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FEDERAL TAXATION OF STATE AND MUNICIPAL BOND INTEREST

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The decade now nearing its close has witnessed a vast expansion in the activities of the federal government. This has inevitably been accompanied by a tremendous increase in its expenditures. The revenues required to meet them were derived for the most part from borrowing and taxation. The former source was the more heavily relied upon, particularly during the earlier years of this period. This was the natural consequence of the general acceptance by governmental leaders of what critics chose to describe as unorthodox and unsound fiscal theories. Taxation was also employed on an increasing scale. The federal income tax was being constantly adjusted in various ways. The aims of the changes were various and not always consistent. Some of them merely anticipated revenues that might otherwise have been garnered in later years; others were motivated by a philosophy of using the taxing power as an instrument of social reform; and still others were intended to increase revenues by closing avenues for tax avoidance or by the more direct method of increasing tax rates. The Supreme Court cooperated with Congress in this field, especially by its exceedingly liberal and sometimes forced constructions of statutory provisions such as Section 22(a) of the various Revenue Acts.[1] The need for tax revenues, however, grew apace as national defense demands were added to those of an expensive and continuing program of social reform. It was quite natural that government leaders should ultimately search for new sources of tax revenues as well as cultivating existing sources more intensively. It was not only natural, but inevitable, if the chaos of inflation or national bankruptcy were to be escaped. But even statesmen hesitated to revise tax systems in a manner incompatible with the supreme demands of political expediency. It was, therefore, not at all strange that attempts should be made to subject to federal taxation income that had been previously deemed immune therefrom. The present discussion will consider the constitutional aspects of one of the suggestions of this character.

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[1] See Helvering v. Clifford, 309 U. S. 331, 60 S. Ct. 554, 84 L. ed. 788 (1940); Harrison v. Schaffner, 61 S. Ct. 759, 85 L. ed. Adv. Ops. 694 (1941); Helvering v. Horst, 311 U. S. 112, 61 S. Ct. 144, 85 L. ed. Adv. Ops. 99 (1940); Helvering v. Eubank, 311 U. S. 122, 61 S. Ct. 122, 85 L. ed. Adv. Ops. 104 (1940); Pavendstedt, *The Broadened Scope of Section 22(a): The Evolution of the Clifford Doctrine* (1941) 51 YALE L. J. 213; Surrey, *The Supreme Court and the Federal Income Tax* (1941) 35 ILL. L. REV. 779.

The two principal types of income deemed immune from federal taxation in 1933 were the compensation of state and municipal officers and employees and the interest on state and municipal obligations.[2] The precise scope of this immunity will be hereinafter discussed. It was based on a judicial extension of the implied immunity doctrine first announced by Mr. Chief Justice Marshall in 1819 in *McCulloch v. Maryland*.[3] The former has recently been judicially determined to be no longer existent even without the aid of Congressional legislation.[4] The present existence of the latter is today the subject of considerable debate. It was the principal topic of discussion at a general session of the National Tax Association at its annual meeting held last October in St. Paul, Minnesota. The tenor of that discussion revealed the fear felt by state officials that federal taxation of the interest on state and municipal bonds would enable the federal government to exert a degree of control over state and municipal activities incompatible with the maintenance of the constitutionally established balance between state and nation and with democratic principles generally. It revealed with equal clarity the determination of the federal government to exert itself to the utmost to achieve a reversal of the doctrine immunizing such income from federal taxation. The repudiation of that doctrine is absolutely essential even if federal authorities limit the proposal to tax such interest to that on future issues of state and municipal obligations. It is not, however, certain that their use of a victory on this question would be confined within such modest limits. It is true that President Roosevelt in his message to Congress on April 25, 1938, limited his recommendation on this matter to legislation taxing the interest on future issues only.[5] However, statements have been subsequently made by persons connected with the federal government indicating a much more inclusive ultimate objective. These were not made in any official capacity, but nevertheless may be taken as evidence of the direction of official thinking on this matter.[6] Thus far Congress has

[2] The term "municipal" is herein used to designate any political subdivision of a state, and any public agency or instrumentality employed by it in the performance of its functions, both strictly governmental and non-strictly governmental.

[3] 4 Wheat. 316, 4 L. ed. 579 (1819).

[4] Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938). This is one of the cases relied upon by the Department of Justice in its study entitled *Taxation of Government Bondholders and Employees.* The reciprocal character of the liability of public salaries to taxation was affirmed in Graves v. People *ex rel.* O'Keefe, 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939).

[5] The same message also recommended legislation to permit states to tax the interest on future issues of federal bonds.

[6] See on this matter an address by Austin J. Tobin, Assistant General Counsel of the Port of New York Authority, delivered at the 30th Annual Convention of the Investment Bankers Association, Hollywood, Florida, December 4, 1941, which was separately published by the Conference on State Defense, New York City.

declined to enact into law even the modest proposal of President Roosevelt.

A very recent move of the federal government in an attempt to secure an adjudication of its power to tax the interest on bonds of a state agency is the assessment of an additional income tax upon the holder of bonds issued by the Port of New York Authority. The additional tax is due to the inclusion in the bondholder's gross income of the interest on those bonds. The statute in force during the year for which the assessment was made expressly excludes from gross income "Interest upon the obligations of a State . . . or any political subdivision thereof."[7] The Commissioner of Internal Revenue is apparently proceeding on the assumption that the bonds in question are not "obligations of a State or any political subdivision thereof." This assumption is undoubtedly well founded.[8] The taxpayer will thus be forced to pay the additional tax unless he can show that the immunity doctrine protects him from this attempted assertion of federal taxing power. It is expected that the Supreme Court will ultimately decide this test case. The importance and effect of a decision by it sustaining the tax will depend entirely upon the basis on which the decision is rested. It is conceivable that the tax might be upheld on the basis of the character of the activity of the Port Authority. Such a decision would leave the broad general problem unsolved. It is, however, more likely that the Court will deal with the problem in the same fundamental manner in which it dealt with that of the reciprocal immunity of the compensation of the employees of the one government from taxation by the other.[9] The subsequent discussion will deal principally with the class of considerations that are likely to affect the decision of that fundamental issue.

The lines along which the government's argument will proceed are clearly indicated in a study made by the Department of Justice during 1938 entitled *Taxation of Government Bondholders and Employees.* This is one of the most elaborate investigations ever made of the problem, but suffers to a considerable degree from the defects likely to infect the special pleading of any advocate for his client's position. The

[7] The same provision has been contained in each of the numerous income tax statutes enacted by Congress after the ratification of the Sixteenth Amendment.

[8] This assumption is supported by the statement of Mr. Justice Stone in the prevailing opinion in Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938), that the employees of the Port Authority "are not employees of the state or a political subdivision of it within the meaning of the regulation (Reg. 77, Art. 643) as originally promulgated." Note that the Port Authority is a bi-state non-stock non-profit governmental corporation organized by the states of New York and New Jersey.

[9] See Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938), and Graves v. People *ex rel.* O'Keefe, 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939).

two arguments urged in support of the power of the federal government were (1) that the reciprocal immunity principle as presently construed does not prohibit federal taxation of state and municipal bond interest; and (2) that, in any event, the scope of that principle has been so limited by the provisions of the Sixteenth Amendment as to permit such taxation even though, apart from that Amendment, the interest on state and municipal bonds would be immune from federal taxation. The latter argument is, for practical purposes, equivalent to a contention that the Sixteenth Amendment conferred a previously non-existent power to tax this class of income. Judicial acceptance of either of these positions would insure a victory for the government's thesis. The taxpayer's only arguments relevant to a consideration of the general principles involved must consist of a denial of the two theories on which the government bases its case for taxability. He will have to prove not merely that the reciprocal immunity principle standing by itself protects such interest against federal taxation, but also that the Sixteenth Amendment has not withdrawn that protection. The Supreme Court has already sustained the conclusion of the Department of Justice that the salaries of municipal employees may be taxed by the United States.[10] It did so, however, by a reinterpretation of the reciprocal immunity principle without relying to any extent upon the Sixteenth Amendment.[11] This at least suggests the desirability of first discussing the bond interest problem in relation to that principle apart from any effect that the Sixteenth Amendment may have had upon its scope.

