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October 28, 1999

Opinion No. 99-217

Constitutionality of a General Personal Income Tax In Tennessee

QUESTION

Does the General Assembly have the power under the Tennessee Constitution to enact a general personal income tax?

OPINION

It is the opinion of this Office that, consistent with the language of Article II, Section 28 of the Tennessee Constitution and the original intent of its framers, the General Assembly may impose a general personal income tax in Tennessee. It may do this by taxing as privileges a broad range of occupations, investments, and activities that produce earnings, and by measuring the tax according to those earnings. Such a tax could also be upheld as a form of property tax, or as an exercise of the legislature's inherent and sovereign powers.

The court decisions that have struck down previous income tax legislation overlooked the historical record that establishes the meaning of the "stock and bonds" clause of Article II, Section 28, and drew implications from that clause that are unwarranted by the proceedings of the 1870 Constitutional Convention. Moreover, the acts considered in those court decisions were not clearly framed to exercise the legislature's unquestioned power to tax as a privilege any business, vocation, employment, or endeavor that produces income, and to measure the tax by a portion of the earnings produced through the exercise of that privilege.

ANALYSIS

I.

INTRODUCTION

The authorities concerning the validity of a State income tax in Tennessee are conflicting and have left lawmakers and the public in confusion. On one hand, decisions going back to the foundation of the

State recognize the virtually unlimited discretion of the General Assembly in exercising its powers of taxation. *Mabry v. Tarver*, 20 Tenn. (1 Humph.) 98 (1839); *French v. Baker*, 36 Tenn. (4 Sneed) 193 (1856); *Jenkins v. Ewin*, 55 Tenn. (8 Heisk.) 456 (1872). On the other hand, two decisions have struck down particular versions of income taxes passed by the legislature. *Evans v. McCabe*, 164 Tenn. 672, 52 S.W.2d 159 (1932); *Jack Cole Co. v. MacFarland*, 206 Tenn. 694, 337 S.W.2d 453 (1960). The latter of these decisions, *Jack Cole*, goes so far as to state that "[r]ealizing and receiving income or earnings is not a privilege that can be taxed." 206 Tenn. at 698. Yet this would appear to conflict with the leading decision in *Bank of Commerce & Trust Co. v. Senter*, 149 Tenn. 569, 260 S.W. 144 (1924), which upheld the corporate excise tax, which is measured by the net earnings of corporations. And no Tennessee decision has delved very deeply into the proceedings and original intent of the delegates at the 1870 Constitutional Convention, which wrote the constitutional provisions on which this debate centers.

Scholarly commentary is similarly in conflict. Most articles that have surveyed the issue indicate that an income tax should be upheld. *See* W. Armstrong, "Constitutional Limitations on Income Taxes in Tennessee," 27 VAND. L. REV. 475 (1974); L. Donelson, "Tax Reform in Tennessee," 5 MEMP. ST. L. REV. 201-20 (1974); L. Laska, "A Legal and Constitutional History of Tennessee, 1772-1972, 6 MEMP. ST. L. REV. 646-53 (1976); T. Simpson, "The Tennessee Constitution and the Income Tax," 10-1 TENN. BAR J. 27 (Feb. 1974); R. Bolling & W. Carper, "The Constitutionality of a Personal Income Tax in Tennessee," 20-3 TENN. BAR J. 9 (May 1984). But the most thorough analysis of the issue, while viewing crucial anti-tax precedents as wrongly decided, concludes that a broad-based income tax is prohibited, upon a narrow reading of the legislature's power to define property and declare privileges. R. Cooper, "Re-examining the Constitutionality of an Income Tax in Tennessee," 28-1 TENN. BAR J. 14 (Jan.-Feb. 1992). *See also* Point/Counterpoint, "Is an Income Tax in Tennessee Constitutional?" 35-9 TENN. BAR J. 22 (Sept. 1999)(L. Donelson, "Yes"; N. Shoaf, "No"). Two opinions of this Office issued in the 1970's concluded on the strength of *Evans* and *Jack Cole* that a general income tax would be unconstitutional. Op. Tenn. Atty. Gen. to Rep. John Spence, Jr. (May 14, 1975); Op. Tenn. Atty. Gen. to Sen. Ray C. Albright (Oct. 27, 1977). Yet in 1981 General William M. Leech, Jr. revisited the issue more thoroughly and concluded that a general income tax would withstand a constitutional challenge. Op. Tenn. Atty. Gen. No. 81-497 (Sept. 2. 1981). His successors as Attorney General have agreed. Op. Tenn. Atty. Gen. No. 85-55 (Mar. 1, 1985)(Gen. Michael W. Cody); Op. Tenn. Atty. Gen. No. 93-48 (July 22, 1993)(Gen. Charles W. Burson). Credible commentators on both sides of the issue view the reasoning of the two court decisions[1] that have struck down previous income tax laws as less than persuasive, and certainly not conclusive.

Consequently, in light of the present public debate over an income tax, this Office has again been asked to review the issue. Because the court decisions are not entirely consistent on the matter and have not dwelt upon the origins of Article II, Section 28 of the Tennessee Constitution, this Office will examine

[1]A few other decisions have cited the results of *Evans* and *Jack Cole* in passing, without any analysis of the issue. *Gallagher v. Butler*, 214 Tenn. 129, 144, 378 S.W.2d 161, 167 (1964); *Sanborn v. McCanless*, 181 Tenn. 150, 178 S.W.2d 765 (1944).

the interpretation of that crucial section over the years, with a focus on the circumstances of its adoption and the original intent of its framers. Interpreting the Constitution in this way, as we believe the Supreme Court would do if confronted with the issue, it is the opinion of this Office that a properly drafted, broad-based personal income tax may be imposed by the legislature and would withstand constitutional challenge.

II.

THE BROAD POWER OF THE LEGISLATURE TO IMPOSE TAXES

A. Background of Tennessee's Constitutional Provisions Concerning Taxation.

Taxation is an essential element of sovereignty, and except as restrained by the Constitution, the General Assembly's power to tax is plenary. "There is no limitation upon the legislature as to the amount or objects of taxation, except that found in the restrictions and prohibitions of the Constitution." *Jenkins v. Ewin*, 55 Tenn. (8 Heisk.) 456, at 477 (1872). Taxation has been a central issue throughout Tennessee's constitutional development. The original Constitution of 1796 mentioned only property taxes, and required all land to be taxed equally, without regard to its value. TENN. CONST., Article I, §26 (1796). As the State's population grew and certain lands proved far more valuable than others, dissatisfaction with this requirement of uniform land taxation was a chief cause for calling the 1834 Constitutional Convention. The Constitution that emerged from that Convention gave the legislature some discretion in property taxation, but required all taxable property to be assessed according to its value. As an exception to this rule, the Constitution of 1835 added,

> But the Legislature shall have power to tax merchants, pedlars, and privileges, in such manner as they may from time to time, direct.

TENN. CONST., Art. II, §28 (1835).

In the wake of the War Between the States, the 1870 Constitutional Convention made some changes in the taxation section. Continuing the traditional focus on property taxation, it removed some of the legislature's discretion by requiring ***all*** property to be taxed according to its value. The revised Article II, §28 declared,

> All property shall be taxed according to its value, that value to be ascertained in such manner as the Legislature shall direct, so that taxes shall be equal and uniform throughout the State. No one species of property from which a tax may be collected shall be taxed higher than any other species of property of the same value.
>
> But the Legislature shall have power to tax Merchants, Peddlers, and privileges, in such manner as they may from time to time direct.

Thus the language concerning privilege taxation was unchanged from the 1835 Constitution. In addition, however, the 1870 Convention inserted the following sentence into Article II, §28: "The Legislature shall have the power to levy a tax upon incomes derived from stocks and bonds that are not taxed *ad valorem*." The proper interpretation of this sentence became the focus of litigation nearly sixty years after its adoption, and is important in resolving the question now presented to this Office.

After the middle of the Twentieth Century, controversy arose over the requirement that all property be taxed according to its value and at the same rate. As a result, a Constitutional Convention was convened in 1971, which proposed an amendment that was ratified by the people and became effective in 1973. That amendment established classifications of property and allowed taxation of those classifications at different rates. The courts have also determined that the 1973 amendment removed the mandate that all property be taxed, and instead made all property "subject to taxation," thereby vesting greater discretion in the General Assembly. *Sherwood Company v. Clary*, 734 S.W.2d 318 (Tenn. 1987). The 1973 rewrite of Article II, §28 maintained the "merchants, peddlers, and privileges" clause, merely removing the initial word "But" as a matter of syntax, since the preceding language as rewritten no longer required all property to be taxed at its full value. The "stocks and bond" clause remained exactly as written in 1870.

Thus the validity of a general State income tax must be determined under the modern wording of Article II, §28, as last amended in 1973.[2] But the crucial wording of this section derives from the original Constitutions of 1835 and 1870, and must be viewed in light of the origins and history of those predecessor provisions.

