No. 94, Original

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff in Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

BRIEF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PLAINTIFFS

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QUESTION PRESENTED

Whether the penalty imposed on State and local governments under the Tax Equity and Fiscal Responsibility Act of 1982 for failure to issue their obligations in registered form, i.e., loss of exemption from Federal taxation of interest thereon, is beyond the power of the Congress and thereby unconstitutional.

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INTEREST OF THE AMICUS CURIAE

This brief is submitted on behalf of the Government Finance Officers Association ("GFOA"). The GFOA, formed in 1903, is a professional organization of State and local finance officers who are deeply involved in planning and financing governmental facilities throughout the nation. Over 8,300 members of GFOA are officials representing State and local governments exercising all degrees of political authority, in major urban areas as well as sparsely populated rural areas. The interests of the members of the GFOA are as diverse as the governments they represent but they are united in their belief that the doctrine of intergovernmental tax immunity is an essential element in assuring the continued ability of State and local governments to function effectively.

The GFOA's interest and concern about Federal interference with State and local government public purpose borrowing practices has been evidenced in Policy Statements of the GFOA adopted at its Annual Conferences. In numerous such statements, the GFOA has reaffirmed its belief in the doctrine of reciprocal immunity whereby just as the Federal government is immune from taxation by State governments so also are the States and their instrumentalities immune from taxation by the Federal government.

The GFOA is concerned that recent Congressional and judicial inroads on the doctrine of tax immunity go beyond legitimate Federal concerns and impair the right of States to determine their own affairs, govern their citizens and meet their governmental responsibilities through the issuance of tax-exempt debt.

One troubling portion of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") *inter alia*, is the provision that purports to hold interest on State and local government obligations to be subject to Federal income taxation for failure to issue such obligations in registered form. The GFOA vigorously assails the penalty of forfeiture of tax exemption because it violates the

historically established tax immunity of State and local government obligations. This penalty is a tax on the power of the States and their local governments to borrow money and, in the view of the GFOA, is repugnant to the Constitution. GFOA's brief discusses the impact of the Sixteenth Amendment upon the doctrine of intergovernmental tax immunity. It will be shown that the Amendment's legislative history and subsequent interpretations of this Court, did not alter, but instead specifically preserved the Constitutional tax immunity enjoyed by interest on State and local government obligations. It also discusses the GFOA position that subsequent actions, including acquiescence (if any occurred), may not change that interpretation.

STATEMENT OF THE CASE

On January 22, 1987, the Honorable Samuel J. Roberts, retired Chief Justice of the Supreme Court of the State of Pennsylvania, acting as a Special Master pursuant to order of the Supreme Court of the United States,[1] delivered to the Court a Report of Special Master, including factual findings and legal analysis[2] in the matter of *South Carolina* v. *Regan*.[3]

In such case, the State of South Carolina, the National Governors' Association and various *amici* challenge the constitutionality of Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982[4] which

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[1] *South Carolina* v. *Regan*, 466 U.S. 948 (1984). On February 22, 1984 the Supreme Court granted the motion of the State of South Carolina to file an original complaint against the Secretary of the Treasury in such Court, 465 U.S. 367 (1984).

[2] Report of the Special Master, hereinafter cited as "Special Master's Report".

[3] 465 U.S. 367 (1984), No. 94, Original.

[4] *See* Tax Equity & Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 310(b)(1), 96 Stat. 324, 596 (1982) [hereinafter cited as TEFRA] which amended certain provisions of the Internal Revenue Code of 1954.

requires that in order for interest paid on an obligation to be eligible for exemption from Federal income taxation under the Internal Revenue Code, the obligation must be in fully registered form.[5] South Carolina and its fellow States maintain that this requirement is an unconstitutional infringement of their right to borrow freely,[6] a right reserved to the States in the Tenth Amendment of the United States Constitution.[7] The Special Master's Report may be read to support two legal propositions[8] which the GFOA believes to be fallacious. The first proposition, which the Solicitor General advocated, is that the history involved in the enactment and ratification of the Sixteenth Amendment[9] is presently irrelevant.[10] We believe such proposition in addition to being wrong does disservice to our constitutional system.

The second proposition inferred from the Special Master's Report is that the fundamental law of the land may be changed by a course of dealings or acquiescence.[11] We believe that this concept of acquiescence or "estoppel" has recently been rejected by this Court in circumstances where the factual determination of acquiescence between the executive and legislative branches of the Federal government was patently clear[12] and as such

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[5] Special Master's Report, p. 2.

[6] *Id.* at 2, 89.

[7] U.S. Const. amend. X. The tenth amendment provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[8] Special Master's Report, p. 163, fn. 463 and pp. 135-137.

[9] See discussion *infra*.

[10] Special Master's Report, p. 163, fn. 463.

[11] Special Master's Report, pp. 135-137.

[12] *Immigration and Naturalization Service* v. *Chadha*, 462 U.S. 919 (1983) and *Charles A. Bowsher, Comptroller General of the United States* v. *Mike Synar, Member of Congress*, 478 U.S. ——, 92 L.Ed.2d 583 (1986).

this proposition is not only legally flawed but also historically inaccurate.

Finally, these propositions if adopted, even inferentially, by the Court can only serve to undermine the dependability of the amendment process, which Benjamin Franklin cited as a keystone in our governmental system due to our fallibility,[13] by its apparent wholesale rejection of reasonable reliance on statements and interpretations offered by competent parties during the amendment process.

Subsequent to the Court's determination to exercise jurisdiction in the *South Carolina* case, the Court issued its decision in *Garcia* v. *San Antonio Metropolitan Transit Authority*.[14] Although the GFOA agrees with the Administration [15] and the dissenting Justices in *Garcia* that such decision was overly-broad and should be subject to review, we do not believe that the exercise of Congress' power under the Commerce Clause has any particular relevance in the instant case. It is undisputed that the Federal government, if it so desires, can allocate to itself exclusive authority to regulate interstate commerce. However, the power to tax is the exclusive domain of neither the States nor the Federal government.

Notwithstanding the decision in *Garcia*, however, it should be noted that in determining to exercise original jurisdiction in the *South Carolina* case, four of the Justices (Chief Justice Burger, Justices Brennan, Marshall and White) found it to be unquestionable that "the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50

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[13] Remarks at the Constitutional Convention, read Monday, September 17, 1787. *Papers of James Madison, His Reports of Debates in the Federal Convention*, Volume III, p. 1596.

[14] 469 U.S. 528 (1985).

[15] See *The Status of Federalism in America: A Report of the Working Group on Federalism of the Domestic Policy Council November 1986.*

States",[16] that Justice Blackmun found the issue presented to be a "substantial one" and "of concern to a number of States"[17] and an additional three Justices (O'Connor, Powell and Rehnquist) found the authority claimed by South Carolina to have "significant historical basis" and the injury alleged "could deprive it of a meaningful political choice".[18]

One of the Justices, however, Justice Stevens, dissenting in part, observed "there is simply no merit to the claim the State has advanced"[19] and "[a] long line of cases plainly forecloses the first claim; the other two are frivolous".[20] Alarmingly, certain Federal courts have focused on the dissent of Justice Stevens to find ". . . the Supreme Court has continued to narrow if not reject immunity doctrine [*sic*]."[21]

The Court may, of course, accept or reject all or any part of the Special Master's factual and legal analysis and recommendation. If the Special Master's factual determination is adopted by the Court, GFOA believes that whether this is the proper case in which to resolve complicated constitutional issues regarding our historic federal system should itself be the subject of careful consideration. The GFOA respectfully suggests that if the Supreme Court does decide to adopt the recommendation as to judgment it do so clearly and state the reason therefor lest its action create more uncertainty as to the

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[16] 465 U.S. 367, 382 (1984).