The Immunity Principle

The principle of intergovernmental tax immunity is merely a specific instance of the broader principle that neither the federal government nor a state may so exercise any of its powers as to prevent or unduly interfere with the other's exercise of its powers or performance of its functions. It was first applied to invalidate what was in effect a state tax on the note issue power of the Bank of the United States, a federally incorporated private bank empowered to act in certain respects as an instrumentality of the federal government.[12] Its note issue power had undoubtedly been conferred upon it for the purpose of providing a national currency. The tax in question thus impinged directly upon a power through whose exercise it performed one of the very functions that warranted its incorporation as a federal

[10] See cases cited in footnote 9.

[11] The concurring opinion of Mr. Justice Black in *Helvering v. Gerhardt* does, however, suggest reopening the "entire subject of intergovernmental tax immunity" and reviewing it in the light of the Sixteenth Amendment.

[12] McCulloch v. Maryland, 4 Wheat. 316, 4 L. ed. 579 (1819).

instrumentality. The opinion of the Court is largely devoted to a discussion of broad general principles, although it did invoke the fact that the tax was on the operations of a federal agency in distinguishing it from a tax on the Bank's property which, it was asserted, would be valid. The significance of the decision lies in the fact that the state's inability to impose the tax was predicated on a complete absence of power. The Court refused to treat it as an instance of an unwarranted exercise of a power possessed by a state. There is no logical reason why the adoption of the one of these assumptions should lead to different applications than could be derived from the adoption of the other. It is quite likely, however, that the acceptance of the Court's theory, as enunciated in this case, did influence the future development of the principle. It is significant in this connection that the refusal to extend its application, and the reduction of its scope by overruling earlier decisions, that have occurred during the last two decades, were accomplished by resort to an approach that rather ignores the theory advanced in *McCulloch v. Maryland*. This matter will be more fully discussed later on.

The next important development occurred when the principle was made reciprocal, and extended to protect state functions against exercises of federal taxing power. The issue in the case in which this extension occurred was the power of the federal government to impose an income tax upon the salary of a state judge. The decision denied the existence of such power.[13] A dissent by Mr. Justice Bradley asserts a theory whose logical development might well have deprived states of all immunity, and would certainly have prevented extending it to situations in which the immediate incidence of the federal tax was upon private persons or corporations. The dissenting opinion implies a distinction between state taxation of federal agencies and federal taxation of state agencies which approximates a distinction made by Mr. Chief Justice Marshall in *McCulloch v. Maryland*. Counsel in that case had contended that "every argument which would sustain the right of the general government to tax banks chartered by the states, will equally sustain the right of the states to tax banks chartered by the general government." The two situations were, however, distinguished on the score that a federal tax on a state agency was the act of a government in which all the states are represented while a state tax on a federal agency was that of a government in which the nation as a whole is unrepresented and over which it can exercise no control. The Chief Justice did not, however, infer from this that the states were not protected against federal taxation. He merely stated that counsel's argument might bring into question the

[13] Collector v. Day, 11 Wall. 113, 20 L. ed. 122 (1871).

"right of Congress to tax State banks" but "could not prove the right of the States to tax the Bank of the United States." The only instance in which any Supreme Court Justice has employed the distinction in denying state immunity from federal taxation is that referred to above. It has had no influence whatever either by preventing the immunity principle from achieving its reciprocal character or in limiting the scope of the protection accorded states against federal taxation. It was recently adverted to in the opinions of Mr. Justice Stone in *Helvering v. Gerhardt*[14] and *Graves v. People* ex rel. *O'Keefe*.[15] There is no evidence, however, that it operated as a factor in determining the decisions in those cases, nor the results in any other cases in which particular federal taxes have been sustained against objections based on the intergovernmental immunity principle. It may be asserted safely that it will play no part in deciding whether the federal government may tax the income derived from state and municipal obligations.

An adequate discussion of our problem does not require a detailed specification of the situations in which the immunity has been accorded and denied. It is more important to indicate the bases on which the scope of the immunity has been limited, at least so far as those are still operative. One such basis has been, and is, the character of the state's function which the federal tax is alleged to burden unduly. The first important decision on this matter was *South Carolina v. United States*.[16] This involved the validity of a federal excise tax on the activities of the agents employed by the state in the conduct of its liquor dispensary system. The adoption of that method for dealing with the liquor problem was admitted by the Court to be a proper exercise of the state's police power. The immediate incidence of the tax was thus upon the state itself in connection with its exercise of one of its most important governmental powers. The tax was sustained despite this fact. The basis for the decision was found in the fact that the state had exercised its police power by itself engaging in a business then generally deemed to lie within the proper field of private enterprise. A factor that weighed most heavily with the Court was the threat to the federal government's revenues if states were permitted to reduce the scope of the federal taxing power by engaging in business. It was concluded that a state's immunity from federal taxation extended only to the protection of its strictly governmental functions. Questions at once arose as to what state functions were strictly governmental. The cases demonstrate that the distinctions

[14] 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938).
[15] 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939).
[16] 199 U. S. 437, 26 S. Ct. 110, 50 L. ed. 261 (1905).

between those state functions that are deemed strictly governmental and those that are not, are not the same as those between governmental and proprietary functions as developed in connection with the problem of a municipality's responsibility for the torts of its agents. A more important test is whether the activity engaged in belongs to the class of those generally deemed to lie primarily within the field of private enterprise.[17] The operation of banks,[18] street railways,[19] and intercollegiate athletic contests as an integral part of an educational program,[20] have all been held to be not strictly governmental activities and, hence, liable to federal taxation of one kind or another. A contrary decision has been reached with respect to the operation of waterworks,[21] ferries,[22] hospitals,[23] and schools.[24] It has been suggested that, since the purpose of the immunity was the protection of the states from destruction through federal taxation, only those functions are protected "which they were exercising when the Constitution was adopted and which were essential to their continued existence."[25] This theory would constitute a most efficient principle for the promotion of a highly centralized federal government, but it cannot yet be said to be the law. It should be noted that a federal tax that burdens or impedes a state so far as it is engaged in exercising non-strictly governmental functions is valid whether the tax be directly on the activity or directly affects it, and whether or not its immediate incidence be on the state or on private persons dealing with it.[26]

This restriction on a state's immunity has a direct, though limited, bearing upon our problem. There exists the possibility that the immunity of the interest on state and municipal bonds from federal taxation might be denied in the case of bonds issued to finance non-strictly governmental state and municipal activities while being continued in the case of other bonds. It may be that this is improbable, but it deserves at least passing notice. The first restriction on the scope of the immunity from federal income taxation of the compensation of state and

[17] See Allen v. Regents of University System of Georgia, 304 U. S. 439, 58 S. Ct. 980, 82 L. ed. 1448 (1938).

[18] North Dakota v. Olson, 33 F. (2d) 848 (C.C.A. 8th, 1929).

[19] Helvering v. Powers, 293 U. S. 214, 55 S. Ct. 171, 79 L. ed. 291 (1934).

[20] Allen v. Regents of University System of Georgia, 304 U. S. 439, 58 S. Ct. 980, 82 L. ed. 1448 (1938).

