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Tax-Free Investments in Kentucky

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straight forward, and positive, which gives authority, and fixed responsibility. Many states are now proposing the Unicameral or single house legislature as a remedy for these evils.

TAX-FREE INVESTMENTS IN KENTUCKY.

Real estate located in another state has no situs in Kentucky, and legislation by this state could not give it a situs here even though the owner is domiciled in Kentucky. (1) The same thing is true of tangible personalty. (2) As to tangible personal property, the ordinary rule is that the situs is at the domicile of the owner. Within certain limits this rule may be changed by legislation, and a statute fixing the situs of intangible personalty at the domicile of a non-resident has the effect of exempting such property from taxation so far as Kentucky is concerned. An example is the statute fixing the situs of intangible trust property at the domicile of the cestui instead of the domicile of the trustee even though the trustee is domiciled in Kentucky and cestui is not. (3)

But all property having a situs in this state, except United States bonds (4) and property expressly exempted in Section 170 of our constitution, must be subjected to the general property tax. An act of the Legislature expressly exempting any other property from taxation would be unconstitutional.

How, then, can one write of tax-free investments in Kentucky? The answer is to be found in the following principle: There may be many different property rights, legally speaking, where there is but one property, economically speaking. The courts when permitted or authorized to do so by the Legislature, can look behind the legal technicalities, see the substantial oneness of the property, and require the holder of only one of the legal rights to pay the tax on the property, exempting the holders of the other legal rights in the same property. But the courts may, when not permitted or authorized to do otherwise by the Legislature, require the holders of two or more legal rights to pay taxes upon the full value of the property, although there is, economically speaking, but one property.

For an illustration, suppose that X owns $100,000 in gold coin, and that Y owns a factory worth $100,000. The State would collect taxes upon $200,000 worth of property. Suppose then that X and his friends A, B, C, and D organize the Alphabet Bank with a capital stock of $100.000. X puts up his $100,000 of gold coin for the capital stock. He has certificates for five shares each issued to A, B, C, and D, be-

cause there must be at least five incorporators, but these dummies hold their stock in trust for X. X then borrows the $100,000 back from the Bank, giving his note. (I know the law against excess loans, but, like some bank officers, am ignoring it.) With this $100,000, X next buys the factory from Y, and Y deposits the money in the Alphabet Bank. X and his friends E and F then organize the X Manufacturing Company with a capital stock of $50,000; and X conveys to it the factory at a valuation of $100,000, taking a note for $50,000 and all of the stock in the Manufacturing Company, but having five shares of the stock issued to E and five shares to F, who hold their stock in trust for X.

Obviously no new wealth has been created. Economically speaking, there is still the same property; but, legally speaking, many new property rights have been created. The Bank owns X's notes for $100,000 and the $100,000 worth of gold coin. The Manufacturing Company owns the factory worth $100,000. Y owns a chose in action against the Bank for $100,000 by reason of his deposit. A, B, C, and D each own $500 worth of stock in the Manufacturing Company. X owns the Manufacturing Company's note for $50,000, is the legal owner of $98,000 worth of stock in the Bank and of 49,000 worth of stock in the Manufacturing Company, and has a cestui's equitable rights against A, B, C, D, E, and Fas to their $3,000 worth of stock which they hold as trustees for him.

Looking at the situation as lawyers, we see property which totals $603,000. As business men looking through the forms at the substance, we see that there is only $200,000 worth of property. If I have done my sums correctly, the State would collect taxes on $250,000 worth of property. The other $353,000 of property which the lawyers see, is "tax-free" in the sense in which that phrase is used in this essay.

We will consider first, what investments are tax-free under our present statutes, and second, what other investments could be made tax-free by statute under our present constitution.

Although a trustee and his cestui both have property rights, the law requires the tax to be paid by only one of them. (5) At least that is true where the cestui's rights are ascertained.

