


# A PAYROLL TAX FOR TENNESSEE CITIES?

by

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As indicated in the attached reprint of the Technical Section from the Tennessee Town & City issue of December, 1950, the question of whether a city can levy a payroll tax is not new in Tennessee. The editor of the Technical Section in that issue wrote, "In recent months officials of several Tennessee cities have asked MTAS for information concerning the 'payroll tax.'"

THE LEGAL ASPECTS

The question of whether a city can levy such a tax is primarily a legal question. Various attorneys have given opinions, some written and some informal, and generally they have treated such a levy as an income tax. This is a crucial point because, if the Tennessee Supreme Court should so regard the tax, it undoubtedly would be invalidated, especially in view of the provision in constitutional amendment no. 7, adopted in 1953, that "the General Assembly shall not authorize any municipality to tax incomes. . . ."

As stated by the author[1] in the attached article, "the law clearly recognizes two distinct types of taxes--one imposed on income and the other a license or excise tax imposed on the privilege of doing business and measured by income." In the case that challenged Louisville's payroll tax[2] the Kentucky Court of Appeals noted, "The validity of the ordinance is principally questioned upon the ground that it imposes an income tax in fact, although it designates the tax as a license fee." That court disposed of this attack by holding that "the tax is not an income tax and that its imposition is within the powers of the city of Louisville." Partial excerpts from its opinion

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[1] James W. Martin is an outstanding authority on taxation. He was director of the Bureau of Business Research, University of Kentucky, for more than 30 years before his retirement a few years ago. He has been president of the National Tax Association, commissioner of revenue of the Kentucky Department of Revenue, consultant and advisor to national, state and local governments, and director of numerous studies on various aspects of taxation.

[2] City of Louisville v. Sebree, 308 Ky. 420, 214 S.W. 2d 248 (1948).

indicate the basis of this holding:

> Confusion in the case may arise from placing so much emphasis on the measure of the tax as to subordinate or lose sight of its true character. The ordinance calls for "license fees for the privilege of engaging in Louisville in occupations, trades, professions, business and other activities." The privilege is to be "measured by the amount of salaries, wages, commissions, net profits and other compensation earned."
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> . . . Such a "license fee" may be imposed either under the police power for the purpose of regulation or the taxing power for the purpose of revenue or both. . . . It is apparent that the present ordinance was enacted as a revenue measure. Since the levy is primarily for revenue, to speak with technical accuracy, the tax imposed is an "occupation tax." . . .
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> It is true the scheme of taxation embodies features characteristic of the familiar income taxes. . . . Lending weight to the taxpayers' argument that it is an income tax is the fact that the ordinance is closely patterned after an ordinance of the City of Philadelphia, which was intended to be and sustained by the courts as an income tax, that city having the power to impose it. . . .
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> This Louisville ordinance lays the tax upon the privilege of working and conducting a business within the city, and only measures the value of the privilege by the amount of earnings or net profits. It is contended that this is but a subterfuge to avoid the absence of power and that, looking beyond the matter of form to the matter of substance, it is but an income tax. The definition or classification may be a matter of approach or point of view. Sometimes one may not see the woods for the nearby trees. The psychological impact loses force when emphasis is placed on what is made subject to taxation rather than on the measure of the tax and the basis of computation. . . . It is laid down in 27 Am. Jur., Income Taxes, Sec. 7:
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> > "General income tax laws usually apply to net income rather than to gross income, and various exemptions and deductions are allowed from gross receipts in computing the amount of income upon which the tax must be paid. Although various types of taxes may be measured by gross receipts, or gross income, such taxes are usually not income taxes. . . Thus, franchise or privilege taxes on corporations are not income taxes, although measured by gross receipts or gross income. Likewise, occupation taxes or privilege taxes on those engaged in specified businesses, although measured by gross receipts, are not income taxes."

