenance of bank deposits in a state creates a business situs there.

The corporation further suggests that the applicable rules of law have changed and that under recent decisions of the United States Supreme Court mere domicile of the debtor is sufficient to sustain a net income tax upon the interest. It is argued that State Tax on Foreign-Held Bonds, supra, was limited by Blackstone v. Miller, 188 U. S. 189, 47 L. Ed. 439, and that while Blackstone v. Miller was overruled by Farmers Loan and Trust Co. v. Minn. 280 U. S. 204, 74 L. Ed. 371, the principle of which was followed in Baldwin v. Missouri, 281 U. S. 586, 74 L. Ed. 1056, Beidler v. South Carolina, 282 U. S. 1, 75 L. Ed. 131, and First National Bank v. Maine, 284 U. S. 312, 76 L. Ed. 313, it is asserted that the recent trend is back toward Blackstone v. Miller.

In the first place Blackstone v. Miller, which was an inheritance tax case, does not seem to have limited the principle of State Tax on Foreign-Held Bonds, as applied to other kinds of taxes embank deposits. See State v. Clement Nat. Bank, 78 Atl. (Vt.) 944, affirmed on other points, 231 U. S. 120, which was decided after Blackstone v. Miller.

In the second place, we do not find any tendency whatsoever to revert Blackstone v. Miller. As the court said in Farmers Loan and Trust Co. v. Minn., supra:

> "Four different views concerning the situs for taxation of negotiable public obligations have been advanced. One fixes this at the domicile of the owner; another at the debtor's domicile; a third at the place where the instruments are found--physically present; and the fourth within the jurisdiction where the owner has caused them to become integral parts of a localized business.* * *"

The court definitely rejected the debtor's domicile as a situs for taxation in Farmers Loan and Trust Co. v. Minn., Baldwin v. Mo., and Beidler v. S. C., supra. The place where bonds and notes, representing the intangibles, physically were present, was rejected in Baldwin v. Missouri, supra. The business situs and the owner's domicile never have been rejected as grounds of taxing jurisdiction, but the question which has remained in doubt is the question whether the same kind of tax may be imposed upon the owner in more than one jurisdiction because the business situs is in one place and the domicile in another. It must be remembered that this question does not arise except where the tax is against the owner, for an excise tax might be imposed, for example, upon the making of the loan by the debtor, without raising any questions due to non-residence of the creditor. State Tax on Foreign-Held Bonds, supra. So

also where the tax is not the same kind of tax it always has been recognized that no question arises; for example, in First National Bank v. Maine, supra, it was recognized that a stock transfer tax might be imposed by the state of incorporation as well as an inheritance tax by the state of domicile of the shareholder.

As peviously noted, the Supreme Court has many times reserved the question as to whether the same kind of tax may be imposed against the same person in both the jurisdiction of business situs and also the jurisdiction of the owner's domicile, where intangibles are involved. This question has been reserved from the inception of the doctrine which overruled Blackstone v. Miller, supra. See Farmers Loan and Trust Co. v. Minn., supra, at page 213, First National Bank v. Maine, supra, at page 331, First Bank Stock Corp. v. Minn., supra, at page 237. It has not been decided yet, for in Curry v. McCandless, U. S. Sup. Ct., May 29, 1939, 83 L. Ed. Adv. Sh. 865, at page 872, only four of the justices, Stone, Black, Frankfurter and Douglas, concurred in the statement:

> "* * *But taxation of a corporation by a state where it does business, measured by the value of the intangibles used in its business there, does not preclude the state of incorporation from imposing a tax measured by all its intangibles. Cream of Wheat Co. v. Grand Forks County, supra (253 U. S. 329, 64 L. Ed. 934, 40 S. ct. 558); see Fidelity & C. Trust Co. v.

Louisville, 245 U. S. 54, 62 L. Ed. 145, 38 S. Ct. 40, L. R. A. 1918C, 124."

Mr. Justice Reed, the fifth judge who concurred in the majority opinion, specifically stated that he did not concur in the above quoted remarks. In Newark Fire Ins. Co. v. State Board, supra, decided at about the same time, this division of thought again is demonstrated, the above four justices specifically taking the position that intangibles may be taxed at the domicile, or place of incorporation, as well as at the business situs, while four of the justices, Reed, Hughes, Butler and Roberts reserved the point and Mr. Justice McReynolds dissented. All that Curry v. McCandless decided was that the decedent had created "two sets of legal relationships resulting in distinct intangible rights," and that there was no state which had exclusive jurisdiction over both relationships. Therefore, these recent opinions do not decide that an intangible may have more than one place of taxation, but when that decision comes it will only deal with the two possibilities, business situs or place of domicile or both, and in view of the fact that this very question was reserved in Farmers Loan and Trust Co., supra, and has been reserved ever since, a decision upon it, whatever the decision may be, will not mean that Blackstone v. Miller, again is the law, and the debtor's domicile as a tax situs will not be reinstated; there has not been any indication

of a tendency to revive either this ground of jurisdiction or the place where securities are physically located.

The corporation also relies upon the cases which uphold taxation of shares of stock against non-resident shareholders by the state of incorporation. These cases are an outgrowth of the authority of a state over a corporation incorporated under its laws. This authority enables the state to control and regulate the corporation and to declare that its shares of stock have a situs within the state. Tappan v. Merchants' National Bank, 19 Wall. 490, 22 L. Ed. 189, Corry v. Baltimore, 196 U. S. 466, 49 L. Ed. 556. It further has been held that this declaration of situs of shares may be made after the charter was granted and need not be expressed in any other way than by taxing the shares. Schuylkill Trust Co. v. Pa., 302 U. S. 506, 82 L. Ed. 392. This doctrine is expressly based on the state's authority to subject the shareholders interest in the corporation to taxation as well as regulation. The source of the authority is the same as validates franchise taxes upon domestic corporations. This always has been recognized to be a distinct field of taxation, and the doctrine of the Tappan, Corry, and Schuylkill Trust Go. cases does not include debts as well as shares of the corporation (State Tax on Foreign-Held Bonds, supra).

We have concluded that the corporation was not subject to net income tax upon the interest from these certificates of deposit in any of the years involved.

Respectfully,

Rhoda V. Lewis

Rhoda V. Lewis
Deputy Attorney General

Approved:

Attorney General