B. <u>The Historical Understanding of Privilege Taxation</u>.

The original understanding of privilege taxation accorded the legislature virtually unlimited power to define a pursuit as a privilege and tax it as such. As the Supreme Court observed under the 1835 Constitution in *French v. Baker*, 36 Tenn. (4 Sneed) 193 (1856), at 195,

> The first Legislature after the formation of the Constitution acted upon the idea that any occupation which was not open to every citizen, but could only be exercised by a license from some constituted authority, was a privilege. And it is presumed this is a correct definition in this application of the term.

See Mayor v. Guest, 40 Tenn. (3 Head) 414 (1859); *Robertson & Heneger*, 37 Tenn. (5 Sneed) 256 (1857). As early as 1839 the Supreme Court recognized that the legislature had "unlimited power to prohibit particular pursuits and avocations in themselves indifferent or useful, and then to license them on

[2]Article II, §28 was also amended in 1982 to give the legislature broader discretion in providing property tax relief to elderly low-income taxpayers. This amendment is not relevant to the instant question.

specified terms, and tax the privilege . . . ." *Mabry v. Tarver*, 20 Tenn. (1 Humph.) 98 (1839). It noted that even the fundamental pursuit of farming could be made a subject of taxation. *Id*.

Soon after the legislature's power to tax merchants, peddlers, and privileges was reaffirmed in the 1870 Constitution, the Supreme Court discussed the scope of that power. In *Jenkins v. Ewin*, 55 Tenn. (8 Heisk.) 456 (1872), the Court recognized that the clause concerning that power was included in the Constitution to "indicate with distinctness, that the power to tax merchants, peddlers, and privileges, was not to be understood as inhibited by the restriction as to the taxation of property." 55 Tenn. (8 Heisk.) at 478. The Court emphasized that

> the power of the Legislature to tax merchants, peddlars, and privileges, was unlimited and unrestricted, and might be exercised in any manner and mode in their discretion.

Id. at 479.

Over the years, the General Assembly identified and taxed a myriad of activities as privileges. The courts almost without exception sanctioned the legislature's ability to reach and tax those privileges. In *Railroad v. Harris*, 99 Tenn. 684, 702, 43 S.W. 115 (1897), the Supreme Court declared, "At the least, any occupation, business, employment, or the like affecting the public, may be classed and taxed as a privilege." In the interesting decision in *Phillips v. Lewis*, 3 Shannon's Cases 230 (Tenn. 1877), the Court held that the mere ownership of property could not be taxed as a privilege, since that property is taxable ad valorem. Thus the legislature could not tax the mere ownership of a dog as a privilege. *See also Ellis v. L. & N. Railroad Co*., 67 Tenn. (8 Bax.) 530 (1876)(railroad could not be authorized to pay privilege tax in lieu of property tax). But the Court recognized the broad legislative power to tax occupations, businesses, and avocations. And while it observed that privileges historically had been associated with activities requiring licensure and not open to anyone without a license, the *Phillips* Court concluded even at that early date that

> an actual license issued to the party is not an essential feature of a privilege, but is only the evidence of the grant of the right to follow the "occupation or pursuit," and the usual and perhaps universal incident to such grant, or that a tax receipt is, or even may be the evidence of the grant. Still, the thing declared to be a privilege is the occupation, the license but the incident to its engagement, prescribed by statute, assuming, however, the license in one form or the other is to be had.

3 Shannon's Cases at 243. Thus under this approach the license could be acquired simply by paying the tax imposed on a privilege identified by the legislature.

Under this authority, privilege taxes were a substantial source of State revenues. The list of vocations, occupations, businesses, and activities taxed as privileges pursuant to Chapter No. 101 of the 1915 Acts, was almost endless, and included 113 different categories, many of which covered multiple endeavors.[3] This list, of course, does not include privileges identified elsewhere in the Code, and through private acts.

The legislature met the licensure requirement for these occupations and activities by requiring those exercising them to pay taxes to the county court clerk, Shannon's Code §§692, 712

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[3]This list, as set out in Shannon's Code §712 (1917), encompassed:

abstract companies
advertising companies
architects and engineers
artists and photographers
athletic clubs
auctioneers
automobile garages and dealers
automobile renters
baseball leagues
bath houses
bicycle dealers
billposters
bottlers
breweries
brokers
butchers
wholesale meat dealers
cash registers and adding machines
check rooms
cigar stands
circuses and menageries
cleaners
coal and coke dealers
coal oil dealers
cobblers
collecting agencies
commercial protective agencies
construction companies
cotton buyers and factors
cotton compresses
cottonseed oil mills
dance halls
dealers in novelties
dealers in soft drinks
dealers in theater tickets
detective agencies
directories
distillers of whiskey
distillers of brandy
dog and pony shows
electric companies
feather renovators
fee buyers
ferries
film dealers
florists
flying jennies
fortune tellers and clairvoyants
fruit stands
futures dealers
games
gas companies
hat cleaners
hotels and taverns
hucksters
ice dealers
intelligence offices and employment agencies
itinerants
junk dealers
kodak and photographic suppliers
laundries
lighting companies
lightening rod dealers
liquor dealers
litigation
livery and feed stables
lunch stands
machines (slot machines)
manufacturers of patent medicine
marble dealers
marriage licenses
messenger services
moving picture shows
parcel cars
park operators
pawnbrokers
peddlers
picnic promoters
playing card dealers
plumbers and gas fitters
railway inclines
ranges and clock dealers
real estate dealers
refrigerating cars
restaurants and cafes
sand and cement dealers
security dealers and loan agents
sewing machine companies and dealers
shoe shining parlors
skating rinks
soda fountain operators
stock yards
street car companies
swimming pool operators
theater operators
transfer businesses
transient merchants from railroad cars
turnpike operators
typewriters
undertakers
variety theaters
victrolas and pianos
warehouses
water companies
wild west shows
express companies
news companies
railroad companies
railroad terminal companies
sleeping car companies
telegraph companies
telephone companies
trading stamp companies and agents

(1917), and by declaring it a misdemeanor to engage in them without paying the prescribed taxes. Shannon's Code §723(a)(2) (1917).

At one point the Supreme Court held that a single act could not be taxed as a privilege, since a single act could not constitute a business, avocation, or pursuit. *Trentham v. Moore*, 111 Tenn. 346, 353, 76 S.W. 904 (1903). Nevertheless, in *State ex rel. Stewart v. Louisville & N. Railroad Co.*, 139 Tenn. 406, 201 S.W. 738 (1918), the Court upheld a tax on the transfer of realty, even if done as a single act. The Court concluded that the case law "did not restrict the definition of privilege to the exercise of an occupation or business which required a license from the State, but expanded it to include a single transaction which the legislature had made a privilege." 139 Tenn. at 413. This had been foreshadowed in *State v. Alston*, 94 Tenn. 673 (1895), in which the Court upheld the inheritance tax as a levy upon the privilege of receiving property by will, which ordinarily would be a single event. Shortly thereafter, the Court repeated its conclusion that "the doing of a single act may be declared a privilege" in *Ogilvie v. Hailey*, 141 Tenn. 392 at 397, 210 S.W. 645, 647 (1918).

Ogilvie is an important decision, in sanctioning a privilege tax on the use of automobiles for pleasure. The plaintiff in that case argued that the use of automobiles for pleasure is not a business or occupation, and thus cannot be declared a privilege. The Supreme Court with "no hesitation" rejected that contention, holding that "the legislative may declare it to be a privilege to operate pleasure cars over the turnpike roads of our counties." 141 Tenn. at 397.

C. <u>The Development of the Theory of Privilege Taxation to Sustain Broad-Based Taxes</u>.

At this juncture, the General Assembly began to exercise its power of privilege taxation to reach a broad range of commercial activities under the umbrella of one tax scheme, and began to impose not merely a flat rate for the exercise of a privilege, but a percentage rate based on the proceeds from a business or transaction. While this was firmly grounded in the doctrine of privilege taxation as it existed at the time, the new, broader-based taxes were a much more lucrative revenue source, and each was judicially challenged.

The Supreme Court generally upheld the new types of taxes without much difficulty. It first addressed them in the landmark decision in *Bank of Commerce & Trust Co. v. Senter*, 149 Tenn. 569, 260 S.W. 144 (1924), which considered the corporate excise tax adopted in 1923. This tax was imposed on all corporations doing business in Tennessee, at the rate of three percent of their net earnings. The Court relied on its many precedents to sanction the tax "as an excise upon the particular privilege of doing business in the corporate capacity." 149 Tenn. at 583. Nor was the Court bothered by the measure of the tax, which reached the taxpayer's net income. The Court found in its own precedents the "authority for the legislature to measure the tax by any reasonable standard." 149 Tenn. at 585.