If we adopt the entity theory of partnership (and for purposes of taxation a firm is a distinct entry (6), the partnership owns property and each partner owns an interest in the partnership; but no one has ever contended that after the firm has paid taxes on partnership property, the individual partner ought also to pay taxes on his interest in the partnership. (7)

When we turn from partner and partnership to stockholder and

corporation, we find the law more complicated. Technically, the stockholder owns shares of stock in the corporation, the corporation owns the property in which its capital stock is invested. Both are legally property. The law may stop there and tax both without violating constitutional provisions for equality and uniformity of taxation or even without violating a constitutional prohibition or double taxation. (8) Or the law may look behind the technicalities, see the substantial oneness of the property and require the tax to be paid on only one valuation without violating a constitutional provision that all property must be taxed. The revenue agents in Kentucky have fought valiantly in an effort to tax shares of stock in the hands of the stockholder. When beaten as to one class of corporations, they have renewed their efforts as to other classes. They have sought to draw really pretty distinctions in this respect between franchise and non-franchise corporations, foreign and domestic corporations, corporations most of whose property is situated in this state and corporations most of whose property is situated outside the state. In a series of most interesting cases, the Kentucky law has become established that when a corporation pays taxes on its property situated in Kentucky, its stockholders need not pay taxes on their shares of stock. The final case (9) in that series holds this to be true even of a foreign, non-franchise corporation, most of whose property is situated outside of Kentucky. The opinion in that case is a very able one and its citation of authorities furnishes a key to the successive steps by which the rule has been applied to shares in the several different classes of corporations.

The legislative sanction for the rule as to franchise corporations is to be found in Kentucky Statutes, section 4088:

> "The individual stockholder of the corporations which are, by this article required to report and pay taxes upon the corporate franchise, shall not be required to list their shares in such companies so long as the corporations pay the taxes upon the corporate property and franchises as herein provided."

The legislative sanction for the rule as to non-franchise corporations is to be found in Kentucky Statutes, section 4085:

> "The property of all corporations, except where herein differently provided, shall be assessed in the name of the corporation in the same manner as that of a natural person * * * *; and so long as said corporation pays the taxes on all its property

of every kind, the individual stockholders shall not be required to list their shares in said corporation."

Some corporate stock in Kentucky is, however, taxed. For instance, stock belonging to a Kentuckian in a foreign corporation all of whose property is situated outside the state and which therefore pays no taxes to Kentucky, must be listed for assessment in the name of the stockholder. (10) The individual stockholders in Building and Loan Associations are required to list and pay taxes on their shares (valued at the amount paid in), but the corporation is not required to pay taxes on the notes, etc., in which it invests the capital stock paid in. (11) The method of taxing banks and trust companies and shares of stock in such corporations is dictated by the restrictions on state taxation of national banks. The corporation pays taxes on its real estate as owner. It also pays, "for and on behalf of" the stockholders, taxes upon all the shares of its stock less the assessed value of its real estate. The individual shareholders are not required to list their shares for taxtion. By an act of 1912 (12), the same method of taxation was applied to domestic life insurance companies as was already in force as to banks and trust companies.

The fact that, with the four exceptions just mentioned, shares of stock need not be listed for taxation in Kentucky, has frequently induced the organizers of corporations to create preferred stock instead of bonds when they expected to find a market for their securities among Kentucky investors. By fixing the rate of dividends on preferred stock, making the dividends cumulative, giving to the preferred stock a priority in the event of dissolution, and placing at a low figure the amount of indebtedness that can be incurred, the preferred stock can be made almost identical with bonds as to security. The resemblance to bonds in everything except liability to taxation is made closer by giving the voting power to the common stock only, and by giving the corporation the right to retire the preferred stock at par after the lapse of a stated time. Although most bonds escape taxation illegally simply because their ownership is concealed, the legal freedom from taxation of preferred stock is attractive to investors and this device will doubtless be more and more frequently used as it becomes better understood.