The Louisville ordinance was founded on a statute which empowered "cities

of all classes . . . to levy and collect any and all taxes provided for in Section 181 of the Constitution of the Commonwealth of Kentucky." That constitutional section empowered the state legislature to "delegate the power to . . . cities . . . to impose and collect license fees on . . . franchises, trades, occupations and professions." Noting that the Louisville ordinance "embraces all 'trades, occupations and professions,'" the Kentucky Court of Appeals cited an earlier case in which this statement appeared: "The authority to tax under this section is as far-reaching and as sweeping as language could make it. It would be difficult to find three words that cover wider fields of employment."[3]

Constitutional amendment no. 7, adopted by the voters of Tennessee in 1953, also banned legislative authorization for any municipality "to impose any other tax not authorized by Sections 28 or 29 of Article II of this Constitution." Section 28 contains this provision: "the Legislature shall have power to tax Merchants, Peddlers, and privileges, in such manner as they may from time to time direct." The following quotations show how the Tennessee Supreme Court has construed this language:

> A privilege is whatever the Legislature chooses to declare to be a privilege and to tax as such. Kurth v. State, 86 Tenn. 134, 5 S.W. 593 (1887).
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> We take it the word privilege was intended to designate a larger, perhaps an indefinite class of objects . . . occupation, . . . avocation, calling, or pursuit, all of which may be declared and have been so held privileges under our constitution. Phillips v. Lewis, 3 Shan. Cas. 230 (1877).
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> At the least, any occupation, business, employment, or the like affecting the public, may be classed and taxed as a privilege. Railroad v. Harris, 99 Tenn. 683, 43 S.W. 115, 53 L.R.A. 921 (1897).

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[3]Hager v. Walker, 128 Ky. 1, 107 S.W. 254, 32 Ky. Law Rep. 748, 15 L.R.A., N.S. 195, 129 Am. St. Rep. 238.

> The Legislature has unlimited and unrestricted power to tax privileges, and this power may be exercised in any manner or mode in its discretion. Wilson v. State, 143 Tenn. 55, 224 S.W. 168 (1919).
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> In fact it has been said in two of our cases that, if thought proper, the Legislature might make the business of farming a privilege. . . . The term "privilege" embraces any and all occupations that the Legislature may in its discretion choose to declare a privilege and tax as such. Seven Springs Water Co. V. Kennedy, 156 Tenn. 1, 299 S.W. 792, 56 A.L.R. 496 (1927).
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> The power to tax privileges is not subject to any constitutional limitation except that the tax levied must not be arbitrary, capricious or wholly unreasonable. Hooten v. Carson, 186 Tenn. 282, 209 S.W. 2d 273 (1948).
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> Taxation of the privilege is upon the occupation or activity carried on amid the social, economic, and industrial environment, under protection of the state. Bank of Commerce & Trust Co. v. Senter, 149 Tenn. 569, 260 S.W. 144 (1923).

A prominent constitutional lawyer in 1965 was asked to advise the Nashville-Davidson County Metropolitan Government Council whether such a payroll tax would be legal. He gave them a negative opinion, primarily based on an assumption that such a tax would be treated as an income tax, with supporting cases. As indicated earlier, we must agree on this point. However, on the crucial point of what can be declared to be a taxable privilege, he simply made this unsupported assertion: "The right to earn a living and to be paid salaries or wages for employment is obviously a basic one and not a privilege." The Kentucky court, in the Sebree case, considered this precise point:

> The assertion that the Kentucky Constitution never contemplated that the common laborer would be subjected to a license tax must be rejected, as must also the argument that in order to be effectual a license must grant a privilege or give authority to do that which if done without a license would be illegal. The power to impose a license fee on trades, occupations or professions, which is authorized to be delegated, is without any language restricting or qualifying its exercise except that it be by general law. . . .
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> It is further urged that the right to earn a livelihood is an inalienable right guaranteed by the Bill of Rights of the Constitution. . . . That this is true may be conceded by all. However, the Bill of Rights does not operate to relieve

> from taxation as against an express grant of power such as is found in Section 181. At most it only affects the amount of the tax by prohibiting an unreasonable or arbitrary exaction. . . .
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> Thus, the power to impose license fees on trades, occupations and professions, which is delegated to cities of the first class by these sections, extends to all but the excepted activities stated in KRS 91.200, and as to all remaining activities is as comprehensive as the power expressly granted by Section 181. In accordance with the conclusion reached as to the scope of Section 181, it necessarily follows that the General Assembly has delegated to cities of the first class the power to require license fees of persons made subject thereto by this ordinance.
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> To this we may add the observation that the tax is not on the right to work or do the things but the doing of them in fact . . . , and that the legislative body of a municipality is free to exercise in its discretion the powers to be found within a grant or delegation of the state legislature when not offending a provision of the Constitution. . . . There is no inherent vice in the taxation of vocations, and business is as legitimate a subject of taxation as property.