[21] Brush v. Com'r. of Internal Revenue, 300 U. S. 352, 57 S. Ct. 495, 81 L. ed. 691 (1937); in effect overruled, on a basis not affecting the purpose for which it is here cited, by Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938).

[22] United States v. King County, 281 Fed. 686 (C.C.A. 9th, 1922).

[23] Mallory v. White, 8 F. Supp. 989 (D. Mass. 1934).

[24] Hoskins v. Com'r. of Internal Revenue, 84 F. (2d) 627 (C.C.A. 5th, 1936).

[25] See Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938).

[26] No comparable restriction on the federal government's immunity from state taxation has thus far been developed.

municipal employees was in the case of those employed in connection with the performance of non-strictly governmental functions.[27] Prior to that decision lower federal courts had on more than one occasion made that the decisive factor in determining the liability of state salaries to federal taxation.[28] The same remark applies to cases decided thereafter.[29] The Supreme Court as recently as 1937 held immune from federal income tax the salary of a municipal employee because he was employed in connection with a strictly governmental function.[30] The same factor determined the liability to federal income taxation of other types of income derived by private lessees from operations carried on on premises leased from a state.[31] It is true that the exclusion from the immunity of compensation of employees employed in connection with a state's non-strictly governmental functions turned out to be a mere prelude to the complete extinction of the immunity in the case of all classes of state and municipal employees. The cases that deprived employees employed in connection with non-strictly governmental functions solely because of that factor still stand. They furnish a persuasive analogy for a similar restriction on the immunity from federal taxation of the interest on state and municipal bonds issued to finance non-strictly governmental functions.

The adoption of the foregoing restriction might prove of little value if states and municipalities issued only general bonds. It might then be quite impossible to determine the particular bonds whose proceeds were used to finance the non-strictly governmental activities. There may be other ways in which the federal government might meet this obstacle, but the most effective would be to secure a broad decision denying immunity to the interest on every state or municipal bond. This result can be achieved only by overruling the decision in *Pollock v. Farmers' Loan & Trust Co.*, which is the only existing decision squarely on the problem.[32] That case dealt primarily with the question whether a tax on the income from real and personal property was a direct tax. The validity of imposing the income tax upon the interest of state and municipal bonds was but briefly discussed in the opinions accompanying the

[27] Helvering v. Powers, 293 U. S. 214, 55 S. Ct. 171, 79 L. ed. 291 (1934).

[28] Frey v. Woodworth, 2 F. (2d) 725 (E. D. Mich. 1924); Mallory v. White, 8 F. Supp. 989 (D. Mass. 1934).

[29] Hoskins v. Com'r. of Internal Revenue, 84 F. (2d) 627 (C.C.A. 5th, 1936).

[30] Brush v. Com'r. of Internal Revenue, 300 U. S. 352, 57 S. Ct. 495, 81 L. ed. 691 (1937). See footnote 21.

[31] Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 52 S. Ct. 443, 76 L. ed. 815 (1932). The overruling of this case by Helvering v. Mt. Producers' Corp., 303 U. S. 376, 58 S. Ct. 623, 82 L. ed. 907 (1938), does not affect the purpose for which it is referred to in the text.

[32] 157 U. S. 429, 15 S. Ct. 673, 39 L. ed. 759 (1895); see same case on rehearing, 158 U. S. 601, 15 S. Ct. 912, 39 L. ed. 1108 (1895), which did not again consider the point for which the case is here cited.

decision. The principal reasoning consists of a quotation from the opinion of Mr. Chief Justice Marshall in *Weston v. Charleston*[33] which had held invalid a municipal property tax upon bonds of the United States. His language in effect asserted that the power to tax the bond, to any extent, must inevitably affect the power to borrow before its exercise and "have a sensible influence upon the contract." The only other case that need be noted is *Flint v. Stone Tracy Co.*[34] This involved a federal tax on the privilege of doing business in corporate form. The tax was measured by net income. It was decided therein, among other things, that the inclusion in corporate income of interest on state and municipal bonds did not violate the immunity principle since such interest was not the tax subject but merely constituted an element in the measure of the tax on the tax subject which was the privilege of doing business in corporate form. The Court was merely following a well-recognized technique in drawing the distinction it did between tax measure and tax subject. It happens to be a technique that is still frequently resorted to in this and other tax problems. While dissenting opinions have occasionally suggested that the case last cited impliedly overruled the *Pollock* Case in so far as that established the immunity of state and municipal bond interest from federal taxation,[35] the arguments in support of the thesis are far from convincing. It seems wiser to discuss the present status of the decision in the *Pollock* Case on the assumption that it has not yet been either expressly or impliedly overruled. The problem is rather whether current trends in judicial construction of the immunity principle foreshadow its imminent repudiation.

The ultimate basis of the reciprocal immunity principle is the necessity of protecting each of the governments in our dual system from being unduly burdened or impeded in the performance of its functions by exercises of the other's power to tax. It is clear that the problems involved in the application of this principle cannot be properly solved without determining the effects upon the one's functioning of a tax imposed by the other. It would seem to be equally clear that its application would require some measure for determining whether those effects were such as could properly be described as unduly burdening or impeding the other's exercise of its powers. It was recognized in *McCulloch v. Maryland* that not every tax imposed upon a federal instrumentality produced the prohibited effects, since the Court expressly as-

[33] 2 Pet. 449, 7 L. ed. 481 (1829).
[34] 220 U. S. 107, 31 S. Ct. 342, 55 L. ed. 389 (1911).
[35] See, *e.g.*, the dissenting opinion of Mr. Justice Brandeis (Messrs. Justices Holmes and Stone concurring) in National Life Ins. Co. v. United States, 277 U. S. 508, 48 S. Ct. 591, 72 L. ed. 968 (1928).

serted that the state might validly tax the Bank's real property and the shareholder's interest in the Bank. Courts have attempted to distinguish the invalid from the valid effects by defining the former as those that are immediate and direct while describing the latter as those that are merely indirect and remote. The suggested test gives little, if any, guidance for classifying the effects of a specific tax in a particular case. The actual decisions, especially during the first century of the principle's history, generally gave only the slightest clue to the solution of this difficulty. The opinions rendered in them contain almost no discussion of the problem. The tax was almost always held invalid if its immediate incidence was upon the other government.[36] The principal exception thereto was the case in which the federal government levied a tax upon a state's non-strictly governmental activities. The effects were also generally held to be direct if the tax was levied upon the other government's officers or employees,[37] upon its bondholders as such,[38] upon contracts or purchases made by it,[39] or upon the private agencies or instrumentalities employed by it in the exercise of its governmental functions.[40] The result was that the immediate benefits of the immunity often inured to private persons. The opinions in most of the cases applying the principle in the foregoing manner seldom attempted to prove that the effect of the taxes thus held invalid in fact burdened the affected government. That they would so burden it seems generally to have been either assumed or supported by a priori generalizations that were sometimes not even made explicit. The distinction between tax subject and tax measure was developed as a formal basis for classifying effects as direct or indirect. The effect of a grant of an immunity in restricting the taxing power of the government seeking to impose the tax received scant recognition except in the cases involving federal taxation of state non-strictly governmental activities. It is not unfair to state that the courts have failed to evolve an adequate test for determining when a direct burden results from a given tax. This necessarily implies a comparable deficiency in respect of tests for determining when the effects are merely remote and indirect.

The first important case in which a shift occurred towards restrict-

[36] Van Brocklin v. Tennessee, 117 U. S. 151, 6 S. Ct. 670, 29 L. ed. 845 (1886).

[37] Collector v. Day, 11 Wall. 113, 20 L. ed. 122 (1871); Dobbins v. Com'rs. of Erie County, 16 Pet. 435, 10 L. ed. 1022 (1842).