[17] *Id.* at 384.

[18] *Id.* at 401.

[19] *Id.* at 403.

[20] *Id.* at 404.

[21] *Shapiro* v. *Baker*, 646 F. Supp. 1127, 1131 (D.N.J., 1986). See also *Harrison J. Goldin, Comptroller of the City of New York* v. *James Baker, Secretary of the Treasury of the United States*, United States Court of Appeals, Second Circuit (1987), 809 F.2d 187, 189 and 191 and *Boli* v. *United States*, United States Court of Claims, Wash., D.C., No. 151-86T, February 11, 1987.

status of the States in the Federal system. The need for clarity is particularly important in view of certain lower courts' reactions to Justice Stevens' opinion. The long-standing protection of the States from Federal taxation that permeates our laws, our court decisions and our constitutional framework and the historical development of this immunity which is rooted in the very foundation of the Federal system cannot and should not be dismissed lightly.

SUMMARY OF ARGUMENT

The Court in the *Pollock*[22] decisions unanimously determined that the Congress may not constitutionally tax the interest on State and local government obligations. The Sixteenth Amendment did not change and was not intended to change the law as stated in the *Pollock* decisions in this particular area. Subsequent actions which fall short of a constitutional amendment even including "acquiescence", if any occurred may not change the law as so stated.

ARGUMENT

I. THE COURT IN THE POLLOCK DECISIONS UNANIMOUSLY DETERMINED THAT THE CONGRESS MAY NOT CONSTITUTIONALLY TAX THE INTEREST ON STATE AND LOCAL GOVERNMENT OBLIGATIONS.

The GFOA is in general agreement with the Special Master's Report insofar as it sets forth the history of reciprocal immunity through *Pollock v. Farmer's Loan & Trust Co.*[23] In such case the Court struck down as unconstitutional an 1894 Act of Congress providing for a levy of taxes (i) which to the extent they constituted a direct tax were not apportioned among the States in accordance with Article I, Section 2 of the Constitution,[24]

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[22] 157 U.S. 429, on rehearing 158 U.S. 601 (1895).

[23] 157 U.S. 429, on rehearing 158 U.S. 601 (1895).

[24] 157 U.S. 429 at 432. Article I, Section 2, clause 3 of the Constitution provides in part: "Representatives and direct taxes shall be apportioned among the several States. . . ."

(ii) which to the extent not direct, were not uniform in accordance with Article I, Section 8 of the Constitution,[25] and (iii) which purported to tax interest on the obligations of States and their instrumentalities.[26] As to this latter point, we would reiterate the words of the Court therein:

> "We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution". [27]

Likewise, the statement of Justice Brown, in dissent:

> "The tax upon the income of municipal bonds falls obviously with the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid." [28]

II. THE SIXTEENTH AMENDMENT DID NOT CHANGE AND WAS NOT INTENDED TO CHANGE THE LAW AS STATED IN THE POLLOCK DECISIONS IN THIS AREA.

A reaction to the main holding of *Pollock*[29] resulted in President Taft seeking a proposed constitutional amendment which would confer upon the national government the power to levy on income a tax "without apportion-

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[25] 157 U.S. 429, at 432. Article I, Section 8, clause 1 of the Constitution provides: "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." On rehearing, the Court determined that taxes on rents or income from real property were direct taxes subject to the rule of apportionment, 158 U.S. 601, 637 (1895).

[26] 157 U.S. 429, 584, 601-602, 652, 653, on rehearing 158 U.S. 601, 693 (1895).

[27] 158 U.S. 601, 630.

[28] *Id.* at 693.

[29] 158 U.S. 601 (1895).

ment among the States in proportion to population".[30] President Taft recommended adoption of the amendment since "[f]or the Congress to assume that the [Supreme C]ourt will reverse itself, and to enact legislation on such an assumption will not strengthen popular confidence in the stability of judicial construction of the Constitution".[31] The Congress passed the proposed amendment and sent it to the States for ratification.

The spectre of taxation of the States' debt obligations was raised (allegedly as an attempt to derail the ratification process[32]) by Governor Charles Evans Hughes of New York in an address to the State legislature.[33] Proponents of the amendment in the Congress reacted immediately, especially in the Senate, and charged that Gov-

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[30] 44 Cong. Rec. 3344, 1548, 1568-69, 3377 (1909). The Senate Finance Committee reported the proposal in the form subsequently adopted as the Sixteenth Amendment: "[t]he 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." *Id.* at 3900. See also 45 Cong. Rec. 1113, January 27, 1910, in which Representative Hull appears to question President Taft's sincerity. *Id.*

[31] 44 Cong. Rec. 1548, 1568-69, 3377 (1909).

[32] See statement of Senator Borah, 45 Cong. Rec. 1698, February 10, 1910 and of Representative Cordell Hull, 45 Cong. Rec. 1113-1114, January 27, 1910.

[33] Message to the New York State Legislature (Jan. 5, 1910). See the text of the Hughes' statement in Appendix A hereto. The New York Times reported the Hughes' statement, Jan. 6, 1910, at 2, col. 4, and simultaneously issued an editorial urging defeat of the ratification of the amendment based on the Governor's criticism. *Id.* at 8, col. 1. Responses of other governors to these observations were then published including those of Governor Gilchrist of Florida who supported ratification in this expressed belief that the notions of self-preservation of the States and freedom from Federal taxation was implicit in any Federal tax action and hence could not be affected by the amendment and Governor Vessey of South Dakota who acknowledged that if the Hughes' position were correct, he would oppose ratification. N.Y. Times, Jan. 7, 1910, at 3, col. 3.

ernor Hughes' warning was unfounded or alarmist.[34] The Senator from New York, Senator Elihu Root, directed his comments to the members of that State's legislature.[35]

Representative Cordell Hull speaking in the House of Representatives described the Hughes' objection as "unsupported by reason or experience".[36]

Governor Fort of New Jersey, in submitting the amendment to the Legislature of that State, took issue with Governor Hughes, stating "[n]or am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power." [37]

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[34] See comments of Senator Borah, 45 Cong. Rec. 1694-98 (1910). Senators Borah's and Root's comments on this issue were also noted by The New York Times, *see* Feb. 11, 1910, at 1, col. 4; Mar. 1, 1910, at 4, cols. 2 and 3, and the newspaper reported that Senator Borah's speech was favorably received:

> When Mr. Borah concluded his argument that it was inherent in the nature of the independent sovereignties of the (states) and the Nation, that neither could tax the means of support of the other, many Senators, including Mr. Bailey of Texas, Mr. Heyburn of Idaho, Mr. Bacon of Georgia, and Mr. Smoot of Utah, crowded up to congratulate him, and all of them indorsed heartily the position he had assumed in regard to Gov. Hughes' attack on the Amendment as it stood.

N.Y. Times, Feb. 11, 1910, at 1, col. 4.

[35] Senator Root answered in both the Senate, and by letter to the Legislature. 45 Cong. Rec. 2539 (1910). For the text of Senator Root's letter see Appendix B hereto. Prior to adoption of the Seventeenth Amendment, members of the United States Senate were appointed by their respective State legislatures and were responsive to them.

[36] 45 Cong. Rec. 1114, January 27, 1910.

[37] Message to the New Jersey Legislature (Feb. 7, 1910). Senator Brown retorted: "It cheers our hearts to read in the press that President Taft agrees with the governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." 45 Cong. Rec. 2245 (1910).