In the light of the foregoing Tennessee cases and the treatment of this point by the Kentucky court, there is room for doubt that a payroll tax would be ruled out by the Tennessee Supreme Court simply because "the right to earn a living and to be paid salaries or wages for employment is obviously a basic one and not a privilege."

The effect of the provision in constitutional amendment no. 7, adopted in 1953, is to reaffirm that the General Assembly may delegate to municipalities the power "to impose any tax authorized by Sections 28 or 29 of Article II of the Tennessee Constitution." In view of the reference to taxation of privileges in section 28, and the construction of this provision by the Tennessee Supreme Court, it is within the realm of possibility, or even probability, that this court would reach the same conclusion reached by the Kentucky court in the Sebree case.

All persons interested in this matter would surely agree that the question can be laid to rest by only one route: actual imposition of the tax by

a Tennessee city, and a test case in the courts. Before a city could enact an ordinance to levy the tax, enabling legislation must be enacted by the General Assembly; such an act should not merely delegate power to levy the tax but should also declare what privileges shall be subject to the tax.[4] To accomplish such a delegation of power for cities that have elected home rule status, a general act would be required, as the Tennessee Constitution provides that "the power of taxation of such municipality shall not be enlarged or increased except by General act of the General Assembly." Attached is a draft of such a bill which treats all home rule municipalities as a class. This would appear to be a reasonable classification, and there should be little doubt that such an act would be sustained as a general act. An alternative would be a general act applicable to all cities of Tennessee, but this would most likely encounter more opposition than one applicable only to home rule municipalities.[5]

SOME POLITICAL CONSIDERATIONS

A payroll tax sometimes is approved by the voters of a city because it reaches many commuters who typically come into a city to work--so-called "daylight citizens" who add to the burden of the city government's work but contribute very little in taxes to the city. The tax has been adopted and retained by popular vote in some Ohio and Pennsylvania cities. Imposition of the tax by an Ohio city even brought about annexation because the people

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[4]In Trading Stamp Co. v. Memphis, 101 Tenn. 180, 147 S.W. 136 (1898), the Tennessee Supreme Court held that "the Legislature alone can create a privilege and authorize its taxation, and . . . a municipal corporation cannot make any occupation a privilege, nor impose a tax upon it, unless it has first been so declared by the Legislature."

[5]Presently 12 cities have home rule status: Clinton, East Ridge, Etowah, Johnson City, Knoxville, Lenoir City, Memphis, Oak Ridge, Red Bank, Sevierville, Sweetwater and Whitwell.

in a suburban area realized that they were paying taxes to the city government and receiving little in return.

Mayor Charles Farnsley sponsored a 1 per cent payroll tax in Louisville soon after being elected to fill out an unexpired term of about two years. He widely advertised that the proceeds of the tax were being used to pave a mile of streets per day, by "half-soling" the middle, traveled half of the streets (parking areas were resurfaced later). The fact that motorists found themselves driving on smooth streets probably was a significant factor in his re-election for a full term by an even larger margin than in his first race for the office.

As mentioned in the attached article, a payroll tax on individuals cannot be passed on, and, as compared with a business or property tax, is less likely to discourage the location of industries and business establishments within a city.

In Tennessee political evaluation of the tax should take into account the allergy that residents of this state, or at least large numbers of them, seem to have to income taxes. Perhaps a good educational program could provide sufficient support to overcome the opposition generally registered against such taxes. Such an effort, at the least, would require a well-organized, factual, and honestly presented information program to thoroughly inform the people as to why a city government needs the proceeds of the tax, and to justify the tax as a source of revenue preferable to other possible sources, or, if this be factual, as an urgently needed source of revenue to supplement existing sources which are being used to the fullest extent possible.