[38] Weston v. Charleston, 2 Pet. 449, 7 L. ed. 481 (1829); Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429, 15 S. Ct. 673, 39 L. ed. 759 (1894).

[39] Panhandle Oil Co. v. Mississippi, 277 U. S. 218, 48 S. Ct. 451, 72 L. ed. 857 (1928); Indian Motorcycle Co. v. United States, 283 U. S. 570, 51 S. Ct. 601, 75 L. ed. 1277 (1931).

[40] McCulloch v. Maryland, 4 Wheat. 316, 4 L. ed. 579 (1819); Gillespie v. Oklahoma, 257 U. S. 501, 42 S. Ct. 171, 66 L. ed. 338 (1922); Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 52 S. Ct. 443, 76 L. ed. 815 (1932).

ing the scope of the immunity by redefining the concept of undue burden was *Metcalf & Eddy v. Mitchell.*[41] The taxpayers therein were consulting engineers employed by several municipalities under contracts with them. The compensation received for services rendered under those contracts was held properly includible in their gross income in computing their federal income taxes. The Court recognized that any tax imposed by the one government is likely to affect the other's exercise of its powers to some extent. It was, therefore, asserted that the immunity principle must be given a practical application which shall take account of the need for protecting both the taxing power of the government imposing the tax and the power of the other affected by the tax. The particular factors stressed in sustaining the tax on the taxpayers' income from their public contracts were that the effect of the tax on the functioning of the municipalities did not "in any substantial manner impair the ability of plaintiffs in error (the taxpayers) to discharge their obligation to the state, or the ability of the state or its subdivision to procure the services of private individuals to aid them in their undertakings." The quoted portion is not wholly free from ambiguity inherent in resort to such phrases as "in any substantial manner." It does, however, imply that private persons claiming a benefit on the basis of the immunity principle will no longer be able to rely upon mere assumptions or general a priori reasoning, but will be required to prove by factual evidence that the tax in fact interferes with the conduct of the other government's operations. This approach has played a prominent part in those subsequent decisions that have refused to extend the immunity and those that have overruled prior cases establishing particular immunities. The decision is more important as reflecting a change of attitude than as defining more precisely the kind of factual situations in which the requisite degree of burden will be held to be either present or absent. This does not mean that this new attitude was immediately effective in preventing new immunities from being established even where a factual test was not applied in determining whether the taxes involved imposed an undue burden upon the other government's operations. The force of analogies furnished by earlier decisions frequently proved decisive. This was true of such decisions as *Burnet v. Coronado Oil & Gas Co.*[42] and *Indian Motorcycle Co. v. United States,*[43] to mention two of the most prominent of such cases. It does, however, mean that the new approach prevailed in some im-

[41] 269 U. S. 514, 46 S. Ct. 172, 70 L. ed. 384 (1926).
[42] 285 U. S. 393, 52 S. Ct. 443, 76 L. ed. 815 (1932), later overruled by Helvering v. Mt. Producers Corp., 303 U. S. 376, 58 S. Ct. 623, 82 L. ed. 907 (1938).
[43] 283 U. S. 570, 51 S. Ct. 601, 75 L. ed. 1277 (1931).

portant decisions,[44] was kept alive by emphatic dissents,[45] and finally became that of a majority of the Supreme Court.

Another significant feature of the opinion in *Metcalf & Eddy v. Mitchell* was the use of the "balancing of interests" technique in determining whether a tax unduly burdened the operations of the government affected by it. Prior decisions had practically ignored as a factor the curtailment of the taxing power of the one government involved in every extension of the immunity principle in favor of the other government. The only significant exceptions were the dissenting opinion of Mr. Justice Bradley in *Collector v. Day,*[46] and the cases sustaining federal taxation of the non-strictly governmental activities of a state.[47] This factor received an increasing emphasis in subsequent decisions,[48] and contributed largely to the overruling of *Collector v. Day* by *Helvering v. Gerhardt*[49] and *Graves v. People* ex rel. *O'Keefe,*[50] and of *Gillespie v. Oklahoma* and *Burnet v. Coronado Oil & Gas Co.* by *Helvering v. Mt. Producers Corporation.*[51] This consideration achieved added influence from the view frequently expressed in Supreme Court opinions that the restriction of the taxing power of the one government was generally accompanied by no corresponding benefit or protection to the other.[52] It was also emphasized that the principal beneficiaries of a grant of immunity were frequently a privileged class of taxpayers who were relieved of the duty, imposed on others, of supporting a government from whose activities they derived protection and other benefits. This argument was invariably coupled with the assertion that these private benefits were being conferred in order to secure for the government affected by the tax a theoretical advantage so speculative in character and measurement as to be unsubstantial. In one case the Court invoked the expanding needs of both the nation and the states as a reason for reconsidering immunities established by prior decisions, and

[44] An excellent illustration is the case of Willcutts v. Bunn, 282 U. S. 216, 51 S. Ct. 125, 75 L. ed. 304 (1931).

[45] See, for example, the dissents in Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 52 S. Ct. 443, 76 L. ed. 815 (1932), and in Indian Motorcycle Co. v. United States, 283 U. S. 570, 51 S. Ct. 601, 75 L. ed. 1277 (1931).

[46] 11 Wall. 113, 20 L. ed. 122 (1871).

[47] See South Carolina v. United States, 199 U. S. 437, 26 S. Ct. 110, 50 L. ed. 261 (1905).

[48] See Willcutts v. Bunn, 282 U. S. 216, 51 S. Ct. 125, 75 L. ed. 304 (1931); James v. Dravo Contracting Co., 302 U. S. 134, 58 S. Ct. 208, 82 L. ed. 155 (1937); Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938); Helvering v. Mt. Producers Corp., 303 U. S. 376, 58 S. Ct. 623, 82 L. ed. 907 (1938); Graves v. People *ex rel.* O'Keefe, 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939).

[49] See footnote 48.

[50] See footnote 48.

[51] See footnote 48.

[52] Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938); Graves v. People *ex rel.* O'Keefe, 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939).

then reversed those decisions.[53] This is merely express confirmation of the inevitable tendency of the courts to be influenced in deciding constitutional issues by currently significant trends of thought. The result of the general acceptance of these various considerations as factors in defining the limits of the immunity principle has been that no new immunities have been added during the last five years while several of those previously established have been repudiated. It should, however, be noted that the cases during this period have all involved taxes imposed on private persons. That is clearly reflected in most of the arguments to which this paragraph has directed its attention.

It has not yet been definitely determined that the immunity principle excludes all instances in which its immediate benefits inure to private persons. This is a not improbable future development except in those situations involving discriminatory taxes. It is, however, still admitted that a tax that precluded the other government from performing its functions, or that obstructed it more than private enterprises were obstructed by such tax, would be invalid by virtue of the immunity principle. The real difficulty is that of determining when a tax produces those results. In all the recent decisions the Supreme Court has stressed the non-discriminatory character of the tax whose validity was being considered. It is practically certain that the immunity principle will in the future, as it has been in the past,[54] be held to have been violated by a tax which operates in a discriminatory manner against the other government, regardless of whether the immediate incidence of the tax be on that government itself or on private persons dealing with it. The Court has gone no further than to affirm that the immunity principle does not require granting one of the governments a competitive advantage over persons in private enterprise by restricting the other government's power to tax.[55] It is to be noted that nothing yet stated or implied can be construed to mean that a prohibited degree of discrimination would arise from a federal tax that discriminated against the states in favor of the federal government itself.

