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California Retail Sales Tax Law After *Diamond*: Facets of a Continuing Problem

The legal incidence¹ of the California retail sales tax has provided fertile ground for litigation since the genesis of the sales tax in 1933.² The focal point of litigation involving this aspect of the sales tax is whether the tax is assessed against the United States Government³ when the government purchases tangible personal property in California.⁴ This issue is dependent upon whether the incidence of the sales tax falls on the retailer or the purchaser.⁵ Generally, if the incidence falls directly on the United States Government as purchaser, a sales tax cannot be imposed without violating the principle of federal immunity from state taxation.⁶ If the incidence falls on the retailer, however, it is theoretically irrelevant that the purchaser may be the federal government because there is no direct taxation of the purchaser.⁷

The California Legislature, in enacting the California Retail Sales Tax Act in 1933, declared the sales tax to be imposed on the *retailer* for the privilege of selling tangible personal property within the state.⁸ This principle was challenged shortly after its inception in *Western Lithograph Company v. State Board of Equalization*.⁹ Under consideration in *Western Lithograph* was whether a retailer was entitled to a refund for sales tax paid on the sale of tangible personal property to a national bank.¹⁰ The retailer had not passed on the tax as part of the

1. The term "legal incidence" is used to indicate the person or activity upon which a tax is placed. See text accompanying notes 81-84 and 90 *infra*.

2. See generally *Western Lithograph Co. v. State Bd. of Equalization*, 11 Cal. 2d 156, 78 P.2d 731 (1938); *Xerox Corp. v. County of Orange*, 66 Cal. App. 3d 746, 136 Cal. Rptr. 583 (1977); *Livingston Rock & Gravel Co. v. De Salvo*, 136 Cal. App. 2d 156, 288 P.2d 317 (1955); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 244 P.2d 21 (1952); *Clary v. Basalt Rock Co.*, 99 Cal. App. 2d 458, 222 P.2d 24 (1950).

3. The use of the terms United States, United States Government or federal government hereinafter will encompass the instrumentalities of the United States. Examples of such instrumentalities are: federal home loan banks, federal credit unions, federal land banks, and intermediate credit banks. See 12 U.S.C. §§1433, 1768, 2055, 2079 (1976).

4. See note 2 *supra*.

5. See note 2 *supra*.

6. See *United States v. County of Fresno*, 429 U.S. 452, 459-60 (1977).

7. See *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339, 347 (1968); *City of Detroit v. Murray Corp.*, 355 U.S. 489, 492 (1958).

8. CAL. STATS. 1933, c. 1020, §§1, 3, at 2599-2600.

9. 11 Cal. 2d 156, 78 P.2d 731 (1938).

10. *Id.* at 158, 78 P.2d at 732.

purchase price but had paid the amount of sales tax due the state.¹¹ The national bank was conceded to be an instrumentality of the United States, and as such, to be exempt from state sales tax.¹² The California Supreme Court upheld the position of the state that the tax fell upon the retailer and, therefore, was properly imposed on sales to the national bank.¹³ As a result, the retailer was not entitled to a refund of the sales tax. Since the decision in *Western Lithograph*, California courts have consistently construed the sales tax law in accordance with the expressed intent of the legislature and with the pronouncement of the California Supreme Court.¹⁴ Nevertheless, in 1976 the United States Supreme Court, in *Diamond National Corporation v. State Board of Equalization*,¹⁵ held that the incidence of the California retail sales tax falls on the *purchaser*, not the retailer.¹⁶ Consequently, the plaintiff national bank, as a purchaser of tangible personal property, was held to be exempt from California sales tax imposed prior to 1969.¹⁷ Applicable provisions of the United States Code in existence prior to 1969 had permitted several forms of state taxation of national banks although sales taxation was not included among the permissible methods.¹⁸ Less than three weeks after the *Diamond* decision, the Ninth Circuit Court of Appeals held that the California sales tax as applied to *leases* of tangible personal property to the United States Government was a violation of the constitutional immunity from state taxation of the federal government.¹⁹

In response to the *Diamond* decision, Senate Bill 472 was enacted by the California Legislature to reaffirm that for *both* state and federal purposes, the retail sales tax is imposed on the *retailer* for the privilege of conducting a retail business within California.²⁰ Senate Bill 472 re-

11. See *id.* at 158, 78 P.2d at 732.

12. *Id.* at 158, 78 P.2d at 733.

13. *Id.* at 167, 78 P.2d at 737.

14. See, e.g., *De Aryan v. Akers*, 12 Cal. 2d 781, 87 P.2d 695 (1939), *cert. denied*, 308 U.S. 581 (1939); *Xerox Corp. v. County of Orange*, 66 Cal. App. 3d 746, 136 Cal. Rptr. 583 (1977); *Livingston Rock & Gravel Co. v. De Salvo*, 136 Cal. App. 2d 156, 288 P.2d 317 (1955); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 244 P.2d 21 (1952); *Clary v. Basalt Rock Co.*, 99 Cal. App. 2d 458, 222 P.2d 24 (1950).

15. 425 U.S. 268 (1976).

16. *Id.* at 268.

17. *Id.*

18. 12 U.S.C. §548 (1976). In 1969, 12 U.S.C. §548 was amended to permit national banks to be taxed in the same manner as state banks, which currently are subject to special taxes in lieu of all other taxes. See CAL. CONST. art. 13, §27; CAL. REV. & TAX. CODE §23182. Accordingly, the imposition of the sales tax on sales to state and national banks is permissible as a matter of state law, independently of a claim of federal immunity, because the sales tax is imposed on the retailer under state law. See CAL. REV. & TAX. CODE §6051. Other agencies of the federal government, however, are exempt from state sales taxation under state or federal law. See CAL. REV. & TAX. CODE §6381. See note 43 *infra*.

19. *United States v. State Bd. of Equalization*, 536 F.2d 294, 295 (9th Cir. 1976).