The Court faced the next broad-based tax in 1926, when it upheld the newly-enacted gasoline tax, which was levied at the rate of three cents per gallon. In *Foster & Creighton Co. v. Graham*, 154 Tenn. 412, 285 S.W. 570 (1926), the Court viewed the tax as being imposed on the privilege of selling, distributing, or storing gasoline, which was readily identified as a privilege under the Court's precedents. The Court rejected the argument that the right to store gasoline is a natural right, not subject to taxation. 154 Tenn. at 422-23.[4]

In *Corn v. Fort*, 170 Tenn. 377, 95 S.W.2d 620 (1936), the Supreme Court upheld the corporate franchise tax, which was levied on "the privilege of engaging in business in corporate form." 170 Tenn. at 382. The tax was measured by the value of capital invested in the State, but the Court stressed that this feature did not convert the levy from a privilege tax into a property tax since it was grounded upon the corporation's right to engage in business. 170 Tenn. at 388-89. The Court stressed that "[n]o constitutional objection lies in the way of a legislative body prescribing any mode of measurement to determine the amount it will charge for the privileges it bestows." 170 Tenn. at 390, *quoting Home Insurance Co. v. New York*, 134 U.S. 594, 10 S.Ct. 593, 595, 33 L.Ed. 1025 (1890).[5]

Finally, in 1948 the Supreme Court issued two important tax decisions. In *Hooten v. Carson*, 186 Tenn. 282, 209 S.W.2d 273 (1948), it had no difficulty in upholding the retail sales tax act passed the previous year. The Court cited many of its precedents in determining that engaging in the business of selling tangible personal property could be taxed as a privilege. And the Court rejected the taxpayer's contention that because his purchase of food had been taxed, his natural rights had been violated. The Court reasoned,

> Regardless of whether the right to buy or sell is a natural right, we think the law is well settled that the State in the exercise of its sovereign power may impose a privilege tax upon any and all business transactions to the end that the general public be protected from unfair trade practices . . . .

186 Tenn. at 288-89. Similarly, in *Knoxtenn Theatres v. Dance*, 186 Tenn. 114, 208 S.W.2d 536 (1948), the Court upheld a privilege tax on the purchase of tickets for admission to a theatre, picture show, or other place of amusement. The Court flatly rejected the old arguments that a privilege

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[4]While *Shields v. Williams*, 159 Tenn. 349, 19 S.W.2d 261 (1929), and *Evans v. McCabe*, 164 Tenn. 672, 52 S.W.2d 159 (1932), fit into the chronology at this point, their analyses are different because they turned upon the meaning of the "stocks and bonds" clause of Article II, section 28, rather than upon a general discussion of the extent of the legislature's power to tax privileges. They are addressed in Parts III (B) and (C) *infra*.

[5]While it upheld the application of the franchise tax to corporations, the Court struck down its application to partnerships, on grounds that to tax partnerships but not single individuals would violate equal protection. 170 Tenn. at 386-87.

could not consist of a single act, and could not extend beyond business transactions. Citing *Ogilvie v. Hailey* with approval, the Court stressed that the pursuit of pleasure may be taxed as a privilege. 186 Tenn. at 119. And the Court further rejected the argument that the right to obtain amusement is a nontaxable natural right that cannot be deemed a privilege. The Court observed that "many of the natural rights of man have necessarily been regulated by laws enacted under the police powers and under the power to raise revenue." 186 Tenn. at 118.

Thus over the years the Supreme Court has sanctioned a broad range of privilege taxes under the authority of Article II, §28. In the Twentieth Century these have included the excise, gasoline, franchise, and sales taxes, which comprise the great majority of revenues now raised by the State. And while the separate license requirement has been watered down to mean no more than the tax registration itself, the underlying concepts remain essentially consistent with the virtually unlimited power of the legislature to identify and tax privileges, which was recognized as rooted in the Tennessee Constitution as early as 1839.

III.

THE INCOME TAX PRECEDENTS

With this background, we turn to consider the precedents that have dealt most directly with income taxes. Obviously, a tax on income might be framed as one on various identified privileges. But the issue is not that simple, because of the unusual "stocks and bonds" clause of Article II, §28, which specifically authorizes a limited type of income tax.

A. ***Bank of Commerce v. Senter*.**

The corporate excise tax is, in its measure, an income tax, levied at the rate of 6% of corporate net earnings. Tenn. Code Ann. § 67-4-806(a)(1998 Repl. Vol.); Chap. No. 406, 1999 Public Acts, §3 [designated as Code § 67-4-2007(a)]. As already noted, it was first enacted in 1923 and upheld in *Bank of Commerce & Trust Co. v. Senter*, 149 Tenn. 569, 260 S.W. 144 (1924). While the tax is imposed on the privilege of doing business in the corporate form, it is figured by a percentage of net income. This application of the tax has posed no problems for the Tennessee courts. *Bank of Commerce* relied on *Flint v. Stone Tracy Co.*, 220 U.S. 151, 31 S.Ct. 342, 55 L.Ed. 389 (1911), in reasoning that

> a tax must be measured by some standard, and the right to select the measure devolved upon the legislative department, and that their selections would be valid unless constitutional limitations were overstepped.

149 Tenn. at 584. As mentioned above, the Tennessee court found in its own precedents the "authority for the legislature to measure the tax by any reasonable standard." 149 Tenn. at 585. The cases do not reveal any instance in which a litigant has contended that it is unreasonable to measure the tax on a privilege by the earnings produced through its exercise.

Thus the corporate excise tax, through the vehicle of a privilege tax, reaches corporate income. Since its enactment in 1923 it has been upheld repeatedly. *See R.J. Reynolds Tobacco Co. v. Carson*, 187 Tenn. 157, 213 S.W.2d 45 (1948); *American Bemberg Corp. v. Carson*, 188 Tenn. 263, 219 S.W.2d 169 (1949). While many aspects of the tax have been litigated over the years, its basis and measure have not been impugned. Of course, the scope of the tax has recently been expanded to reach business entities beyond corporations through Chapter No. 406 of the 1999 Public Acts.

B. *Shields v. Williams*.

This brings us to the decisions that appear to be impediments to enacting an income tax. In *Shields v. Williams*, 159 Tenn. 349, 19 S.W.2d 261 (1929), the Court addressed an act of that year by which the General Assembly had purported to exercise its express power accorded under Article II, §28 "to levy a tax upon incomes derived from stocks and bonds that are not taxed *ad valorem*." In levying a tax upon stock and bond income generally, the legislature also removed the ad valorem taxes from those stocks and bonds. The plaintiffs challenged this scheme, contending that the special clause of Article II, §28 authorized an income tax only on stocks and bonds that were not taxed under the general provisions of that Article because they could not legally be taxed ad valorem. These would include bonds issued by the United States government and certain railroad stocks and bonds that were exempt from taxation under charter provisions granted by the State. Since stocks and bonds had to be taxed as intangible personal property under the first clause of Article II, §28, the plaintiffs argued that the legislature could not excuse those otherwise taxable stocks and bonds from ad valorem taxes and, as a substitute for the lost tax base, concomitantly tax their income. The Court concluded, however, that the clause did permit just that sort of swap-out, and that the legislature, by exempting stocks and bonds from property taxes, could subject them to an income tax.

While the Court inquired as to the intent of the framers of the 1870 Constitution and briefly quoted from its Journal, 159 Tenn. at 356-57, it based its reading of the clause on the assumption that the members of the Constitutional Convention knew that interest from federal bonds had been held to be nontaxable and that those delegates accordingly would not have sought to tax such interest. The Court reasoned that since the delegates must have been aware of these holdings, the proposition that federal bonds were exempt was

> so obvious and so plausible it could scarcely have escaped the consideration of the lawyers in the Constitutional Convention, and we cannot believe that discerning body contemplated conferring on the Legislature especial power to levy on stocks an income tax of such doubtful validity. . . .
>
> To construe the income tax clause according to complainants' contention is to convict the makers of our Constitution of inserting in that solemn document a futile provision which they must have known was vain. We are unable to entertain such an idea.

> The clause, in our opinion, was not designed to authorize an attempt to tax incomes from stocks and bonds not taxable but to authorize a tax upon incomes derived from stocks and bonds that were (lawfully) not taxed ad valorem.

159 Tenn. at 359. The Court thus upheld the tax on stocks and bonds that the legislature had exempted from property taxes. This tax has afterward been commonly known after its sponsor, Senator Frank S. Hall of Dickson County, as the Hall Income Tax.

Thus the Court upheld a very limited income tax in Tennessee, but upon a theory that was soon to prove fatal to a broader income tax.

C. ***Evans v. McCabe*.**

In 1931, in dealing with the budget crisis stemming from the Great Depression, the General Assembly enacted a graduated personal income tax upon incomes of all sorts. That Act, Chapter No. 21 of the Acts of the 1931 Extra Session, did not allude to any specific constitutional basis. When it was promptly challenged, the Supreme Court determined that it failed as either a property tax or a privilege tax. It failed as a property tax because it was not levied at a rate uniform with taxes levied on other property under Article II, §28. 164 Tenn. 681. It failed as a privilege tax because the Court viewed the provision authorizing the Hall Income Tax, which had been upheld three years earlier, as implying that taxes on other sorts of income are prohibited. The Court reasoned, 164 Tenn. at 682,

> If the Convention of 1870 contemplated an income tax as a privilege tax it must have included the income tax clause as a limitation on the power to levy such a tax. From such a viewpoint this clause is an exception or a proviso. The clause was certainly not designed to confer an additional power of privilege taxation. The preceding clause, in terms as broad as possible, had countenanced the power of the legislature to tax every privilege. The intent, however, was that only the incomes mentioned should be taxed.