Senator Brown, a sponsor of the resolution, although not disposed to oppose the taxing of State and local government securities, nonetheless expressed surprise at Governor Hughes' comments, stating:

> The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities.[38]

Significantly, *no member of the Congress supported the proposition that the amendment would permit the taxation of the interest on State debt obligations.*[39] The Hughes' furor died down and the proposal was ratified as the Sixteenth Amendment to the Constitution.[40]

The Special Master accepts this analysis and notes that ". . . the principal sponsors of the Sixteenth Amendment took pains to assure the Congress that passage of the Six-

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[38] 45 Cong. Rec. 2245-2246 (1910). Senator Brown implied that if Hughes were correct the resolution would not have passed the Congress so easily.

[39] In 1940, in comments accompanying a revenue bill which provided for Federal taxation of the interest on municipal debt, Senator Brown of Michigan felt it important to revisit the Hughes furor and sought to rebut the allegations that Hughes' actions were a ploy to defeat the Sixteenth Amendment, 86 Cong. Rec. 12291-12304, 12293 (September 19, 1940) in order to postulate an argument that ratification took place after consideration and acceptance of the Hughes position. This argument was joined strongly by Senator Austin, *Id.* at 12294, including insertion of a report recording certain governors' reactions to the Hughes' statements, *Id.* at 12297. The text of such report is included as Appendix C hereto.

Subsequent decisions of Governor Hughes while serving as Chief Justice of the Supreme Court indicate that he was satisfied with the Senatorial defense of the intent of the amendment. See *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 386 (1938); *James* v. *Dravo Contracting Co.*, 302 U.S. 134, 154 (1937) and *Willcuts* v. *Bunn*, 282 U.S. 216 (1930).

[40] See proclamation of the Secretary of State, February 25, 1913.

teenth Amendment would not, in and of itself, authorize Federal taxation of municipal bonds." [41]

However, the Special Master posits that the understanding of the sponsors offers no support for South Carolina's position insofar as "the Sixteenth Amendment did not purport to address the scope of the Federal taxing power as applied to activities of the States".[42] The GFOA believes that the Special Master erred in his assessment of the significance of the sponsors' understanding.

Much Congressional debate ensued following enactment of the Sixteenth Amendment. In introducing the first income tax statute adopted pursuant to such amendment, Representative Cordell Hull noted that the statute particularly provided that interest on State obligations was specifically excluded from the definition of income so as not to raise a constitutional question.[43]

As the interests and economic needs of the Federal government grew, several unsuccessful attempts were made to legislate such taxation. In 1918, under questioning from a sympathetic Senator, Mr. Smith of Arizona, Senator Thomas presented a lengthy review of the concurrent and subsequent congressional and judicial interpretations of the Sixteenth Amendment, particularly the exchange between Governor Hughes and Senator Root, commenting:

> Upon the strength and under the interpretation outlined in [the Root letter to the New York State Leg-

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[41] Special Master's Report, pp. 162-163.

[42] Special Masters Report, p. 163, fn. 463. The Circuit Court of Appeals for the Second Circuit, incorrectly, in the view of the GFOA, disagrees with the Special Master on this point: "In *Pollock*, the Supreme Court held a Federal statute imposing a tax on income from municipal bonds to be unconstitutional. . . . The passage of the Sixteenth Amendment to the Constitution in 1913 and numerous Supreme Court decisions since that time have cast doubt on the vitality of *Pollock*". *Goldin* v. *Baker*, 809 F.2d 187, 189 (1987).

[43] 50 Cong. Rec. 508 (1913). For a related discussion see the Appendix D hereto.

> islature], the General Assemblies of the States of New York and New Jersey finally ratified the amendment. I think I am safe in asserting that such was the understanding of the legislatures of the other ratifying States. I affirm that it could not have been ratified at all had it been supposed to clothe the Federal Government with power to impair the integrity and undermine the structure of the States through the power of unlimited taxation. Nothing in the debates of the Congress nor in the comments of the press during the period of its consideration—nothing, indeed, until the message of Gov. Hughes appeared—was said or written which intimated that the representatives of the people in the Congress of the United States were subjecting their States, the agencies and instrumentalities thereof, to the taxing power of the Nation.[44]

A similar attempt as an "emergency revenue measure" during World War I [45] was met by a strong rebuttal from Senator Borah:

> I think, however, that while it seems we are engaged in these days in an unconscious, if not a conscious, movement to destroy the sovereignty of the States, we may pause before taking the final step to consider

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[44] 56 Cong. Rec. 10,631. For a related discussion, see Appendix E. Senator Knox answered the remarks of Senator Thomas, noting "the observations which I intend to make have, in my judgment, a very direct and immediate effect upon the winning of this war . . . . [T]he exigencies of the present situation are so grave that if Congress can constitutionally impose the tax it should do so." 56 Cong. Rec. 10,933 (1918).

Senator Knox then inserted into the record the extensive response made by Senator Borah to Governor Hughes, stating that it "was addressed at that time particularly to the proposition that the sixteenth amendment did not affect the question, and for myself I think the Senator from Idaho conclusively maintained that proposition." *Id.*

[45] 56 Cong. Rec. 10,941 (1918). Senator Borah rose to answer Senator Knox and observed that the taxes struck down in *The Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870) and *Lane County* v. *Oregon*, 74 U.S. (7 Wall.) 71 (1868), were both enacted as wartime measures.

> whether it is wise to go all the way. I do not believe a few million dollars is any price to put up against the Federal system which was originally constructed by the fathers. If we take away the rights of the State to control the franchise, and then go further and lay taxes upon the very instrumentalities of the State governments, certainly we shall have concluded that the States as sovereign entities are no longer essential. That may be the doctrine which we are to accept, but under no conceivable circumstances shall I ever subscribe to it. I repeat, as I have said elsewhere, you can have no great Federal Union without great and powerful Commonwealths upon which the Federal Government may rest.[46]

Subsequently, the Congress failed to pass a constitutional amendment which would have authorized prospective taxation.[47]

Proposals to tax such interest were made several times and extensive and objectively inconclusive hearings were held as to whether a constitutional question was involved with the consensus at such hearings as hereinafter set forth being that a substantial constitutional impediment prohibited such taxation.

At one such hearing, a letter from Secretary of the Treasury Andrew W. Mellon was read into the record, stating that the Secretary assumed it to be clear under

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[46] 56 Cong. Rec. 10,941 (1918). On October 10, 1918, Senator Kellogg offered extensive rebuttal to the comments of Senator Knox, echoing the remarks of Senators Thomas and Borah. 56 Cong. Rec. 11,181-87 (1918). For other contemporaneous discussions, see H.R. Rep. No. 767, 65th Cong., 2d Sess. 9 (1918); S. Rep. No. 617, 65th Cong., 3rd Sess. 6 (1918).

[47] *Hearings before the Comm. on Ways and Means, House of Representatives on Tax-Exempt Securities,* H.R.J. Res. 102, 67th Cong., 1st Sess. (1922) [hereinafter cited as *1922 Hearings*]. Several resolutions were introduced in Congress for the stated purpose of amending the Constitution so as to permit the prospective taxation of interest on municipal securities. Extensive hearings (there are 196 pages of testimony) were held on such resolutions.

judicial interpretation that the Sixteenth Amendment does not permit the Federal Government to tax income derived from State or local government securities,[48] and that the effective means of restricting further issues of tax-exempt securities by State or municipal government would be by constitutional amendment.[49]

On June 6, 1924, the Senate received a report of the Chairman of the Federal Trade Commission regarding taxation and tax-exempt income.[50] In response to the question "Is Congress obliged to exempt State bonds?" the report stated that the income tax acts exempt the obligations of the States, Territories, possessions, and their political subdivisions. However, such response questioned whether, even without this provision in the Federal income tax acts, the interest from the securities of the States or their political divisions would not be held tax exempt on constitutional considerations.[51] Citing to *Pollock v. Farmer's Loan & Trust Co.*[52] the report interpreted the position of the Supreme Court as holding that

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[48] *See 1922 Hearings, supra* note 47, at 11-12. Secretary Mellon endorsed the intent of one of the resolutions, which it is noted by Representative McFadden "was drawn by the Treasury Department." *Id.* at 11.