20. CAL. STATS. 1978, c. 1211, §19, at —.

pealed and amended various sections of the Revenue and Taxation Code that could have been construed as inconsistent with this concept.²¹ Senate Bill 472 also added to the Civil Code a sales tax reimbursement schedule²² and two presumptions.²³ Sales tax reimbursement as used in this context means an express or implied contractual arrangement between the retailer and the purchaser that the purchaser will reimburse the retailer for the state sales tax obligation incurred in the transaction.²⁴ The two presumptions are that the retailer and purchaser have agreed to the addition of sales tax reimbursement to the sales price of tangible personal property and that the property is sold at a price that includes tax reimbursement.²⁵

The objective of this legislation is to enable the state to realize the sales tax revenue derived from leases of tangible personal property to the United States Government and from sales of such property to certain instrumentalities of the federal government that otherwise would be exempt from state sales taxation.²⁶ By reexpressing the legislative intent that the sales tax is a privilege tax on the retailer for all tax purposes, state *and* federal, the legislature has attempted to circumvent an application of the *Diamond* holding should the federal government challenge again the incidence of the sales tax.²⁷ The avowed purpose of the inclusion of the sales tax reimbursement schedule and the pre-

21. See, e.g., CAL. STATS. 1973, c. 296, §5, at 706 (enacting CAL. REV. & TAX. CODE §6052.5); CAL. STATS. 1941, c. 36, §1, at 536 (enacting CAL. REV. & TAX. CODE §§6052, 6053, 6054).

22. See CAL. CIV. CODE §1656.1(c)(1).

23. See *id.* §1656.1(a). This section provides:

Whether a retailer may add sales tax reimbursement to the sales price of the tangible personal property sold at retail to a purchaser depends solely upon the terms of the agreement of sale. It shall be presumed that the parties agreed to the addition of sales tax reimbursement to the sales price of tangible personal property sold at retail to a purchaser if:

(1) The agreement of sale expressly provides for such addition of sales tax reimbursement;

(2) Sales tax reimbursement is shown on the sales check or other proof of sale; or

(3) The retailer posts in his premises in a location visible to purchasers, or includes on a price tag or in an advertisement or other printed material directed to purchasers, a notice to the effect that reimbursement for sales tax will be added to the sales price of all items or certain items, whichever is applicable.

Section 1656.1(b) provides:

It shall be presumed that the property, the gross receipts from the sale of which is subject to the sales tax, is sold at a price which includes tax reimbursement if the retailer posts in his premises, or includes on a price tag or in an advertisement (whichever is applicable) one of the following notices:

(1) "All prices of taxable items include sales tax reimbursement computed to the nearest mill."

(2) "The price of this item includes sales tax reimbursement computed to the nearest mill."

24. See CAL. REV. & TAX. CODE §6051; CAL. CIV. CODE §1656.1. See text accompanying notes 36-38 *infra*.

25. CAL. CIV. CODE §1656.1.

26. See generally CAL. STATS. 1978, c. 1211, §19 at —. See note 3 *supra* and note 43 *infra*.

27. See CAL. STATS. 1978, c. 1211, §19, at —.

sumptions concerning sales tax reimbursement was for use in determining a proper measure of sales tax and for obtaining the benefit of an income tax deduction of the sales tax paid by the purchaser.²⁸ It is evident that the State of California has attempted to alter the retail sales tax law to avoid a claim that the operation of the tax law runs afoul of the constitutional immunity currently enjoyed by the federal government. At stake in this controversy are the competing demands for state revenue and federal autonomy.

The purpose of this comment will be to demonstrate that Senate Bill 472 has not and cannot alter California sales tax law in any manner that would withstand another federal tax immunity challenge before the United States Supreme Court. This will be illustrated by identifying in the case law the test utilized by the United States Supreme Court to determine whether federal immunity has been violated by a state tax and by applying the test to California sales tax law. The reasons for the resulting failure of Senate Bill 472 to circumvent the *Diamond* decision and the remaining alternatives will be adduced.

BACKGROUND: CALIFORNIA RETAIL SALES TAX LAW

States enacted sales tax measures to fulfill the demands on government created by the enlarged scope of governmental activities following World War I and the depression of the 1930's.²⁹ The first such enactment in California, the Retail Sales Tax Act of 1933, imposed a tax on retailers for the privilege of selling tangible personal property, measured by the gross receipts from the sale of such property within the state.³⁰ In order to reach tangible personal property that was used, stored, or consumed in California but was purchased outside the state or in interstate commerce, the Use Tax Act of 1935 was enacted to impose an excise tax at the same rate as the sales tax, payable by the consumer.³¹ The two bodies of law were consolidated in 1941³² to form a complementary package for the purpose of assuring that all personalty sold or used in California is taxed.³³ At that time the legislature again expressed the intention to assess the sales tax as a privilege tax imposed on the retailer.³⁴

28. CAL. STATS. 1978, c. 1211, §22, at —.

29. Rice & Estes, *Sales and Use Taxes as Affected by Federal Governmental Immunity*, 9 VAND. L. REV. 204, 211 (1956).

30. CAL. STATS. 1933, c. 1020, §3, at 2600.

31. CAL. STATS. 1935, c. 361, §3, at 1298.

32. CAL. STATS. 1941, c. 36, §1, at 532.

33. Southern Pac. Co. v. Gallagher, 306 U.S. 167, 171 (1939).

34. CAL. STATS. 1941, c. 36, §1, at 536 (enacting CAL. REV. & TAX. CODE §6051). The total sales tax paid by the consumer is measured currently at the rate of six percent of the price agreed upon at the initial sales transaction. Four and three-quarters percent is allocated to state govern-

California courts, in interpreting the provisions of the sales tax law, have uniformly held that the sales tax is to be imposed on the retailer.³⁵ Thus, the retailer is solely obligated to pay the tax and has no right of action against the consumer if the consumer does not agree to the addition of the sales tax to the price.³⁶ Reimbursement of the retailer for the sales taxes paid has been a matter of contractual arrangement between retailer and purchaser,³⁷ and when the contract is silent on the question of tax, the purchaser cannot be made to pay.³⁸ The law has thus been interpreted by the California courts to create a relationship between the sovereign and the retailer, not between the state and the consumer.³⁹ Despite this theoretical appraisal, in practice the sales tax results in an increased burden on the purchaser. If the purchaser is the federal government, a contractor or distributor dealing under contract with the government, or a government employee or officer, the question arises whether the increased financial burden amounts to an unconstitutional violation of federal immunity from state taxation.⁴⁰

FEDERAL IMMUNITY FROM STATE TAXATION

There are two sources to which federal immunity from state taxation can be traced. As first enunciated by Justice Marshall in the United States Supreme Court decision of *McCulloch v. Maryland*,⁴¹ one basis for federal immunity is found, by implication, in the supremacy clause of the United States Constitution.⁴² The second source of federal immunity is simply that specifically granted by federal law.⁴³

ment and the other one and one-quarter percent is returned by the state to local government under the Bradley-Burns Uniform Local Sales and Use Tax Law. *See generally* CAL. REV. & TAX. CODE §§6051, 7200-11. An additional one-half percent is permitted to be levied in counties composing rapid transit districts. *See* CAL. REV. & TAX. CODE §7261.