Drawing upon *Shields v. Williams*, the Court concluded that "[a] restraint upon the power to tax incomes, however, is inevitably implicit in Section 28 of Article II." *Id.*

Nothing in the *Evans* opinion detracts from the general line of cases that holds the legislature to have virtually unlimited powers of privilege taxation. Rather, the decision is structured solely around the "stocks and bonds" clause and turns upon the implication that by expressly authorizing one type of income

taxation, the framers meant to prohibit all other types. The Court did not bother to distinguish its holding in *Bank of Commerce v. Senter* that had sanctioned taxation of corporate income.[6]

D. ***Jack Cole Co. v. MacFarland*.**

In addition, a very limited income tax was struck down in *Jack Cole Company v. MacFarland*, 206 Tenn. 694, 337 S.W.2d 453 (1960). The act addressed by this decision, however, was so arcane that, but for two broad-ranging sentences, the case would be of little consequence.

The Act under scrutiny in *Jack Cole*, Chapter No. 252, 1959 Public Acts, imposed a tax upon earnings of corporations that did not pay the franchise or excise taxes, at the same rate as those taxes. This peculiar act sought to plug a loophole created in the tax laws by federal court decisions. During the era when *Jack Cole* was decided, the precedents of the United States Supreme Court held that a state could not impose a tax on an activity in interstate commerce if the incidence of the tax was on the "privilege of doing business." *Spector Motor Service v. O'Connor*, 340 U.S. 602, 71 S.Ct. 508, 95 L.Ed 573 (1951); *Freeman v. Hewit*, 329 U.S. 249, 67 S.Ct. 274, 91 L.Ed. 265 (1946). Thus Tennessee's franchise and excise taxes, which were imposed on precisely this privilege, could not be applied to businesses, like *Jack Cole Company*, operating exclusively in interstate commerce. The Tennessee Court, in fact, noted that *Jack Cole* operated only in interstate commerce and had never paid Tennessee's corporate taxes. 206 Tenn. at 695. In an obvious effort to address this loophole, the 1959 General Assembly carefully designed the language of Chapter No. 252 to circumvent these federal holdings. Section 1 of the Act expressly declared, "This tax shall not be construed as a tax on the privilege of carrying on business in Tennessee, the same being upon the privilege of being in receipt of or realizing net earnings in Tennessee . . . ." By declaring that the taxable privilege was "being in receipt of or realizing net earnings in Tennessee," the Legislature avoided the semantic trap posed by the *Spector Motor* decision, since, as far as federal law was concerned, Tennessee could certainly tax the receipt of earnings within the state.

In avoiding the federal pitfall, however, the Legislature forced the Court to rule directly on its authority to tax the privilege of receiving earnings. In doing so, the Court harked back to *Evans* and struck down the act as an income tax. It is clear that, if the tax in *Jack Cole* had been imposed on the privilege of doing business, measured by net earnings, it would have been upheld insofar as Tennessee law is concerned. Indeed, it then would have had the same basis as the corporate excise tax imposed since 1923 and upheld in *Bank of Commerce*. But the General Assembly, in struggling with an unusual interaction of State and federal tax principles, had expressly prohibited the Court from considering the tax as a tax on

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[6]Interestingly, the Act stricken by *Evans* included a 4% income tax on corporations. Chap. No. 21, 1931 Extra Session, §3(b). This tax fell along with the rest of the Act, although it clearly could have withstood attack, at least if it had been properly structured, under the doctrine of *Bank of Commerce*.

the privilege of doing business.[7]

Having been directed by the General Assembly to view the tax in *Jack Cole* in a peculiar light, the Court made two oft-quoted statements that pertain generally to income taxes. It pronounced, "Realizing and receiving income or earnings is not a privilege that can be taxed." 206 Tenn. at 698. In justifying this conclusion, the Court stated that "[s]ince the right to receive income or earnings is a right belonging to every person, this right cannot be taxed as privilege." 206 Tenn. at 699. The Court did not discuss how this conclusion affected the corporate income tax levied since 1923. Nor did the Court attempt to distinguish the other cases that had sustained the legislature's power to tax "natural rights."

IV.

CRITIQUE OF THE INCOME TAX PRECEDENTS

A. Taxing Income through the Vehicle of a Privilege Tax - *Bank of Commerce v. Senter*.

Despite the language of later cases that draws into question the legislative power to tax income, no decision has questioned the continuing vitality of *Bank of Commerce v. Senter*. That case demonstrates that the legislature may reach and measure a tax by income without laying the privilege directly upon the receipt of earnings or income as it did in *Jack Cole*. In *Corn v. Fort*, 170 Tenn. 377, 390, 95 S.W.2d 620 (1936), the Court stressed that "[n]o constitutional objection lies in the way of a legislative body prescribing any mode of measurement to determine the amount it will charge for the privileges it bestows," quoting *Home Insurance Co. v. New York*, 134 U.S. 594, 600, 10 S.Ct. 593, 595, 33 L.Ed. 1025 (1890). Obviously, earnings from the exercise of a privilege constitute an appropriate and constitutional tax base when the legislature designates them as such.

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[7]It became apparent over the years that the *Spector* doctrine was only an empty shell. *See Northwestern States Portland Cement Co. v .Minnesota*, 358 U.S. 450, 79 S.Ct. 375, 3 L.Ed.2d 421 (1959); *Mid-Valley Pipeline Co. v. King*, 221 Tenn. 724, 431 S.W.2d 277 (1968). In 1977, *Spector* was expressly rejected and overruled by the United States Supreme Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288-89, 97 S.Ct. 1076, 1084, 51 L.Ed.2d 326 (1977). It is now clear that Tennessee can tax businesses operating exclusively in interstate commerce if they have some nexus with the State, so long as the tax is properly apportioned. Thus it is no longer necessary under federal law for the General Assembly to avoid taxation of the privilege of doing business, in attempting to reach businesses operating exclusively in interstate commerce.

B. *Shields*, *Evans*, and the 1870 Constitutional Convention.

1. The Court's Implication.

From this survey, it is evident that the only substantial precedent against an income tax in Tennessee is *Evans v. McCabe*. And nothing in that decision impugns the General Assembly's sweeping power to tax privileges, except the implication the case draws from the "stocks and bonds" clause, as construed in *Shields v. Williams*. Certainly this implication -- that by designating one narrow class of incomes for taxation, the framers meant to prohibit taxation of other classes of income -- is not an unreasonable one to draw from the face of Article II, §28. But it is by no means the only implication that can logically be drawn. The clause could be read as merely prohibiting double taxation of stocks and bonds, under both property and privilege tax theories. Or the implication could be that no tax can be imposed on incomes from stocks and bonds that ***are*** taxed ad valorem, leaving no implication at all about taxation of types of income not derived from stocks and bonds.[8] While the Supreme Court in *Evans* briefly cited the Journal from the 1870 Convention, it nevertheless did not follow the only logical conclusion from that Journal, and did not consult the record of the debates during the Convention that was available. Had the Court done so, it would have seen that none of these implications is justified, and that the underlying "assumption, taken from *Shields*, that the income tax clause was adopted as an exception to the property and privilege tax provisions in Section 28," is wrong. R. Cooper, "Re-examining the Constitutionality of an Income Tax in Tennessee," 28-1 TENN. BAR. J. 14, at 19 (Jan.-Feb. 1992)[hereinafter Cooper Article].

2. The Historical Record.

A study of the proceedings of the 1870 Convention reveals that the "stocks and bonds" clause was added in a vain effort to tax securities exempted from tax by federal and State laws. This is evident from the Journal itself, which reveals that earlier drafts of this sentence of Article II, §28 gave the legislature power to tax "incomes derived from stocks and bonds exempted by the laws of the United States from taxation." JOURNAL OF 1870 CONSTITUTIONAL CONVENTION at 260 (Proceedings of Feb. 8, 1870). While the Court in *Shields* noted this, 159 Tenn. at 357, it rejected the contention that the clause was finally framed to include railroad stocks that were exempt from taxation by State charter, as well as federal bonds, and thereby emerged with the encompassing language "stocks and bonds that are not taxed ad valorem." Further study of the Convention debates conclusively reveals, however, that this contention was historically correct.

Both major Nashville newspapers covered in depth the proceedings and debates of the 1870 Convention. As carried in the editions of those newspapers on February 13, 1870, the debates of February 12 focused on this clause, and the clear aim of the delegates was to find a way to tax federal

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[8]In fact, the concurring opinion of Justice Chambliss in *Evans*, which analyzed the tax in question as a property tax, specifically reserved any opinion as to the taxability of income not directly derived from property taxable ad valorem, such as services and intangibles. 164 Tenn. at 683 (Chambliss, J. concurring).

bonds. The delegates were aware of the court decisions that prohibited such taxation, but most disagreed with those decisions and wanted to contest the issue. The wording of the clause was altered from the original draft to include within its scope the securities that had been exempted from taxation by State charters. It is not necessary to make any assumption or draw any implications about the intended meaning of the clause -- its meaning is readily evident from the record of the Convention.[9]

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[9]The relevant portion of the Convention debate of February 12, 1870, as it appeared on Page 1 of both the *Republican Banner* and the *Nashville Union and American* for February 13, is as follows:

TAX ON BONDS EXEMPTED BY THE UNITED STATES

The Convention now took up paragraph four, as reported by the committee. It was read as follows:

"The Legislature shall have power to levy a special tax upon incomes derived from stocks and bonds exempted by the laws of the United States from taxation."

