Intergovernmental Tax Immunities: An Analysis and Suggested Approach to the Doctrine and Its Application to the State and Municipal Bond Interest

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INTERGOVERNMENTAL TAX IMMUNITIES: AN ANALYSIS AND SUGGESTED APPROACH TO THE DOCTRINE AND ITS APPLICATION TO STATE AND MUNICIPAL BOND INTEREST

I. Introduction

In the June 26, 1969, advertisement for the Port of New York Authority commuter car bonds, general counsel and bond counsel advanced the opinion that "under the Constitution of the United States of America, now in force, interest on the bonds...is exempt from income taxes now or hereafter imposed by the United States unless such taxes should be consented to by the States of New York and New Jersey...". Subsequently, on August 7, 1969, the House of Representatives passed the Tax Reform Act of 1969, which contained provisions to implement limited taxation of interest from state and municipal obligations. Although these provisions did not fare well during the bill's consideration by the Senate's Committee on Finance, and were eliminated from the Tax Reform Act as enacted, the legislative attack upon the statutory exemption granted to state and municipal bond interest from federal income taxes again raises the question as to the constitutional immunity of such interest. This question has been indirectly considered by the Court since that time because of the statutory exemptions granted such interest in the Revenue Act of 1913.

   (a) General Rule — Gross income does not include interest on—
   (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.
4. For a complete list of the numerous legislative attempts to revise the exemption, see, Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91st Cong., 1st Sess., pt. 6, at 2200 n.18 (1969) [hereinafter cited as Hearings]; Foley, Jr., Reciprocal Taxation of the Income From Federal, State and Municipal Bonds, 6 Legal Notes on Local Govt. 179 n.1 (1941).
5. The Court held federal taxation of interest from municipal bonds to be unconstitutional in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).
and subsequent revenue acts. The recent modification of this statutory exemption removing certain industrial bond interest from the exemption\(^7\) as well as the most recent attempt to modify it, suggest that there may be further attempts to limit the loss of federal revenues resulting from this exemption by some further modification short of total repeal of Section 103 of the Internal Revenue Code of 1954.\(^8\)

In view of this and the fact that bond underwriters may continue attempts to get guarantees of constitutional protection from bond counsel to facilitate the sale of state and municipal obligations, the constitutional question is worthy of renewed examination. This comment will view generally the broad area of intergovernmental tax immunity from a functional standpoint and, more specifically, the area of taxation of interest from governmental obligations.

II. GENERAL CONSIDERATIONS OF INTERGOVERNMENTAL TAX IMMUNITY

Because of the maze created in the area of intergovernmental tax immunities by a combination of surprising judicial footwork in distinguishing the taxes involved and some inconsistent applications of the principles evolved in the development of the immunities doctrine, this comment will not attempt an examination of intergovernmental tax immunity by type of tax.\(^9\) Rather, examination will begin by viewing the fundamental policies supporting the initiation and expansion of the doctrine and those policies underlying the present trend in limiting governmental immunity. This will be followed by a review of the judicial techniques employed over the past 50 years in effectuating the limiting policies.

A. Policies Underlying Expansion and Limitation of the Immunities Doctrine

Governmental immunity from taxation by other government units having concurrent or overlapping tax jurisdiction began with the decision in McCulloch v. Maryland,\(^10\) which held that the State of Maryland could not constitutionally tax instrumentalities of the United States by placing

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8. It is estimated that the loss of federal revenues is approximately $2 billion. Hearings, supra note 4, at 2255, 2258. The political opposition marshalled to defeat the attempt to modify the effect of the section 103 exemption to the extent that the wealthy could be required to pay some fair share of the national financial burden without the availability of a tax shelter in tax-exempt interest suggests that total repeal of section 103 will not be politically feasible for some time to come.
9. For a comprehensive view of intergovernmental tax immunity with emphasis on the nature of the tax, see Brown, Intergovernmental Tax Immunity: Do We Need a Constitutional Amendment, 25 Wash. U.L.Q. 153 (1940); Powell, The Remnant of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 757 (1945); Powell, The Waning of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 633 (1945); Ratchford, Intergovernmental Tax Immunities in the United States, 6 Nat'L Tax J. 305 (1953).
a stamp tax upon the notes of banks chartered by the United States or require such banks to pay a $15,000 annual tax. Resting on the Supremacy Clause\textsuperscript{11} for the proposition that the states could not tax instrumentalities created under federal law which the Constitution declares to be supreme over state law, Justice Marshall said:

The question is, in truth, a question of supremacy; and if the right of the states to tax the means employed by the general government be conceded, the declaration that the constitution, and the laws made in pursuance thereof, shall be the supreme law of the land, is empty and unmeaning declamation.\textsuperscript{12}

Because of this early declaration in \textit{McCulloch} it has been stated that the primary basis of federal immunity from state taxation is federal supremacy.\textsuperscript{13} However, as the doctrine progressed, federal immunity was also attributed to the practical necessities of maintaining a dual system of governments with overlapping jurisdictions.\textsuperscript{14} It was this latter reasoning, based on the notion of dual sovereignties, that allowed the Supreme Court to extend the doctrine of governmental tax immunity to the states and their instrumentalities in \textit{Collector v. Day}.\textsuperscript{15} De-emphasizing the supremacy argument of \textit{McCulloch}, the \textit{Day} court reasoned:

It is conceded in the case of \textit{McCulloch v. Md.} that the power of taxation by the States was not abridged by the grant of a similar power to the Government of the Union; that it was retained by the States, and that the power is to be concurrently exercised by the two governments; and also that there is no express constitutional prohibition upon the States against taxing the means or instrumentalities of the General Government. But, it was held . . . to be prohibited by necessary implication; otherwise, the States might impose taxation to an extent that would impair, if not wholly defeat, the operations of the federal authorities when acting in their appropriate sphere. . . . And we shall now proceed to show that, upon the same construction of that instrument [the Constitution], and for like reasons, that government is prohibited from taxing the salary of the judicial officer of a State. . . .

\textsuperscript{11} Article VI of the Constitution of the United States provides:

(2) This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

\textsuperscript{12} \textit{McCulloch v. Maryland}, 17 U.S. (4 Wheat.) 316, 433 (1819).


The general government, and the States, although both exist within the same territorial limits, are separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former, in its appropriate sphere is supreme; but the States within the limits of their powers not granted, or in the language of the 10th Amendment, "reserved," are as independent of the General Government as that government within its sphere is independent of the States. . . . [1]f the means and instrumentalities employed by [the General Government] to carry into operation the powers granted to it are, necessarily, and, for the sake of self-preservation, exempt from taxation by the States, why are not those of the States depending upon their reserved powers, for like reasons, equally exempt from federal taxation? Their unimpaired existence in the one case is as essential as in the other. . . . In both cases the exemption rests upon necessary [constitutional] implication, and is upheld by the great law of self-preservation. . . .

Although the Day court reduced the importance of the supremacy clause as a foundation for federal tax immunity, it is clear that a constitutional basis was ascribed to the dual sovereignty notion and that this basis applied to both federal and state immunity. During the initial expansion of the doctrine into the area of state immunity, this reasoning led to the notion that state immunity was both reciprocal and coextensive with that enjoyed by the federal government.17 However, later decisions acknowledged the lack of true reciprocity because of the support of federal immunity derived from the supremacy clause.18

The extension of the doctrine of intergovernmental tax immunity to the states allowed its rapid expansion into areas that eventually caused the Court to reverse the trend and redirect it toward limitation of the doctrine. The judicial practice of extending immunity to individuals directly connected with the exercise of federal powers began with Dobbins v. The Commissioners of Erie County,19 where it was held that a state could not tax the income of an officer of the United States. Collector v. Day,20 provided a reciprocal immunity for state employees. This notion was later expanded on the basis that it was unconstitutional for one sovereignty to tax individuals or private interests standing in a close relationship with the other sovereignty where the tax resulted in an economic burden upon the non-taxing sovereignty.21

16. Id. at 123-27.
20. 78 U.S. (11 Wall.) 113 (1870).
Concern over the expansion of the immunities doctrine and the resultant effect upon the tax jurisdictions of the state and federal governments caused the Court to reverse itself and start a trend toward limiting the doctrine. Interestingly, the basic reasons given for limiting the doctrine were corollary notions derived from the arguments of dual sovereignties and the supremacy clause. An example of this reasoning may be seen in Helvering v. Gerhardt, where it was held that a federal income tax upon the salary of an employee of a state instrumentality was constitutional. In Gerhardt, Mr. Justice Stone stated:

[One] reason rests upon the fact that any allowance of a tax immunity for the protection of state sovereignty is at the expense of the sovereign power of the nation to tax. Enlargement of the one involves diminution of the other. When enlargement proceeds beyond the necessity of protecting the state, the burden of the immunity is thrown upon the national government with benefit only to a privileged class of taxpayers. With the steady expansion of the activity of state governments into new fields they have undertaken the performance of functions not known to the states when the Constitution was adopted, and have taken over the management of business enterprises once conducted exclusively by private individuals subject to the national taxing power. In a complex economic society tax burdens laid upon those who directly or indirectly have dealings with the state, tend, to some extent not capable of precise measurement, to be passed on economically and thus to burden the state government itself. But if every federal tax which is laid on some new form of state activity, or whose economic burden reaches in some measure the state or those who serve it, were to be set aside as an infringement of state sovereignty, it is evident that a restriction on national power, devised only as a shield to protect the states from curtailment of the essential operations of government which they have exercised from the beginning, would become a ready means for striking down the taxing power of the nation.

