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Roger J. Traynor
State Board of Equalization
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Operation of the State Sales Tax

By PROFESSOR ROGER J. TRAYNOR
State Board of Equalization

It is a pleasure to have this opportunity to talk to you about the sales tax, particularly in view of the resolution which was presented here this morning. It may be helpful to make a few observations, in the hope that they may operate to the mutual advantage of iron and steel groups and the State Board of Equalization.

When the legislature met in January, 1933, it faced a critical tax situation. Owing to the heavy demands that had been made by various governmental agencies and also to the fact that general business conditions were so dull that substantial sources of revenue were inadequate. The State obtained most of its tax revenue from the gross receipts tax on utilities and from the tax measured by income on other corporations, but because of the depression, the gross receipts of utilities decreased considerably and most businesses had little or no net income.

The legislators' attempts to increase the taxes on utilities met defeat early in the session. The fiscal situation of the counties was desperate. The counties obtained most of their taxes from real property, but the alarming increase in tax delinquencies demonstrated not only that no more money could be obtained from real property, but that, in fact, relief had to be given to real property.

Such was the dilemma that faced the legislature. If government were to continue, more money had to be obtained. That money could not be obtained from taxes on real property, and real property taxes had to be reduced.

In the light of that generalization that the sales tax has to take up some of the governmental expenditure, the constitutional amendment adopted by the people on June 27 was designed to do two things:

1. To secure the necessary funds for governmental purposes.
2. To relieve real property.

The legislature made several heroic attempts to decrease governmental expenditures. That was a task of tremendous difficulty. Every time the legislature attempted to curb governmental expenses some particular group getting advantage of the same or similar expenditures involved voiced objections. The spatha of the people heightened the difficulty. The legislature's attempts to curb expenditures, therefore, were only partially successful. Perhaps some of the expenditures that they did cut out were not cut with a great deal of wisdom. The session, however, realized its main objectives; real property taxes were lowered, through the shifting of a large portion of the school burden from the counties to the state, and additional revenues were obtained by the passage of the sales tax.

As you know, prior to the constitutional amendment, the State contributed to the support of the public school system $30 per pupil in average daily attendance in the elementary and high schools. The constitution of the State required that the least burden should be on the local taxing districts. The constitutional amendment, the Riley-Stewart plan, reduced the counties of this burden, a burden of roughly $4,000,000 a year. The sales tax was designed to obtain this $40,000,000 a year, which was formerly obtained from real property taxes.

In the light of your resolution, your attitude toward the sales tax will depend upon whether it saves or costs you money. The way to determine that is to estimate how much you lose by virtue of inter-state commerce's compelling your absorption of the sales tax. Is the amount of sales tax that you absorb greater than the amount of money you save on your real property taxes? If it is, then the sales tax is operating to your disadvantage.

Now, in regard to your particular industry, the greatest defect in the sales tax is a defect that is inherent in this kind of taxation and a defect that is emphasized in your resolution, competition with inter-state commerce. Perhaps several of you may wish to know about that. The particular solution which I think implicit in your resolution, goes to the very heart of the whole sales tax. Before tackling the solution which I think implicit in your resolution, I might take up some of the other solutions that have been proposed. Perhaps, however, I should give you a picture of the problem as I see it.

Because of the belief of the members of the Supreme Court, shortly after the formation of the Union, that there should be the greatest possible freedom of commerce between the various States, they restricted taxation on inter-state commerce. I think their decisions were far too broad, but in view of the condition of the country at the time they were made, they are understandable. Something had to be done to mitigate the jealousy, bickerings and trade barriers that were building up between the new States. John Marshall, a man of great vision, influenced the Supreme Court to decide the cases in a way which would encourage a free flow of commerce among and between the various States.

The whole picture is changed now. There is not the need for this encouragement of inter-state commerce, and it would seem fair that inter-state commerce should now be subjected to the same burdens as domestic commerce.