[49] *Id.* at 12. In February, 1923, the Senate conducted hearings on H.R.J. Res. 314 which had passed the House of Representatives on January 23, 1923. *Tax-Exempt Securities, Hearings before a Subcomm. of the Senate Comm. on the Judiciary on H.R.J. Res. 314,* 67th Cong., 2d Sess. (1923) [hereinafter cited as *1923 Hearings*]. H.R.J. Res. 314 provided in part that "[t]he United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State . . . ." *1923 Hearings, supra,* at 1. The Senate never acted on the resolution and it was reintroduced in the House on January 10, 1924. After being debated again, it was rejected on February 8, 1924, by a vote of 247-133.

[50] S. Doc. No. 148, 68th Cong., 1st Sess. (1923) [hereinafter cited as *FTC Report*]. The request of the Senate was made in Senate Resolution 451, adopted February 28, 1923.

[51] *FTC Report* at 2.

[52] 157 U.S. 429, *on rehearing,* 158 U.S. 601 (1895).

by constitutional implications neither the State governments nor the Federal government has the power to tax the instrumentalities of the other.[53] The Commission report concluded that the Sixteenth Amendment did not extend the taxing powers of Congress to include interest paid on State obligations.[54]

The Congress held additional hearings on reciprocal immunity[55] with the result in 1924 that a majority of the House Ways and Means Committee determined that a constitutional amendment was a prerequisite to Federal taxation of municipal securities.[56]

In 1936, the Congressional Joint Committee on Internal Revenue Taxation received for information and discussion purposes a report which concluded that the Federal government, notwithstanding the Sixteenth Amendment,

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[53] *FTC Report*, at 2.

[54] *Id.* at 2.

[55] Prior to the defeat of the re-introduced H.J. Res. 314, *see supra* note 49, the Committee on Ways and Means referred to the House a report on Tax-Exempt Securities, H.R. Rep. No. 30, 68th Cong., 1st Sess. (1924) [hereinafter cited as *1924 House Report*], which stated:

> The amendment proposed strikes at an evil in our system of taxation which is already great and, if unchecked, will grow to such magnitude as to even threaten the existence of our institutions. The Constitution of the United States, as it now stands, not only permits the issuance of tax-exempt securities by either the Federal or State Governments but absolutely prevents the Federal Government on the one hand from levying income tax on securities issued by the several States, and the States on the other hand from levying an income tax on the securities issued by the Federal Government.

1924 *House Report, supra*, at 1.

[56] Tax Exempt Securities, Report to accompany H.J. Res. 136, 68th Cong., 1st Sess., Rept. No. 30 (1924), pp. 6-9. For a collection of law articles, opinions and letters in respect of the power of the Congress to tax interest from municipal bonds, see *Tax-Exempt Securities*, printed for the use of the Senate Committee on Finance, March 26, 1924.

had no power to tax the income of State securities.[57] In 1937, the Subcommittee of the Committee on the Judiciary of the United States Senate issued a report, regarding the taxation of interest on municipal securities. The report contained a response from Mr. Roswell Magill, Acting Secretary of the Treasury, which stated:

> If this result [taxation of municipal securities] could be achieved by legislation alone, the solution of the problem of the tax-exempt security would be relatively simple. Unfortunately, it seems perfectly clear under the decisions of the courts that the desired result cannot be attained in the case of State and municipal issues by any action short of the submission and ratification by the States of a constitutional amendment.[58]

In *Brushaber* v. *Union Pacific Railroad Co.*, the Supreme Court accepted Senator Brown's conclusion referenced earlier, noting "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 . . ., and not to change the existing interpretation except to the extent necessary to accomplish the result intended . . . ." [59] (emphasis added)

In cases subsequent to enactment of the Sixteenth Amendment which reaffirm the existence of and yet limit the scope of immunity, the question of the effect on State

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[57] *The Taxing Power of the Federal and State Governments* [hereinafter cited as *1936 Report*]. Under the joint captions "(J) State Securities (1) Development of Doctrine of State Immunity," the Report unequivocally states: "[t]he Federal Government has no power to tax the obligations on the interest therefrom of a State or political subdivision," *1936 Report*, at 60, and "[t]hat the Federal Government has no power to tax the income of State securities, notwithstanding the provisions of the sixteenth amendment, is further established in the case of *National Life Insurance Company* v. *United States*." *1936 Report*, at 62.

[58] Report of the Subcommittee of the Committee on the Judiciary of the United States Senate on S.J. Res. 5 and S.J. Res. 154, at 4, 1937.

[59] *Brushaber* v. *Union Pac. R.R. Co.*, 240 U.S. 1, 18-19 (1916).

activity was considered and generally distinguished from any *prior* interference with the borrowing power. For instance, in *Willcuts* v. *Bunn*,[60] Chief Justice Hughes stated:

> [I]t 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 from the government in the bonds themselves . . . ." [61]

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[60] 282 U.S. 216, 226 (1930).

[61] *Id.* at 227. The holding in *Willcuts* is consistent with determinations of the Court in *National Life Ins. Co.* v. *United States*, 277 U.S. 508 (1928), and *United States* v. *Atlas Ins. Co.*, 381 U.S. 233 (1965). In *National Life*, the Court struck down a provision of the Federal income tax law which permitted insurance companies to exclude municipal bond interest from gross income but required that the amount of such interest be deducted also from the allowable deduction with the effect that the tax paid was the same as if all the income were taxable. The Court ruled that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free". 277 U.S. at 519. In *Atlas*, the Court upheld a requirement of the Federal income tax law that required insurance companies to prorate exempt interest between the company and its policyholders. The Court noted, "[i]t is apparent from the face of the Act that . . . Congress did not consider the application of the formula in the usual case to lay a tax on exempt interest . . ." and, "[a]s time and again stated in the Committee Report and by those who presented the bill on the floor of the Senate, the purpose of the [proration] formula provided by the Senate was to avoid taxing exempt interest". 381 U.S. at 240-41. The Court further added that the Department of the Treasury said in a letter that the formula did not place a tax on exempt interest but that an exception had been worked into the bill in case of such eventuality. 381 U.S. at 241 n.12. See also the dialogue between then Senate Finance Committee Chairman Harry F. Byrd and Senator Strom Thurmond, 105 Cong. Rec. 9400-01 (June 10, 1959) (discussion of proration formula and reiteration of immunity doctrine).

Similarly, in *James* v. *Dravo Contracting Co.*, Chief Justice Hughes noted:

> [t]here is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. 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 obligations as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,—considerations which are not found in connection with contracts made from time to time for the services of independent contractors.[62]

In *Helvering* v. *Gerhardt*,[63] Justice Stone, writing for six members of the Court, including Justice Hughes, found the salaries of a state instrumentality employee to be subject to Federal taxation,[64] and distinguished the holding from an attempt to tax the income received by a private investor from State bonds, and thus threaten to impair the borrowing power of the State.[65]

Shortly after *Gerhardt*,[66] the Court determined in *Graves* v. *O'Keefe*[67] that the salaries of Federal employ-

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[62] 302 U.S. at 152-53 (quoting from *Pollock* v. *Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895)).