35. *Western Lithograph Co. v. State Bd. of Equalization*, 11 Cal. 2d 156, 162, 78 P.2d 731, 734 (1938); *Xerox Corp. v. County of Orange*, 66 Cal. App. 3d 746, 756, 136 Cal. Rptr. 583, 589 (1977); *Livingston Rock & Gravel Co. v. De Salvo*, 136 Cal. App. 2d 156, 160, 288 P.2d 317, 319 (1955); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 34, 244 P.2d 21, 23 (1952).

36. *Livingston Rock & Gravel Co. v. De Salvo*, 136 Cal. App. 2d 156, 161, 288 P.2d 317, 319 (1955); *Clary v. Basalt Rock Co.*, 99 Cal. App. 2d 458, 461, 222 P.2d 24, 26 (1950).

37. *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 35, 244 P.2d 21, 24 (1952).

38. *Id.*

39. *De Aryan v. Akers*, 12 Cal. 2d 781, 785, 87 P.2d 695, 697 (1939), *cert. denied*, 308 U.S. 581 (1939); *Western Lithograph Co. v. State Bd. of Equalization*, 11 Cal. 2d 156, 163, 78 P.2d 731, 735 (1938).

40. *See, e.g., Diamond Nat'l Corp. v. State Bd. of Equalization*, 425 U.S. 268 (1976); *United States v. Mississippi Tax Comm'n*, 421 U.S. 599 (1975); *Dickinson v. First Nat'l Bank*, 393 U.S. 409 (1969) *aff'g* 291 F. Supp. 855 (N.D. Fla. 1968); *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339 (1968); *United States v. State Bd. of Equalization*, 536 F.2d 295 (9th Cir. 1976); *United States v. State Bd. of Equalization*, 450 F. Supp. 1030 (N.D. Cal. 1978).

41. 17 U.S. 316 (1819).

42. *See generally* U.S. CONST. art. VI, cl. 2.

43. *See, e.g., 4 U.S.C. §107(a)* (1970) (limitation of waiver of immunity from sales and use taxes in federal areas); 12 U.S.C. §1433 (1976) (federal home loan banks); 12 U.S.C. §1825 (1976) (Federal Deposit Insurance Corp.); 12 U.S.C. §1768 (1976) (federal credit unions); 12 U.S.C. §2055 (1976) (federal land banks); 12 U.S.C. §2079 (1976) (intermediate credit banks); 12 U.S.C.

In *McCulloch v. Maryland*, a state tax on the Bank of the United States was interpreted to be an assertion of state power that frustrated the operation of federal law and thus was impermissible.⁴⁴ A doctrine of absolute immunity was fashioned with the supremacy clause as its basis.⁴⁵ Following the decision in *McCulloch v. Maryland*, implied governmental immunity was expanded to invalidate not only state taxes that were directly imposed on the federal government, but also those that *indirectly* imposed additional costs on the government.⁴⁶ The test used by the United States Supreme Court was an economic one: if any economic burden of a tax fell on a governmental interest, it necessarily created an interference with the operations of the federal government, an interference prohibited by *McCulloch v. Maryland*.⁴⁷ The power to tax was considered tantamount to the power to destroy.⁴⁸

Correspondingly, the economic burden of a *federal* tax on *state* governmental interests was prohibited under the reciprocal doctrine of intergovernmental immunity.⁴⁹ This constitutional immunity of either government from taxation by the other arose from the requirement, inherent in the constitutional system, that each government must be left free from undue interference by the other in order to administer its affairs within its own sphere.⁵⁰ Beginning in the late 1920's, the Court began to recognize an intrinsic limitation of the concept of implied intergovernmental immunity.⁵¹ The recognition of this limitation led to a retreat from the economic burden theory.⁵² In *Metcalf & Eddy v. Mitchell*,⁵³ consulting engineers, under various contracts with the State of Massachusetts and its subdivisions, sought to recover income taxes paid by them to the United States.⁵⁴ The grounds for entitlement to the tax refund were that the engineers were employees or officers of the state and thus were exempt from federal income taxation under the

§2098 (1976) (production credit associations and banks for cooperatives chartered under the Farm Credit Act of 1933).

44. See 17 U.S. 316, 436 (1819).

45. See *id.*

46. See, e.g., *Graves v. Texas Co.*, 298 U.S. 393 (1936) (Alabama statute imposing tax on withdrawal of gasoline from storage for use and sold to U.S. Army and T.V.A. unconstitutional); *Panhandle Oil Co. v. Mississippi*, 277 U.S. 218 (1928) (Mississippi gasoline tax on distributors who sold to United States unconstitutional); *Dobbins v. Commissioners of Erie County*, 41 U.S. 435 (1842) (Pennsylvania income tax on federal officer's salary unconstitutional).

47. See 17 U.S. 316, 436-37 (1819).

48. *Id.* at 431.

49. See *Collector v. Day*, 78 U.S. 113, 122-28 (1871) (federal income tax on state judge unconstitutional).

50. *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 477-78 (1939); *Metcalf & Eddy v. Mitchell*, 269 U.S. 514, 523-24 (1926). See NOWAK, ROTUNDA & YOUNG, CONSTITUTIONAL LAW 367 (1978).

51. See *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926).

52. *Id.*

53. 269 U.S. 514 (1926).