Mr. Jones, of Lincoln, moved to strike out the paragraph, as the Supreme Court fifty years ago had decided that States could not tax incomes derived from United States securities.

Mr. Kennedy thought the right was clear to tax incomes on these securities, and he offered the following in lieu:

"The Legislature shall have power to levy a tax upon incomes derived from stocks and bonds that are not taxed *ad valorem*."

Mr. Jones, of Giles, claimed that the Legislature had a clear right to tax incomes derived from bonds, although there was no right to tax the bonds themselves as property.

Mr. Stephens said the decision showed that the holder of United States securities was unquestionably protected from taxation on the principal, but he thought the incomes derived from those securities might be taxed. He was in favor of putting a provision in the Constitution giving the Legislature power to tax incomes on United States bonds. This would bring the matter before the Supreme Court, and then if it was decided against them, why all right.

Mr. House, of Montgomery, said they might discuss this matter for a week and would then be no better able to decide about it than now. The point was, could they put this clause in the Constitution and raise the question whether the tax could be made or not? He was highly in favor of testing the matter by conferring on the Legislature the power proposed to be given in the paragraph reported by the committee.

Mr. Thompson, of Davidson, thought the Legislature had power to tax the incomes referred to without putting the provision proposed by the committee in the Constitution. He was opposed to adopting the report of the committee, believing that it would be considered by the courts of the United States as an intended insult.

Mr. Turner said he had taken pains to examine all the authorities and decisions in regard to this question which he could find, and he was satisfied that the provision reported by the committee would not come in conflict with any of them. He was in favor of making the experiment and testing the rights of the State in this particular.

Mr. Williamson did not like the amendment of Mr. Kennedy; he thought it was dodging the question. If they wanted to tax incomes on United States bonds, let them say so. He was in favor of making a square fight. He did not believe they could do a thing indirectly which they could not do directly. He believed they might tax incomes derived from Government bonds as so much money. He did not desire to make an experiment. If they were not satisfied that they could levy this tax, let them strike out the proposition entirely.

Mr. Jones, of Lincoln, said he would go as far as any man in taxing those bonds, if he was satisfied that it could be done. Some said that they could not tax the bonds themselves, but might tax incomes derived from them. He could not see the distinction as some gentlemen urged it.

Mr. Gardner said he heartily approved the paragraph in lieu offered by Mr. Kennedy.

Mr. Kennedy said he had an object in the wording of his amendment, which was to render liable to taxation incomes derived from certain bonds, which he understood had been issued by the State and declared not taxable.

Mr. Porter, of Haywood, moved the previous question.

The motion of Mr. Jones, of Lincoln, to strike out the paragraph reported by the committee, was lost by a vote of 16 to 51.

Thus it becomes starkly apparent that this crucial clause was inserted into the 1870 Constitution, in the aftermath of the Civil War, in an effort which the delegates knew was dubious, to tax federal bonds and railroad securities. Cooper Article at 18. The clause was "not treated by the delegates as an exception to the preceding provisions but rather was considered a separate issue altogether." L. Laska, "A Legal and Constitutional History of Tennessee, 1772-1972, 6 MEMP. ST. L. REV. 650 (1976)[hereinafter Laska Article]. The assumption made by the Court in *Shields v. Williams* is not borne out by the facts. And while the Journal of the Convention includes merely the motions made and votes taken, it is consistent with the newspaper accounts. Moreover, it is well established that the proceedings of the Constitutional Convention should be examined to determine the intent of the document that resulted from its deliberations. *Shelby County v. Hale*, 200 Tenn. 503, 510-11, 292 S.W.2d 745, 748 (1956); *State v. Cloksey*, 37 Tenn. (5 Sneed) 482, 486 (1858). Just as the courts use Madison's notes and the *Federalist Papers* to interpret the federal Constitution, the contemporaneous newspaper accounts of Tennessee's 1870 Convention are an appropriate source for determining our Constitution's meaning.

In addition, this construction of the constitutional language is confirmed by the legislature's actions under the clause in question in the years immediately after the Convention. In Chapter 149, §5, of the 1881 Acts, the General Assembly levied a tax on "the income derived from all stock in any incorporations which are by their charters exempt from an *ad valorem* tax, or from any bonds exempt from such tax . . . ." Similar provisions were included in the 1883, 1885, 1887, and 1889 revenue laws.[10] Shannon's Code of 1917, at §710 (derived from Chap. 602, §8, 1907 Acts), purported to tax "incomes derived from United States bonds and all other stocks and bonds not taxed ad valorem." The courts, however, had declared this levy unconstitutional insofar as it applied to federal bonds. *See Mosely v. State*, 115 Tenn. 52, 86 S.W. 714 (1905). The accepted understanding, as set out in Note 3 to §710 of Shannon's Code of 1917, with reference to the stocks and bonds clause of Article II, §28, was that "our constitutional provision is itself unconstitutional, because violative of the constitution of the United States." The Court in *Shields v. Williams* chose, however, to ignore this understanding, even though the plaintiffs there pointed it out. The *Shields* Court assumed that the court and parties in *Mosely* did not have "any thought that the income tax clause of section 28 authorized such taxation." 159 Tenn. at 360. But the many previous efforts of the General Assembly to act in accordance with the disputed clause belie this assumption. Obviously, the history of legislative action pursuant to the clause, as well as the later accepted understanding that its intended application to federal bonds and railroad securities could not be achieved, as

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The paragraph in lieu, by Mr. Kennedy, was then adopted by a vote of 67 to 2. Mr. Jones, of Lincoln, and Mr. Williamson voting in the negative.

[10]Chap. 106, §5, 1883 Acts; Chap. 5, §6, 1885 Extra Session Acts; Chap. 1, §7, 1887 Acts; Chap. 130, §7, 1889 Acts.

reflected in the Code comments themselves, buttresses the conclusion that the *Shields* court erred in construing the clause to allow the legislature to exempt stocks and bonds generally from ad valorem taxation.

3. Impact of the "Stocks and Bonds" Clause on Privilege Taxation.

This being the case, it becomes clear that the 1870 Convention was not attempting to limit the scope of property or privilege taxation. Cooper Article at 19. The "stocks and bonds" clause was not intended to restrict the broad powers of privilege taxation that had existed under the 1835 Constitution, and which were incorporated wholesale into the 1870 document. *Evans v. McCabe* is wrong in concluding that the designation of one class of incomes to be taxed necessarily denied to the legislature power to tax other types of income. 164 Tenn. at 680. Rather, the mention of this one type of income was intended to encourage the legislature to attempt to tax securities that could not be taxed ad valorem. The clause emphasizes that the Convention did not intend to allow such securities that could not be taxed as property to escape taxation altogether. The clause cannot be read historically to carry any implication about taxing other types of income, or to limit the legislature's preexisting and virtually unfettered power to tax privileges.

The income tax scrutinized in *Evans v. McCabe* was not structured as a privilege tax, but the Court, as an alternative theory, considered whether the tax could stand as a privilege tax. The Court did not indicate that the tax exceeded the legislature's general power to identify and tax privileges, but that it was "destroyed" by the implications of the "stocks and bonds" clause. 164 Tenn. at 682. But such implications were foreign to the minds of the framers at the 1870 Convention, as contemporary scholarship has revealed. Thus *Evans* should not be deemed today to condemn a properly-framed State income tax since it is rooted in an analysis that is historically incorrect.[11]

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[11]The fact that *Shields v. Williams* and *Evans v. McCabe* misconstrued the implications of the "stocks and bonds" clause does not impugn the validity of the Hall Income Tax today. While *Shields* erred in assuming that this special clause was not intended primarily to reach federal bonds and railroad securities, the clause obviously does authorize a tax on stocks and bonds that are not, in fact, taxed ad valorem. The 1973 constitutional amendment and its subsequent construction by the Supreme Court have resolved any continuing questions about the power of the legislature to excuse stocks and bonds generally from ad valorem taxes. That amendment changed the opening phrase of Article II, §28 from "[a]ll property . . . shall be taxed," to "all property . . . shall be subject to taxation . . . ." In *Sherwood Company v. Clary*, 734 S.W.2d 318 (Tenn. 1987), the Supreme Court construed this change to give the legislature much greater discretion than previously. *Sherwood* upheld the legislature's judgment that nonbusiness tangible personal property, which the Constitution places in a classification to be taxed at 5% of its value, was likely to produce no appreciable revenue, and that it was administratively impractical to tax this classification. The court thus upheld Tenn. Code Ann. § 67-5-901(a)(3)(A)(derived from Chapter No. 337, 1977 Public Acts), whereby the legislature decreed that such property "shall be deemed to have no value."