The last paragraph serves both as a conclusion to our consideration of stock and as an introduction to our consideration of bonds, notes, and other indebtedness. Just as it is true that there is only one property, economically speaking, but there are two properties, legally speaking, in the case of trustee and cestui, of firm and partner, or of corporation and stockholder, so is it true that while the business man

sees only one property, the lawyer sees one property right in the creditor to his debt and another property right in the debtor to the thing for which the debt was incurred or in which borrowed money is invested. To tax both involves the same sort of duoble taxation that would be involved if the state taxed separately the trustee on his legal title and the cestui on his equitable title, the firm on its property and the partner on his interest in the stockholder on his shares of stock. What conceivable difference does it make, either as to the ability of the owner to pay taxes or as to the burden on the state of protecting the property, that X in our supposititious case took from his Manufacturing Company in exchange for the factory $50,000 in stock and a note for $50,000 instead of taking $100,000 in stock? The value of a debt depends upon the property of the debtor which can be subjected to its payment, just as the value of corporate stock depends upon the property which the corporation owns.

The double taxation involved in assessing encumbered property at its full value and of also assessing the debt in the hands of the creditor, was discussed in the convention which framed our present constitution. The following amendment was proposed to the section on exemptions:

> "A purchase money lien or mortgage on real property to secure a debt created in good faith, shall, for the purpose of taxation, be regarded an interest in the property upon which the lien exists, and the amount of such encumbrance shall be deducted from the valuation of the property in the assessment thereof, provided the debt, to secure which the lien is created, be assessed and taxed for the purposes for which the real property is liable."

The Chairman of the Committee on Revenue and Taxation said concerning this proposed amendment:

> "I do not understand it to be an exemption. It is a provision to guard against what is sometimes called double taxation. I do not think it belongs here."

The amendment was rejected. (13) Later the same provision was offered as a separate section and it was again rejected. (14)

Another delegate offered the following section:

> "Whenever there is a lien on land for the purchase money, the tax shall be levied on the land, and the owner of said land shall pay the tax; but shall have a credit on the lien indebtedness for the amount of the tax on said land, in the proportion that the

debt bears to the whole value of the land; but the lien debt shall not be taxed in the hands of the lien-holder."

This also was rejected. (15)
The Convention adopted the following section:

"All mortgages and other liens upon real estate shall be deemed, pro tanto, a taxable interest in said property, and it shall be the duty of the General Assembly to make provision for an equitable adjustment of such taxes between the owner of the fees and the one holding an equitable interest therein." (16)

Another section was adopted extending those provisions to personal estate. (17) But on reconsideration, both of these sections were afterwards rejected. (18) The reported debates show that the reason for this action was a fear that railroads and other corporations could have their mortgage bond issues deducted in assessing their property, although the bond-holders lived out of the state and hence could not be reached.

The general rule now is that, in assessing property, no deduction can be made on account of the owner's debts. (19) To this rule, however, there are four exceptions. A bank is not required to pay taxes upon the notes, etc., in which its deposits are invested, the depositors being required to list the deposits in their own names. The Court, in one case (20), bases this exception upon the theory that a bank is a quasi-trustee for its depositors, but in a later case (21) bases it upon the legislative intent. By the act of 1912, referred to above, the reserves of a domestic life insurance company, held to secure its outstanding policies, are treated like bank deposits. A Building and Loan Association is not required to pay taxes on the notes in which it invests borrowed money. (22) A borrower from a Building and Loan Association is not required to pay taxes on his shares of stock which are pledged to the corporation to secure a loan. The legislative sanction for the last two exceptions is found in Kentucky Statutes, sections 4093-4094.

There is no instance under the Kentucky law in which a debt is tax-free in the hands of the creditor for the reason that the property for which it was incurred, by which it is secured, or in which borrowed money is invested, is taxed in the name of the debtor.

Reverting now to the case supposed as an illustration, we find that Y is taxed upon his bank deposit value at $100,000. Although the Bank owns $100,000 in gold coin and X's note for $100,000, it pays no taxes as owner. It pays taxes for and on behalf of its stockholders

on their shares of stock valued at $100,000. The Manufacturing Company pays taxes on its factory valued at $100,000. X pays taxes on the Manufacturing Company's note valued at $50,000. He pays no taxes on his bank stock because the bank has paid the taxes on that. He pays no taxes on his Manufacturing Company stock bceause the corporation has paid taxes on its property. A, B, C, D, E, and F pay no taxes on the stock which they own as trustees for the same reasons and for the additional reason that, even if it were taxable in the hands of its owner, the cestui and not the trustees would pay the tax.