Thus, the concept of dual sovereignties was modified by the practical notion that it contemplates some passing on of economic burdens between the sovereignties. Although in Gerhardt this modification of the dual sovereignty concept went only to the limitation on state immunity, the same reasons were assigned as a basis for the subsequent holding in Graves v. New York ex rel. O'Keefe that the salary of an employee

22. This was expressly recognized in New York v. United States, 326 U.S. 572 (1946), when, speaking for the Court, Mr. Justice Frankfurter stated: "In the older cases, the emphasis was on immunity from taxation. The whole tendency of recent cases reveals a shift in emphasis to that of limitation upon immunity." Id. at 581.
23. 304 U.S. 405 (1938).
24. Id. at 416.
25. This was suggested as early as 1926 in Metcalfe & Eddy v. Mitchell, 269 U.S. 514, 523-24 (1926), and would overrule the notion suggested by such early cases as Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 586 (1895), and Collector v. Day, 78 U.S. (11 Wall.) 113 (1870), that where governmental tax immunity rests on the dual sovereignty doctrine, any burden, however slight, upon the sovereign will invalidate the tax.
of a federal instrumentality is constitutionally subject to a state income tax.

Although the dual sovereignty argument was the means of limiting federal immunity in O'Keefe, that decision also provided the basis for the later use of the supremacy clause as a limitation on federal tax immunity when it was stated:

[S]uch differences as there may be between the implied tax immunity of a state and the corresponding immunity of the national government and its instrumentalities may be traced to the fact that the national government is one of delegated powers, in the exercise of which it is supreme. Whatever scope this may give to the national government to claim immunity from state taxation of all instrumentalities which it may constitutionally create, and whatever authority Congress may possess as incidental to the exercise of its delegated powers to grant or withhold immunity from state taxation, Congress has not sought in this case to exercise such power.27

Later decisions extended the congressional authority under the supremacy clause to insulate federal instrumentalities and their transactions from state tax jurisdictions even though such instrumentalities or transactions would, in the absence of congressional action, be beyond the permissible scope of judicially granted immunities.28

Combining the federal legislative power to insulate its instrumentalities and the transactions of those instrumentalities with Congress' failure to do so, the Court has used the supremacy clause as a basis for implying consent to taxation for the purpose of limiting the application of tax immunity where a state tax results in only an economic burden being placed upon the federal government.29 This is applied even though the burden may be direct and substantial.30 It should be noted that there is no corresponding judicial principle for limiting state immunity that is analogous to, or as a corollary of, this supremacy limitation of federal immunity.

Two additional rationales underlying the judicial limitation of the immunities doctrine suggested in Gerhardt were: (1) movement by the states into competitive business enterprise and (2) use of the immunities primarily to benefit private interests.31 As was seen in Gerhardt, these considerations fall within the framework of the dual sovereignty limitation rather than the supremacy reasoning.32 However, as the pressure to limit the immunities doctrine increased, these reasons often assumed

27. Id. at 485.
31. See p. 418 supra.
32. Id.
independent significance and were not necessarily cast as an integral part of a dual sovereignty argument.\textsuperscript{33}

When the issue has been the application of constitutional immunity to a state business enterprise, the Court has denied immunity from federal taxation on the basis that such immunity does not extend to business activities conducted by the state for gain.\textsuperscript{34} By reasoning beyond the concern for the diminution of federal tax jurisdiction which primarily underlies the business enterprise rationale, the Court has advanced the notion that constitutional immunities should not be used to place the state at a competitive advantage over private enterprise when it chooses to operate in the normal business sphere.\textsuperscript{35}

When the primary benefits of constitutional tax immunity inure to private interests because of their close relationship to the state, the Court has denied such private interests the immunity shield, stating that "no implied constitutional immunity can rest on . . . merely hypothetical interferences with governmental functions."\textsuperscript{36} In addition to a policy that such derivative immunities should not be the principal benefit of an implied constitutional immunity intended to protect only the sovereignty, there is another strong consideration in limiting the extension of constitutional immunity to private interests. That is, such private interests should not receive shelter from the exempt sovereignty because it allows them to avoid contributing their share of the financial support to the taxing sovereignty whose benefits and privileges they enjoy.\textsuperscript{37}

The four policies which support the trend toward limiting the application of the immunities doctrine — i.e., dual sovereignty, supremacy, state business enterprise, and derivative immunity — have been effectuated by various judicial techniques. The following section will examine these techniques, using an analysis of the legal incidence in the imposition of state and federal taxes as a focal point. Since the legal incidence of a tax determines the question of what or who is legally subject to the tax, such an analysis provides a good beginning point. However, it should be noted that often the Court can avoid this stage of analysis and proceed directly in the application of the limiting policies.\textsuperscript{38}


\textsuperscript{34} Allen v. Regents of the Univ. Sys. of Georgia, 304 U.S. 439 (1938); Ohio v. Helvering, 292 U.S. 360 (1934); South Carolina v. United States, 199 U.S. 437 (1905).

\textsuperscript{35} See Helvering v. Gerhardt, 304 U.S. 405, 421 (1938); Rakestraw, supra note 18, at 153–59.


B. Judicial Techniques in Limiting Intergovernmental Tax Immunity

1. The Legal Incidence Test

As the dual sovereignties rationale developed into a limiting device in the application of constitutional tax immunities, one of the elements of the rationale — i.e., the principle that some passing of the economic burdens of taxation between the sovereignties is constitutionally permissible — required the Court to examine more closely the nature of each particular tax. It was no longer sufficient to end the analysis with a finding that the tax in some way burdened the immune sovereign. Rather, it became necessary to determine whether a sovereignty, its property or transactions, was actually being taxed. If the incidence of the tax in question was not upon the sovereignty, but only resulting in the eventual placing of an economic burden upon the sovereignty, different considerations were applicable. This led to the necessity of distinguishing between the legal effect of a tax and its economic results on the sovereign. As a result, the legal incidence test, which distinguishes between the object of taxation and the measure or ultimate source of payment, evolved.

The first aspect of the legal incidence test — the determination of whether a tax immune subject is merely the measure of a tax applied to some other subject — developed early in the present limiting trend. An example may be seen where estate and inheritance taxes require immune federal or state bonds to be included within the taxable estate. Here the actual subject of taxation is the transfer of property with the immune property operating as a convenient measure for the imposition of the tax. The legal incidence of such a tax is not upon a sovereignty merely because an immune object is the means used to measure the tax imposed on a transfer.


40. Greiner v. Lewellyn, 258 U.S. 384 (1922) (municipal bonds); Plummer v. Coler, 178 U.S. 115 (1900) (federal bonds); Ratchford, supra note 9, at 313.

41. The distinction between the subject of taxation and the measure of the tax was first enunciated during the expansion of the immunities doctrine and was not considered a limiting device. Rather, it was a means of insuring the proper application of the doctrine to situations where the tax could be said to be burdensome to a sovereign. In the instance of an estate tax on the transfer of property, the fact that governmental bonds are included in the gross estate as a means of measuring the transfer tax does not directly burden the issuing sovereign nor does it indirectly impose a burden by removing the sovereign's competitive advantage.

42. It has been suggested that if the subject of taxation is permissible under the immunities doctrine, then the measure of the tax need not comply with the doctrine. Ratchford, supra note 9, at 313. Such an approach ignores the problems that may arise from indirect economic burdens which may flow from taxation of various transactions. The distinction between the measure and the subject of taxation should be retained only for the limited purpose of determining the legal incidence of a tax. Cf., contra, United States v. County of Allegheny, 322 U.S. 174 (1944) (taxation of the leasehold interest).
The more significant aspect of the legal incidence test — distinguishing between the subject of taxation and the ultimate source of payment — was employed by the Court prior to the actual enunciation of such a test. Thus the Court has found that a state tax upon the gross receipts of a federal contractor was not a tax upon the federal government and that a federal income tax imposed upon the salary of an employee of a state instrumentality was not "in form or substance a tax upon" the instrumentality.