It is extremely doubtful that recent decisions afford private taxpayers any hope of reducing their tax burdens by relying upon the immunity principle where the tax in question does not discriminate against the other government. This is due in large part to the fact that the Supreme Court has definitely rejected the view that the fact

[53] Helvering v. Mt. Producers Corp., 303 U. S. 376, 58 S. Ct. 623, 82 L. ed. 907 (1938).

[54] See National Life Ins. Co. v. United States, 277 U. S. 508, 48 S. Ct. 591, 72 L. ed. 968 (1928); Miller v. Milwaukee, 272 U. S. 716, 47 S. Ct. 280, 71 L. ed. 487 (1927); Schuylkill Trust Co. v. Pennsylvania, 296 U. S. 113, 56 S. Ct. 31, 80 L. ed. 91 (1935).

[55] Helvering v. Gerhardt, 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938).

that a tax imposed by the one government increases the other government's cost of conducting its operations invalidates the tax.[56] Such increase in cost is now viewed as a normal incident of our dual system of government. In its latest expression on this point, the Supreme Court has definitely stated that the prior view on that point was no longer tenable.[57] The currently accepted position logically excludes from the problem all economic theories as to the shifting and ultimate incidence of taxes. The taxpayer in one of the cases, in which the Court applied this rule, had suggested that a state might make the tax so excessive as actually to interfere with the federal government's activities. The Court failed to meet this argument squarely, disposing of it with the suggestion that Congress could protect the United States against that danger.[58] That is a complete answer so far as a state tax is involved. But a state itself has no comparable power to protect itself against an excessive exercise of the federal government's taxing power. It is unlikely that such a state power will ever be recognized. It is certainly conceivable that a federal tax might be so large that a state might have to relinquish some of its activities because the available tax resources were insufficient to defray the added costs traceable to the federal tax. This is a possibility even though the tax might not be discriminatory. The Court may some day be called upon to decide whether such a situation comes within its theory of a tax which precludes a state from performing its functions and which is invalid because of that factor. It is quite likely that the Court's new theory on the non-importance of the effect of a tax imposed by one government upon the costs of the other government will work to the disadvantage of the states, and furnish the federal government with another effective instrument for achieving that overwhelming dominance in our federal system at which its policies in other fields are aiming.

The discussion thus far has dealt with matters that would be pertinent in considering any problem as to the present scope of the reciprocal immunity principle. It now becomes necessary to apply it to the specific case of a federal income tax upon the interest on state and municipal bonds. The immunity of such interest from such taxation dates from the decision in *Pollock v. Farmers' Loan & Trust Co.*[59] It has existed without challenge since that time. Taxpayers have invoked

[56] James v. Dravo Contracting Co., 302 U. S. 134, 58 S. Ct. 208, 82 L. ed. 155 (1937); Graves v. People *ex rel.* O'Keefe, 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939); Alabama v. King & Boozer and United States, 62 S. Ct. 43, 86 L. ed. Adv. Ops. 1 (1941).

[57] Alabama v. King & Boozer and United States, 62 S. Ct. 43, 86 L. ed. Adv. Ops. 1 (1941).

[58] James v. Dravo Contracting Co., 302 U. S. 134, 58 S. Ct. 208, 82 L. ed. 155 (1937).

[59] 157 U. S. 429, 15 S. Ct. 673, 39 L. ed. 759 (1894).

it during recent years in their attempts to bring other forms of income within the immunity principle. The Court's views on it can be gleaned from the distinctions upon which it has relied in answering those taxpayers' arguments. It was accepted without question by the Court that refused to extend the immunity to include gains derived from a taxpayer's sale of such obligations.[60] Its basis was therein asserted to be the same as that on which it had originally been founded, namely, that a tax on the amounts payable under the bond contracts bore directly on the power to borrow. The other important case in which its status was considered was *James v. Dravo Contracting Co.*[61] The taxpayer therein claimed immunity from a state tax imposed upon its gross income received under a construction contract with the United States. It sought support for its position in the immunity of state bond interest from federal taxation. The prevailing opinion distinguished the latter case on the score that it was based on the theory that a tax on the interest operated directly upon the power to borrow, that it involved important considerations respecting the permanent relations of a government to investors in its bonds, and involved such government's ability to maintain its credit. A dissenting opinion accepted the taxpayer's view of the controlling importance of the bond interest case. Nothing that the Court has recently said about the immunity of state and municipal bond interest from federal taxation can be fairly construed to indicate what its decision would now be on that issue.

Taxpayers would be foolish to base any undue optimism on the facts considered in the preceding paragraph. A close scrutiny of the reasoning in *Helvering v. Gerhardt*[62] and *Graves v. People* ex rel. *O'Keefe*[63] reveals reasoning that is fairly certain to defeat their hopes or give reality to their worst fears. The former of these started *Collector v. Day*[64] on its way to join the host of other cases that have been expressly overruled during the past decade. The latter not only finished that job but also repudiated the entire reciprocal immunity that had protected the compensation of the officers and employees of the one government from taxation by the other. Many of the arguments used to support these decisions apply, *mutatis mutandis,* to the reciprocal immunity principle in relation to the interest on federal, state, and municipal obligations. The state official's salary involved in the *Gerhardt* Case was described as derived from employment similar to that found in private industry. It was then asserted that a non-discriminatory tax thereon could by no reasonable probability be consid-

[60] Willcutts v. Bunn, 282 U. S. 216, 51 St. Ct. 125, 75 L. ed. 304 (1931).
[61] 302 U. S. 134, 58 S. Ct. 208, 82 L. ed. 155 (1937).
[62] 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938).
[63] 306 U. S. 466, 59 S. Ct. 595, 83 L. ed. 927 (1939).
[64] 11 Wall. 113, 20 L. ed. 122 (1871).

ered to preclude the state involved from performing the function in connection with which Gerhardt was employed, or obstruct it more than private enterprises are obstructed by the existing tax system. Then follow the significant remarks that at most the tax would increase somewhat the cost of state government, and would relieve Gerhardt of his duty of financial support to the national government in order to secure to the state a purely speculative and unsubstantial advantage. The conclusion that Gerhardt's salary may be taxed by the United States is further supported by the statement that the protection of the states does not require conferring upon them a competitive advantage over private persons in carrying on the operations of government.

The *O'Keefe* Case sustained a state tax upon the salary of an employee of a federally owned corporation, but it announced in broad terms the liability of all federal compensation to state income taxation. The reasoning of the prevailing opinion contains much that is pertinent to our present inquiry. In addition to invoking the general factors heretofore discussed, it is asserted that it was not the purpose of the immunity principle to confer upon the employees of one government an immunity from taxation by the other government whose benefits they enjoy, nor to give the government the advantage of paying lower salaries. The tax is also justified on the score that it is upon income which becomes the taxpayer's property when received, and that it is paid from his private funds and not, directly or indirectly, from public funds. It is also affirmed that the theory that a tax upon income is a tax upon its source has been rejected. The immunity of the interest on governmental securities had been supported on the basis that it amounted to a tax upon the contract and thus upon the power to borrow. It is probable that the rejection of the theory mentioned above will be used to support a contention that the bond interest cases have thereby been deprived of their principal support. If that occurs—and it is not unlikely to occur—the likelihood that the immunity of such interest will be continued is greatly reduced.