54. *Id.* at 518.

War Revenue Act.⁵⁵ The Court held that the plaintiffs were not employees or officers of the state in their capacity of consulting engineers under contract and as a result were not entitled to a refund.⁵⁶ The Court did recognize, however, that taxation by either the state or the federal government will necessarily affect the operating costs of the other and that both governments must be permitted to function with a minimum of interference by the other.⁵⁷ Indeed, neither government may seriously curtail the exercise of the powers nor impair the efficiency of the functions of the other government.⁵⁸

The continued restriction of the intergovernmental immunity doctrine resulted in repudiation of the economic burden doctrine.⁵⁹ In 1937, the Supreme Court, applying a more flexible standard, held that a state tax imposed on the gross receipts of a federal contractor was a valid exaction since the tax was not assessed against the government and the increased cost to the government did not *substantially interfere* with the performance of federal functions.⁶⁰

In 1941 the Court expressly discarded the economic burden theory and, in its place, espoused a legal incidence test.⁶¹ In *Alabama v. King & Boozer*,⁶² the Court held that a state sales tax was validly imposed on the purchase of building materials by a contractor for use in performance of a "cost plus" building contract with the government.⁶³ Although title to the material vested in the government upon delivery and the government had agreed to reimburse the contractor for the sales tax, the *legal incidence* of the tax was held to fall on the contractor-purchaser.⁶⁴ The factors influencing the Court's decision were that the contractor, as purchaser, was not the agent or representative of the government, and that only the contractor was legally obligated to pay for the material under the facts of the case.⁶⁵

Since its origin in *Alabama v. King & Boozer*,⁶⁶ the legal incidence test has been consistently used to determine whether state or local taxes

55. *Id.*

56. *Id.* at 525-26.

57. *Id.* at 523-24.

58. *See id.*

59. *See generally* James v. Dravo Contracting Co., 302 U.S. 134 (1937).

60. *Id.* at 161. A tax to be a valid exaction also must be nondiscriminatory. *United States v. County of Fresno*, 429 U.S. 451, 460, 464 (1977); *James v. Dravo Contracting Co.*, 302 U.S. 134, 149-50 (1937).

61. *See Alabama v. King & Boozer*, 314 U.S. 1, 9 (1941).

62. 314 U.S. 1 (1941).

63. *See id.* at 14.

64. *See id.*

65. *See id.* at 9-10.

66. The elements of the legal incidence test have undergone some modification since 1941. See text accompanying notes 81-84 *infra*.

violate the immunity of the federal government.⁶⁷ As a result, the federal immunity doctrine no longer extends to persons seeking to establish derivative immunity solely through their dealings or relationship with the federal government.⁶⁸ This proposition was illustrated in *Detroit v. Murray Corporation*⁶⁹ where city and county taxes levied against a subcontractor under government contract were held not to infringe upon the immunity of the federal government.⁷⁰ The taxes were based in part on the value of materials and "work in process" to which the United States held legal title, but which were in the possession of the subcontractor.⁷¹ Although the taxes were styled as personal property taxes by the applicable Michigan statutes, they were imposed directly on the subcontractor, not the United States or its property, and the use of the property was for the private benefit of the subcontractor.⁷² Thus the Court found that the legal incidence of the taxes fell on the subcontractors and not on the federal government.⁷³

As recently as 1977, the legal incidence test was applied to permit the imposition of an annual tax on possessory interests in housing owned by the federal government.⁷⁴ In *United States v. County of Fresno*,⁷⁵ the United States Forest Service owned housing on national forest lands located in California and provided this housing to its employees as part of their compensation.⁷⁶ Fresno and Tuolumne Counties taxed the possessory interests of the federal employees in the housing under California statutes permitting the imposition of an annual tax on possessory interests in improvements on tax exempt land.⁷⁷ In determining that the tax was constitutional, the Court noted that although the tax created an economic burden on the government, the tax was nonetheless valid because it was neither directly imposed on the government nor discriminatory.⁷⁸ This case illustrates the distinction between direct and indirect taxation under the legal incidence test and the effect of such distinction: a tax that financially burdens governmental operations will be permitted so long as it is not discriminatory, directly im-

67. See, e.g., *United States v. County of Fresno*, 429 U.S. 452 (1977); *United States v. Mississippi Tax Comm'n*, 421 U.S. 599 (1975); *Gurley v. Rhoden*, 421 U.S. 200 (1975); *City of Detroit v. Murray Corp.*, 355 U.S. 489 (1958); *Kern-Limerick, Inc. v. Scurlock*, 347 U.S. 110 (1954).

68. See generally *United States v. County of Fresno*, 429 U.S. 452 (1977); *Gurley v. Rhoden*, 421 U.S. 200 (1975). But see *United States v. Mississippi Tax Comm'n*, 421 U.S. 599 (1975).

69. 355 U.S. 489 (1958).

70. *Id.* at 495.

71. *Id.* at 491.

72. *Id.* at 492-93.

73. *Id.* at 495.

74. See *United States v. County of Fresno*, 429 U.S. 452, 464-65 (1977).

75. 429 U.S. 452 (1977).

76. *Id.* at 454.

77. *Id.* at 455-56.

78. *Id.* at 464.

posed, nor indirectly burdensome.⁷⁹ Thus, any tax whose legal incidence falls directly on the federal government is prohibited.⁸⁰

To ascertain where the legal incidence of a tax falls, the applicable taxing statute must be scrutinized. When a state sales tax purporting to be an excise or privilege tax is challenged, the critical issues are two-fold: (1) who does the statute claim to tax; and (2) if the statute claims to tax the retailer, is the tax necessarily passed on to the purchaser?⁸¹ If the statute *expressly* imposes the tax on the purchaser, the tax is invalid if the purchaser is the federal government.⁸² Similarly, if the retailer is *required* to pass on the tax to the purchaser, then the practical effect is a direct imposition on the purchaser and, therefore, an invalid tax if the purchaser is the federal government.⁸³ If the statute professes to tax the *retailer*, it must be determined whether the practical effect of the statute is nevertheless so direct as to constitute impermissible taxation.⁸⁴

In *Diamond National Corporation v. State Board of Equalization*,⁸⁵ the United States Supreme Court found that the California retail sales tax was legally incident on the purchaser.⁸⁶ The *per curiam* opinion of the majority decided the issue of the legality of the California taxing scheme, predicated the decision on the Court's holding in *First Agricultural National Bank v. State Tax Commission*.⁸⁷

In *Agricultural National Bank*, the Massachusetts Supreme Judicial Court had determined that sales and use taxes imposed on purchases of tangible personal property were proper as applied to sales to a national bank.⁸⁸ One of the justifications advanced by the Massachusetts court for the validity of the sales tax imposition was that the tax was a tax on vendors, not on the bank as a purchaser.⁸⁹ The United States Supreme

79. *Id.* at 462, 464.