The question of which Tennessee city should be the "guinea pig" to bring about a test case may appropriately be treated as a political consideration. In addition to the legal arguments that can be made in support of a payroll

tax, it would also seem to be highly desirable to establish, to a court's complete satisfaction, that the tax is urgently needed to finance public services. Such justification might be better established for a city like Memphis, where the conditions and problems characteristic of the "inner core" of our large cities exist in much greater number and magnitude than in a city such as Oak Ridge.

Judges are sometimes persuaded by practical considerations, especially if a case can go either way as a matter of law. In a case from Oak Ridge, for example, it might be brought out that the AEC is committed to subsidize the city government to an indeterminate amount, depending generally upon the extent to which local sources of revenue are being utilized. A court might conclude that no great damage would be done by invalidating the tax, since it would simply bar this one source and AEC would still be committed to the subsidy arrangement to make up deficiencies in revenues. The test case would be critical, because the future of the tax in Tennessee would rest on the outcome.

SOME ADMINISTRATIVE CONSIDERATIONS

Withholding by employers would be essential for administration of a payroll tax. This is provided for in the attached bill draft. In addition, administrative measures would have to be taken to insure that self-employed persons pay the tax if it is applicable to them (in Paducah, Kentucky, where already a business license tax was being paid by self-employed persons, the payroll tax was made to apply to "all persons employed by others"). Further study would be needed to determine whether an ordinance should cover both employed individuals and businesses, as is the case in Louisville (individuals pay a percentage of gross salaries and wages, and businesses pay a percentage of net profits).

Kentucky cities derive a substantial benefit in administration by having access to the state's income tax returns (the state in turn checks their returns against federal returns). Tennessee cities would be more on their own, but administration should pose no serious problems, and the cost should be a very small percentage of the proceeds. The State of Tennessee has an agreement with the Federal Internal Revenue Service to exchange tax information, under which only personnel of the State Department of Revenue may examine federal income tax returns. Federal law also provides that the Governor may make a written request that state personnel be permitted to make such examinations to assist in the administration of local taxes. If a city levies a payroll tax such assistance would depend upon whether arrangements could be made to have state personnel do the work on behalf of the city.

AN ACT to empower any home rule municipality to levy taxes on the taxable privileges of engaging in any trade, occupation or profession or being employed within the municipality

WHEREAS, cities that have elected to be home rule municipalities cannot enlarge their taxing powers by charter amendments and the General Assembly cannot enact private acts for such municipalities, and consequently the only means of enlarging their taxing powers is by general acts; and

WHEREAS, the General Assembly desires to delegate additional taxing powers to such home rule municipalities as a class; therefore,

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE:

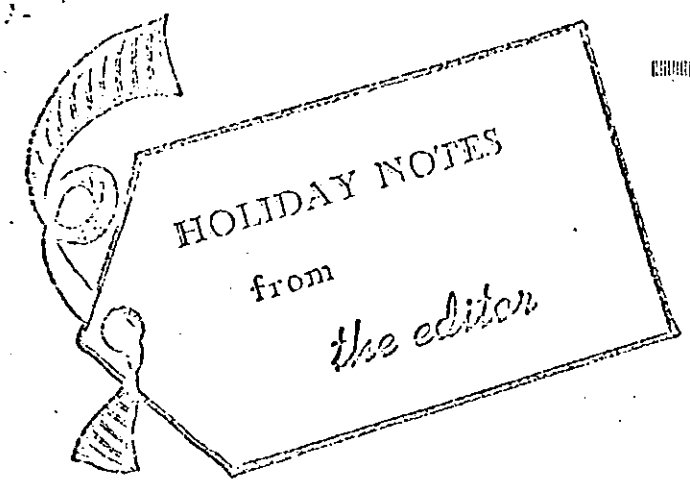
Section 1. Any city that has elected to be a home rule municipality under Article XI, section 9, of the Tennessee Constitution, is hereby empowered by ordinance to levy a tax on individuals for the privilege of engaging in any trade, occupation or profession or being employed within the city, which are hereby declared to be taxable privileges, and to require employers to withhold and remit such taxes due from their employees. The measure of such a tax shall be the gross income earned by individuals from such taxable privileges within the city, not to exceed one per cent (1%) of their gross income; "gross income" shall mean the same as defined for purposes of the Federal income tax.