The distinction between subject of taxation and source of payment became more formalized in Alabama v. King & Booser, where the Court upheld a state sales tax as applied to a government contractor doing work under a cost-plus-fixed-fee contract which directly passed the economic burden of the tax to the federal government. Although the tax was upon retail sales and the seller was denominated as the taxpayer, the statute imposed upon such sellers the duty to collect the tax from the purchaser, thus making the purchaser statutorily liable to the seller for the amount of the tax. The King & Booser court interpreted the statutory term "purchaser of tangible goods" to mean "the person who orders and pays for them when the sale is for cash or who is legally obligated to pay for them if the sale is on credit." By viewing the contractual relationship between the federal government and the contractor, the Court found against the argument pressed by the United States as intervenor that the legal incidence of the tax was on the federal government, stating: "We cannot say that the contractors were not, or that the Government was, bound to pay the purchase price, or that the contractors were not the purchasers on whom the statute lays the tax.

Use of the legal incidence approach in King & Booser required both an analysis of the legal application of the tax statute as indicated on its face and an analysis of its application as affected by the relationship between those statutorily liable and the immune sovereignty. An example of the use of these considerations, with emphasis upon the effect of the tax statute, may be seen in the subsequent case of United States v. Allegheny County, where an ad valorem property tax was imposed by Pennsylvania upon the property of the Mesta Machine Company. Included in the assessment was a substantial amount of machinery owned by the federal

45. 314 U.S. 1 (1941).
46. Id. at 7.
47. Id. at 9.
48. Id. at 10.
49. Under the contract, title to goods purchased passed to the government upon delivery.
50. 314 U.S. at 14. For similar treatment of a state use tax as applied to a federal government contractor under a cost-plus-fixed-fee contract, see Curry v. United States, 314 U.S. 14 (1941).
51. 322 U.S. 174 (1944). Some commentators have suggested that this case developed the legal incidence test. Rollman, supra note 39, at 11; Van Cleve, supra at 39.
government and leased to Mesta. Interpreting a statutory provision that the taxes were to be a lien upon the property as being applicable to only the real estate, with the value of the lien increased by the tax upon machinery, the Pennsylvania supreme court found that the tax as imposed fell upon real estate alone.52 The United States Supreme Court, on the other hand, found the legal incidence of the tax to be upon property owned by the federal government, and answered the argument of the Pennsylvania supreme court by stating:

[R]enunciation of any lien on Government property itself, which could not be sustained in any event, hardly establishes that it is not being taxed. The fact is that the lien on the underlying land is increased because of and in proportion to the assessment of the machinery. If the tax is collected by selling the land out from under the machinery, the effect on its usefulness to the Government would be almost as disastrous as to sell the machinery itself. The coercion of payment from compelling the Government to move its property and interrupt production at the Mesta plant would defeat the purpose of the Government in owning it and leasing it. . . . [T]he Government's property interests are not taxable either to it or its bailee.53

An example of the legal incidence analysis where the emphasis was placed upon the application of a tax as affected by the relationship between the party statutorily liable and the immune sovereignty may be seen in Kern-Limerick, Inc. v. Scurlock.54 Here, contractors constructing a naval base were brought within the cloak of intergovernmental tax immunity with respect to an Arkansas sales tax collectible from purchasers when the provision in their contract dealing with purchases of material provided that "the contractor shall act as the purchasing agent of the government in effecting such procurement and the government shall be directly liable to the vendors for the purchase price."55 Comparing the Kern-Limerick contract with that in Alabama v. King & Booser,56 the Court stated that "the contract here in issue differs in form but not in economic effect on the United States. The nation bears the burden of the Arkansas tax as it did that of Alabama."57 However, the Court found "that the purchaser under this contract was the United States. Thus,

52. United States v. County of Allegheny, 322 U.S. 174, 187 (1944). Concerning the interpretation of state tax statutes as they affect the federal government, the Court stated:

Where a federal right is concerned we are not bound by the characterization given to a state tax by state courts or Legislatures, or relieved by it from the duty of considering the real nature of the tax and its effect upon the federal right asserted.  

Id. at 184 citing Carpenter v. Shaw, 280 U.S. 363, 367 (1930).

53. Id. at 187. The Court does indicate that a tax limited to the bailee's leasehold interest would be allowed. This would bring into play the distinction between the subject of and the measure of the tax. Id. at 186--87. See United States v. City of Detroit, 355 U.S. 466 (1958).


55. Id. at 112 n.2.

56. 314 U.S. 1 (1941).

King & Booser is not controlling for, though the government also bore the economic burden of the state tax in that case, the legal incidence of that tax was held to fall on the independent contractor and not upon the United States. 58

After it is determined whether the legal incidence of a tax falls upon a governmental unit or its instrumentalities, different results will obtain upon application of the immunities doctrine depending upon whether it is the federal government or a state or municipal governmental unit that is affected by the tax, and whether such effect is the imposition of the legal incidence of the tax or represents a passing of economic burden.

2. Legal Incidence Upon Federal Government

If the legal incidence of a state or municipal tax is upon the property or transactions of the federal government or its instrumentalities, such a tax will be found unconstitutional. 59 This result may be supported by either the supremacy or the dual sovereignty arguments. For a state to have the original power to tax the federal government, these arguments, which are fundamental to the immunities doctrine, must be overcome. Since both the supremacy and dual sovereignty concepts are grounded in the Constitution, 60 it is difficult to conceive of any judicial expansion of the limiting rationales derived from either the same constitutional concepts 61 or those embodying practical considerations 62 as being sufficient to overcome the basic immunities doctrine. However, this is not to say that the Court is totally unable to limit the application of the immunities doctrine where it is argued that the legal incidence of a state or municipal tax falls upon an instrumentality of the federal government.

58. Id. at 122 (emphasis added). Although Kern-Limerick appears to place federal agency officials in a position to draw constitutional lines restricting state and municipal tax jurisdictions as to persons dealing with the agency merely by the drafting of the contract, prerequisite to such action is a delegation of Congressional authority. See Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110, 115-17 (1954). Moreover, it must be clear that the relationship between the contractor and the government is intended to expose the government to the incidence of the tax. Upholding a local doing-business tax, the Court, in United States v. Township of Muskegon, 355 U.S. 484 (1958), stated:

Constitutional immunity from state taxation does not rest on such insubstantial formalities as whether the party using government property is formally designated a "lessee." Otherwise immunity could be conferred by the draftsman's pen. The vital thing...is that... (the contractor) was using the property in connection with its own commercial activities. The case might be different if... (the contractor) could properly be called a "servant" of the United States in agency terms.

Id. at 486.

59. Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110 (1954); Mayo v. United States, 319 U.S. 441 (1943) (inspection fee). This formalistic approach provides an easy answer to the question of immunity and allows the Court to avoid the policy questions that would be necessary otherwise. A recent case that provides a good example is First Agricultural Nat'l Bank v. State Tax Comm'n, 392 U.S. 339, 347 (1968).

60. See pp. 416-17 supra.
61. See pp. 416-18 supra.
62. See pp. 419-20 supra.
Some limitation of the doctrine may be effected by applying what may be termed a "constitutional instrumentality test" which examines whether an agent of the United States is to be considered an instrumentality under the constitutional tax shield. The policy underlying limitation by this technique is to avoid placing private interests in the position of a primary beneficiary of the constitutional immunity. Thus, the dominant considerations in applying this test focus on the closeness of the relationship between the claimed instrumentality and governmental activities.

3. Legal Incidence Upon The State

Although the rationale and principles of a constitutional instrumentality test are applicable to determine whether the agents of, or those connected with, a state or municipal corporation are protected by the immunities doctrine, this approach has not been a principal limiting device where the immunity runs to the state. A primary technique in judicial limitation of state immunity from federal taxation is to determine whether the particular property or transaction subject to taxation should be included within the constitutional protection. This determination employs what

65. Reviewing the applicable elements in the determination of this relationship, Justice Marshall said:

As the Court said last Term, "there is no simple test for ascertaining whether an institution is so closely related to governmental activity as to become a tax-immune instrumentality." Various formulations of the controlling test have been used to determine whether institutions or individuals are immune: whether they "have been so incorporated into the government structure as to become instrumentality of the United States and thus enjoy governmental immunity;" whether they "are arms of the government deemed by it essential for the performance of governmental functions;" and "are integral parts of [a government department and] ... share in fulfilling the duties entrusted to it;" whether they have been so "assimilated by the Government as to become one of its constituent parts;" and whether the institution is regarded "virtually as an arm of the Government."