80. *Id.* at 459.

81. See *United States v. Mississippi Tax Comm'n*, 421 U.S. 599, 608 (1975); *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339 (1968).

82. *United States v. County of Fresno*, 429 U.S. 452, 459 (1977).

83. See *United States v. Mississippi Tax Comm'n*, 421 U.S. 599, 607-08 (1975); *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339, 347-48 (1968); *Federal Land Bank v. Bismarck Lumber Co.*, 314 U.S. 95, 99 (1941).

84. See generally *City of Detroit v. Murray Corp.*, 355 U.S. 489, 492-93 (1958).

85. 425 U.S. 268 (1976).

86. *Id.* at 268. The *Diamond* decision, for all its import to the California treasury, consisted of a single paragraph:

The judgment is reversed. We are not bound by the California court's contrary conclusion and hold that the incidence of the state and local sales taxes falls upon the national bank as purchaser and not upon the vendors. The national bank is therefore exempt from the taxes under former 12 U.S.C. §548 (1964 ed.), which was in effect at the time here pertinent. *First Agricultural Nat. Bank v. Tax Comm'n*, 392 U.S. 339, 346-48 (1968). Reversed.

87. 392 U.S. 339 (1968).

88. *First Agricultural Nat'l Bank v. State Tax Comm'n*, 353 Mass. 172, 181, 197, 229 N.E.2d 245, 251, 260 (1967), *rev'd* 392 U.S. 339 (1968).

89. *Id.* at 251.

Court reversed the decision of the Massachusetts court, holding that the legal incidence of the tax was on the purchaser because the tax was required to be passed on, and thus, was an impermissible direct tax.⁹⁰ Furthermore, the Court determined the wording of the statute revealed the intent of the Massachusetts Legislature that the sales tax be passed on to the purchaser and that lack of sanction against the vendor for refusing to pass on the tax did not mean the tax was on the vendor.⁹¹ The Court also stated that the interpretation of the statute, requiring the retailer to pass on the tax, was reinforced by the prohibition against any vendor advertising that the tax would be assumed or absorbed.⁹² By inference, then, the Court found the California sales tax invalid based on the same considerations.

A comparison of the Massachusetts statutes determined by the United States Supreme Court to place the legal incidence of the sales tax on the purchaser, with the relevant provisions of the California retail sales tax law that were in effect at the time of the *Diamond* decision, reveals striking similarities. The Massachusetts sales tax law provided in part that:

Reimbursement for the tax hereby imposed shall be paid by the purchaser to the vendor and each vendor . . . shall add to the sales price and shall collect from the purchaser the full amount of the tax . . . ; and such tax shall be a debt from the purchaser to the vendor⁹³

In comparison, the California Revenue and Taxation Code, at the time of the *Diamond* decision, provided that, "The tax hereby imposed shall be collected by the retailer from the consumer in so far as it can be done."⁹⁴ Both the Massachusetts and California sales tax law contained provisions prohibiting any advertisement that the sales tax would be absorbed or assumed by the retailer.⁹⁵ The construction given the above statutes by the Massachusetts and California judiciary is correspondingly parallel.

The Massachusetts Supreme Court construed the relevant provisions of the Massachusetts sales tax law *not* to mandate that the tax be collected from or passed on to the purchaser.⁹⁶ Rather, these provisions were interpreted to allow the retailer the option to add the tax to the

90. 392 U.S. 339, 347-48 (1968).

91. *Id.*

92. *Id.*

93. *Id.* at 347; MASS. GEN. LAWS ANN., c. 58, App. §1-1, subsec. 3.

94. CAL. STATS. 1941, c. 36, §1, at 536.

95. See MASS. GEN. LAWS ANN., c. 58, App. §1-1, subsec. 23; CAL. STATS. 1941, c. 36, §1, at 536.

96. First Agricultural Nat'l Bank v. State Tax Comm'n, 353 Mass. 172, 179-80 & n.14, 229 N.E.2d 245, 250 & n.14 (1967).

selling price and were "aimed more at the cultivation of a happy relationship between the vendors and customers than at any mandate that the tax be collected from the purchaser."⁹⁷ The prohibition against the retailer advertising that the tax would be absorbed was deemed to prevent the "small vendor" from being placed at a competitive disadvantage with "larger retailers".⁹⁸

California courts have consistently determined that the applicable provisions of the California tax law permitted the retailer to pass the tax on to the purchaser but did not charge the retailer with the mandatory duty of collection.⁹⁹ The retailer was authorized to collect the tax from the consumer "in so far as it may consistently be done" for purposes of reimbursement.¹⁰⁰ Authority to pursue reimbursement was restricted when the existing contractual or constitutional rights of the consumer would be infringed.¹⁰¹ The consumer, therefore, had no implied obligation in reference to the tax unless he agreed to be obligated.¹⁰² Reimbursement of the retailer for the tax depended on the contractual arrangements of the parties.¹⁰³ California courts have declared that the prohibition against advertising the absorption of the tax did not require the retailer to add the sales tax as an additional charge.¹⁰⁴ Rather, the purpose of this prohibition was to "place retailers on an equal basis since it is deemed unfair competition for the strong to absorb the tax and build up his trade at the expense of the weaker dealer who could not absorb it."¹⁰⁵

97. *Id.*

98. *Id.*

99. *Xerox Corp. v. County of Orange*, 66 Cal. App. 3d 746, 756, 136 Cal. Rptr. 583, 589 (1977); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 34, 244 P.2d 21, 23 (1952).