Section 2. Individuals subject to privilege taxes under any ordinance adopted pursuant to the provisions of this act shall be exempt from any taxes levied under chapter 42, Title 67, Tennessee Code Annotated, on the same privileges.

Section 3. The provisions of this act are declared to be severable. If any portion hereof, or its application to particular persons or circumstances, shall be held to be invalid, the remainder of the act or its application to other persons and circumstances shall not be affected, it being the legislative intent to enact these provisions severally.

Section 4. This act shall be effective from and after its passage, the public welfare requiring it.

9/17/69




At this season of the year, it is appropriate that we here at MTAS pause long enough to wish each of you a Very Merry Christmas and a Happy and Prosperous New Year.

To this traditional greeting should be added a note of appreciation to every city official and employee—Congratulations on a job well done throughout the year just ending, and best wishes for a new year of progress and achievements.

## the payroll tax

In recent months officials of several Tennessee cities have asked MTAS for information concerning the "payroll tax." In the foreseeable future pressure for new sources of revenue is expected to mount rapidly. Inflation with attendant rising costs for all services and goods, continuing citizen demand for improved and expanded services, and new municipal obligations for civil defense and stream sanitation are forces to be reckoned with in the financial picture of the days and months ahead. In this environment Louisville's experience with the payroll tax becomes meaningful, and it is with great pleasure that we present in the Technical Section this month the timely article by Mr. James W. Martin of the University of Kentucky.

## new city charters

Several years ago an examination of the Uniform City Manager and Commission Law (Chapter 173 of the Public Acts of Tennessee, 1921) revealed that it was defective in certain respects. Subsequently a revision was undertaken by Dr. Greene and the writer, in cooperation with Mr. Bingham of the Tennessee Municipal League. When Mr. Victor C. Hobday joined MTAS, the completion of this revision was assigned to him. Before he left, Mr. Hobday finished a draft of a new proposed Council Manager Act, and MTAS is now in the process of final editing preparatory to its publication.

As a by-product of this effort, a condensed version of the city manager charter was prepared for use as a standardized draft by Tennessee city officials. From this draft it was a comparatively easy matter to prepare a companion charter to provide for the strong-mayor plan. These two charters are not intended to serve as finished documents, but rather to be used as a draft from which a final charter might be prepared to include revisions, where necessary or desirable, to meet particular local conditions.

General distribution of these two charter drafts is not contemplated, but copies are available to Tennessee city officials upon request. If you would like to have one or both of these charter drafts, a letter or postcard addressed to this office will bring these materials to you by return mail.

## on attending conventions

Your MTAS consultants have taken "time out" to attend a few conventions during the past several months. For example, Mr. Snoderly, our Engineering-Public Works Consultant has been to the Public Works Association Conference and the Southern Building Code Congress. Mr. Greenwood, MTAS Legal Consultant, attended the American Bar Association Convention and the Annual Conference of the National Institute of Municipal Law Officers.

These are in no sense "pleasure junkets," but represent hard work and a determined effort on our part to keep abreast of latest developments in these specialized fields in cities all over the country. When your requests are received, MTAS must be in position to give you the best and latest technical information available. Conferences attended by professional people and city officials provide a valuable and practicable means of obtaining this kind of information so that it can be passed on to you.

*Knoxville, December, 1950* *G. W. S.*

# Payroll Tax: The Louisville Experience

○ JAMES W. MARTIN, Director, Bureau of Business Research, University of Kentucky

As is the case in Tennessee, the constitution of Kentucky appears to preclude the imposition of a city income tax. For many years most city officials assumed that, therefore, no Kentucky city tax measured in any way by personal income would be constitutional.

Because this error prevailed so widely in Kentucky and possibly exists among Tennessee city officials, civic leaders in the state may find the story of Louisville's experience distinctly revealing. To tell that story in simple but technically accurate language is the purpose of this paper.

## ORIGIN OF THE LOUISVILLE PAYROLL TAX PLAN

When shortly after the close of World War II Mayor Charles Farnsley became chief executive, it was apparent to everybody concerned that Louisville, like most other cities of 300,000 to 500,000 population, was failing to render the quantity and quality of public services popularly demanded because revenues had not kept up with increases in costs. Additional revenues, therefore, were urgently needed.