Analysis of these reasons that influenced the majority of the Supreme Court in overruling a long prevailing doctrine makes it highly probable that the interest on state and municipal bonds will be held constitutionally liable to federal income taxation. The views expressed in the majority opinions in the *Gerhardt* and *O'Keefe* Cases are as applicable to bond interest as to the compensation of public officers and employees. The principal, and in fact the sole, hope of states and municipalities to escape is affirmative proof that the effects of such taxation will preclude them from performing their functions. This may well prove to be an impossible task, especially since it has been definitely decided that mere proof that their costs of performing those func-

tions will be increased will not establish that the tax will preclude them from performing them. How far such a result will be held provable by proof that the increased costs will, in the light of the practically available tax resources, impose curtailments upon state and municipal activities, is a matter on which there can be no guiding authority at the present time. The practical difficulties that courts would encounter, if they adopted a test that depended upon the tax resources of states and municipalities, are such as to make its adoption highly improbable. The result is almost certain to be an indirect federal control of state and municipal activities, especially during a period of increasing federal expenditures and taxation. It is certain that the founding fathers never intended such a result, but their views receive scant recognition from the modern advocates of the new order in the United States.

The question inevitably arises whether states will also be permitted to tax the interest on the bonds of the United States and its public agencies and instrumentalities. In the case of public salaries the immunity principle was so reinterpreted as to permit each government to tax the compensation of the other's officers and employees. The Court has shown no active tendency to use the theory of federal supremacy, or the distinction made in *McCulloch v. Maryland,* as the basis for denying the reciprocal character of the intergovernmental immunity within the limits defined by the decisions prior to the recent change in approach. It seems quite probable that reciprocity will be maintained with respect to each government's power to tax the interest on the other's obligation, as was done with respect to the compensation of public officers and employees. The prohibition against discriminatory taxation is likely to be all that will be left of the reciprocal immunity principle in this field. But even if this proves a mistaken forecast, Congress probably has the power to render the interest on federal obligations liable to state taxation by expressly giving its consent thereto.[65] The question is whether it would always do so as long as it persisted in taxing the interest on state and municipal bonds. There is, moreover, one factor that will always prevent the states from standing on complete equality with the federal government. The bonds of the United States will continue to be viewed as its instrumentalities. The Congress has the power to give them practically any degree of immunity from state taxation that it may deem necessary and proper to effectuate the federal government's power to borrow.[66] This would in-

[65] See Baltimore Nat. Bk. v. State Tax Commission of Maryland, 297 U. S. 209, 56 S. Ct. 417, 80 L. ed. 586 (1936). Congress gave such consent to the taxation of the salaries of federal officers and employees by the Public Salary Tax Act of 1939.

[66] Smith v. Kansas City Title & Trust Co., 255 U. S. 180, 41 S. Ct. 243, 65 L. ed. 577 (1921); The Federal Land Bk. of St. Paul v. Bismarck Lumber Co., 62 S. Ct. 1, 86 L. ed. Adv. Ops. 46 (1941).

clude the power of exempting their capital value from state property taxes and the interest thereon from state income taxes. If such immunity were conferred upon them while the interest on state and municipal securities was subjected to federal income taxation, the resulting discrimination in favor of federal bonds would not be held a discriminatory tax against the states within the meaning of the doctrine prohibiting each government to discriminate against the other in exercising its taxing power. Since the states have no comparable power to make the interest on their bonds and on those of their municipalities immune from federal taxation, they are bound to be in the position of underdogs if ever the protection accorded them by the *Pollock* Case is taken from them by a revised version of the immunity principle. It is unnecessary to do more than mention the increased power to control state activities that will inure to the federal government if the Treasury should succeed (as it probably will) in inducing the Supreme Court to overrule the *Pollock* Case.[67]

The Sixteenth Amendment

Advocates of the proposal to subject state and municipal bond interest to federal income taxation also contend that the Sixteenth Amendment has removed all obstacles thereto. It is their claim that its provisions have definitely removed such income from any protection that it would otherwise be accorded under the reciprocal immunity principle. The previous discussion has shown that it will probably be unnecessary to invoke this argument. It will, however, be desirable to weigh it here both to make the discussion complete and to indicate the difference in results if the case for taxability is solely based on the Sixteenth Amendment rather than on a reinterpretation of the immunity principle.

It is necessary for an understanding and appraisal of this argument to review briefly the historical events that led up to the adoption of this amendment. The federal government had practically ignored the income tax as a source of revenues during the first century of its existence except during the Civil War period. Its first resort to it during a time of peace was in 1894. It was the validity of the 1894 Act that was in issue in the *Pollock* Case.[68] The principal grounds of the

[67] For general discussions of the problems of intergovernmental tax immunity, see Anderson, *The Problem of Tax Exempt Securities* (1924) 8 Minn. L. Rev. 273; Cohen and Dayton, *Federal Taxation of State Activities and State Taxation of Federal Activities* (1925) 34 Yale L. J. 807; Magill, *Tax Exemption of State Employees* (1926) 35 Yale L. J. 956; Rottschaefer, *Federal Taxation of "Exempt" Income* (1924) 8 Minn. L. Rev. 112; Stoke, *State Taxation and the New Federal Instrumentalities* (1936) 22 Iowa L. Rev. 39.

[68] Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429, 15 S. Ct. 673, 39 L. ed. 759 (1895); on rehearing, 158 U. S. 601, 15 S. Ct. 912, 39 L. ed. 1108 (1895).

attack pertinent to the present discussion were (1) that the income tax was a direct tax so far as it was imposed on the income from real or personal property, and invalid because not conforming to the constitutional requirement that direct taxes be apportioned among the states on the basis of their respective populations;[69] and (2) that it was invalid so far as it was imposed on the interest on state and municipal bonds. The case was first decided by a Court composed of only eight of the nine Justices. It was held that the tax on the income from real property was a direct tax. The reasons were that a tax on rent was a tax on the realty producing the rent, and, since it was universally admitted that a tax on the realty was a direct tax, therefore a tax on rent was equally a direct tax. Two of the Justices dissented from this conclusion. The Court was equally divided on the question whether a tax on the income from personal property was a direct tax. This was one of the principal reasons urged by taxpayers' counsel for a rehearing. The Attorney General requested a rehearing on all the issues in the case. The scope of the actual rehearing followed the latter request, although the emphasis in the prevailing opinion was upon the character of the tax on income from personal property. The result of the rehearing was a definite five to four decision that the tax was a direct tax in so far as it was imposed on the income from either real or personal property. The substance of the reasoning by which this result was sustained can be summed up in the statement that the tax on such income was invalid because of its source. The tax on it was held in effect a tax on its source, the property producing it, and a direct tax because a tax on such source would have been a direct tax.

The validity of the tax on the interest on state and municipal bonds was passed on only in the first decision. There was no dissent on the decision that it was invalid under the reciprocal immunity principle. This was affirmed by even those Justices who dissented from the remainder of the decision. The ultimate basis for the decision is found in the opinion of Mr. Chief Justice Fuller. His principal reliance was upon the decision of Mr. Chief Justice Marshall in *Weston v. Charleston*[70] which had held a municipal property tax on federal bonds invalid for want of power in the states and their municipalities to impose it. After quoting from the prevailing opinion in that case the language that "The right to tax the contract to any extent, when made, must operate on the power to borrow before it is exercised, and have a sensible influence on the contract", Mr. Chief Justice Fuller continued as follows: "Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the

[69] U. S. CONST. ART. 1, §2; U. S. CONST. ART. 1, §9.
[70] 2 Pet. 449, 468, 7 L. ed. 481, 488 (1829).

power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the Constitution." The only reference to this matter in the opinions rendered when the case was decided after rehearing is in the prevailing opinion of Mr. Chief Justice Fuller. He describes the first decision as holding that the interest on municipal bonds could not be taxed "because of want of power to tax the source, and no reference was made to the nature of the tax as being direct or indirect." This affords no reasonable support to any theory that the tax on municipal bond interest was held invalid because the source of the taxed income was the bond. The statement was merely a shorthand device for referring back to the argument used in the prevailing opinion on the first decision of the case. That shows that the real basis for the holding was the burden imposed by the tax upon the exercise of the states' and municipalities' power to borrow. This itself was viewed merely as a specific instance of the broader principle that the federal government lacked the power to so tax as to interfere with state and municipal functions. Nothing more is required to establish this than reference to the fact that the part of the prevailing opinion devoted to this problem relies upon cases applying the immunity principle which could by no legal legerdemain be fitted into the argument that would have to be used to make the *Pollock* Case hold that the tax on municipal bond interest was invalid because of the source of the income taxed. The dissenting opinion of Mr. Justice White expressly distinguishes the taxation of the income from real and personal property from the taxation of municipal bond interest. The problem with respect to the former was whether the Congress had followed the constitutionally prescribed method in exercising a power which it admittedly had; the problem with respect to municipal bond interest was whether Congress had any power to tax it at all. He answered the latter by denying the existence of that power.