100. *De Aryan v. Akers*, 12 Cal. 2d 781, 786, 87 P.2d 695, 697 (1939), *cert. denied*, 308 U.S. 581 (1939); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 34, 244 P.2d 21, 23 (1952).

101. *De Aryan v. Akers*, 12 Cal. 2d 781, 786, 87 P.2d 695, 697 (1939), *cert. denied*, 308 U.S. 581 (1939).

102. *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 34, 244 P.2d 21, 23 (1952); *Clary v. Basalt Rock Co.*, 99 Cal. App. 2d 458, 461, 222 P.2d 24, 26 (1950).

103. See note 102 *supra*.

104. *Livingston Rock & Gravel Co. v. De Salvo*, 136 Cal. App. 2d 156, 162, 288 P.2d 317, 320 (1955); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 35, 244 P.2d 21, 24 (1952).

105. *De Aryan v. Akers*, 12 Cal. 2d 781, 787, 87 P.2d 695, 697 (1939), *cert. denied*, 308 U.S. 581 (1939); *Livingston Rock & Gravel Co. v. De Salvo*, 136 Cal. App. 2d 156, 162, 288 P.2d 317, 320 (1955); *Pacific Coast Eng'r Co. v. State*, 111 Cal. App. 2d 31, 35, 244 P.2d 21, 24 (1952). Now that there is no prohibition against advertising that the retailer will absorb or assume the sales tax, there may be an issue of unfair competition as, theoretically, the strong retailer can build up trade at the expense of the weaker seller—the very inequity the former statute purportedly sought to avoid. See *De Aryan v. Akers*, 12 Cal. 2d 781, 787, 87 P.2d 695, 697 (1939), *cert. denied*, 308 U.S. 581 (1939). Furthermore, should the retailer absorb the tax or should the tax actually be a retailer tax, the complementary sales and use tax package becomes distorted. See text accompanying note 33 *supra*. This distortion will occur because the purchaser buying goods within the state will pay no tax, while the purchaser buying such goods outside state borders for use, consumption or storage within California must pay the use tax. See text accompanying note 31 *supra*. Although the goods are taxed once, see text accompanying note 33 *supra*, those persons buying goods outside the state for use in California will consequently have to pay six percent more than for an identical item purchased within the state.

Consequently, based on the similarities in both the statutory form and construction of California and Massachusetts law,¹⁰⁶ the underlying rationale of the United States Supreme Court in the *Diamond* case becomes evident. The conviction of the Court that the California sales tax at the time of the *Diamond* decision was required to be passed on to the purchaser, thereby placing the legal incidence of the sales tax on the purchaser,¹⁰⁷ countermanded 40 years of California judicial construction to the contrary.

To remove from the sales tax law those provisions that could be construed to place the legal incidence of the tax on the purchaser, the California Legislature repealed the aforementioned statutes and enacted other related changes.¹⁰⁸ Nevertheless, California sales tax law, as altered by Senate Bill 472, cannot be successfully sustained if a challenge grounded on federal immunity is brought before the United States Supreme Court.

THE EFFECT OF SENATE BILL 472 ON THE *DIAMOND* DECISION

In establishing why Senate Bill 472 cannot alter California sales tax law sufficiently to withstand another challenge before the United States Supreme Court, it is important to note again the incorporation of the sales tax reimbursement schedule and the presumptions regarding sales tax reimbursement into the sales tax law.¹⁰⁹ It is this comment's contention that both are indicative of a consumer tax.

The sales tax reimbursement schedule is used to determine the amount owed by the purchaser to the retailer in reimbursement for the tax paid by the latter to the state. The California Supreme Court, in *Western Lithograph Company v. State Board of Equalization*,¹¹⁰ recognized that the controversy surrounding the imposition of the sales tax had resulted in large part from the inclusion in the sales tax law of a specific method whereby the retailer might calculate reimbursement.¹¹¹ The sales tax schedule, formerly contained in the Revenue and Taxation Code,¹¹² would have been repealed by Senate Bill 472 as originally introduced¹¹³ because it was considered to be inconsistent with the concept that the tax is incident on the retailer.¹¹⁴ The schedule was replaced in the final version of Senate Bill 472, however, as an addition to

106. See text accompanying notes 93-105 *supra*.

107. *Diamond Nat'l Corp. v. State Bd. of Equalization*, 425 U.S. 268 (1976).

108. See CAL. STATS. 1978, c. 1211, §§1-22, at —.

109. See CAL. CIV. CODE §1656.1. See note 23 *supra*.

110. 11 Cal. 2d 156, 78 P.2d 731 (1938).

111. *Id.* at 167, 78 P.2d at 735.

112. CAL. STATS. 1973, c. 296, §5, at 706.

113. SB 472, 1977-78 Regular Session, *as introduced*, March 7, 1977.

114. See CAL. STATS. 1978, c. 1211, §19, at —.

the Civil Code rather than the Revenue and Taxation Code.¹¹⁵ This curious relocation of a tax schedule from the Revenue and Taxation Code to the Civil Code arguably indicates an intent to sweep a controversial provision under the rug.

Additionally, the presumptions enacted by Senate Bill 472 possess consumer tax characteristics.¹¹⁶ The purchaser is *presumed* to have agreed to the addition of sales tax reimbursement to the sales price when the sales tax is shown on a sales check or other proof of sale, or when the retailer posts on the premises or includes in an advertisement or on a price tag a notice that sales tax reimbursement is added to the sales price.¹¹⁷ Any one of these routine business practices automatically triggers the presumption that the purchaser has agreed to pay the sales tax.¹¹⁸ Furthermore, if the retailer posts on the premises or includes on a price tag or in an advertisement that the price of taxable items includes sales tax reimbursement, it is *presumed* that the property was sold at a price that included sales tax reimbursement.¹¹⁹ Consequently, the circumstances giving rise to the presumptions that the purchaser agreed to the addition of the sales tax and that the property is sold at a price that includes the sales tax, result in direct imposition of the tax on the purchaser, thereby placing the legal incidence of the tax on the purchaser. This effect is distinguishable from the ordinary shift of a business or property tax that is reflected in a higher price.¹²⁰