Alongside this necessity, the Mayor came to office with an economic philosophy which his colleagues on the Board of Aldermen accepted as sound. In brief, the Mayor took the position that business taxes and some applications of property taxes tend to interfere with economic development whereas taxes imposed on individuals as such cannot readily be passed on to somebody else and will not lead the taxpayer to discontinue his economic activities. For example, a doctor will not discontinue medical practice in an established city location merely because the jurisdiction imposes a tax not in effect outside the municipality. This consideration is doubly true of an employed person, such as a bookkeeper in the office of the same physician. Of course, Mayor Farnsley would accept some modifications of this generalization if the tax rate were unreasonable.

Mayor Farnsley had observed the operation of city income taxes in such cities as Philadelphia and Toledo and provisionally concluded that a kindred tax measure in Louisville would hinder the long-run economy of the city less than would an increase in property taxation. Moreover, the latter was impracticable (because of constitutional rate limits) except through the painful means of raising assessments. Consequently the Mayor began consulting with counsel regarding the feasibility of a Louisville payroll tax and perhaps a business tax measured by income rather than by gross receipts as under the already existing practice. The question of constitutionality halted the discussion when he consulted legal counsel.

Shortly afterward the Mayor submitted to the University of Kentucky Bureau of Business Research the basic question of whether Louisville could constitutionally impose a payroll tax and, if so, whether the state legislature would have to pass enabling legislation in order to legalize such a tax. In submitting the question, the Mayor explained that, though he had consulted legal counsel, he had not asked the city's Department of Law for a formal opinion.

After a few weeks, the Bureau developed an answer which formed the basis for further unfolding of the Louisville plans and which, therefore, requires discussion.[1]

In business taxation, the memorandum showed that the law clearly recognizes two distinct types of taxes —one imposed *on income* and the other a license or excise tax imposed *on the privilege of doing business* and measured by income. In developing this theory, the memorandum cited historical and legal precedent to indicate the law.[2]

The memorandum went on to explain that the cases make it clear that a tax on an occupation is to be distinguished from a tax on the conduct of business. The state legislation had long authorized "licensing any business, trade, occupation or profession." That is, the charter of Louisville differentiated between the conduct of business or trade and the engaging in an occupation. Moreover, it appeared to be clear under the law that, if the same

[1] James W. Martin and Glenn D. Morrow, *A Louisville Tax Measured by Earned Income*, an unpublished manuscript submitted to the City of Louisville. See also James W. Martin and Glenn D. Morrow, "May Kentucky Cities Legally Impose Taxes Measured by Pay Roll?" *The Kentucky City*, XII, No. 3 (August, 1946), 8-11. The published paper was derived from the Louisville memorandum by generalizing the content to make the analysis applicable to all classes of municipalities and not merely to cities of the first class, of which Louisville is the only one.

[2] Although irrelevant to the present discussion, Mayor Farnsley had also submitted the question as to whether the city could measure its tax on business establishments by income rather than by gross receipts. The conclusion stated in the text not only answered this second question directly but laid the groundwork for answering the principal question with which this paper is concerned.

person conducted a business and also engaged in an occupation, he could legally be licensed in both capacities. For example, a businessman might establish a shoe repair shop and operate it. If he did so, he would be conducting a business. He might or might not himself do shoe repair work. If he did so, he would be engaged in the occupation of shoe repairman as well as conducting the business of repairing shoes. In that case he could be taxed both for conducting a business and for engaging in an occupation.

The memorandum pointed out, moreover, that the grant of authority to cities was general in character and that the supreme court of the state had so held. Thus, according to the decisions, any or all occupations could be taxed. In the light of this situation, the memorandum suggested that a payroll tax imposed expressly on the conduct of any occupation within the Louisville corporate boundaries should be sustained by the courts notwithstanding the fact that certain businesses or all businesses might be taxed as such.

The Bureau memorandum also offered certain tests which, from evidence contained in the opinions, would make the courts more certain to sustain a license tax measured by the gross income which each individual derived from engaging in an occupation. Among other things, the memorandum suggested that, in the interest of legality, "it would perhaps be well for any Kentucky city attempting to impose a payroll tax (a) to exercise care in drawing up the ordinance to make it positively clear that the tax was being measured by gross payroll receipts, (b) to exempt no income whatsoever, and (c) to make the rates proportional" to the receipts from the conduct of the taxpayer's occupation.