[63] 304 U.S. 405 (1938).

[64] *Id.* at 424. The Court found the salaries of a construction engineer and two assistant general managers of the Port of New York Authority are subject to Federal income taxation. The Port of New York Authority, now the Port Authority of New York and New Jersey is a bi-state corporation created by compact between the States of New York and New Jersey and is consented to by the Congress.

[65] *Id.* at 417.

[66] 304 U.S. 405 (1938).

[67] 306 U.S. 466 (1939).

ees could be subject to state income taxation.[68] The decision in *Graves* (which effectively resulted in State and local government salaries and Federal government salaries being treated the same from a reciprocal immunity standpoint) overruled two prior decisions of the Court.[69] Not only did the Court not overrule *Pollock*, it observed:

> The theory of the tax immunity of either government, state or national, and its instrumentalities, from taxation by the other, has been rested upon an implied limitation on the taxation power of each, such as to forestall undue interference, through the exercise of that power, with the governmental activities of the other.[70]

In a series of lectures delivered in 1951 former, Supreme Court Justice Roberts observed:

> It appears always to have been conceded that a tax laid directly on bonds of a state is invalid. The principal has been extended to a federal income tax applied to interest on municipal bonds.[71]

After the determination of the Court that salaries of State and Federal employees were not immune from taxation,[72] test litigation on the question of State obligations was advocated and, in at least two instances, commenced

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[68] *Id.* at 486.

[69] *Id.* at 486. *The Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870); *New York ex rel. Rogers* v. *Graves*, 299 U.S. 401 (1937).

[70] *Id.* at 477-78.

[71] O.J. Roberts, *The Court and the Constitution*, The Oliver Wendell Holmes Lectures p. 23 (1951). In such lectures, Justice Roberts questioned Justice Holmes' response to Chief Justice Marshall, i.e., "[t]he power to tax is not the power to destroy while this court sits". *Panhandle Oil Co.* v. *Knox*, 277 U.S. 218 (1928). He asserts that if Holmes' statement means that "one sovereign is free to tax the instrumentalities of the other up to the point where nine justices or a majority of them pragmatically declare the burden has become, in their opinion, too heavy . . . [t]his could only mean that the Court is a super-legislature"., *id.* at 12-13.

[72] *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938); *Graves* v. *O'Keefe*, 306 U.S. 466 (1939).

with embarrassing results for the Treasury Department.[73] Of historical interest is the presence in one such instance of earlier opinions given as an attorney by Charles Evans Hughes.[74]

After *Graves* v. *O'Keefe* the tone of the 1939 congressional hearings became somewhat less definitive as to whether a constitutional amendment was necessary with the Bureau of Internal Revenue[75] more aggressive on the matter than the Justice Department.[76]

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[73] The two cases were *Commissioner of Internal Revenue* v. *Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), and *Commissioner of Internal Revenue* v. *White's Estate*, 144 F.2d 1019 (2d Cir. 1944).

[74] Charles Evans Hughes issued an opinion in 1925 as to "the powers and immunities of the Port of New York Authority and the status of its bonds." Such opinion states:

> The *immunity* of the bonds from Federal taxation follows from the fact that, as already stated, the port authority is a public agency, a governmental instrumentality of the two States. . . . In this view, the bonds issued by the port authority will be on the same footing as state and municipal bonds issued for governmental purposes and are not subject to taxation by the Federal Government.
>
> The income of these bonds will be likewise free from Federal taxation for the reason that a tax upon the income of the bonds is in substance and in legal effect a tax upon the bonds themselves and *upon the borrowing power of the State confided to its instrumentality.*

Opinion of Charles Evans Hughes, Nov. 10, 1925 (emphasis added, citations omitted). Two significant points are to be noted in the opinion. One, the opinion referred to *immunity* from taxation, rather than exemption from taxation, under the contemporary Internal Revenue Code. Two, the decisions of that period determining the existence of such immunity and whether the obligations were validly issued by the State or its instrumentality as an exercise of the State's borrowing power were based on a reading of *State* rather than Federal law.

[75] See *Tax-Exempt Salaries, Hearings before the House Comm. on Ways and Means*, Statement of John P. Wenchel, Chief Counsel, Bureau of Internal Revenue, 76th Cong., 1st Sess. 65-67 (1939).

[76] See *Tax-Exempt Salaries Hearings Before the House Committee on Ways and Means*, Statement of James W. Morris, Assistant Attorney General, 76th Cong., 1st Sess. (1939), at 52.

Additional hearings and reports were conducted in 1940 [77] and on September 19, 1940, the Senate by a vote of 44 to 30 [78] effectively adopted a Minority Report which concluded ". . . [w]hether or not the supreme power to tax the States is the power to destroy them, it is most definitely and certainly the power to control them." [79] Numerous other instances of Congressional attention to this matter were evident during this period.[80]

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[77] *Taxation of Governmental Securities and Salaries, Report of the Special Comm. on Taxation of Governmental Securities and Salaries Pursuant to S. Res. 303 (75th Cong.)*, S. Rep. No. 2140, Part 1, Part 2, 76th Cong., 3d Sess. (1940) [hereinafter the "1940 Report"].

[78] 86 Cong. Rec. 12,291-12,304 (1940).

[79] Part 2 of the 1940 Report represented the views of the minority of the Special Committee on Taxation of Governmental Securities and Salaries [hereinafter cited as *Minority Report*]. The *Minority Report* attacked the proposal to tax the interest on State and local obligations as both unconstitutional and economically unsound, and additionally noted that the proposal was opposed on the constitutional basis by the 45 State Attorneys General. *Minority Report, supra*, at 1-2. It states emphatically:

> [I]t is difficult to believe that those who support this measure really appreciate the shocking political consequences of the method by which it is proposed to tax these securities. The enactment has been described as a simple statute, yet it necessarily asserts a supreme Federal power to tax the States themselves. The Department of Justice itself so describes the power claimed. Its argument encompasses an abandonment of the concept of this Government as a Federation of Independent States; it would subordinate the States to an all powerful central government. The proponents of the measure ignore these constitutional implications. But we submit that the power claimed opens a wide avenue to centralization. Whether or not the supreme power to tax the States is the power to destroy them, it is most definitely and certainly the power to control them.

Minority Report, supra, at 3.

[80] See, e.g., *Tax-Exempt Salaries; Hearings before the House Comm. on Ways and Means*, 76th Cong., 1st Sess. (1939); *House Comm. on Ways and Means; The Public Salary Tax Act of 1939, Report accompanying H.R. 3790*, H.R. Rep. No. 26, 76th Cong., 1st Sess. (1939); *Hearings on H.R. 3790 Before the Senate Comm.*

It should not be inferred from the foregoing matter that the Congress is oblivious to the constitutional argument. The Congressional Report accompanying the Tax Reform Act of 1969 noted:

> [T]here is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local governments. It is also maintained that the exemption is part of a Federal system of government under which the Federal Government does not infringe on the powers of the State and local governments. This position has been disputed, and many authorities have indicated that the Federal Government does have a constitutional right to tax the interest on State and local securities.[81]

Both the Congress and this Court have been mindful of similar constitutional restraints on Congressional action in regard to State and local government operations in establishing "uniform laws on the subject of Bankruptcies".[82] Even during the Depression, the bankruptcy

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on Finance, An Act Relating to the Taxation of the Compensation of Public Official Employees, 76th Cong., 1st Sess. (1939); *The Public Salary Tax Act of 1939, Report accompanying H.R. 3790, H.R. Rep. No. 112* 76th Cong., 1st Sess.; *State Taxation of Federal Employees, Opinions of the Supreme Court of the United States together with the concurring and dissenting opinions,* S. Doc. No. 55, 76th Cong., 1st Sess. (1939); *Taxation of the Compensation of Public Officers and Employees, Conference Report accompanying H.R. 3790,* H.R. Rep. No. 390, 76th Cong., 1st Sess. (1939); *Power of Congress to Tax the Interest from State and Local Securities and the Compensation of State and Local Employees, Report to the Joint Comm. on Internal Revenue Taxation by its staff pursuant to Section 1203, Revenue Act of 1926,* United States Government Printing Office, Washington, 1939; *Taxation of Governmental Securities and Salaries, Hearings Before the Senate Special Comm. on Taxation of Governmental Securities and Salaries, pursuant to S. Res. 303 (75th Cong.)* 76th Cong., 1st Sess. (1939); *Tax-Exempt Securities: Hearings before the House Comm. on Ways and Means, on Proposed Legislation Relating to Tax-Exempt Securities,* 76th Cong., 1st Sess. (1939).