However, any state passing a sales tax has to confront these United States Supreme Court decisions. Gross receipts from the sale of goods which are manufactured outside the State, and pursuant to the contract of sale shipped into California, cannot be taxed. Protesting resolutions sent to the legislature cannot circumvent the existing legal situation. If you attempt to tax this inter-state commerce, people will pay their taxes under protest and sue to recover them, and the State will have piled up a huge interest indebtedness. The legislature cannot do anything about it.

The solution, then, comes to one of two alternatives. One is to exempt your products from taxation entirely, and the other, which seems to me the better, that is, if you are going to have a sales tax at all, is to get remedial legislation from Congress.

Whether your group, or similar groups, are active or apathetic, the situation must change. It is getting intolerable, not only with regard to the sales tax, but also with regard to business, franchise and excise taxes generally. Corporations engaged in interstate commerce exclusively do not have to pay any franchise tax. They are not taxed, as you are, according to your net income under the business and corporation franchise tax. All of these anomalies must be removed. They can be removed, I think, by Congressional legislation in one of two ways:

1. By a statute on the part of Congress subjecting inter-state commerce to the same tax burden that the domestic commerce is subjected to.

2. Another solution, and one which is gathering a great deal of support at the present time, is Federal taxation, particularly along the lines of the sales tax. The idea is for the Federal Government to collect the sales tax and then allocate the money back to the States. Thus, the State will have piled up a huge interest indebtedness. It confronts, however, all sorts of political difficulties. Proper allocation would be an administrative as well as a political problem.

The other solution, that is the one which is implicit, it seems to me, in your resolution, is that manufactured products be exempt from the sales tax entirely.

When the sales tax bill was evolving, its sponsors felt that there should be as few exemptions as possible. The reason for that was that in view of the large amount of money that was needed, the base had to be as broad as possible. Another conviction was that tax exemptions in any form are unjustifiable. Is there any reason, to cite an extreme example, why the city of Sacramento should not tax the State Capitol? Is there any reason why the city of Berkeley should not tax the State University, and why churches and colleges should not pay taxes? If the products of manufacturers of steel and iron are to be exempt, then is skillful should be exempt; then the office equipment that is sold to business people should be exempt, and so on down the line. Briefly, one exemption opens the door to exemptions generally.

Another possible solution is the formulation of rules and regulations by the State Board designed to operate with as little difficulty as possible in your business. That is what it has attempted to do. A basic principle is the proper formulation and application of its rules has been to protect California business in every way possible. The taxpayer whose business in inter-state commerce must base his claim for exemption on the most definite and precise legal authority.

It seems to me that your group faces a situation which is inherent in a sales tax. You cannot circumvent the inter-

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Our acts result always from either impulse or contemplation. Impulse from within is the result of quick thinking, and often dictated by the so-called subconscious mind; therefore when we act on impulses we are very apt to do the thing that would seem, for the moment at least, to serve our selfish ends regardless of the rights of others and regardless of whether the thing is right or wrong, because we have not had an opportunity for analysis. If we would "stop, look, and listen" before acting from impulse as we always do from contemplation, we would more often be right and our ends, whether selfish or not, would be better served.

The President has said that reform will follow recovery, and he is right to a greater extent than many of us will suspect. The world is tired of strife. With contacts men become better informed and the contacts that this movement has brought about is changing human thinking; it has developed a new spirit of interdependence. This revolution in thought also has its moral and spiritual aspects for our codes of fair competition will have a profound effect upon our other codes, such as social, civil, criminal, political, and religious; and we will hold what we gain in this connection, for we will have reached a greater degree of intelligence and understanding which will precede our "returning to 1929."

Cooperation of the Purchasing Agents

(Continued from Page 15)

practice in connection with these codes, and I think it is getting results. People come in and condemn the code. I call their attention to the fact that it is their code; that they wrote it; that the Government merely approved it.

Furthermore, they come in and say, "Under the code we cannot do this—and that."