Under those general rubrics, the Court has looked to various specific factors and characteristics to determine the status of the specific institution: whether it is organized for private profit, and whether the Government has retained such control over it so that "it could properly be called a 'servant' of the United States in agency terms;" whether it was organized to effectuate a specific governmental program; whether its ownership, substantially or totally, lies in the Government; whether government of officials handle and control its operations; whether its officers or any significant portion of them are appointed by the Government; whether the Government gives it significant financial aid, whether it is charged by law with carrying out some of the Government's international commitments, and whether it performs "functions indispensable to the workings" of a governmental unit.

may be termed the governmental-proprietary test, which encompasses a
distinction between the proprietary activities of a state or municipal
corporation and essential governmental transactions or property, with the
latter falling within the constitutional immunity.67 While such a test is
analogous to the constitutional instrumentality test, the policies effectuated
by it are different. These policies are: (1) the dual sovereignty limitation
that state business activities should not diminish the federal tax jurisdic-
dion where such activity would be taxable if conducted by private
enterprise;68 and (2) the argument that the state may not use constitutional
immunity to place business activity conducted for gain at a competitive
advantage over private enterprise.69

Because of the policies underlying the use of the governmental-
proprietary test as a limiting device, the important factor in the test is
to view the taxable activity or property in light of its relationship to
the usual sphere of private business activity, disregarding the fact that
the activity or property may be impressed with a governmental function.70
This is most clearly expressed in Allen v. Regents of the University System
of Georgia,71 where the Supreme Court, upholding a federal tax imposed
upon admission charges collected by a state educational institution at its
athletic exhibitions, stated:

When a State embarks in a business which would normally be taxable,
the fact that in so doing it is exercising a governmental power does
not render the activity immune from federal taxation. . . . The im-
portant fact is that the State, in order to raise funds for public
purposes, has embarked in a business having the incidents of similar
enterprises usually prosecuted for private gain. If it be conceded that
the education of its prospective citizens is an essential governmental
function of Georgia . . . it does not follow that if the State elects
to provide the funds for any of these purposes by conducting a
business, the application of the avails in aid of necessary governmental
functions withdraws the business from the field of federal taxation.
. . . [H]owever essential the system of public education to the
existence of the State, the conduct of exhibitions for admissions paid
by the public is not such a function of state government as to be free
from the burden of a non-discriminatory tax laid on all admissions.
. . . Moreover, the immunity implied from the dual sovereignty

67. Allen v. Regents of the University System of Georgia, 304 U.S. 439 (1938); South
Carolina v. United States, 199 U.S. 437 (1905). This test is not applicable
when the question is of federal immunity from state or municipal taxation. Since
federal powers are derived by constitutional delegation as opposed to the reservation
of powers in the states, there is no latitude for the federal government to engage in
business activities conducted for gain. Consequently, all federal activities will be
U.S. 95, 102 (1941); Graves v. New York ex rel. O'Keefe, 306 U.S. 466, 477 (1939);
68. See p. 418 & note 34 supra. See New York v. United States, 326 U.S. 572
(1946).
69. See Rakestraw, supra note 18, at 153-59.
70. See Ohio v. Helvering, 292 U.S. 360, 369 (1934); Flint v. Stone Tracy Co.,
220 U.S. 107, 172 (1911); South Carolina v. United States, 199 U.S. 437, 463 (1905).
71. 304 U.S. 439 (1938).
recognized by the Constitution does not extend to business enterprises conducted by the States for gain.\textsuperscript{72}

Practical application of a governmental-proprietary test has been somewhat clouded by the opinion in \textit{New York v. United States},\textsuperscript{76} where the Supreme Court upheld a federal excise tax imposed on the sale of natural or artificial mineral waters. The State of New York which bottled and sold the natural mineral waters from the state reservoir through the Saratoga Springs Authority, claimed immunity from the tax on the basis that it was engaged in the exercise of a traditional and essential governmental function.\textsuperscript{74} Mr. Justice Frankfurter, writing for the Court, rejected the reasoning of Allen and stated:

To rest the federal taxing power on what is "normally" conducted by a private enterprise in contradiction to the "usual" governmental functions is too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion. The essential nature of the problem cannot be hidden by an attempt to separate manifestations of indivisible governmental powers.\textsuperscript{76}

For a standard as to what activities of the state could be subjected to federal taxation, it was posited that "so long as Congress generally . . . [taxes] the source of revenue by whomsoever earned and [such a source is] not uniquely capable of being earned only by a State, the Constitution of the United States does not forbid it merely because its incidence falls also on a State."\textsuperscript{76} As examples of a state activity or property that would partake of uniqueness sufficient to bring it within the governmental immunity, it was suggested that "[o]nly a State can own a State house; only a State can get income by taxing. These could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State."\textsuperscript{77}

The approach of Justice Frankfurter reduces any governmental-proprietary distinction to a test of whether the incidence of a federal tax operates to discriminate against the property or transactions of a state.

\textsuperscript{72} \textit{Id.} at 451-53. In Helvering \textit{v. Gerhardt}, 304 U.S. 405 (1938), decided the same day, the Court enunciated the following principle concerning governmental-proprietary distinctions:

[One] principle of limitation for holding the tax immunity of state instrumentalities to its proper function . . . dependent upon the nature of the function being performed by the state or in its behalf, excludes from the immunity activities thought not to be essential to the preservation of state governments even though the tax be collected from the state treasury.

\textit{Id.} at 419.

This statement is broader, and capable of more limiting application than the language of the \textit{Allen} Court. However, the \textit{Gerhardt} limiting principle is dictum while the language of the \textit{Allen} Court was used to resolve the case on its facts.

\textsuperscript{73} 326 U.S. 572 (1946).

\textsuperscript{74} The governmental function claimed was the disposition of natural resources.

\textit{Id.} at 580-81.

\textsuperscript{75} \textit{Id.} at 580.

\textsuperscript{76} \textit{Id. at 582.}

\textsuperscript{77} \textit{Id.}
The reasoning employed by Justice Frankfurter appears to minimize the effectiveness of a constitutional immunity implied from a notion of dual sovereignties where the activities of each sovereign within its appropriate sphere of authority are to be unimpaired by the other sovereign's taxation. The operative limiting factor is the practical consideration that the states may not diminish the tax jurisdiction of the federal government by the expansion of state activities into areas of private enterprise. Justice Frankfurter's dictum would extend this practical argument to a rule that would allow direct federal taxation of many legitimate state activities with the constitutional immunity providing a narrow exception only for such state activity or property that is unique to the state. To the extent that the limitation of governmental tax immunity stemming from the concept of dual sovereignties concerns the inappropriateness of enlargement of the tax immunity of one sovereignty to the diminution of the tax jurisdiction of the other and therein evinces some suggestion that the limitations should, to a degree, be reciprocal, it seems that Justice Frankfurter went too far. If there is to be any reciprocity in the dual sovereignty limitation, then the effect of the supremacy doctrine in immunizing the federal government and its instrumentalities from the incidence of state taxation must be considered when evaluating the appropriate scope of state immunity.

Although the New York opinion clouds application of proprietary-governmental type reasoning as a limitation of tax immunity, it must be observed that the cloudiness goes only to its application in borderline cases. The emphasis is on further limitation of the immunities doctrine by allowing federal taxation of areas of activity that may have escaped taxation if a clear proprietary distinction were required. Thus, the governmental-proprietary distinction is of pragmatic value in initially assessing the application of the immunities doctrine to state and municipal activities and will resolve the constitutional question in many instances.

The preceding techniques of limiting the immunities doctrine, although principally used when the legal incidence of a tax falls on the governmental unit, may be applied as well where the incidence of the tax falls elsewhere but results in an economic burden upon the government.

78. Clearly the Court could have arrived at the same result on the basis of the governmental-proprietary distinction. Justice Frankfurter's rejection of this distinction and his use of the non-discriminatory approach represents the position of only two of the eight justices deciding the case. Four justices concurring in an opinion written by Chief Justice Stone stated:

[W]e would find it difficult not to sustain the tax in this case, even though we regard as untenable the distinction between "governmental" and "proprietary" interests on which those cases rest to some extent. But we are not prepared to say that the national government may constitutionally lay a non-discriminatory tax on every class of property and activities of States and individuals alike.