[81] 1969 U.S. Code Cong. & Admin. News 1825-26.

[82] U.S. Constitution, Article 1, Section 8, clause 4.

courts were restrained from issuing "any order or decree . . . interfer[ing] with any of the political or governmental powers of the taxing district . . . necessary in the opinion of the judge for essential governmental purposes." [83] In *United States* v. *Bekins* [84] Solicitor General Jackson (subsequently Supreme Court Justice Jackson) argued that the powers of the Federal government under the bankruptcy provisions of the Constitution were more extensive than the Federal taxing power.

It should therefore be clear that if Congress lacks the power to regulate States or local governments (absent their consent) in matters related to bankruptcy it must lack the power to impose a tax on the interest on their obligations.

Solicitor General Jackson also noted that:

> Tax burdens, of course, are involuntary burdens and, as this Court has said, may be destructive. The power to tax may be the power to destroy, and *it may be laid upon a State as a State only when it has assumed that obligation. . . .*" [85] (emphasis added)

III. SUBSEQUENT ACTIONS WHICH FALL SHORT OF A CONSTITUTIONAL AMENDMENT, EVEN INCLUDING "ACQUIESCENCE", IF ANY OCCURRED, MAY NOT CHANGE THE LAW AS SO STATED.

The Special Master described recent Congressional activities as follows:

> Moreover, there is a history of Federal regulation in this field. Congress began regulating municipal industrial development bonds in 1968. Congressional regulation—extended in 1969 to municipal arbitrage financing practices—has entailed intricate and complex substantive restrictions on the ability of States and localities to issue debt securities the interest on which is free of Federal income tax. These Federal

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[83] 1934 Amendments to the Bankruptcy Act of July 1, 1898, Chapter IX, Sections 78-80.

[84] 304 U.S. 27.

[85] 304 U.S. 27, 32-38.

> restrictions are demonstrably more intrusive upon the States' ability to raise revenue in the amounts and for the purposes that they see fit than TEFRA's registration requirement. Yet, until South Carolina's original complaint in this action in February 1983, the States had not challenged Federal regulation in this area. Seemingly,the States accepted these Federal regulations as the price of their ability to minimize their own interest costs by issuing Federal tax-exempt bonds.[86]

The Special Master's assumption that the States "accepted these federal regulations" is wholly without foundation.

It is true that the Congress began regulating municipal industrial development bonds in 1968 (although unsuccessful suggestions of such regulation were made earlier[87]). However, it is also true that the United States Treasury, certain Members of the Congress and even municipal issuers themselves (who joined clarifying amendments offered by Senator Howard Baker and Representative Wilbur Mills) questioned whether such bonds were "obligations of States or local governments".[88] Senator Howard Baker's proposed amendments (which he noted were supported by the National Governors Conference, the National Association of Attorneys General, the National Association of State Auditors, Comptrollers and Treasurers, the Council of State Governments, the National League of Cities, the United States Conference of Mayors, the Municipal Finance Officers Association (the forerunner of the GFOA) and the National Institute of Municipal Law Officers) were directed toward the presence in the financings of a private, taxable beneficial obligor, because, as Senator Baker observed:

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[86] Special Master's Report, p. 135.

[87] See e.g. *Repeal of Tax-Exempt Status of Certain Muncipal Bonds,* 107 Cong. Rec. 9139 (1961) and 107 Cong. Rec. 11901 (1961).

[88] See Conference Report on Revenue And Expenditure Control Act of 1968, P.L. 90-364, U.S. Code Congressional and Administrative News, 90th Cong., 2d Session (1968), p. 2379 *et. seq.*

> So long as the Congress does not propose to challenge the long-standing Constitutional rule of the states' and local governments' immunity from taxation of their obligations, the *only* basis for taxing any bonds issued by State or local governments is that they are the issuer's obligations in name only. . . .[89]

Likewise, in 1969 when the Congress extended such regulation to alleged arbitrage practices, the Senate in its report on the so-called Tax Reform Act of 1969 noted ". . . questions have been raised in such cases as to whether such bonds in reality are obligations of a State or local government where the proceeds from the securities acquired secure the payments under the initial bonds".[90]

Although no such demonstration is evident on the record the Special Master somehow found such regulation to be demonstrably more intrusive upon the State's ability to raise revenues in the amounts and for the purposes as determined by the States than the TEFRA requirements.[91] In fact, until the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986, arbitrage prohibitions were not viewed as particularly intrusive since the evil which the Congress sought to correct in 1969 was, for all practical purposes, a myth and, as such, the restrictions imposed were not unduly burdensome.

The State Treasurer of South Carolina Grady L. Patterson, Jr. testified before the Senate Finance Committee at that time that with certain contemplated amendments the arbitrage provisions were acceptable.[92] Representatives of GFOA testified that properly defined "no such

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[89] 114 Cong. Rec. 30980 October 11, 1968. Emphasis in original. For the full text of Senator Baker's statement see Appendix F hereinafter.

[90] U.S. Code Congressional and Administrative News, 91st Cong., 1st Session (1969), p. 2254.

[91] Special Master's Report, p. 135.

[92] Committee on Finance, United States Senate, Tax Reform Act of 1969, H.R. 13270 p. 277, 279.

[arbitrage] bonds can be lawfully issued." [93] Investments of public funds are generally made awaiting the uses for which such funds were raised, and, in the large majority of cases the permissible periods for unlimited investment opportunity and the applicable construction or acquisition periods were in harmony.

The lack of litigation referred to by the Special Master in this area until the *South Carolina* case is also partially explained by the lack of a procedure for judicial review absent a taxpayer action. In 1978 the Congress sought to remedy this apparent deficiency, noting:

> As a practical matter, there is no effective appeal from a [Internal Revenue] Service private letter ruling (or failure to issue a private letter ruling) that a proposed issue of municipal bonds is taxable. In those cases, although there may be a real controversy between a State or local government and the Service, *present law does not allow the State or local government to go to court.* The controversy can be resolved only if the bonds are issued, a bondholder excludes interest on the bonds from income, the exclusion is disallowed, and the Service asserts a deficiency in its statutory notice of deficiency. This uncertainty coupled with the threat of the ultimate loss of the exclusion, invariably makes it impossible to market the bonds. In addition, it is impossible for a State or local government to question the Service rulings and regulations directly.[94] (emphasis added)

In response, a provision was added to the Internal Revenue Code permitting the Tax Court, the Court of Claims and the Federal District Courts to issue declaratory judgments as to the tax status of proposed municipal debt issuances.[95]

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[93] *Id.* at p. 79, 82. Summary of Joint Statement for GFOA, National Association of State Auditors, Comptrollers and Treasurers by Louis Goldstein, State Comptroller of Maryland and John D. Herbert, State Treasurer of Ohio, and Daniel B. Goldberg, counsel, Municipal Finance Officers Association (presently GFOA).