I make it a practice to ask what section of the code covers these restrictions. I do this because occasionally in such instances I find, upon checking these codes, that the men representing the various industries are in error, and that they themselves have not the correct interpretation of their own codes. I think the sooner we get down to enforcing the codes, and leaving out what they think they might say, the less criticism will be directed at the codes. The success of the NRA depends upon the speed with which the errors are eliminated and the misrepresentations are stopped. I think we are all definitely in favor of NRA, and should not do anything to hinder it.

I think the "selling below cost" condition in the codes is one of the first things there is, because no purchasing agent is ever in favor of buying anything below cost. "Selling below cost" soon eliminates a source of supply and, after all, a source of supply is one of the principal needs of a retailer. Our source of supply must make money or it cannot continue.

"Buy locally" has caused no end of discussion in the past. I think the codes have, in a way, solved that. Prices, quality and service are always considered when a purchase is made. Prices, in most instances, are now equal. I have never heard any criticism of the quality of goods manufacturing by any member of this group. That leaves service as the only element left to be discussed. Can anybody, too, three or four thousand miles away from here, equal the service of a local firm? You cannot very well expect to get better service away from home than you get at home. It seems to me that the matter of local buying, whose goods are locally manufactured, has almost been solved for you by the codes.

I have been asked to speak on the cooperation of the purchasing agents, and I hastened up through this history to show you that the purchasing agents have been trying to educate themselves so that they could buy intelligently, buying intelligently, I think, is not a thing to be feared by any manufacturer, that a thing that cannot be avoided.

The purchasing agents have asked me to bring this to you: That we would like to have you bring to us any new products you develop, or any new developments of old products. We should like to have you bring ideas to us for discussion that we may be better informed.

We want to bring our problems to you and receive your support and investigation.

Now, as to the cooperation of the purchasing agents themselves, I have been asked to invite you to bring your problems to us whenever we can help, I want to assure you, gentlemen, that you will receive our enthusiastic and whole-hearted cooperation.

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state commerce problem nor can you prevent the avoidance of the sales tax by your competitors in interstate commerce. You may get a rule which mitigates the situation, but the inherent viciousness lies in the exemption afforded by the United States Constitution.

I should like to spend the rest of the time allotted to me in talking to you about the outstanding rule applicable to your business, namely, that if a contractor erects a building on a lump sum contract he is considered the consumer of materials, and the taxable sale is the sale to him. In other words, the tax applies to the gross receipts from the sale of all iron and steel and other manufactured products to the contractor. That rule applies likewise to the sub-contractor. If, however, the contractor or the sub-contractor has agreed to erect the building, or to do the work for a fixed sum, and has turned the fixed sum over to the contractor or sub-contractor, then he is considered the retailer of the materials and the tax applies to the charges that he makes for the materials.

The most difficult situation involves fabricated products. If a contractor makes his own product out of raw materials, and installs it, he is considered the retailer thereof. For example, take a person who installs electrical fixtures. He manufactures the fixture himself and also installs it. If the lump sum rule applied to him there would be no tax on the gross receipts from the sale of the fixtures. Or take a person who makes cement pipe out of his own sand and gravel and installs that cement pipe. If the lump sum rule applied to him there would again be no tax, thus entailing discrimination against people who do not manufacture and install their own materials. In order to protect people who buy from others the things which they install, some rule has been devised applicable to persons who both manufacture their own products and installed them. And to the rule arose that if tangible personal property is fabricated out of other materials and then installed, the tax will apply to the fair retail value of the fabricated materials.