Id. at 586.

However, for the most part, different considerations prevail where the tax affects the government only as an economic burden.

4. Economic Burden Upon The Federal Government

Once it is established that the legal incidence of a state or municipal tax does not fall upon the federal government, then the immunities doctrine will not render the tax unconstitutional merely because it results in an economic burden upon the federal government or its instrumentalities. There are two policies underlying this limitation of federal immunity: (1) The notion that under a system of dual sovereignties some economic tax burden is constitutionally permissible; and (2) the power of Congress under the supremacy clause to withdraw transactions or property from state tax jurisdictions that would not have been within the scope of the judicially granted tax immunity. The latter reasoning allows the Court to hinge the issue of federal tax immunity on the legalistic basis of whether or not the incidence of the tax falls upon the federal government, removing economic considerations as to the nature and extent of burdens resulting from the tax. Thus, whether the burden is in the nature of increased federal expenditure to offset the tax or the ultimate payment of the tax, it need not be evaluated in terms of detrimental effect.

There is one exception to this broad limitation of the immunities doctrine as applied to federal immunity — the states or municipalities may not structure a tax so that the economic burden of ultimate payment is discriminatorily placed upon the United States. Thus, before a state or municipal tax may escape the immunities doctrine, its economic burden must fall both on private interests and the federal government equally. Similarly, such taxes may not be structured or administered in such a manner as to discriminate against those with whom the federal government deals.

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81. See p. 418 & note 25 supra.
82. See p. 419 & note 28 supra.
83. There has been some doubt expressed by the Court as to its right and ability to go beyond a legalistic application of the immunity to indulge in such considerations as the nature and extent of economic burden necessary to trigger immunity. See New York v. United States, 326 U.S. 572, 581-82 (1946).
85. United States v. City of Detroit, 355 U.S. 466, 473 (1958); Ratchford, supra note 9, at 324.
5. Economic Burden Upon State Or Municipal Government

When the legal incidence of federal taxation falls upon those persons with whom the state or municipality deals and results in an economic burden on such governmental units, the governmental-proprietary and discrimination tests are applicable. Thus, where the economic burden falls upon state activities having the incidents of a normal business enterprise, no protection will be afforded by the immunities doctrine unless the tax has been structured or applied discriminatorily.

When the tax results in an economic burden upon an essential state or local function and that function is not denied immunity by reason of the governmental-proprietary test, the question of whether the immunity doctrine provides relief depends upon the directness of the burden and the benefits obtained by relief from such a burden. These considerations, as enunciated in Helvering v. Gerhardt, form what may be denominated a benefit-burden test:

[W]here the tax laid upon individuals affects the state only as the burden is passed on to it by the taxpayer . . . the immunity [does not apply] when the burden on the state is so speculative and uncertain that if allowed it would restrict the federal taxing power without affording any corresponding tangible protection to the state government; even though the function be thought important enough to demand immunity from a tax upon the state itself, it is not necessarily protected from a tax which well may be substantially or entirely absorbed by private persons.

In Gerhardt, the tax challenged was a federal income tax which the national government had collected from the employees of a state instrumentality. Thus, the economic burden upon the state with which the Court was concerned was in the nature of increased operating expenses rather than a direct passing of the taxpayers' economic burden as in a cost-plus-fixed-fee contract. Relying heavily on the uncertainty of the increase in expense to the state from the federal income tax, the decision turned on the rationale that some passing of economic burdens is a necessary incident of concurrent tax jurisdictions and therefore constitutionally permissible.

88. See note 79 supra.
89. See note 72 supra.
91. 304 U.S. 405 (1938).
92. Id. at 419-20.
93. Id. at 421. The Court took the position that to some extent the economic burden was unmeasurable.
94. Id. at 422-24. Also underlying the decision is the assumption that the burden would be substantially borne by the individual taxpayer. In view of this, the Court was reluctant to relieve such individuals from their duty to support the federal government whose benefits and privileges they enjoy. Id. at 420-21. In Wilmette Park Dist. v. Campbell, 338 U.S. 411 (1949), when considering the effect upon an instrumentality of the state of a federal tax imposed upon admissions, the Court stated:

It is true, of course, that unless there is a shift in demand for admissions to a particular school, imposition of the tax may in an unmeasurable extent adversely
In considering the benefit to the state — reduced operating expenses — from tax immunity in this instance, the Court measured it against the economic burden which would be placed on the state if immunity were not allowed, \(^95\) with the key to such a balancing found in the Court's statement that the tax "does not curtail any of those functions which have been thought hitherto to be essential to their continued existence as states."\(^96\) Thus, to come within the immunity doctrine the benefit of tax immunity will have to result in protection of the continued existence of the state \textit{qua} state.\(^97\) The notion that an unconstitutional tax would have to "curtail" such a benefit was modified later in the Gerhardt opinion to include, as unconstitutional, burdens that threaten "unreasonably to obstruct any function essential to the continued existence of the state government."\(^98\)

To restate the considerations of the benefit–burden test, it must be determined if the operation of the economic burden upon the state is so uncertain that application of the immunity doctrine would deny federal tax revenues without giving any corresponding tangible protection to the state. Where it is likely that private citizens will substantially absorb the economic burden of the tax there is sufficient uncertainty to deny the immunity. Before the corresponding tangible protection required to be afforded the state will comply with the requirements of the immunity doctrine, it will be necessary to show that the state function sought to be protected is essential to the continued existence of the state. The standard by which the effect of the tax is measured is whether the economic impact unreasonably threatens to obstruct any essential state function.

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\(^95\) Helvering v. Gerhardt, 304 U.S. 405, 420–21 (1938).
\(^96\) Id. at 420 (emphasis added).
\(^97\) It may be noted that the language incorporating the concept of essential governmental function into the benefit-burden test is framed in terms that would comport with the language in New York v. United States, 326 U.S. 572, 580–82 (1946), and is broader than that in Allen v. Regents of the Univ. System of Georgia, 304 U.S. 439, 451–53 (1938). This suggests that once it is found that sufficient burden does reach the state, then the range of functions that will be deemed essential governmental functions is narrower than the scope of state activities that will be protected by the governmental-proprietary distinction of the \textit{Allen} Court. This aspect of the benefit-burden test may be cast as dictum since the Gerhardt Court resolved the case on the basis of insufficient burden and did not reach the question of essential governmental function.

It has been suggested that the Port Authority is not such a function essential to the continued existence of the state that would comply with the immunity doctrine. Powell, \textit{supra} note 9, at 644. However, it would seem that any governmental function which would qualify under the standard of the \textit{Allen} Court should suffice. The only basis for distinguishing the benefit-burden test and requiring more stringent standards for the governmental activity which will trigger immunity is that this test comes into play only when there is an economic burden upon the state and the legal incidence of the federal tax falls elsewhere, whereas the governmental-proprietary distinction of the \textit{Allen} Court is used where the legal incidence of federal taxation falls upon the state.\(^98\) Helvering v. Gerhardt, 304 U.S. 405, 424 (1938) (emphasis added).
III. IMMUNITY OF INTEREST FROM STATE OR MUNICIPAL OBLIGATIONS

The preceding discussion has reviewed the rationales and techniques of the Supreme Court in dealing with the general area of intergovernmental tax immunity. These must be kept in mind when viewing the Court's treatment of the doctrine as it applies to federal taxation of interest from state or municipal obligations. Also, the principles must be applied consistently with the trend toward limitation of the doctrine providing a framework for their application.

Viewing the chronological progression of the doctrine as it applies to interest from governmental obligations, attention will be focused initially upon Weston v. City Council, where the issue was whether a city could impose a personal property tax upon governmental obligations of the United States held by its residents. Finding a contract executed in exercise of the governmental power to borrow money to be "an operation essential to the important objects for which the government was created," the Court held the tax unconstitutional under the supremacy rationale of McCulloch. Concerning the operation of the tax as it affected the United States, the Court stated:

The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government; to any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely.

The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States. . . .