In light of *Sherwood*, the legislature's present decision not to tax stocks and bonds ad valorem is even more clearly within its powers than was its decision to deem nonbusiness tangible personal property to have no value. The 1973 constitutional amendment specifically accorded the legislature "power to classify Intangible Personal Property into subclassifications and to establish a ratio of assessment to value in each class or subclass . . . ." The legislature accordingly has chosen not to impose the property tax generally on stocks and bonds. *See* Tenn. Code Ann.

C. The "Natural Right" Theory -- *Jack Cole*.

While the 1960 decision in *Jack Cole* is based primarily on *Evans*, it contains some additional principles that must be considered. The Supreme Court there said that "[r]ealizing and receiving income or earnings is not a privilege that can be taxed," 206 Tenn. at 698, since it is a natural "right belonging to every person." 206 Tenn. at 699. But this "natural right" approach runs directly contrary to other Tennessee decisions, and, as revealed by *Bank of Commerce v. Senter*, it is not necessary to tax "the privilege of receiving income" to impose, in effect, an income tax.

1. The "Natural Right" Theory.

Before its decision in *Jack Cole*, the Supreme Court had repeatedly rejected the idea that natural rights are not subject to privilege taxation. This was foreshadowed in *Ogilvie v. Hailey*, 141 Tenn. 392, 210 S.W. 645 (1918), in which driving a car for pleasure was deemed a taxable privilege. The Court's rejection of this idea was expressly stated in *Foster & Creighton Co. v. Graham*, 154 Tenn. 412, 285 S.W. 570 (1926), where the taxpayer claimed that storage of gasoline was a natural right. 154 Tenn. at 422-23. Subsequently, as discussed *supra* at 8-9, the Supreme Court in 1948 twice rejected this claim when it was asserted in the more plausible contexts of the right to purchase food, *Hooten v. Carson*, 186 Tenn. 282, 288-89, 209 S.W.2d 273 (1948), and the right to obtain amusement, *Knoxtenn Theatres v. Dance*, 186 Tenn. 114, 118 208 S.W.2d 536 (1948). The Court observed in the latter case that "many of the natural rights of man have necessarily been regulated by laws enacted under the police powers and under the power to raise revenue." 186 Tenn. at 118. *See also Seven Springs Water Co. v. Kennedy*, 156 Tenn. 1, 299 S.W. 792 (1927)(upholding a tax on selling water from a spring on a farmer's land); *Humphries v. Carter*, 172 Tenn. 392, 112 S.W.2d 833 (1938)(upholding a tax on selling plants and shrubs from one's home); *Mabry v. Tarver*, 20 Tenn. (1 Humph.) 98 (1839)(indicating that farming may be taxed as a privilege); *Phillips v. Lewis*, 3 Shannon's Cases 230, 242 (1877)(same).

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§§ 67-5-1101 *et seq.* and 67-5-1201 *et seq.* (limited authorization for taxation of stock of investment and insurance companies); *see also* Tenn. Code Ann. §§ 67-2-104(g), (h), & (i)(related exemptions from Hall Income Tax). In fact, it has presumed "all intangible property" to come within the $7,500 exemption specified by the Constitution for tangible personal property. Tenn. Code Ann. § 67-5-602(c)(2)(derived from Chapter No. 262, 1977 Public Acts). While the *Sherwood* decision did not specifically address this act, it referred to it in the same vein as the similar 1977 act which it did uphold. 734 S.W.2d at 321. Obviously, if the legislature has discretion to deem a category of property to have no value when the Constitution says it is to be taxed at 5% of value, it also has discretion to refrain from taxing a category of intangibles, with respect to which the Constitution accords the legislature complete discretion.

As a result, the 1973 amendment has afforded the legislature the sort of discretion concerning taxation of stocks and bonds that *Shields v. Williams* assumed the 1870 Convention intended. And since stocks and bonds are not now taxed ad valorem, there can be no doubt of the legislature's power to impose the Hall Income Tax on their income, under the precise wording of the disputed clause. Moreover, in light of the intended meaning of that clause as revealed by the historical record, it appears that that provision carries no negative implication about the legislative power to tax stocks and bonds that ***are*** taxed ad valorem. And since this Office concludes that a broad-based income tax would be valid, such a tax could clearly include the privilege of investing in stocks and bonds, measured by the income therefrom.

Jack Cole did not attempt to reconcile its reasoning with these precedents. Instead, it quoted general definitions of privilege from *Corn v. Fort* and *Lonas v. State*, 50 Tenn. (3 Heisk.) 287 (1871). These brief quotations do not justify the Court's conclusion. The passage from *Corn v. Fort* is not directly relevant to the issue. *Lonas v. State* upheld a statute "prohibiting the intermarriage or cohabitation of whites and negroes." 50 Tenn. at 287. As one observer has remarked, this case is such a judicial relic that it should be regarded as an "improper definitional source." W. Armstrong, "Constitutional Limitations on Income Taxes in Tennessee," 27 VAND. L. REV. 475, at 487 (1974)[hereinafter Armstrong Article]. Moreover, to the extent that this case might be read to hold that marriage is a natural right, it is instructive to note that marriage licenses have been taxed throughout the State's history. 6 R. White, MESSAGES OF THE GOVERNORS OF TENNESSEE [hereinafter MESSAGES] at 158 (1963); Shannon's Code §712 at p. 465 (1917).

Furthermore, as Armstrong puts it, "very respectable authority exists for the concept that the receipt of income is indeed a taxable privilege." Armstrong Article, 27 VAND. L. REV. at 489. In *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313, 57 S.Ct. 466, 467, 81 L.Ed. 666 (1937), the United States Supreme Court described an income tax as

> founded upon the protection afforded by the state to the recipient of the income in his person, ***in his right to receive the income***, and in his enjoyment of it when received. These are the ***rights and privileges*** which attach to domicil within the state. (emphasis added)

Thus the Court's declaration in *Jack Cole*, that receiving income is a natural right and not a privilege that can be taxed, is inconsistent with the Court's own, more thoroughly reasoned precedents, and is virtually unsupported in the context of *Jack Cole* itself.

2. Theoretical Underpinnings of an Income Tax

The decision in *Jack Cole* must also be viewed in light of the General Assembly's peculiar directive that the tax in question should "not be construed as a tax on the privilege of carrying on business in Tennessee, the same being upon the privilege of being in receipt of or realizing net earnings in Tennessee . . . ." Chap. No. 252, §1, 1959 Public Acts. As already pointed out, these unusual instructions stemmed from an effort to plug a loophole in the franchise and excise taxes resulting from now-discarded federal decisions that allowed purely interstate businesses to escape state privilege taxes on doing business. As a result of this directive, the Court in *Jack Cole* was forced to address the bare privilege of receiving income or earnings.

This is not, however, the customary method for structuring a privilege tax, even one designed to reach income. The corporate excise tax, which is measured by net earnings, is placed on the privilege of doing business in the corporate form, and was accordingly upheld in *Bank of Commerce v. Senter*. On

the strength of that landmark decision, as well as other cases (such as *Corn v. Fort*) that give the legislature broad discretion in determining the measure of a taxable privilege, a levy that functions as an income tax can be premised on the privilege of engaging in the business or activity that produces income, and not on the bare receipt of income itself.

Thus *Jack Cole* can scarcely be regarded as the last word on income taxation in Tennessee. If judicial precedents are to be given weight according to the strength of their reasoning and analysis, then *Jack Cole* is a weak reed indeed. Moreover, when the decision is closely read, it turns entirely on the peculiar legislative designation of the taxable privilege in that instance. Even if receiving income cannot be a taxable privilege, nothing in *Jack Cole* says or implies that income cannot be the measure of taxability of some other privilege. Indeed, a different construction would conflict with many of the leading Tennessee precedents and would result in invalidation of the corporate excise tax itself. It cannot reasonably be assumed that the courts would take the slender reed of *Jack Cole* to overturn the more thoroughly reasoned precedents established over many years.

Thus, in the final analysis, *Jack Cole* is a unusual and weak decision, and aids little in deciding the principal issue at hand.

V.

VIABILITY OF AN INCOME TAX AS A PRIVILEGE TAX

A. Legislative Authority to Tax Privileges by the Income Produced.

It thus becomes clear that *Evans v. McCabe* incorrectly read the historical record and improperly held the "stocks and bonds" clause of Article II, §28 to limit the legislature's far-ranging power to tax privileges, and that *Jack Cole* sheds little additional light on the issue. We then are left with the virtually unfettered authority of the legislature to designate and tax privileges, and a large number of precedents that have effectuated that power. Indeed, as already noted, nothing in *Evans v. McCabe*, apart from its historically unfounded and erroneous construction of the "stocks and bonds" clause, indicates that an income tax would not stand as a privilege tax. And while the tax invalidated in *Evans* might still be assailed because it did not purport to be a privilege tax, the General Assembly could easily remedy that defect in any income tax legislation by expressly declaring the tax to be levied on certain specified privileges.