The manner in which the Internal Revenue Service treats the sales tax for purposes of deductibility is also significant to the determination of legal incidence, because taxes generally are deductible only by the person upon whom they are imposed.¹²¹ It is the *purchaser* in California who is allowed by the Internal Revenue Service to deduct state and local sales taxes paid in the computation of his or her federal income tax when the tax was separately stated at the time it was paid.¹²² This is true even though the voluntary assumption of tax liability ordinarily does not give rise to a deductible item,¹²³ and even though the incidence of the sales tax, under the imposing statute, does not fall on the consumer.¹²⁴ In this instance, however, state and local sales taxes may

115. Compare CAL. STATS. 1973, c. 296, §5, at 706 with CAL. CIV. CODE §1656.1(c)(1).

116. See CAL. CIV. CODE §1656.1. See note 23 *supra*.

117. See note 23 *supra*.

118. See note 23 *supra*.

119. See note 23 *supra*.

120. See generally *Western Lithograph Co. v. State Bd. of Equalization*, 11 Cal. 2d 156, 163, 78 P.2d 731, 735 (1938).

121. *Magruder v. Supplee*, 316 U.S. 394, 396 (1942) (citing TREAS. REG. 94, ART. 23(c)-1 (1936) (Revenue Act of 1936), 1 FED. REG. 1802, 1824 (1936)).

122. See 26 C.F.R. §1.164-5 (1978).

123. *Borland v. Commissioner*, 123 F.2d 358, 360 (7th Cir. 1941).

124. See 26 C.F.R. §1.164-5 (1978).

be deducted from gross income in computing federal income tax only if the tax is a *sales* tax as distinguished from an excise or *privilege* tax or other form of exaction.¹²⁵ California claims that the tax on the sale of tangible personal property is a privilege tax,¹²⁶ yet the Internal Revenue Service allows the deduction. Consequently, it appears that the federal government recognizes that in *substance*, the tax imposed on sales of personalty in California is a *sales* tax, as opposed to a privilege or excise tax and that it is imposed on the consumer although statutory *form* places the incidence of the tax on the retailer.

Moreover, the treatment accorded the sales tax by the State of California for purposes of deductibility is highly persuasive as an indication of the legal incidence of the tax. The Franchise Tax Board authorizes the purchaser to deduct state and local sales taxes paid in computation of the purchaser's state income tax.¹²⁷ The applicable statute additionally expresses the legislative intent that, to the extent that the tax was separately stated, the sales tax paid by the consumer "shall be treated as a tax *imposed on* and paid by such consumer."¹²⁸

Furthermore, the factors that give rise to a contractual obligation implied in any sales transaction regarding sales tax reimbursement are nearly identical to the conditions required by the Internal Revenue Service for a finding that the sales tax was separately stated for purposes of deducting the sales tax from federal income tax.¹²⁹ A reading of Senate Bill 472 discloses that the conformity of factors giving rise to both the presumptions and tax deductibility was enacted with the intent to provide a method enabling the purchaser to deduct the sales tax from income to be reported on federal and state tax returns.¹³⁰ Under these circumstances, the enactment of this provision attests to the tacit acknowledgement of the legislature that the sales tax is actually incident on the purchaser.¹³¹

125. *Commissioner v. Thompson*, 193 F.2d 586, 588 (10th Cir. 1951).

126. CAL. REV. & TAX. CODE §6051.

127. *Id.* §17204(a)(3).

128. *Id.* §17204(b)(5) (emphasis added).

129. Compare CAL. CIV. CODE §1656.1(a), (b) with 26 C.F.R. §1.164-5 (1978). Section 1.164-5 provides in part:

The requirement that the amount of tax must be separately stated will be deemed complied with where it clearly appears that at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purpose of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. For example, where the law imposing the state or local tax for which the taxpayer seeks a deduction contains a . . . provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the state or local tax was separately stated at the time paid by the consumer.

130. See CAL. STATS. 1978, c. 1211, §22, at —.

131. For example, in a press release relating to the introduction of Senate Bill 233, a bill

Inconsistencies in the regulations promulgated by the State Board of Equalization are probative of the weakness of the stance taken by the legislature in declaring the sales tax to be legally incident on the retailer.¹³² The regulations provide that sales tax is to be imposed on leases of tangible personal property to the United States and on sales to certain federal instrumentalities.¹³³ Sales tax does not apply, however, to sales or leases to Indians who reside on a reservation whether negotiated on or off the reservation when the property is delivered on the reservation.¹³⁴ Additionally, the regulations provide that neither sales nor use tax applies to the sale or use of tangible personal property to foreign consul officers, employees or their families.¹³⁵ These exemptions are inconsistent with the premise that the sales tax is a privilege tax imposed on the retailer, because if that were the case, it would be irrelevant that the purchaser is someone who would be exempt had the legal incidence been on that purchaser.¹³⁶

Furthermore, economic realities as well as statutory law are considered in determining the legal incidence of a state tax.¹³⁷ For example, in *First Agricultural National Bank v. State Tax Commission*,¹³⁸ the Court found that business practicalities resulted in a passing on of the tax,¹³⁹ and in *United States v. Mississippi Tax Commission*,¹⁴⁰ a sales tax in the form of a wholesale markup on liquor sold to military installations was held to be imposed unconstitutionally.¹⁴¹ Because the applicable regulation promulgated by the Tax Commission required the distributors to collect the tax from the military, the tax was legally incident on the United States.¹⁴² Moreover, the Court stated that "even in the absence of this clear statement of the Tax Commission's intentions, obvious economic realities compelled the distillers to pass on the *economic burden* of the markup."¹⁴³ In these two cases, the Court invalidated state sales taxes on the grounds that the taxes were required to be

proposing a reduction in the amount of the sales tax as opposed to an income tax exemption credit, the author stated, "All tax payers contribute to California's continuing surplus, and all should share in the pleasure of *paying less taxes*." Senator John W. Holmdahl, Press Release, Sales Tax Reduction Proposal before State Senate, January 19, 1979 (emphasis added).