Although Weston concerned local taxation of federal securities, the Court subsequently recognized the reciprocal immunity of obligations of state or municipal governments from federal taxation. Once it was established that the holder of governmental obligations may not be subjected to taxation on the basis of his property interest, the next question was whether the income received by the holder from such obligations was similarly immune. This was answered by the Supreme Court in Pollock v. Farmers' Loan & Trust Co., where it was held that the interest from municipal bonds was not constitutionally subject to federal taxation. To

100. Id. at 467.
101. Id. at 467-69.
102. Id.
104. 157 U.S. 429 (1895).
support this holding, the Pollock court quoted the preceding passage from Weston v. City Council, and stated further:

[T]he same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities. . . . [I]t is obvious that taxation on the interest therefrom would operate on the 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.105

Since both the Weston and Pollock cases were decided during the expansion phase of the immunities doctrine, when any burden on a governmental unit was sufficient to invalidate a tax, it was not material whether the exact nature of the burden was an increased expense for the issuing governmental unit or whether it represented a direct passing of the taxpayers’ burden to the government. However, clearly in both instances the burden is the indirect economic effect of increased expenses for the issuer if it is to retain the capacity to borrow money as freely in a competitive market as before such taxes. Unfortunately, the language of the Pollock court, and the lack of any necessity to analyze the nature of the burden imposed by taxation of income from governmental obligations, combined to foster the notion that such taxation was economically a tax upon the governmental unit. This reasoning will be traced through the following review of the application of the immunities doctrine to taxation of interest from governmental obligations.

Following Pollock, the Court began to limit the expansion of the immunities doctrine in the area of governmental obligations. For example, in 1900 the Court upheld a state inheritance tax imposed upon a legacy of United States bonds.106 Similarly, ten years later a federal tax on corporate net income over $5,000 received by a corporation from all sources — including interest from municipal and state bonds — was upheld as a tax upon the doing of corporate business.107 In both cases, the inclusion of governmental obligations or the interest therefrom in the tax base served as a convenient measure for the taxation of some other transaction — i.e., the transfer of property or the doing of corporate business.

Subsequently, in 1927, taking the position that “directly to tax the income from securities amounts to taxation of the securities themselves,”108

105. Id. at 585–86.
106. Plummer v. Coler, 178 U.S. 115 (1900). Five years later, in Hibernia Savings Soc’y v. San Francisco, 200 U.S. 310 (1906), the Court upheld a state personal property tax levied on checks or warrants issued by the United States Treasury and payable any time within four months, on the basis that such a tax did not interfere with governmental functions.
107. Flint v. Stone Tracy Co., 220 U.S. 107, 144–46 (1911). For an earlier case upholding a state doing-business tax measured by dividends upon capital stock where large amounts of capital were invested in federal bonds, see Home Ins. Co. v. New York, 134 U.S. 594 (1890).
the Court, in National Life Insurance Co. v. United States, invalidated provisions of a federal tax on life insurance companies which taxed the interest, dividends, and rents received less deductions for (1) interest received from tax-exempt securities, and (2) a sum equal to 4% of the company's legal reserves diminished by the amount of any tax-exempt interest. The tax had the effect of imposing a greater burden upon taxable property merely because the taxpayer owned tax-exempt government securities. This application of the immunities doctrine to interest from government securities was broadened two years later in Missouri v. Gehner, where similar provisions in a state tax were invalidated. The Gehner court stated that where:

ownership of United States bonds is made the basis of denying the full exemption which is accorded to those who own no such bonds this amounts to an infringement of the guaranteed freedom from taxation. It is clear that the value of appellant's government bonds was not disregarded in making up the estimate of taxable net values.

This position represents the notion that a taxing authority cannot compensate for revenues lost because of immune government bonds by placing corresponding burdens, which operate as an indirect tax on immune income, upon the other areas subject to tax. However, in neither National Life nor Gehner was the Court required to question the basic constitutional status of interest from governmental obligations under the immunity doctrine. Thus, these cases do not represent any solidifying of the basic doctrine of tax immunity, but rather represent an application of the doctrine assuming its validity as to such interest based on the notion that a tax on interest is economically a tax on the source.

In 1930, the Court in Willcuts v. Bunn found that gains derived from trading in municipal bonds were constitutionally taxable by the federal government. Distinguishing the situation of a tax upon profits gained through trading in municipal bonds from that of a tax upon interest received, the Court affirmed its earlier position in the Pollock case by stating:

But it does not follow, because a tax on the interest payable on state and municipal bonds is a tax on the bonds and therefore forbidden, that the Congress cannot impose a non-discriminatory excise tax upon the profits derived from the sale of such bonds. The sale of the bonds by their owners, after they have been issued by the State or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds.

110. 281 U.S. 313 (1930).
111. Id. at 321-22.
112. 282 U.S. 216 (1931).
113. Id. at 227.
As a general limiting standard in applying the immunities doctrine to the question of gains derived from trading in immune bonds, the Court posited: "Before the power of Congress to lay the excise tax in question can be denied in the view that it imposes a burden upon the States' borrowing power, it must appear that the burden is real, not imaginary; substantial, not negligible." Thus, the nature of the burden from taxing such gains was subjected to analysis and found constitutionally permissible.

The surprising factor in the Willcuts case is the Court's willingness to indulge in an analysis of the nature of the burden of a tax as a limiting device in applying the immunities doctrine to the gains situation, while mechanically reciting the notion that "a tax on the interest payable on state and municipal bonds is a tax on the bonds" as representative of the doctrine's application to a federal tax upon bond interest. It is submitted that the apparently inconsistent approaches merely represent the Court's desire to leave completely open the question of the immunity of municipal bond interest until presented with the problem. This can be supported by the observation that when the Court in 1939 stated that "[t]he theory, which once won qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable," the Court had already shifted its characterization of the operation of a tax upon bond interest in terms of the immunities doctrine to:

That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' and which would directly affect the Government's obligation as a continuing security.

Thus, although commentators hailed the 1939 statement as the basis for the future demise of the immunities doctrine as applied to interest from governmental obligations, the question was still open. However, now it was framed in terms of the effect of the tax on the governmental unit and consequently would not be subject to easy analysis and resolution by the emergence of the legal incidence test.

Another 1930's case, Denman v. Slayton, shows the Court moving toward limitation of the doctrine as it applies to taxation on municipal bond interest. Here, the Court upheld a provision in the Internal Revenue Code disallowing as a deduction interest on indebtedness incurred or continued in purchasing or carrying obligations which are tax exempt. The Court found that the manifest purpose of the disallowance was to

114. Id. at 234.
115. Id. at 227.
118. E.g., Foley, Jr., supra note 3, at 185; Wenchel, Federal-State Reciprocal Taxation of Income from Public Securities, 17 Taxes 507, 552-54 (1939).
prevent the escape from taxation of income properly subject thereto by the purchase of exempt securities with borrowed money and that this did not result in defeating any constitutionally guaranteed exemption. Further, the burden resulting from the disallowance of a deduction for interest incurred in the purchase of exempt securities was found constitutionally permissible.

Subsequently in 1965, commenting on the Denman case, the Court in United States v. Atlas Insurance Co. stated: "We affirm the principle announced in Denman . . . that the tax laws may require tax-exempt income to pay its way." In Atlas Insurance, provisions in the Life Insurance Company Income Tax Act of 1959 allocated prorata the tax-exempt interest to policy reserves with the result that the taxable income of insurance companies was greater than if all of the tax-exempt interest had been allocated to the company's share of income. Holding that the tax burden thus imposed was permissible, the Court said:

In the last analysis Atlas' insistence on both the full reserve and exempt-income exclusions is tantamount to saying that those who purchase exempt securities instead of taxable ones are constitutionally entitled to reduce their tax liability and to pay less tax per taxable dollar than those owning no such securities. The doctrine of intergovernmental immunity does not require such benefit to be conferred on the ownership of municipal bonds. Congress was entitled to allocate investment income to policyholders as it did. The formula "was designed to subject all to payment of their just share of a burden fairly imposed. . . ."

Again, although neither the Denman nor the Atlas Insurance court analyzed the constitutionality of the basic application of the immunity doctrine to interest from governmental obligations, there does emerge from these cases a concern over the availability of constitutional tax immunities to individuals who use them for shelter in escaping payment of their share of the national financial burden. This attitude may prove particularly significant should Congress challenge application of the immunities doctrine to state and municipal bond interest with tax provisions similar to the proposed measures in the Tax Reform Act as originally passed by the House of Representatives.