Thus there appears to be no impediment to the legislature's naming many vocations, occupations, businesses, and activities as privileges and taxing the income they generate. The legislative right to tax virtually any occupation or pursuit as a privilege is unquestioned. Indeed, as already observed, as early as 1915 the legislature taxed at least 113 categories of privileges, including many in which Tennesseans still engage in order to make their livings today. While these early privilege taxes, like today's Occupational Privilege Tax, Tenn. Code Ann. §§ 67-4-1701 *et seq.*, did not measure the tax by the income produced,

Bank of Commerce v. Senter and other cases offer clear authority for such a measure.

B. The Historical Scope of Taxable Privileges.

In spite of its conclusive refutation of *Evans v. McCabe*, the Cooper Article indicates that some doubts still exist about the legislature's ability to impose an income tax as a privilege tax. Cooper Article at 19-20. The Article relies on the 1871 legislative message of Governor John C. Brown, who had been president of the 1870 Constitutional Convention. Governor Brown explained that "[t]he theory of taxation in Tennessee is not based upon the idea of income or profits from wealth, but upon absolute values, privileges, etc." MESSAGES at 146 (1963). Cooper suggests that income and wealth are things separate from privilege. Cooper Article at 20.

In the opinion of this Office, Governor Brown's message cannot be read as outweighing the broad construction of privilege taxation in Tennessee dating back to the Constitution of 1835. The message says nothing about incomes derived from labor, rather than from wealth. The compiler of the Governor's Messages, in an analysis after the 1871 message, notes that nineteen "privileges" were then subject to taxation, including merchants license, billiard halls, tipplers, lawyers, physicians, artists, peddlers, marriage licenses, brokers and auctioneers, hotels, hacks and wagons, insurance agents, sewing machines, livery stables, cattle dealers, and butchers. MESSAGES at 158 (1963). This list, which by 1915 had grown to at least 113 taxable privileges, includes activities that are not inherently different from many other modern methods of earning a living, which would appear to be taxable as privileges should the legislature so designate them.

Granted, in Governor Brown's day, the designated privileges were not taxed according to a percentage of their income. But many various rates were set and many measures used for taxing the enumerated privileges. *See* Shannon's Code §712 (1917). Nothing in Tennessee case law, except perhaps the unfounded language in *Jack Cole*, casts any doubt on measuring privilege taxes by the income produced from the excise of the privilege. Indeed, that is the precise measure upheld in *Bank of Commerce v. Senter* for the corporate excise tax.

The Cooper Article admits that "[a]rguably, employment that generates a wage or salary could fall within an expanded definition of a privilege tax on a business or occupation . . . ." Cooper Article at 22. It seems apparent, however, that merely measuring the privileges that were already taxed in 1871, or 1915, by the income derived from their exercise instead of some other measure would have gone a long way toward creating an income tax. And while the 1870 Convention delegates may not have specifically contemplated an income tax, neither did they contemplate enactment of the excise (1923), gasoline (1923 and 1925), franchise (1935), and sales (1947) taxes that have since been levied and upheld on a privilege tax theory. But neither the idea of taxing lucrative occupations, nor of measuring that tax by income, is inconsistent with the original concept of privilege taxation, as embodied in both the 1835 and 1870

Constitutions.[12]

C. The Method for Levying an Income Tax in Tennessee.

Thus the most obvious method for imposing an income tax would be to designate as taxable privileges as broad an array of occupations and activities as possible, and to measure the tax by earnings. In fact, such a tax is so consistent with Tennessee precedents that it might survive even under *Evans v. McCabe*, since the act scrutinized in that case did not designate any taxable privilege. There is no serious question that the legislature can designate as privileges the 19 activities mentioned by Governor Brown, the 113 endeavors listed in 1915, or the 21 professions taxed by today's Occupational Privilege Tax, Tenn. Code Ann. § 67-4-1702. The legislature has merely to change the measure of these privileges to equal the income they produce, and to expand the list.

Indeed, the Journal of the 1870 Convention reveals that the delegates specifically considered whether the legislature should have power to tax lucrative, permanent occupations. On February 10, 1870, one of the delegates, former Whig Governor Neill S. Brown (the brother of the Convention's president) moved to strike the word "privileges" from Article II, §28 and to insert instead the phrase "such occupations as are not permanent in their character, or special in their nature." JOURNAL OF 1870 CONSTITUTIONAL CONVENTION at 284. This would have confined taxation to temporary and extraordinary pursuits. The next day Brown withdrew this amendment and moved to add a more specific provision that "the business of farming, mechanical and manufacturing pursuits and the learned professions shall not be considered privileges under this Constitution." This amendment was rejected by a vote of 45-to-18. JOURNAL OF 1870 CONSTITUTIONAL CONVENTION at 287. Through this action, the Convention ensured that the broad power of privilege taxation contained in the 1835 Constitution would be preserved, so that these chief means of earning a living would be fully subject to taxation, at the discretion of the legislature. *See also* Laska Article, 6 MEMP. ST. L. REV. at 652-53.

Logically, if the General Assembly can list and tax each separate occupation and activity as a privilege, it can describe such pursuits in more generic terms. It could, for instance, name as privileges all, or nearly all, of the occupations categorized in the federal Standard Industrial Classification Manual which is referred to in some present Tennessee tax statutes. *See, e.g.*, Tenn. Code Ann. §§ 67-4-712; 67-6-330; 67-6-530. Or it could in broader terms declare it a privilege to engage in a business,

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[12]Certainly income taxes were not unknown to the framers of the 1870 Constitution, since they had been used during the Civil War by the Confederacy, as well as by the Union. *See* W. Klein, B. Bittker, & L. Stone, FEDERAL INCOME TAXATION 4-5 (Little, Brown & Co. 7th ed. 1987); Laska Article at 652; Cooper Article at 22. But the federal income tax of that era, levied between 1862 and 1872, reached only 1% of the population, D. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS 36 (West Pub. Co. 2d ed. 1993), and income taxes were not a focus of the proceedings of the Convention, except in its vain efforts to find a way to tax federal bonds and railroad securities. The Journal and debates of the Convention reveal no more intent to prohibit a general income tax than to prohibit a general sales tax, a gasoline tax, or the corporate franchise and excise taxes.

profession, occupation, trade, employment, enterprise, or endeavor, to invest or deposit money or capital, to sell one's labor or property, to engage in a lease or rental, or otherwise to apply one's talents, skills, time, efforts, resources, or property for personal gain or advantage; it could then tax each of these privileges by the income it produces.[13]

Thus it is the opinion of this Office that, consistent with Article II, §28 of the Tennessee Constitution and the intent of its framers, the General Assembly has power, in effect, to impose an income tax in Tennessee by designating as privileges everything people do to earn money, and measuring the tax by the earnings from the exercise of those privileges.[14]

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[13]The main categories of workers whose occupations have not heretofore been designated as privileges include those who work as employees for businesses, industries, individuals, and governmental entities. Of course, many such persons would be reached if engaging in the substance of their work (i.e., secretary, industrial worker, teacher, etc.) were deemed a privilege. And it would seem consistent with the legislature's powers for it to label engaging in employment for another as a taxable privilege. Obviously, the legislature can characterize working for State or local government as a privilege. Congress, through the Public Salary Act, 4 U.S.C. §111, has authorized states to tax the earnings of federal employees, so long as they are not discriminated against. And a recent decision has made it clear that a state, through the device of a privilege tax, may tax the earnings of federal employees and officers. *Jefferson County, Alabama v. Acker*, ___ U.S. ___, 119 S.Ct. 2069, 67 U.S.L.W. 3682 (June 21, 1999)(upholding application of the Alabama occupational privilege tax to the salaries of federal judges).

[14]Obviously a levy imposed by these terms would reach the great majority of income received by Tennesseans. To the extent that some income might not readily be characterized as resulting from the exercise of such privileges, it is the opinion of this Office that the General Assembly may also tax the privilege of "receiving income or earnings." While such a tax, under very peculiar circumstances, was struck down in *Jack Cole*, the conclusory language in that opinion is in conflict with many better reasoned decisions, as discussed in Part IV(C)(1) *supra* at 18-19. Moreover, much passive income, such as that from trusts and annuities, could not exist except for the legal framework and protection offered for such devices by State law. Certainly the State can tax the privilege of receiving and enjoying the protections and benefits provided by government itself; in the broad sense, those protections and benefits include fostering the economic and legal systems that make possible the receipt and enjoyment of all income. Ultimately, as the Armstrong Article, 27 VAND. L. REV. at 489, and the United States Supreme Court have put it, an income tax can be founded upon the rights and privileges to receive and enjoy income, which attach to domicile within the State and are fostered by the protections the State provides to those who reside or derive earnings within its borders. *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313, 57 S.Ct. 466, 467, 81 L.Ed.2d 666 (1937); *see also Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 628-29, 101 S.Ct. 2946, 2959, 69 L.Ed.2d 884 (1981)(tax justified by state's maintenance of a civilized society and economic order); *Hooten v. Carson*, 186 Tenn. 282, 288-89, 209 S.W.2d 273, 275 (1948)("the State ***in the exercise of its sovereign power*** may impose a privilege tax upon any and all business transactions ***to the end that the general public be protected from unfair trade practices*** . . . ." (emphasis added)).