The Court's own interpretation of the theory upon which the *Pollock* Case was decided was that the federal income tax on the income from real and personal property, as levied by the 1894 Act, was invalid as an unapportioned direct tax, and that the tax on municipal bond interest was invalid because of a complete absence of power in Congress to tax it by any method. It was the source of the former class of income that made the tax a direct tax and thus invalid because not properly apportioned. The source of the second class of income was no factor in holding the tax on it invalid, if the term "source" be given the same denotation belonging to it when used in reference to the tax on incomes from property sources. Such was the Court's own theory

of its action. This has an important bearing on the meaning of the Sixteenth Amendment so far as its historical genesis is a proper factor in its interpretation. The fact is that the decision in the *Pollock* Case was looked upon as interposing an insuperable barrier to a practicable and fair income tax because of its holding that taxes on income from property sources were direct taxes, not because of the non-taxability of interest on state and municipal bonds. A proposal for an amendment to make a practical and fair tax possible was introduced in the Senate in 1909, phrased in the following language: "The Congress shall have the power to lay and collect direct taxes on incomes without apportionment among the several states according to population." It was ultimately submitted to the states in the form in which it now appears in the Constitution, and became a part of the Constitution during February, 1913. It reads as follows: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." The change in language between the original proposal and the form in which it was submitted is marked, but its significance is another matter. The pertinent evidence is not only fragmentary but confusing. It would require a bold act of faith to hold that the Congress that submitted the proposal to the state legislatures intended to deprive state and municipal bond interest of an immunity which had become an accepted commonplace of constitutional law. It would require an even more vigorous act of faith to conclude that the legislatures that ratified it believed that they were approving a waiver of an immunity which the decisions of the Supreme Court had declared existed, and doing so while leaving the federal government's immunity intact. The fears of Governor Hughes of New York that the phrase "from whatever source derived" would accomplish that result were claimed to be unfounded by Senator Borah of Idaho. The truth of the matter is that the available evidence does not warrant a dogmatic assertion on what was intended to be accomplished by the phrase just referred to.[71]

The judicial construction of the Amendment gives no support whatever to the view that it made the interest on state and municipal bonds liable to federal taxation. The Supreme Court's first expression of opinion on the question is that of Mr. Chief Justice White in *Brushaber v. Union Pacific Railroad Company*.[72] It occurred in the course of a general discussion of what he deemed a basic error underlying the argu-

[71] See on this whole matter R. G. AND GLADYS C. BLAKEY, THE FEDERAL INCOME TAX (1940) pp. 60-68; STUDY OF THE DEPARTMENT OF JUSTICE ON TAXATION OF GOVERNMENT BONDHOLDERS AND EMPLOYEES, especially Part II, Chaps. V-VIII; Hubbard, *The Sixteenth Amendment* (1920) 33 HARV. L. REV. 794; Evans v. Gore, 253 U. S. 245, 40 S. Ct. 550, 64 L. ed. 887 (1920).

[72] 240 U. S. 1, 36 S. Ct. 236, 60 L. ed. 493 (1916).

ments urged in support of a series of constitutional objections to numerous features of the 1913 Income Tax. Asserting that the propositions urged revealed a high degree of confusion, he found the source thereof in counsel's assumption that "the Sixteenth Amendment provides for a hitherto unknown power of taxation, that is, a power to levy an income tax which, although direct, should not be subject to the regulation of apportionment applicable to all other direct taxes." It is this proposition that he denies by his statement that "It is clear on the face of this text (of the Amendment) that it does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed, from apportionment from a consideration of the source whence the income was derived." The purpose of the Amendment is construed to be to prevent the courts from looking to the source of income for the purpose of determining whether a tax on it is direct, to change the then existing interpretation of "direct taxes" only so far as necessary "to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct taxes." The ultimate purpose of this involved reasoning process was to make income taxes levied after the Sixteenth Amendment subject to the uniformity requirement.[73] But, whatever its purpose, it rests on the theory that the Sixteenth Amendment was solely intended to nullify the effects of that part of the decision in the *Pollock* Case that held the tax on income from property sources to be a direct tax. That view is incompatible with any theory that its aim was to nullify that part of that decision which had held that the federal government had no power to tax the interest on municipal bonds. It was a most natural view for Mr. Chief Justice White to take, since he had been the principal dissenter in the *Pollock* Case. Its implications cannot be avoided by twisting the decision in the *Pollock* Case into a holding that the federal government lacked power to impose an income tax on incomes from property sources. It is a perfectly reasonable interpretation of the Sixteenth Amendment, and involves a theory that the phrase "from whatever source derived" was inserted because the *Pollock* Case had based its view that a tax on incomes from property was direct on the source of such incomes. The view that the Amendment did not make taxable any income which was constitutionally protected against federal taxation

[73] U. S. CONST. ART. 1, §8.

when the Amendment was adopted has been repeated in several subsequent cases.[74] The statements of this proposition are all technically dicta. The only case in which the issue might have been squarely raised was that of *Evans v. Gore*,[75] but the prevailing opinion therein expressly stated that no contention had been made that the "Amendment rendered taxable as income anything which was not so taxable before."

It was stated above that the position just discussed is a perfectly reasonable interpretation of the Amendment. But it is not the only reasonable one. A contrary view as to its effect was asserted in the dissenting opinion of Mr. Justice Holmes (concurred in by Mr. Justice Brandeis) in *Evans v. Gore*. It is based upon the phrase "from whatever source derived." The reasoning is as lacking in cogency as it is marked by a cryptic quality. It was suggested by Mr. Justice Black in his concurring opinion in *Helvering v. Gerhardt*[76] that the problem of federal taxation of the salaries of state employees be reviewed "in the light of the Sixteenth Amendment." His remarks are equally applicable to the instant problem. The Court has thus far declined to follow his suggestion. It has solved the public salary problem by a reinterpretation of the immunity doctrine. Should it, however, decide to review the bond interest problem in the light of the Sixteenth Amendment, it will undoubtedly rely most heavily upon the facts that the Amendment is in the form of a grant of power, that the scope of the power conferred is defined by the phrase "from whatever source derived," and that this gives to every part of the Amendment its natural meaning. Such an argument would be weighty indeed. It would probably prevail, the more so because of the ambiguous character of the historical argument for or against either of the possible interpretations. The possibility should not even be excluded that the present Court would interpret the historical evidence as lending support to the position of Mr. Justice Holmes in his dissent in *Evans v. Gore*.

The results of a decision basing federal power to tax the interest on state and municipal bonds exclusively upon the Sixteenth Amendment, that is, upon the view that it has relieved federal income taxes from restrictions that would otherwise apply to them under the immunity principle, will be considerably different from what they would be were the immunity principle merely reinterpreted to permit federal

[74] Stanton v. Baltic Mining Co., 240 U. S. 103, 36 S. Ct. 278, 60 L. ed. 546 (1916); Peck & Co. v. Lowe, 247 U. S. 165, 38 S. Ct. 432, 62 L. ed. 1049 (1918); Eisner v. Macomber, 252 U. S. 189, 40 S. Ct. 189, 64 L. ed. 521 (1920); Evans v. Gore, 253 U. S. 245, 40 S. Ct. 550, 64 L. ed. 887 (1920).