### ENACTMENT OF THE PAYROLL TAX ORDINANCE

In the light of the memorandum, the Mayor asked advice from the city's Department of Law, which acquiesced in the legal conclusions reached by the Bureau of Business Research.[3] The Mayor then consulted the Board of Aldermen, which agreed tentatively to imposing a payroll tax equal to 1 per cent of each employed person's receipts from carrying on his occupation. The Director of the Bureau of Business Research was invited to serve as consultant and to assist the city law department in preparing a bill for enactment as an ordinance.

The Department of Law and the Bureau of Business Research at the University of Kentucky, with the assistance of Professor Paul Oberst of the University of Kentucky Law College, undertook to carry out the Mayor's instructions. The first problem, of course, was to secure a technically correct draft. The bill was drawn and the material submitted to the Mayor and the Board of Aldermen. After review by the Mayor and the finance committee of the board, several questions as to policy arose. One proposition was that, if each person engaged in an occupation in Louisville were permitted an initial exemption, even though that arrangement necessitated higher rates, the payroll tax would be more acceptable. Another was that domestic servants working in private homes should not be subject to the tax. These and other suggestions involving departure from the plan commended as constitutional were canvassed in detail by the Department of Law and the Bureau of Business Research advised by Professor Oberst. In the series of conferences it became apparent that each departure from the uniform and indiscriminate application of the tax to all persons engaged in an occupation in the city added to the risk of having the ordinance declared unconstitutional. It seemed probable, for example, that an exemption of part of each person's income would be more hazardous in this respect than omitting certain occupations. Indeed, it was concluded that, if the city could select individual occupations and tax them without taxing others, as the cases definitely held, it could, according to the same theory, impose a tax on all save selected occupations if the excepted occupations were reasonably and clearly distinguished from all others. If a legislative body classifies certain persons to be taxed and others to be exempt, the line between the taxed and the untaxed must be based on a substantial difference.

When enacted, the Louisville ordinance had resolved all questions, except the one respecting the exemption of domestic servants in private homes, in favor of doing everything possible to make the payroll tax legal. A flat, 1 per cent rate applied to all gross receipts from the conduct of any occupation within Louisville with the single exception of domestic servants.[4]

There are basic distinctions between the Louisville ordinance and the income tax plans of Philadelphia, Toledo, and other cities. Under the legal theory of income taxation, income may be taxed where it is earned notwithstanding the fact that the income recipient resides elsewhere. Also, income may be taxed at the home of the recipient notwithstanding the fact that his business is carried on in some other place. The income tax ordinance, therefore, frequently requires the payroll tax of everybody employed in the city and like payments of everybody living in the city who is employed outside the municipal corporate limits. The Louisville ordinance imposes the license tax on the conduct of an occupation *solely within the city* of Louisville. The city may be without authority to license occupations outside its limits. Thus, a person may live within the corporate limits of Louis-

[3] It is appropriate, as was done in the paper itself when published, to recognize the contributions made by Professor Paul Oberst and Dean A. E. Evans of the University of Kentucky College of Law.

[4] Later, the ordinance was amended to exempt also certain occupations incident to the operation of churches and charities.

ville without being subject to the tax if his occupation is conducted wholly outside of the city.

### OPERATION OF THE LOUISVILLE PAYROLL TAX

Shortly after its enactment, the Louisville payroll tax was subjected to attack in the state courts. As defined by Judge Stanley, who wrote the supreme court opinion,[5] the principal question hinged on the allegation that the ordinance "imposes an income tax in fact, although it designates the tax as a license fee." On this point the state supreme court held that the tax was, in fact as well as in form, a license tax and that the city did not seek illegally to impose an income tax. The court expressly reserved the question of whether a municipality could or could not impose a tax on incomes. In this respect the supreme court adopted outright the opinion of Trial Judge Amos Eblen.

In sustaining the tax *generally,* Judge Eblen had held invalid the clause which provided for the exemption of domestic servants. The supreme court sustained the act in its entirety, thereby approving the lower court's general findings but overruling its disapproval of the exemption. Thus, the legality of the Louisville payroll tax ordinance was established at an early date by the highest court in the state.