[94] 1978 U.S. Code Cong. & Admin. News, 6913.

[95] Internal Revenue Code § 7478.

Even if the acquiescence referred to by the Special Master did in fact exist or can be implied, any such acquiescence cannot change the constitutional immunity of interest on State and local obligations from federal income taxation. This Court has recently decided that a Congressional-veto structure utilized 295 times in 1,986 statutes from 1932-1975 and numerous times thereafter was unconstitutional [96] noting:

> the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution.[97]

Additionally, if "acquiescence" may act as a bar to the assertion of a particular Constitutional right or protection, litigation (which might otherwise be avoided) in the Federal courts is the likely result. This increase in litigation is particularly likely insofar as the recently enacted Tax Reform Act of 1986 violates each of the standards that the Special Master found lacking in *South Carolina* v. *Regan*,[98] i.e., such Act changes how much the States may borrow,[99] the purposes for which they borrow,[100] how they decide to borrow [101] and other obviously important aspects of the borrowing process.[102]

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[96] *Immigration and Naturalization Service* v. *Chadha*, 462 U.S. 919, pp. 944-945.

[97] *Id.* at 944. This provision was cited to by the majority in *Charles A. Bowsher, Comptroller General of the United States* v. *Mike Synar, Member of Congress*, 478 U.S. ——, 92 L. Ed. 583, 603 (1986). Justice White in his dissent in *Bowsher* v. *Synar* notes that both the Congress and the Executive expressed their assent to the statute in contention. *Id.* at 617.

[98] Special Master's Report, p. 118.

[99] P.L. no. 99-514. Title XIII, Sections 1301 *et. seq.*, Section 146 of the Internal Revenue Code of 1986 provides for a volume cap on certain debt obligations.

[100] See Section 141 to 145 of the Internal Revenue Code of 1986.

[101] See Section 146 for State allocation of volume cap and public approval process.

[102] See Section 146(f) for rebate requirements of earnings to the Federal government which may raise questions as to a discrimi-

CONCLUSION

The Supreme Court would be remiss if it reviews the applicable provisions of the Internal Revenue Code (initially Section 103(j) of the Internal Revenue Code of 1954) narrowly without returning to subsection (a) of such Section and tracing the Congress' attempt to steadily erode State sovereignty. It is proper for the Court to ask whether the Sixteenth Amendment would have been ratified by the States if Senator Borah and his colleagues in the Senate had asserted that such Amendment implied that the Federal government could regulate, limit, direct, abolish or tax the borrowing power of the States or their instrumentalities. In *Bowsher* v. *Synar*, the Court noted how the interpretations of the first Congress provided "weighty evidence" of the Constitution's meaning since many Members took part in the Constitutional Convention.[103] In the instant situation the very Members who proposed and defended the Sixteenth Amendment consistently explained it *prior to ratification and for many years thereafter.*

The Court should particularly be aware that alternative compliance and enforcement methods are readily available to the Congress if the Court should find the registration requirement or penalty for failure to register to be unconstitutional. For a discussion of such alternatives please see the briefs filed in this case by the National Institute of Municipal Law Officers[104] and the National Governors' Association.[105]

It should be noted that to the extent registration of municipal securities is a desirable good, such good is achievable in ways other than imposing loss of tax exemption. The GFOA, along with others has suggested various ways of achieving compliance that is consistent

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natory and confiscatory tax applicable only to State and local governments.

[103] *Bowsher* v. *Synar*, 478 U.S. ——, 92 L. Ed. 2d 583, 595 (1986).

[104] *Amicus Curiae* Brief, September 1983.

[105] Brief of Plaintiff in Intervention, May 1987.

with the Federal objectives of hampering tax avoidance or the movement of illegal moneys.

A method which would achieve bond registration without denying tax exemption would be to impose a monetary penalty on persons purchasing tax-exempt bearer securities. This penalty, which would be in addition to the existing penalties, could virtually insure full compliance with bond registration. Another method to be considered would be the imposition of restrictions on the movement of bearer debt in interstate commerce which would operate through clearing banks and the Federal Reserve System.

To accept the Special Master's recommendation on the constitutionality of the penalty provision is to undercut further the vitality of the constitutional immunity from Federal taxation of income from State and municipal obligations and to lend support to the contention of some that the interest exemption is awarded at Congress' discretion rather than being constitutionally based.

The historical development of tax immunity is rooted in the very foundation of the federal system and, as such, cannot and should not be dismissed lightly. The power to tax can indeed be the power to destroy. If our system of federalism is to mean anything, neither the legislature nor the courts should tamper with the vital immunity of the States and their instrumentalities from the potentially coercive and destructive taxing power of the Federal government.[106]

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[106] For policy reasons as to why the Congress should not intrude in State and local activities see the remarks of Representative Rostenkowski in Appendix G hereto and as to Congress' stated intention to avoid intruding, see remarks of Senator Long in Appendix H hereto.

Respectfully submitted,

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APPENDICES

APPENDIX A

MESSAGE OF GOVERNOR HUGHES

STATE OF NEW YORK
EXECUTIVE CHAMBER,
ALBANY

January 5, 1910

To the Legislature:

I have received from the Secretary of State of the United States a certified copy of a resolution of Congress entitled "Joint Resolution Proposing an Amendment to the Constitution of the United States," and in accordance with his request I submit it to your honorable body for such action as may be had thereon.

The amendment proposed by this joint resolution, adopted by two-thirds of both houses of Congress, is as follows:

> "Article XVI. 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 power to lay a tax upon incomes, without apportionment, was long supposed to be possessed by the Federal government and has been repeatedly exercised. Such taxes were laid and paid for the purpose of meeting the exigencies caused by the Civil War.

In 1895, in the case of Pollock v. Farmers' Loan & Trust Company (158 U.S. 601), the United States Supreme Court decided that taxes on the rents or income of real estate, and taxes on personal property or on the income of personal property, are direct taxes and hence under the Constitution cannot be imposed without apportionment among the several States according to their respective populations.

It was not the function of the court, and it did not attempt, to decide whether or not a Federal income tax

was desirable. It simply interpreted the Constitution according to the judgment of the majority of its members and left the question of the advisability of conferring such a power upon the Federal government to be determined in the constitutional method.

The limitations so placed upon the Federal taxing power are thus described by Mr. Justice Harlan in his dissenting opinion:

> "Any attempt upon the part of Congress to apportion among the States, upon the basis simply of their population, taxation of personal property or of incomes, would tend to arouse such indignation among the freemen of America that it would never be repeated. When, therefore, this court adjudges, as it does now adjudge, that Congress cannot impose a duty or tax upon personal property, or upon income arising either from rents of real estate or from personal property, including invested personal property, bonds, stock and investments of all kinds, except by apportioning the sum to be so raised among the States according to population, it practically decides that, without an amendment of the Constitution—two-thirds of both Houses of Congress and three-fourths of the States concurring—such property and incomes can never be made to contribute to the support of the national government. (Id., pp. 671, 2)
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> * * *
>
> "Incomes arising from trades, employment, callings, and professions can be taxed, under the rule of uniformity or equality, by both the national government and the respective State governments, while incomes from property, bonds, stocks, and investments cannot, under the present decision, be taxed by the national government except under the impracticable rule of apportionment among the States according to population. No sound reason for such a discrimination has been or can be suggested." (Id., p. 680.)

I am in favor of conferring upon the Federal government the power to lay and collect an income tax without apportionment among the States according to population. I believe that this power should be held by the Federal government so as properly to equip it with the means of meeting national exigencies.