[75] 253 U. S. 245, 40 S. Ct. 550, 64 L. ed. 887 (1920). This case may almost certainly be deemed to have been impliedly overruled by O'Malley v. Woodrough, 307 U. S. 277, 59 S. Ct. 838, 83 L. ed. 1500 (1939), but the opinion relies not at all upon the Sixteenth Amendment.

[76] 304 U. S. 405, 58 S. Ct. 969, 82 L. ed. 1427 (1938).

taxation of the interest on such bonds. It has been made an integral part of recent reinterpretations of that principle that discriminatory taxes are still prohibited by it. The Sixteenth Amendment would impose no such restriction on the power of the federal government to tax either the interest on state and municipal bonds or other types of income derived by private persons from states or municipalities. It is inconceivable that any court would read into the language of the Sixteenth Amendment a prohibition against discriminatory taxation. It might be that the due process clause of the Fifth Amendment would be construed to prohibit it, but so far no federal tax has been held invalid thereunder because of a classification made in its imposition. Reliance upon any other provision of the Constitution would appear to be out of the question.[77] It will have to be upon Congress.

There is another difference of considerable importance. The limitations upon the immunity doctrine that have recently been made by the Supreme Court have all involved taxes whose immediate incidence was upon private persons. The Court has been careful to point out that the taxes in question were not imposed upon the states or their public agencies and instrumentalities. The interpretation of the Sixteenth Amendment that would permit federal taxation of municipal bond interest would equally permit federal taxation of income received by states and municipalities and their public agencies and instrumentalities. The protection accorded such income by the implications of *United States v. Baltimore & Ohio Railroad Co.*[78] would immediately be gone. How serious a burden this might become, were Congress minded to exercise its power, would depend upon what the Supreme Court might ultimately hold to be "income" within the meaning of the Sixteenth Amendment. If it should ever construe it to mean either gross income or gross receipts, the results might be serious indeed. It would certainly be a serious matter if the tuition fees received by state schools should be held taxable. The worst possible blow would be dealt states if their tax revenues were held to constitute income. These are not wholly imaginary possibilities. The remarks concerning a discriminatory use of the power, made in the preceding paragraph, are equally applicable here. There is, of course, no guarantee that the immunity principle may not be reinterpreted to permit some of these results. But it still remains true that more is likely to be permitted under the suggested construction of the Sixteenth Amendment than under any probable reinterpretation of the immunity principle.

[77] The discrimination here discussed does not include that resulting from the United States giving its own obligations preferred treatment over those of the states. That has already been discussed when considering the problem under the immunity principle.

[78] 17 Wall. 322, 21 L. ed. 597 (1872).

The last difference to be noted is this. The suggested interpretation of the Sixteenth Amendment will operate wholly in favor of the federal government. A reinterpretation of the immunity principle might, but is less likely to, operate in the same one-sided manner.

It is patent, therefore, that sole reliance by the Court upon an expanded interpretation of the effect of the Sixteenth Amendment may well be a more serious matter for the states than a revision of the immunity principle. Reliance upon the latter may entail equally serious results for the states, but is not as likely to do so. The results to them of a reliance upon both lines of reasoning by the Supreme Court will be the same as those following from a sole reliance upon the Sixteenth Amendment. The position of the states, if either sole or concurrent reliance is placed on that Amendment, will be that of being more at the mercy of the federal government than they have ever been. This is not something to be taken lightly in an era when the tendency towards centralization of governmental power is the dominant note in political philosophies and practices.

Application to Prior Issues

The Treasury has at times represented its position to be that it will propose the taxation of the interest on only those state and municipal bonds that are issued on or after the date of enactment of a federal statute providing for the taxation of the interest on state and municipal bonds.[79] There is nothing in the arguments that support its taxation that requires the Treasury to so limit its demands. The interest on such bonds will be taxable, so far as the question of power is involved, regardless of the date when the bonds were issued. It is true that the due process clause of the Fifth Amendment prohibits retroactive federal taxation within rather vaguely defined limits.[80] But it would certainly not prohibit the taxation of interest received at any time on or after the beginning of the calendar year in which the statute imposing the tax was enacted.[81] A special problem would arise as to the interest on bonds which had never been statutorily exempt. A change in judicial decision depriving such interest of the protection of the immunity principle would theoretically make recipients of such interest liable to taxation thereon during the past years. The due process clause does not protect them against the results of an overruling decision. Legislation will be required to protect their interests adequately. Federal

[79] See official Treasury Department press release of March 14, 1941, announcing the commencement of a test case against bondholders of the Port of New York Authority.

[80] Nichols v. Coolidge, 274 U. S. 531, 47 S. Ct. 710, 71 L. ed. 1184 (1927).

[81] Brushaber v. Union Pacific R. Co., 240 U. S. 1, 36 S. Ct. 236, 60 L. ed. 493 (1916).

bondholders will be in the same predicament under state income tax statutes if the immunity principle is revised to permit each government to tax the interest on the other's bonds. This will not be true where Congress has made the interest on such bonds exempt from state taxation. Congress, however, has the power to relieve federal bondholders of this threat, and can certainly be relied upon to do so. It has recently been stated that "The constitutionality of taxing the income from future issues of state and municipal bonds is no longer very doubtful."[82] This is probably correct, but any implication that the question of power depends on the date of issue is wholly erroneous, as is any implication that may have been intended that applicable constitutional limitations might be violated by taxing future income from bonds issued before the law was changed to provide for the taxation of the income from this class of bonds. However, these are all matters incident to a shift to a new status. They do not involve basic issues and principles.

CONCLUSION

The problem of "tax exempt" income was recently solved with respect to public salaries by so reinterpreting the immunity principle as to exclude such incomes from its protection. The first steps have now been taken to deprive the interest on state and municipal bonds of an immunity from federal taxation that is of long standing. The preceding discussion has aimed to set forth the considerations that are likely to play an important part in the decision of that issue. It has dealt with only those major lines of approach that are likely to be adopted by advocates for and against a change in the present law. There are other minor arguments sometimes urged in support of the change. The most important of these runs along the following lines. It is correctly asserted that all federal income taxes have been deemed excises since the adoption of the Sixteenth Amendment. Since it has always been held that an excise tax measured by income may include "exempt income" in the measure of the tax (provided it does not discriminate against such income),[83] therefore a non-discriminatory federal tax on the interest on state and municipal bonds is now valid. The fallacy of the position is that the privilege taxed is the very right to receive the income, not some other independent privilege as in the other decided cases invoked in support of this thesis. However, reliance upon this argument is unnecessary. The others discussed in this article suffice to show that the Supreme Court will very likely permit the United States to tax the interest on such bonds. The varying results upon state powers dependent upon the bases adopted for reaching this decision have also

[82] Paul, *The Emergency Job of Federal Taxation* (1941) 27 CORN. L. Q. 3, 6.
[83] Flint v. Stone Tracy Co., 220 U. S. 107, 31 S. Ct. 342, 55 L. ed. 389 (1911).

been indicated. It is doubtful that the change will entail an inability on the part of the states and their political subdivisions to perform adequately their major functions. It does, however, hold a serious threat to any programs for expansion of their functions which they might contemplate. It will, in any event, subject their activities to a degree of federal control that will play hand in hand with the other centralizing tendencies prevailing in the United States today for which the Supreme Court has built the requisite constitutional framework.