In the difficult question of goods which may goods be considered to have been fabricated? When is iron and steel comparable to the cement pipe, for example, spoken of earlier? Perhaps the best way of answering that question would be to investigate the steel and iron foundries to see in what degree the tangible personal property fabricated has changed its original form. The Board has ruled that merely drilling, cutting, welding and punching holes in iron or steel for erection in a building is not a fabrication, and that the tax applies to the gross receipts of the sale of the steel to the contractor or sub-contractor. In other words, the answer to the question is the degree of fabrication, the change of species, the extent to which the new product is an entirely different product. The question is largely one of degree. The answer to it depends upon the facts in each particular case.
It is a pleasure to have this opportunity to talk to you about the sales tax, particularly in view of the resolution which was presented here this morning. It may be helpful to emphasize the hope that they may operate to the mutual advantage of the iron and steel groups and the State Board of Equalization.

When the legislature met in January, 1933, it faced a critical taxation situation. Owing to the heavy demands that had been made upon governmental funds, as well as local, huge sums of money were needed. The existing sources of revenue were inadequate. The State obtained most of its revenue from the gross receipts tax on utilities and from the tax imposed on other corporations, but because of the depression, the gross receipts of utilities decreased considerably and most businesses had little or no net income.

The legislators' attempts to increase the taxes on utilities met with only partial success. Perhaps some of the advantages that would be obtained by the people on June 27 were designed to do two things:

1. To secure the necessary funds for governmental purposes.

2. To relieve real property.

The legislature made several heroic attempts to decrease governmental expenditures. That was a task of tremendous difficulty. Every time the legislature attempted to curb government expenditures, one particular group got an advantage from the particular expenditures involved voiced objections to the cuts.

The anxiety of the people heightened the difficulty. The legislature's attempts to curb expenditures, therefore, were only partially successful. Perhaps some of the expenditures did cut, but the constitutional amendment adopted by the people on June 27 was designed to do two things:

1. By a statute on the part of Congress subjecting interstate commerce to the same tax burden that the domestic commerce is subjected to.

2. Another solution, and one which is gathering a great deal of support at the present time, is Federal taxation, particularly along the lines of the sales tax. The idea is for the Federal Government to collect the tax and then allocate the money back to the States. This is an heroic ambition. It confronts, however, all sorts of political difficulties. Proper allocation would be an administrative as well as a political problem.

The other solution, that is the one which is implicit, it seems to me, in your resolution, is that manufactured products be exempt from the sales tax entirely.

When the sales tax bill was evolving, its sponsors felt that there should be as few exemptions as possible. The reason for that was that in view of the large amount of money that was needed, the base had to be as broad as possible. Another conviction was that tax exemptions in any form are unjustifiable. Is there any reason, to cite an extreme example, why the city of Sacramento should not tax the State Capitol? Is there any reason why the city of Berkeley should not tax the State University? After all, churches and colleges should not pay taxes? If the products of manufacturers of steel and iron are to be exempt, then foodstuffs should be exempt; then the office equipment that is sold to business people should be exempt, and so on down the line. Briefly, one exemption opens the door to exemptions generally.

The possible solution is the formulation of rules and regulations by the State Board designed to operate with as little vigor as possible on your business. That is what it has attempted to do. A basic principle in the formulation and application of its rules has been to protect California industry in every way possible. The taxpayer whose business is in interstate commerce must base his claim for exemption on the most definite and precise legal authorization.

It seems to me that your group faces a situation which is inherent in a sales tax. You cannot circumscribe the inter-
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The President has said that reform will follow recovery, and he is right to a greater extent than many of us will suspect. The world is tired of strife. With contacts men become better informed and the contacts that this movement has brought about is changing human thinking; it has developed a new spirit of interdependence. This revolution in thought also has its moral and spiritual aspects for our codes of fair competition will have a profound effect upon our other codes, such as social, civic, criminal, political, and religious; and we will hold what we gain in this connection, for we will have reached a greater degree of intelligence and understanding which will preclude our "reverting to type."

**Cooperation of the Purchasing Agents**

(Continued from Page 10)

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Furthermore, they come in and say, 'Under the law we cannot do this—and that.' I make it a practice to ask what section of the code covers these restrictions. I do this because occasionally in such instances I find, upon checking these codes, that the men representing the various industries are in error, and that they themselves have not the correct interpretation of their own codes.