One other attack on the payroll tax ordinance has been tried out in the courts.[6] In this case it was alleged, on the grounds originally developed in the federal case of *McCulloch* vs. *State of Maryland*[7] and further extended in subsequent cases, that the ordinance could not apply to officials and employees of the United States government. Kentucky's highest court, citing recent decisions by the United States Supreme Court,[8] held in effect that the immunity of the United States from state and local taxation does not extend to salaries paid by the federal government. It was determined, therefore, that the occupational license was to be applied to persons working for the United States government to the same extent as to other persons even though the city might find it necessary to provide special administrative machinery to collect the tax from these persons. No city, of course, can require the government of the United States to collect and pay the tax in the same way that it can require a private employer to do so.

A second development incident to the operation of the new payroll tax (and of a business tax enacted at the same time) as tied in with the entire revenue system was significant. About the same time the litigation above referred to was pending in the courts, the city provided a comprehensive survey of its revenue system. The Bureau of Business Research undertook this study, which was largely in the hands of James W. Martin, Director, Glenn D. Morrow, Research Associate, and Jack Shelton, Research Assistant, who prepared the Bureau's report on the Louisville revenue system.[9]

The report, although disclosing certain weaknesses, showed on the basis of generally accepted standards that the revenue system of Louisville was reasonably fair and effective in raising the revenue needed with the single exception that property taxes were poorly administered. The surveyors did not suggest any major changes in the revenue system but did express the view that, as circumstances permitted, assessment administration in the city ought to be improved[10] in keeping with the substantial betterment of property tax collection which City Finance Director Ed Dieruf had already brought about under the Mayor's supervision.

Finally, it should be noted that in the last two years the payroll tax has produced sufficient additional revenue to relieve the city's financial plight and has done so without any political upheaval. The contest for a full term as Mayor was waged largely on the wisdom of the payroll tax, and the voters re-elected Mayor Farnsley by a decisive vote.

The actual revenue produced by the payroll tax approximates $1 million each quarter, or $4 million annually. In a city the size of Louisville, this is a substantial element in the total budget, and the new money has enabled the city to make numerous improvements, including reconstruction of an extraordinary mileage of streets as well as betterment of many other public services. Indeed, the Mayor's friends referred to his street surfacing program as reconstruction of "a mile a day."

In the light of more than two years' operation, the Louisville ordinance, enacted in a state which is still presumed to forbid city income taxes, has proved eminently successful in hurdling legal difficulties and in producing sorely needed and really substantial revenue for the city. A careful study has indicated that, as far as the operation of this particular tax is concerned, there are no apparent gross inequalities. Mayor Farnsley's re-election in a controversy centered basically on the wisdom of the tax leads the observer to believe that Louisville residents recognize its operation as generally fair.

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[5] *City of Louisville et al. vs. Sebree et al.*, 308 Ky. 420, 214 S. W. (2d) 248.

In *Myers, City Director of Finance vs. City of Louisville*, 310 Ky. 348, 220 S. W. 2d) 852, question was raised as to whether the city could expend in one fiscal year amounts already withheld but not turned over to the city until after the close of the year. The court answered affirmatively on the ground that sums received by an agent are constructively received by the principal.

[6] *Cook et al. vs. Commissioners of Sinking Fund of City of Louisville et al.*, 312 Ky. 1 (Adv. Sheets), 226 S. W. (2d) 328.

[7] 4 Wheat. 316, 4 L. Ed. 579 (U. S. 1819).

[8] Including *Graves vs. New York ex rel. O'Keefe*, 306 U. S. 466, 59 S. Ct. 595, 83 L. Ed. 927 (1939), and *Helvering vs. Gerhardt*, 304 U. S. 405, 58 S. Ct. 969, 82 L. Ed. 1427 (1938).

[9] The report covering some 200 manuscript pages was not published as a whole. Later, James W. Martin and Madelyn Lockhart prepared a paper, "Operation of a Local Income Tax," for publication in the March, 1950 number of *Public Management*, pp. 54-57.

[10] At the present time, with the cooperation of Jefferson County and the commonwealth, far-reaching modernization of assessment administration is in progress.