So much for tax-free investments under our present statutes. Can the Legislature go farther in this direction without a constitutional amendment? What shall we say of a statute providing that the owners of notes, bonds, or debts otherwise evidenced, shall not be required to list same for taxation so long as the debtor pays the taxes upon the property encumbered to secure the payment thereof, or for which the debt was incurred, or in which the money for which the note or bond was given is invested? This is not the proper place to discuss the justice of such a statute or its advantages, its tendency to lower the interest rate, to attract capital to the state, or to encourage small private investors to lend on mortgages instead of making unsecured personal loans which can be concealed. Would it be constitutional? The Kentucky bar are generally of the opinion that it would not. But the fact that the Constitutional Convention rejected provisions forbidding the double taxation of debtor and creditor, does not necessarily mean that the Constitution requires such double taxation. It may be optional with the Legislature. If I have correctly deduced the general principle from the illustrations presented and the cases cited above and if that general principal is applicable to this case, then the courts, in this instance as in the others, when permitted or authorized to do so by the Legislature, can look behind the legal technicalities and see and recognize the substantial oneness of the property without violating the rule that no property having a situs here can be exempted from taxation except that mentioned in Section 170; and it follows that the statute suggested would be constitutional.

AUTHORITIES CITED.

(1) Louisville Ferry Co. v. Kentucky, 188 U. S. 385.

(2) Union Transit Co. v. Kentucky, 199 U. S. 194.

(3) City of Henderson v. Barrett's Executor, 152 Ky. 648, 153 S. W. 992.

(4) Commonwealth v. Hearne's Executor and Trustee, 100 S. W. 820, 30 Ky. L. Rep. 1195.

(5) City of Henderson v. Barrett's Executor, supra.

(6) City of Louisville v. Tatum, Embry, & Co., 111 Ky. 747, 64 S. W. 836, 23 Ky. L. Rep. 1014.

(7) See Meguiar v. Helm, 91 Ky. 19, 14 S. W. 949, 12 Ky. L. Rep. 751.

(8) See Franklin County Court v. Deposit Bank, 87 Ky. 370, 383.

(9) Commonwealth v. Fidelity Trust Co., 147 Ky. 77, 143 S. W. 1037.

(10) This does not apply to shares in national banks, the situs of the stock being fixed by federal statute at the place where the bank is located. Quaere: could a state in chartering a corporation so fix the situs of its shares of stock that another state could not apply to them the doctrine that the situs of intangible personalty is at the domicile of the owner?

(11) Commonwealth v. Fayette Building Association, 71 S. W. 5, 24 Ky. L. Rep. 1223.

(12) Kentucky Statutes, section 4273a.

(13 2 Debates 2564.

(14) Id. 2696.

(15) Id. 2702.

(16) Id. 2799.

(17) Id. 2818.

(18) Id. 2837-2838.

(19) Henderson Bridge Co. v. Commonwealth, 99 Ky. 623, 31 S. W. 486, 17 Ky. L. Rep. 389, 29 L. R. A. 73, Affirmed, 166 U. S. 150.

(20) Deposit Bank v. Davies County, 102 Ky. 174, 39 S. W. 1030, 1041, 19 Ky. L. Rep. 248.

(21) Commonwealth v. Bank of Commerce, 118 Ky. 547, 81 S. W. 679, 26 Ky. L. Rep. 407.

(22) Commonwealth v. Home & S. F. Co., 127 Ky. 537, 106 S. W. 221, 32 Ky. L. Rep. 435.

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ABSTRACTS OF CASES DECIDED BY THE KENTUCKY COURT OF APPEALS.

Stratton v. Northeast Coal Company.

Decided April 23, 1915. Appeal from Floyd Circuit Court.

Master and Servant. The mere fact that a servant receives an injury while engaged in the service of the master, does not make the master responsible for the damages. It is a well settled principle,