122. It must be noted that in Denman the Court ignored the implications of the earlier case of Missouri Ins. Co. v. Gehner, 281 U.S. 313 (1930), to the effect that a taxpayer could not be required to pay a greater tax because of his ownership of exempt securities than if the exempt securities were disregarded in computing the tax.
123. 381 U.S. 233 (1965).
124. Id. at 247.
125. INT. REV. CODE of 1954, § 804.
IV. Conclusion

After having considered the policies and techniques of the Court in the application of the intergovernmental tax immunity doctrine, although the final analysis will necessarily remain speculative, it may be fruitful to apply these considerations to actual and possible federal legislative action bringing interest from state and municipal obligations within the federal tax jurisdiction. Viewing the constitutional question of immunity in general terms, it must be noted that any immunity for such interest would flow not from the supremacy clause since that rationale applies only to federal immunity but rather from the dual sovereignty concept which contemplates some passing of tax burdens between the sovereignties. In all instances of federal income taxation of such interest, the legal incidence of the tax is not upon the issuing government or instrumentality; rather, the legal incidence is upon the individual holder who receives the interest. Moreover, the economic burden that the issuing governmental units may bear as a result of such taxation is not a direct passing of the tax cost from the obligation holder to the issuer but rather represents increased expenses necessarily incurred if the issuer is to retain its former borrowing capacity in the competitive market. Whether this effect is termed direct or indirect, it is to some degree speculative and incapable of precise measurement because the interest paid by the issuer and the offering price of the obligations are dependent upon the mechanisms of the marketplace.127 Thus the constitutional question of immunity is reduced to one concerning the nature of interference posed by such taxation and the benefits to be derived by the affected sovereignty from the immunity.128

Considering initially the present tax structure, Section 103 of the Internal Revenue Code of 1954 provides that the exemption afforded interest from state and municipal obligations does not apply to certain industrial revenue bonds.129 Here the immunity issue is resolved on the

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127. On December 3, 1969, it was reported that the City of Philadelphia had received no bids for the issuance of $64.2 million in general obligation bonds because the 7.5 percent interest rate was too low. The asking rate was said to be 8 percent. Phila. Inquirer, Dec. 3, 1969, at 1, col. 2. In contrast, the interest offered on similar obligations in 1965 generally did not exceed 4.5 percent. Moody’s, MUNICIPAL AND GOVERNMENT MANUAL 1937 (1966).

When interest rates of offered obligations are lower than the current market rate the obligations can be sold by lowering the offering price at which they can be obtained. This serves to adjust the yield to investors to a more competitive level — yield is comprised of an interest component and a capital gains component. Staats, The Municipal Bond Market and Tight Money, FEDERAL RESERVE BANK OF PHILADELPHIA BUS. REV. 6 (June 1968).

128. See pp. 430–31 supra.

129. INT. REV. CODE of 1954, § 103(c), provides in pertinent part:

(1) Subsection (a)(1) not to apply. — Except as otherwise provided in this subsection, any industrial development bond shall be treated as an obligation not described in subsection (a)(1).

(2) Industrial development bond. — For purposes of this subsection, the term “industrial development bond” means any obligation—

(A) which is issued as part of an issue all or a major portion of proceeds of which are to be used directly or indirectly in any trade
nature of the interference by such taxation. Assuming *arguendo* that sufficient interference with the governmental borrowing power in the area of industrial redevelopment financing could be shown,\textsuperscript{130} and that the question of instrumentality is not at issue,\textsuperscript{131} the fact that government borrowing may be considered an activity essential to the continued existence of the government unit will not alone bring the interest within the immunity doctrine. As has been seen, the governmental function — borrowing for a public purpose — must be viewed as coupled with the specific activity to which it relates.\textsuperscript{132} In this instance, the activity is as a landlord or vendor of industrial properties. As a landlord or vendor of industrial property, the governmental unit has moved into the arena of ordinary business activity and as such its activities would not come within the constitutional shield.\textsuperscript{133} Thus, the essential governmental function — borrowing — involved in financing such activity is no longer immune from federal taxation.\textsuperscript{134} Moreover, the transaction one step removed — *i.e.*, receipt of interest by the obligation holder — is also outside the scope of immunity.\textsuperscript{135}

In addition to industrial revenue bonds, Section 601 of the Revenue Act of 1969 has revoked the exemption for interest from certain arbitrage

or business carried on by any person who is not an exempt person (within the meaning of paragraph (3)), and

\textbf{(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—}

(i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

(ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

\textsuperscript{130} It has been argued that the loss of the exemption for interest from industrial development bonds will sharply curtail this means of financing economic progress by most of the municipalities which used this means of finance in the past. Robinson, *Industrial Development Bonds: They're Not What They Used To Be*, Federal Reserve Bank of Philadelphia Bus. Rev. 7–8 (Mar. 1969).

\textsuperscript{131} The position of the Treasury Department in advocating the removal of the exemption for industrial development bonds was that such governmental units established for the purpose of their issuance were not obligations of instrumentalities within the meaning of the statute since the primary obligation of the indebtedness, according to the underlying arrangement between the governmental unit and the benefiting industry, is upon the industry and thus the obligation represented by such bonds is that of the private industry. Proposed Treas. Reg. § 1.103–7, 33 Fed. Reg. 4950 (1968).

\textsuperscript{132} See p. 426 *supra*.

\textsuperscript{133} *Id.*


\textsuperscript{135} However, it may be argued that the benefit-burden and instrumentality tests should be applied first, see Wilmette Park Dist. v. Campbell, 338 U.S. 411 (1949); Helvering v. Gerhardt, 304 U.S. 405 (1938); *Hearings, supra* note 4, at 2199 n.16. The nature of the potential constitutional defect in affording immunity to industrial revenue bond interest arising from the activity involved allows the problem to be settled on a legalistic basis in a manner consistent with the present limiting trend in the immunities doctrine and avoids difficult policy judgments that the Court may be reluctant to make. See *New York v. United States*, 326 U.S. 572 (1946).
bonds issued by state and municipal governmental units.\textsuperscript{136} Arbitrage bonds may be broadly described as bonds issued when the proceeds are expected to be used for investment purposes by the purchase of other bonds or securities to produce a yield for the issuer higher than that expected by holders of the issuer's bonds.\textsuperscript{137} The reasoning which was applicable to the industrial development bond exception will similarly deny constitutional immunity to the interest from arbitrage bonds. Here the issuer has used borrowing power to move into the business area of investment for profit and is in a position analogous to that of the investment banker. Thus, the governmental–proprietary test would deny immunity.\textsuperscript{138}

Although it would presently seem unlikely that across-the-board taxation of state and municipal bond interest will be imposed by Congress, attempts to bring this potential source of revenue within federal tax jurisdiction have occurred in the past\textsuperscript{139} and will probably occur in the future. The more pronounced the difference between the savings by state and municipal governments and the loss of federal revenues resulting from the Section 103 exemption of such interest, the better the chance of future reform. This differential is currently estimated to be approximately $1 billion, with the federal tax loss estimated at $2 billion and the savings to the states estimated at $1 billion.\textsuperscript{140} Before limited reform such as that contained in the proposed House bill\textsuperscript{141} is considered, it will be helpful to consider the immunity question in terms of a complete repeal of the Section 103 exemption.\textsuperscript{142}

\textsuperscript{136} Title VI of the Tax Reform Act of 1969 provides in pertinent part:
Sec. 601. Arbitrage Bonds.
(a) Not To Be Treated As Tax-Exempt Obligations. — Section 103 (relating to interest on certain governmental obligations) is amended by redesignating subsection (d) as (e), and by inserting after subsection (c) the following new subsection:
(d) Arbitrage Bonds.—
(1) Subsection (a) (1) Not to apply. — Except as provided in this subsection, any arbitrage bond shall be treated as an obligation not described in subsection (a) (1).
(2) Arbitrage Bond. — For purposes of this subsection, the term "arbitrage bond" means any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly—
(A) to acquire securities (within the meaning of section 165(g) (2) (A) or (B)) or obligations (other than obligations described in subsection (a) (1)) which may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue which is materially higher (taking into account any discount or premium) than the yield on obligations of such issue, or
(B) to replace funds which were used directly or indirectly to acquire securities or obligations described in subparagraph (A).

\textsuperscript{137} See Id.
\textsuperscript{138} See pp. 426–28 supra. It is also doubtful that the benefit of protecting such an investment business by the issuer could be argued in good faith as being essential to the continued existence of the issuer.
\textsuperscript{139} See note 4, supra.
\textsuperscript{140} Hearings, supra note 4, at 2256–58.
\textsuperscript{142} The most direct impact of any modification of the statutory exemption would arise in the instance of complete repeal of Section 103.
The critical consideration in terms of constitutional immunity should Section 103 be repealed would be the nature of the interference under the benefit-burden test. Here the criteria for such an examination requires a determination of whether the economic burden is so uncertain — i.e., it is likely that the burden will be substantially absorbed by private citizens — that the immunity of such interest would restrict the federal tax jurisdiction without giving any corresponding tangible protection to the state.\textsuperscript{143} The protection afforded to the state must benefit a function essential to the continued existence of the state.\textsuperscript{144} The standard by which an interference is measured is whether it unreasonably threatens to obstruct the essential function.\textsuperscript{145}

Assuming that the power to borrow will be coupled with an essential state function and that the status of instrumentality is not in question, consideration of whether the burden upon an issuer of governmental obligations in terms of increased interest or other costs will be uncertain should be viewed in the context of other factors already affecting such costs. Initially, it must be observed that continuing inflation and the resulting tight money situation have forced municipal and state bond interest far in excess of its customary rates.\textsuperscript{146} Additional factors are presented in the investor’s concern with the risks attending investment in such bonds. Negative effects may result from: (1) the publicizing of the urban crisis; (2) the possible inability of municipalities to raise substantial amounts of new revenue by taxation during a “taxpayers’ revolt”; and (3) the lack of investor confidence in the politicians in control of the municipalities.\textsuperscript{147} Such factors would seem to create some degree of uncertainty in the establishment of the interest level to be paid by the issuer of state or municipal bonds.

