TAXATION - INCOME TAXES: Liability of employees of railroad federal equity receiver or trustee under Section 77 of the National Bankruptcy Act.

6-19

June 18, 1937.

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Hon. Forrest Smith,
State Auditor,
Jefferson City, Missouri.

Dear Sir:

A request for an opinion has been received from you under date of June 1, 1937, such request being in the following terms:

> "This office has had many inquiries asking whether or not the salaries paid to employees of railroads operating under Federal receiverships are subject to state income tax.
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> "This office has been holding that the salaries of such employees are subject to tax for state income tax purposes, except in the case of a receiver appointed by the Federal Court. The State Supreme Court held in the case of State ex rel vs. Truman 4 SW (2) 433 that salaries paid receivers are not subject to state income tax.
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> "I would very much appreciate a written opinion as to whether or not salaries of employees of railroads operating under Federal receiverships, other than the receiver appointed by the Federal Court, are subject to state income tax."

Most of the railroad companies under the jurisdiction of the Federal Court and employing a large number of persons in Missouri, are being operated by a trustee in reorganization proceedings under Section 77 of the National Bankruptcy Act, such as the Missouri Pacific Railroad Company, the St. Louis Southwestern Railway Company, the St. Louis-San Francisco Railroad Company, and their subsidiaries. The Wabash Railway Company is the only large railroad having headquarters in Missouri which is operating under a federal equity receivership. We presume your inquiry relates to employees of the receivers or trustees operating all of these companies.

We have recently, in an opinion to you dated May 5, 1937, concerning the taxability of employees of Federal Reserve Banks, reviewed at some length the history and present status of the constitutional principle that a state cannot tax the essential governmental functions of the United States Government, and we refer you to that opinion, deeming it unnecessary to set these matters forth again.

It is true that in the Truman case ((State ex rel Thompson vs. Truman, 4 S.W. (2d) 453 (1928)) mentioned in your letter, the Supreme Court of Missouri held that the compensation of a federal equity receiver is not subject to Missouri income taxes. However, the decision in that case was based on the theory that the United States Constitution prohibits such taxation, and there have been developments since the date of that decision which would seem to have the effect of allowing such taxation even if the decision in the Truman case stated the law at the time it was handed down.

In 1934 Congress enacted a statute contained in 28 U.S.C.A. as Section 124a thereof, as follows:

> "State taxation; business conducted by receivers, trustees or other court officers subject to
> "Any receiver, liquidator, referee, trustee, or other officers or agents appointed by any United States court who is authorized by said court to conduct any business, or who does conduct any business, shall, from and after June 18, 1934, be subject to all State and local taxes applicable to such business the same as if such business were conducted by an individual or corporation: Provided, however, That nothing in this section contained shall be construed to prohibit or prejudice the collection of any such taxes which accrued prior to June 18, 1934, in the event that the United States court having final jurisdiction of the subject matter under existing law should adjudge and decide that the imposition of such taxes was a valid exercise of the taxing power by the State or States, or by the civil subdivisions of the State or States imposing the same. (June 18, 1934, c. 585, 48 Stat. 993)."

Also, since the decision in the Truman case, the Supreme Court of the United States has decided the case of Michigan v. Michigan Trust Co., 286 U.S. 334 (1932), holding that a receiver appointed by a Federal Court must pay franchise taxes to the state of incorporation for the privilege of exercising the corporate franchise which he is authorized to exercise by the Federal Court itself. In the course of this opinion the court said:

> "To protect through a receiver the enjoyment of the corporate privilege and then to use the appointment as a barrier to the collection of the tax that should accompany enjoyment would be an injustice to the state and a reproach to equity."

Even before the decision in the Truman case the Supreme Court of the United States in the case of St. Louis-San Francisco Railroad Co. v. Middlekamp, 256 U.S. 226 (1921) had held that the Missouri Franchise Tax could be collected from a railroad being operated under war time governmental control.

The only way in which an employee of a business can escape state income taxation on the theory that to tax his income would be to impose a burden on an essential governmental function of the United States, is for him to establish that a tax on the business or instrumentality employing him would constitute a burden on a federal governmental instrumentality. This is illustrated by the case of New York ex rel Rogers v. Graves, 81 L.Ed. 202, decided January 4, 1937 in which, on page 206, the court said:

> "The railroad company being immune from state taxation, it necessarily results that fixed salaries and compensation paid to its officers and employees in their capacity as such are likewise immune."

It has always been recognized by the federal courts that it is unfair for a purely private business to escape taxes to which its competitors are subject, when a receiver is appointed for it. In 1933 the United States District Court for the Western District of Missouri decided, in the case of Howe v. Atlantic, Pacific & Gulf Oil Co., 4 Fed.Supp.162, that a federal equity receiver was not liable for Missouri gasoline taxes. That decision has been offered as the reason for the enactment of Section 124a of the United States Code quoted above (CCH Bankruptcy Law Service, Paragraph 681, quoting a House Report of the United States Congress to that effect).

The Howe case was reversed by the Circuit Court of Appeals under the name of Kansas City v. Johnson, 70 Fed. (2d) 369 (1934), and certiorari was denied - 293 U.S. 617 (1934). To the same effect is Gillis v. California, 293 U.S. 62 (1934). Where the business is essentially private, it is manifestly unfair to allow it to escape state taxes merely because a receiver has been appointed for it by a federal court, and if the business is subject to taxes, the income of its employees is likewise so subject. The reasoning in Kansas City v. Johnson and Gillis v. California, supra, is likewise applicable to income taxes of employees because it gives a corporation under receivership or trusteeship an advantage in obtaining employees, if those employees are not required to pay state income taxes, when the employees of competitors of such business are required to pay income taxes.

In conclusion, it is our opinion that employees of a federal equity receiver or of a trustee under Section 77 of the National Bankruptcy Act, operating a railroad under the jurisdiction of a federal court, are liable for Missouri income taxes on their income so received.

Very truly yours,

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Assistant Attorney General.

APPROVED:

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