I think the sooner we get down to enforcing the codes, and leaving out what we think they might say, the less criticism will be directed at the codes. The success of the NRA depends upon the speed with which the errors are eliminated and the misrepresentations are stopped. I think we are all definitely in favor of NRA, and should not do anything to hinder it.

I think the "selling below cost" condition in the codes is one of the finest things there is, because no purchasing agent is ever in favor of buying anything below cost. "Selling below cost" soon eliminates a source of supply and, after all, a source of supply is one of the principal needs of a purchasing agent. Our source of supply must make money or it cannot continue.

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Prices, quality and service are always considered when a purchase is made. Prices, in most instances, are the new exacting factor. I have never heard any criticism of the spirit of the products manufactured by any member of this group. That leaves us out of the only element left to be discussed. Can anybody too, three or four thousand miles away, tell you here, equal service of a local? You cannot very well expect to get better service away from home than you can get at home. It seems to me that the matter of local buying, where goods are locally manufactured, has almost been solved for you by the codes. I have been asked to speak particularly on the cooperation of the purchasing agents, and I have set up through this history to show you that the purchasing agents have been trying to educate themselves so that they could buy intelligently. I think it is not a question of intelligence but that a thing they should desire.

The purchasing agents have asked me to bring this to you: That we would like to have you bring to us any new products you develop, or any new developments of old products. We should like to have you bring these ideas to us for discussion that we may be better informed.

We want to bring your problems to you and receive your support and investigation.

Thus to the cooperation of the purchasing agents themselves, I have been asked to invite you to bring your problems to us whenever we can help. I want to assure you, gentlemen, that you will receive our enthusiastic and whole-hearted cooperation.

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I would like to spend the rest of the time allotted to me in talking to you about the outstanding rule applicable to your business, namely, that if a contractor erects a building on a lump sum contract he is considered the consumer of iron and steel, and the taxable base is the cost of the materials. In other words, the tax applies to the gross receipts from the sale of all iron and steel and other manufactured products to the contractor. That rule applies likewise to the sub-contractor. If, however, the contractor or the sub-contractor has agreed to erect the building, or to do the work for a particular sum, and has agreed to furnish the materials for a particular sum, he is considered the retailer of the materials and the tax applies to the charges that he makes for the materials.

The most difficult situation involves fabricated products. If a contractor makes his own product out of raw materials, and installs it, he is considered the retailer thereof. For example, take a person who installs electrical fixtures. He may manufacture the fixture himself and then install it, or he may buy electrical fixtures and install them. In other words, the tax applies to the gross receipts from the sale of the fixtures. If the lump sum rule applied to him there would be no tax on the gross receipts from the sale of the fixtures. Or take a person who makes cement pipe out of his own sand and gravel and installs that cement pipe. If the lump sum rule applied to him there would be no tax, thus entailing discrimination against people who do not manufacture and install their own materials. In order to protect people who buy from others the things which they install, some rule had to be devised applicable to persons who both manufacture and install their own products and installed them. And so the rule arose that if tangible personal property is fabricated out of other materials and then installed, the tax will apply to the fair retail value of the fabricated materials. The rule stated is exactly the same as the one in effect in California for a long time.

Now the difficult question arises: When may good be considered to have been fabricated? When is iron and steel comparable to the cement pipe, for example, spoken of earlier? Perhaps the best way of answering that question would be to investigate the steel and iron boundaries to see in what degree the tangible personal property fabricated has changed its original form. The Board has ruled that merely drilling, cutting, welding and punching holes in iron or steel for erection in a building is not a fabrication, and that the tax applies to the gross receipts of the fabricator to the contractor or sub-contractor. In other words, the answer to the problem is the degree of fabrication, the change of species, the extent to which the new product is an entirely different product. The question is largely one of degree. The answer to it depends upon the facts in each particular case.

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