VI.

VALIDITY OF AN INCOME TAX AS A PROPERTY TAX

Another possible means of imposing a State income tax is to label income itself as a species of intangible personal property and to tax it at the State level. While this approach was not viable in the *Evans v. McCabe* era, it is tenable now on account of the 1973 amendment to Article II, §28.

To be sustained as a property tax, a levy must comply with the exacting provisions of Article II, §28. All parties agreed in *Evans* that the 1931 income tax act did not comply with the constitutional requirement that the tax be levied at a rate uniform with taxes levied on other property. 164 Tenn. at 681. The 1931 Act obviously failed this test because it was itself graduated, and because its rates bore no relationship to the ad valorem taxes on other real and personal property.

The Tennessee Constitution was amended in 1973 to remove the uniformity clause and establish a classified property tax. The clause now removed was the reason the tax in *Evans* failed as a property tax, so that decision is no longer a barrier to this approach. The present version of Article II, §28 specifically declares that "[t]he Legislature shall have power to classify Intangible Personal Property into subclassifications and to establish a ratio of assessment to value in each class or subclass . . . ." Income might conceivably be defined as comprising one or several of these classes.

The conceptual nature of a tax on income has been the subject of considerable theorizing by both federal and state courts. The dominant view is to categorize an income tax as an indirect, excise, or privilege tax. *Hattiesburg Grocery Co. v. Robertson*, 126 Miss. 34, 88 So. 4 (1921); *Standard Lumber Co. v. Pierce*, 112 Ore. 314, 228 P. 812 (1924); *Crescent Manufacturing Co. v. Tax Commission*, 129 S.C. 480, 124 S.E. 761 (1924). There is certainly respectable authority, however, for characterizing an income tax as a property tax. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 15 S.Ct. 673 (1895); *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 15 S.Ct. 912 (1895)(holding federal tax on income, to the extent derived from property, to be a direct tax on property, and therefore unconstitutional because not apportioned among the states); *Eliasberg Brothers Mercantile Co. v. Grimes*, 204 Ala. 492, 86 So. 56 (1920); *State v. Pinder*, 30 Del. 416, 108 A. 43 (1919). Heretofore in Tennessee income has not been regarded as a type of property separate and apart from both its source and the form in which it is maintained once it is received. Thus it has not previously been thought of as a distinct species of intangible personal property. But in *Sherwood Company v. Clary*, 734 S.W.2d 318, 321 (Tenn. 1987), the Supreme Court recognized that the General Assembly

> was given very broad discretion with respect to determining the value and definition of property in each of the authorized classifications or subclassifications.

And since no preordained classifications are established by the Constitution for intangible personal

property, in contrast to the framework specified for real and tangible personal property, the legislature's discretion concerning intangibles is particularly broad.

As this Office discussed in its 1981 opinion, Op. Tenn. Atty. Gen. No. 81-497 (Sept. 2, 1981), the call of the 1971 Limited Constitutional Convention that wrote the amended version of Article II, §28 contained a prohibition against consideration of a personal income tax. While it is settled that this aspect of the call was not legally binding, *Snow v. City of Memphis*, 527 S.W.2d 55 (Tenn. 1975), its existence militates against construing the constitutional changes stemming from that Convention as justifying as income tax. But since this construction results from the creation of a classified property tax system, rather than from the direct imposition of an income tax, it would be improper to accord the call much weight.

Thus this Office is aware of no constitutional impediment to classifying income as a separate species of intangible personal property. The very broad power of the legislature to define and classify the property in each authorized class or subclass indicates that an act defining income as a species of intangible personal property and taxing it as such would be valid. While in Tennessee income has not previously been conceived to be a taxable species of intangible personal property, the courts would be obligated to honor an act of the legislature deeming it to be such. Thus even though such a concept would be a novel one in Tennessee property tax law, it is the opinion of this Office that such an act would be valid.

VII.

VALIDITY OF AN INCOME TAX UNDER THE INHERENT POWERS OF THE GENERAL ASSEMBLY.

It has also been suggested that the legislature might impose an income tax directly, without attempting to structure it as either a property or a privilege tax, under its inherent, sovereign powers. Article II, §28 does not state or necessarily imply that it was designed to subsume all of the State's inherent taxing power. Some other states whose constitutions mention only property and privilege taxes have imposed income taxes as such, rejecting arguments that to mention two types of taxes thereby prohibits all others. *See Stanley v. Gates*, 179 Ark. 886, 19 S.W.2d 1000 (1929); *Diefendorf v. Gallet*, 41 Ida. 619, 10 P.2d 307 (1932). There is some case law in Tennessee on each side of this proposition.

Of course, the General Assembly draws its power directly from the people, and the Constitution merely limits and channels that power. Absent some constitutional restriction, the General Assembly has inherent authority to make all needful laws without a specific grant of permission in the Constitution. *Dennis v. Sears, Roebuck & Co.*, 223 Tenn. 415, 446 S.W.2d 260 (Tenn. 1969); *Perry v. Lawrence County Election Commission*, 219 Tenn. 548, 411 S.W.2d 528 (1967). The Supreme Court in *Friedman Brothers v. Mathes*, 55 Tenn. (8 Heisk.) 488, 492 (1872), pronounced,

> The taxing power is an essential incident of sovereignty. The only

> limitations upon it must be sought in the organic law. It is not conferred by constitutions--but we look to them only for the limitation upon it. If they do not exist in the Constitution they do not exist at all, and the State is left to measure the exercise of this tremendous power by its necessities alone. It may create its own sources of revenue, and determine at discretion what shall be taxable and what not taxable--if the organic law itself has not restricted this discretion.

Since the Constitution does not necessarily imply that Article II, §28 embodies all State taxing power, the notion that the legislature may impose an income tax through its inherent power cannot be dismissed. Many later Tennessee decisions do state or imply, generally in an offhand fashion without much analysis, that property and privilege taxes cover the whole domain of permissible taxation. *Railroad Co. v. Harris*, 99 Tenn. 684, 701-02, 43 S.W. 115, 199 (1897); *Tennessee Trailways, Inc. v. Butler*, 213 Tenn. 136, 142-43, 373 S.W.2d 201 (1963). But this runs against

> the well-settled principle that ***a constitutional limitation upon the power of taxation will never be inferred or implied***. The right to tax is essential to the existence of government, and is peculiarly a matter for the legislature, and ***the legislative power in this respect can only be restrained by a distinct and positive expression in the fundamental law***. (emphasis added)

Vertrees v. State Board of Elections, 141 Tenn. 645, 658, 214 S.W. 737 (1919). Plainly, there is no such "distinct and positive expression" forbidding an income tax in the text of the Tennessee Constitution.

Once one rejects as unfounded the implication drawn by *Evans v. McCabe* that an income tax is prohibited, nothing in the Constitution forbids a State income tax.[15] So it is conceivable that the courts would approve an income tax that was not labeled as a privilege or property tax. But once the assumption underlying *Evans* is rejected, there is also nothing to prohibit the enactment of an income tax through the vehicle of a privilege tax. So while action under the legislature's inherent and sovereign power is conceivable, the only real obstacle to enactment of an income tax in Tennessee is *Evans* and the implication it draws that the "stocks and bonds" clause precludes taxation of income from other sources, an implication

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[15]Article XI, §9, as amended in 1953, provides:

> The General Assembly shall not authorize any municipality to tax incomes, estates, or inheritances or to impose any other tax not authorized by Sections 28 or 29 of Article II of this Constitution.

Thus while the State currently taxes estates, inheritances, and incomes from stocks and bonds, cities and towns cannot be authorized to do so. It is unclear whether the courts would use this language to prevent municipalities from levying privilege taxes measured by income, should the legislature authorize them to do so.

that is contrary to the historical record.

VIII.

CONCLUSION

Upon this analysis, it seems clear that the General Assembly does have the power to levy a properly-structured income tax as a privilege tax imposed on income-producing activities and measured by earnings, as a tax on income as a species of intangible personal property, and possibly as a direct and uncategorized tax imposed under the legislature's inherent authority. The flawed logic of *Evans v. McCabe* and *Jack Cole* is not persuasive and cannot reasonably be regarded as putting the income tax issue to rest. As Armstrong puts it, "One cannot believe that the last word on the subject of privilege has been authoritatively uttered by the Tennessee court . . . ." Armstrong Article, 27 VAND. L. REV. at 489. This is particularly true in light of the conclusive proof in the records from the 1870 Constitutional Convention that the "stocks and bonds" clause of Article II, §28 was not intended to restrict taxation of income from other sources.

For these reasons, this Office in its 1981 opinion concluded that a State income tax is constitutionally defensible and has consistently maintained that position since that time. Of course, no one can know with absolute assurance how the present Supreme Court would rule if confronted with the issue. But this Office is confident that the Court's ruling would not be confined to the precedents that have heretofore been cited as the basis for the proposition that the Constitution prohibits a personal income tax. And when viewed afresh in light of the wording of Article II, §28 and the intent of its framers as revealed in the historical record, this Office concludes that the General Assembly does have the power to levy a State income tax in Tennessee.

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