Assuming the loss of the tax exemption, the nature of the distribution\textsuperscript{148} of ownership of tax-exempt bonds alone creates some uncertainty as to the burden that would fall upon the issuer. A substantial amount of such bonds is held by owners not subject to federal income taxation.\textsuperscript{149}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline
\textbf{Date} & \textbf{Total} & \textbf{Held by} & \textbf{Held by} & \textbf{Held by} & \textbf{Held by} & \textbf{State} & \textbf{Misc.} \\
& \textbf{Amount} & \textbf{Commercial} & \textbf{U.S. Govt.} & \textbf{Private Non-Bank} & \textbf{Corps.} & \textbf{Local} & \\
& \textbf{Outstanding} & \textbf{Banks} & \textbf{Investment} & \textbf{Non-Bank Investors} & \textbf{Savings} & \textbf{Local} & \textbf{Gts.} \\
& & & \\
& & & & & & \\
\hline
1965 & 99.2 & 38.6 & .8 & 36.0 & 15.2 & .4 & 3.3 & 5.8 & 1.9 \\
1966 & 104.8 & 40.3 & .9 & 38.2 & 14.4 & .3 & 4.1 & 4.6 & 2.0 \\
1967 & 113.3 & 45.6 & 1.0 & 39.8 & 15.5 & .3 & 4.8 & 4.2 & 2.1 \\
\hline
\end{tabular}
\caption{Securities of State and Local Governments, Territories and Possessions Outstanding June 30 (In Billions)}
\end{table}

\textsuperscript{143} See p. 430 supra.
\textsuperscript{144} See p. 431 supra.
\textsuperscript{145} Id.
\textsuperscript{146} See note 127 supra.
\textsuperscript{148} The estimated distribution of outstanding securities issued by state and local governments, territories and possessions is as follows:

<table>
<thead>
<tr>
<th>Securities of State and Local Governments, Territories and Possessions Outstanding June 30 (In Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>1965</td>
</tr>
<tr>
<td>1966</td>
</tr>
<tr>
<td>1967</td>
</tr>
</tbody>
</table>

\textsuperscript{149} Id.
Further, commercial banks, who hold the largest portion of the outstanding tax-exempts, will desire to be in a position to continue sharing in the $15 billion in demand deposits which state and local governments place in the nation's banks. Thus, there will be some competitive pressure between the banks to hold such governmental obligations regardless of the tax exemption. Moreover, the banks are limited by regulation in the channeling of their investment funds, and governmental obligations have generally been considered to represent a sound investment. Also, the insurance companies, who are substantial holders of tax-exempt obligations, in striving for sound investments will find the tax liability attenuated because part of the income may be allocated to policy reserves. On the other hand, private investors, absent increased interest by the issuer, it may be assumed, will move their investment funds to other areas, thereby avoiding absorption of the tax as imposed on this form of income.

Clearly, there is uncertainty as to the extent of the economic burden from taxation of interest that will have to be absorbed by the issuer. However, it has been long agreed that some increase in interest levels will result. This must be viewed in context of the dual sovereignty concept that some passing of economic burden is constitutionally permissible. Even if the relative certainty that the individual investor would require higher interest rates to remain in the market were sufficient to satisfy the question of speculativeness under the benefit–burden test in favor of granting immunity, it still would have to be shown that the economic burden of the increased costs would unreasonably threaten to

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150. See Staats, supra note 147, at 8. In 1967, the commercial banks held $45.6 billion of the $113.3 billion in such securities outstanding.


152. In 1967, private investors held $39.8 billion of the outstanding governmental securities. See note 148 supra.

153. The breakdown of individual holdings by income is:

<table>
<thead>
<tr>
<th>1962 Income (Dollars)</th>
<th>Per Cent (Approx.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 2,999</td>
<td>*</td>
</tr>
<tr>
<td>3,000 - 4,999</td>
<td>*</td>
</tr>
<tr>
<td>5,000 - 7,499</td>
<td>*</td>
</tr>
<tr>
<td>7,500 - 9,999</td>
<td>1</td>
</tr>
<tr>
<td>10,000 - 14,999</td>
<td>*</td>
</tr>
<tr>
<td>15,000 - 24,999</td>
<td>2</td>
</tr>
<tr>
<td>25,000 - 49,999</td>
<td>7</td>
</tr>
<tr>
<td>50,000 - 99,999</td>
<td>24</td>
</tr>
<tr>
<td>100,000 and over</td>
<td>67</td>
</tr>
</tbody>
</table>

* Less than one-half of 1 per cent.

Staats, supra note 147, at 4. The yield of tax-exempts is approximately 30 percent less than corporate bonds of comparable quality. Thus, as the investor exceeds the 30 percent tax bracket, the tax savings from purchasing tax-exempts increases. Therefore, the high-tax-bracket individuals will be more likely to look for more profitable yields once the exemption is repealed. See Staats, supra note 147, at 4–7.

154. Staats, supra note 147, at 9; Hearings, supra note 4, at 2257–58, 2281; Foley, supra note 4, at 182. If inflationary pressures have forced the interest rates to a point far in excess of traditional rates, it may be difficult to argue that an additional 1 or 1.2 percent attributable to the loss of the exemption will unreasonably threaten to
obstruct the power of the issuer to borrow. Another factor militating
against immunity is the fact that the persons who will primarily benefit
from immunity are the individuals in the high income brackets, for
whom the exemption provides a tax-shelter allowing them to avoid their
share of the national financial burden.\textsuperscript{155}

In view of the uncertainty attached to the economic burden upon
the issuer of governmental obligations, it is submitted that the policies
limiting the scope of constitutional tax immunity will prevail should the
Section 103 exemption be repealed and such Congressional action be
tested in court. Although the application of the benefit–burden test leaves
the court much leeway, it would take a substantial fiscal argument to
overcome the pressure toward limitation of the immunities doctrine.

Having arrived at the position that any constitutional immunity
claimed in the face of a repeal of the Section 103 exemption is at best
doubtful, it is further submitted that when the burdens upon the issuer
are attenuated by only partial taxation of interest from state and municipal
obligations there would seem to be little basis for a claim of immunity.
In the Tax Reform Act of 1969 as originally passed by the House, the
Section 103 exemption was limited as to individuals by means of the
disallowed tax preferences.\textsuperscript{156} The amount of such interest that would be
included in gross income was lumped together with other disallowed tax
preferences, such as the capital gains deduction and accelerated deprecia-
tion\textsuperscript{157} thus limiting some of the alternatives by which the individual
could avoid imposition of the full measure of income taxation. Moreover,
as enacted, the Tax Reform Act only imposes as a minimum tax on the
tax preference items a 10\% rate on the sum of such preference items
in excess of $30,000, and which is greater than the taxes that would be
imposed without regard to the minimum tax.\textsuperscript{158}

Had the Section 103 preference item not been deleted from the final
Act, the effect upon the issuer resulting from such taxation could be
nothing other than speculative. Moreover, with the other tax shelters
similarly limited it would seem as likely as not that the burden would
be substantially absorbed by the affected individual. It is submitted that
such modification of the Section 103 exemption and similar limited
modifications partially exposing interest from state and municipal obliga-
tions to the federal tax jurisdiction will be able to marshall little force
in an argument for constitutional immunity.

\textit{Leonard C. Homer}

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\textsuperscript{155} See p. 436 & note 94 supra. It is sometimes argued that high-income taxpayers
are financially supporting the issuing governmental unit by an implied tax of 30 percent
when purchasing governmental obligations which pay 30 percent less interest. This
represents savings to the issuer and has the same effect as if the issuer could tax the
interest. See Staats, \textit{supra} note 147.