132. Compare 18 CAL. ADM. CODE §1614 with *id.* at §1616 and *id.* at §1619.

133. 18 CAL. ADM. CODE §1614(a), (c).

134. *Id.* §1616(d).

135. *Id.* §1619.

136. See, e.g., 32 OP. ATT'Y GEN. 262-63 (1958) (sales to Indians not exempt from sales or use taxes because tax on retailer).

137. See generally *United States v. Mississippi Tax Comm'n*, 421 U.S. 599, 609-10 n.8 (1975); *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339, 348 (1968).

138. 392 U.S. 339 (1968).

139. *Id.* at 348.

140. 421 U.S. 599 (1975).

141. *Id.* at 613.

142. *Id.* at 608-09.

143. *Id.* at 609-10 n.8 (emphasis added).

passed on to the purchaser and in part that economic realities *ordained* an identical result. Consequently, whether mandated by statutory law or by business practicalities, the sales tax of necessity is passed on and the practical effect is a direct imposition of the tax on the purchaser.

Finally, the United States Supreme Court is not bound to accept the expressed intent of the California Legislature nor the determination of California courts regarding the legal incidence of the state sales tax.¹⁴⁴ This statement would appear to be contradictory to a concept inherent in federalism that the highest court of a state is the final arbiter of state law.¹⁴⁵ The legal incidence of the state sales tax is normally a matter for determination by state courts¹⁴⁶ and, admittedly, a significant aspect of state autonomy is the power of taxation.¹⁴⁷ But when federal rights are involved and when state law impinges on constitutionally protected areas, the determination of legal incidence is a federal question.¹⁴⁸ Confusion in this area is attributable to past inconsistent statements by the United States Supreme Court in reference to the binding effect of the declarations of a state legislature and interpretations of state courts concerning the legal incidence of a tax.¹⁴⁹ The posture of the present Court, however, is in accord with the principles that the Court is not bound by the characterization of a state court regarding the incidence of a tax when questions of federal immunity are raised, nor is express legislative intent controlling when the practical operation and effect of the law is inconsistent with statutory form.¹⁵⁰

In the final analysis, California has employed a legal fiction in placing the incidence of the sales tax on the retailer to evade a confrontation with the federal immunity doctrine.¹⁵¹ The United States Supreme

144. See *Diamond Nat'l Corp. v. State Bd. of Equalization*, 425 U.S. 268 (1976).

145. See *Gurley v. Rhoden*, 421 U.S. 200, 208 (1975). See generally U.S. CONST. amend. X; L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 301-02 (1978).

146. See *Diamond Nat'l Corp. v. State Bd. of Equalization*, 425 U.S. 268 (1976) (Stevens, J., dissenting); *Gurley v. Rhoden*, 421 U.S. 200, 208 (1975); *Alabama v. King & Boozer*, 314 U.S. 1, 9-10 (1941).

147. See Comment, *Federal Immunity from State Taxation: A Reassessment*, 45 U. CHI. L. REV. 695, 717 (1978).

148. *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339, 346-47 (1968); *Kern-Limerick, Inc. v. Scurlock*, 347 U.S. 110, 121 (1954); *United States v. State Bd. of Equalization*, 450 F. Supp. 1030, 1035 (1978).

149. The following is a sampling of inconsistent statements by the United States Supreme Court regarding the effect of state legislation and judicial interpretations on the legal incidence of a tax. "These determinations of the incidence of the tax by the state court are controlling. . . ." *Federal Land Bank v. Bismarck Lumber Co.*, 314 U.S. 95, 99 (1941). "There can be no doubt from the clear wording of the statute that the Massachusetts Legislature intended that this sales tax be passed on to the purchaser. For our purposes, at least, that intent is controlling." *First Agricultural Nat'l Bank v. State Tax Comm'n*, 392 U.S. 339, 347-48 (1968). "We are not bound by the California court's contrary conclusion. . . ." *Diamond Nat'l Corp. v. State Bd. of Equalization*, 425 U.S. 268, 268 (1976).

150. See *Diamond Nat'l Corp. v. State Bd. of Equalization*, 425 U.S. 268, 268 (1976); *Gurley v. Rhoden*, 421 U.S. 200, 208 (1975).

151. Another practical objective in employing this legal fiction is to facilitate collection of the

Court has pierced this facade and is not likely to succumb to legislative exhortations merely because California sales tax law has been altered in form but not substance. The aggregate force of the above arguments presage the probable success of a constitutional challenge to the amended sales tax law embodied in Senate Bill 472.

CONCLUSION

The California retail sales tax is a major source of revenue for the state.¹⁵² The holding of the United States Supreme Court in *Diamond National Corporation v. State Board of Equalization* that the legal incidence of the sales tax falls upon the purchaser,¹⁵³ invalidated the imposition of sales tax on sales of tangible personal property to federal instrumentalities and on leases of such property to the United States Government. Thus, the revenue derived from these transactions was reduced proportionately. In an effort to alter the sales tax law to avoid a future application of the *Diamond* holding, Senate Bill 472 was enacted.¹⁵⁴ This legislative response, however, will meet with failure on challenge to the United States Supreme Court. Among the reasons for this failure are the operation and effect of the law which remain basically unchanged from that in force at the time of the *Diamond* decision, and the inevitable consequence under such a taxing scheme that the consumer must pay the tax to acquire the purchased property. Accordingly, two alternatives are available to the State of California. One alternative is to exempt from taxation all sales and leases of tangible personal property to the federal government. The alternative best calculated to secure the objective of the state, however, is to seek congressional sanction for permissible imposition of sales tax on leases to the United States Government and on sales to its incorporated instrumentalities.

Faith J. Geoghegan

tax by the state. The retailer is required to secure a permit from the state to engage in the retail trade. See CAL. REV. & TAX. CODE §6066. Thus, subjection of the retailer to legal liability for payment of the tax avoids the difficulties associated with an attempted collection of the tax by the state from each purchaser on each individual sale and consequent legal action upon default of the purchaser.

152. See GOVERNOR'S BUDGET FOR 1979-80 at A-6 (1979).

153. 425 U.S. at 268.

154. See CAL. STATS. 1978, c. 1211, §19, at —.