But the power to tax income should not be granted in such terms as to subject to Federal taxation the incomes derived from bonds issued by the State itself, or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the Federal taxing power would be an impairment of the essential rights of the State which, as its officers, we are bound to defend.

You are called upon to deal with a specific proposal to amend the Constitution, and your action must necessarily be determined not by a general consideration of the propriety of a just Federal income tax, but whether or not the particular proposal is of such a character as to warrant your assent.

This proposal is that the Federal Government shall have the power to lay and collect taxes on incomes "from whatever source derived."

It is to be borne in mind that this is not a mere statute to be construed in the light of constitutional restrictions, express or implied, but a proposed amendment to the Constitution itself which, if ratified, will be in effect a grant to the Federal government of the power which it defines.

The comprehensive words, "from whatever source derived," if taken in their natural sense, would include not incomes from ordinary real or personal property, but also incomes derived from State and municipal securities.

It may be urged that the amendment would be limited by construction. But there can be no satisfactory assurance of this. The words in terms are all-inclusive. An

amendment to the Constitution of the United States is the most important of political acts, and there would be no amendment expressed in such terms as to afford the opportunity for Federal action in violation of the fundamental conditions of State authority.

I am not now referring to the advantage which the State might derive from the exclusive power to tax incomes from property, or to the argument that for this reason the power to tax such incomes should be withheld from the Federal government. To that argument I do not assent.

I am referring to a proposal to authorize a tax which might be laid in fact upon the instrumentalities of State government. In order that a market may be provided for State bonds, and for municipal bonds, and that thus means may be afforded for State and local administration, such securities from time to time are excepted from taxation. In this way lower rates of interest are paid then otherwise would be possible. To permit such securities to be the subject of Federal taxation is to place such limitations upon the borrowing power of the State as to make the performance of the functions of local government a matter of Federal grace.

This has been repeatedly recognized. In the case of The Collector v. Day (11 Wall. on p. 127), decided in 1870, the United States Supreme Court said:

> "It is admitted that there is no express provision in the Constitution that prohibits the general government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implications, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that govern-

ment. Of what avail are these means if another power may tax them at discretion?"

In the case of Pollock v. Farmers' Loan & Trust Co. (157 U.S. on pp. 584-5), Chief Justice Fuller said, referring to the tax upon incomes from muncipal bonds, one of the matters there involved:

> "A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. * * * But we think the 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."

In the same case Mr. Justice Field said (Id. on p. 601):

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States."

And the learned Justice added, quoting from United States *v.* Railroad Co. (17 Wall. on pp. 322, 327) as follows:

> "The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court, and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments from the taxing power of the Federal government. If they may be taxed lightly, they may be taxed

> heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other."

While the justices of the court in the Pollock cases differed in opinion upon the question whether a tax upon income from property was a direct tax and as such could not be laid without apportionment, they were unanimous in their conclusion that no Federal tax could be laid upon the income from municipal bonds. Mr. Justice White, who dissented in the Pollock case with regard to other questions, as to this said (157 U.S. on p. 652):

> "The authorities cited in the opinion are decisive of this question. They are relevant to one case and not to the other, because, in the one case, there is full power in the Federal government to tax, the only controversy being whether the tax imposed is direct or indirect; while in the other there is no power whatever in the Federal government, and, therefore, the levy, whether direct or indirect, is beyond this taxing power."

It is certainly significant that the words, "from whatever source derived," have been introduced into the proposed amendment as if it were the intention to make it impossible for the claim to be urged that the income from any property, even though it consist of the bonds of the State or of a municipality organized by it, will be removed from the reach of the taxing power of the Federal government.

The immunity from Federal taxation that the State and its instrumentalities of government now enjoy is derived not from any express provision of the Federal Constitution, but from what has been deemed to be necessary implication. Who can say that any such implication with respect to the proposed tax will survive the adoption of this explicit and comprehensive amendment?

We cannot suppose that Congress will not seek to tax incomes derived from securities issued by the State and its municipalities. It has repeatedly endeavored to lay such taxes and its efforts have been defeated only by implied constitutional restriction which this amendment threatens to destroy. While we may desire that the Federal government may be equipped with all necessary national powers in order that it may perform its national function, we must be equally solicitous to secure the essential bases of State government.

I therefore deem it my duty, as Governor of the State, to recommend that this proposed amendment should not be ratified.

CHARLES E. HUGHES

New York State Senate Journal, 133rd. Session, Vol. 2, Executive Journal, pp. 54-60.

APPENDIX B

LETTER TO SENATOR ROOT

Washington, D.C.
February 17, 1910

MY DEAR SENATOR:

Since our conversation last month I have given much consideration to the scope and effect of the proposed income tax amendment to the Constitution of the United States.

Much as I respect the opinion of the governor of the State, I can not agree with the view expressed in his special message of January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.

The proposed amendment is in these words:

"ART. 16. The Congress shall have the 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 objection made to the amendment is that this will confer upon the National Government the power to tax incomes derived from bonds issued by the States or under the Authority of the States, and will place the borrowing capacity of the State and its governmental agencies at the mercy of the Federal taxing power.

I do not find in the amendment any such meaning or effect, I do not consider that the amendment in any degree whatever will enlarge the taxing power of the National Government or will have any effect except to relieve the exercise of that taxing power from the requirement that the tax shall be apportioned among the several States. The effect of the amendment will be in my view,

the same as if said, "The United States may lay a tax on incomes without apportioning the tax, and this shall be applicable whatever the source of the income subjected to the tax," leaving the question, "What incomes are subject to national taxation?" to be determined by the same principles and rules which are now applicable to the determination of that question.

If we were to construe the proposed amendment only by a critical examination of its words, the view upon which the objection is based would be reached by practically cutting the provision in two and reading it as if it read, "the Congress shall have the power to lay and collect taxes on incomes from whatever source derived," without the concluding words. But we are not at liberty to do this. The amendment consists of a single sentence and the whole of it must be read together. It expresses but a single idea, and that is that the tax to which it relates must be laid and collected without apportionment among the several States and without regard to any census or enumeration, while the words "from whatever source derived" are obviously introduced to make the exemption from the rule of apportionment comprehensive and applicable to all taxes on incomes.

We are not left, however, to a mere critical examination of words. This provision, as Mr. Justice Bradley said of the Constitution in the Legal tender cases, is "to be interpreted in the light of history and of the circumstances of the period in which it was framed." Justice Story said of another clause of the Constitution, in Brisco v. The Bank of Kentucky (2 Peters, 332).

> "And I mean to insist that the history of the colonies before and during the Revolution and down to the very time of the adoption of the Constitution constitutes the highest and most authentic evidence to which we can resort to interpret this clause of the instrument, and to disregard it would be to blind ourselves to the practical mischiefs which it was

meant to suppress and to forget all the great purposes to which it was to be applied."

This view must necessarily be applied to the proposed amendment if it be adopted. It will be construed in the light of the judicial and political history which led to the proposal and which appears upon the public records of our Government.

What is that history? The Constitution of 1787 conferred upon the National Government the power of taxation without any limit whatever, except that taxes on exports were prohibited.

The method of exercising the power, however, was subjected to two limitations. One, that imposts, duties, and excises should be uniform, and the other that direct taxes should be apportioned among the States. The apportionment provisions were as follows:

"ARTICLE I.

"SEC. 2. Representatives and direct taxes shall be apportioned among the several States which may be included within this Union according to their respective numbers," etc. (Amended, but not in this respect, by the fourteenth amendment.)

"SEC. 9. No capitation or other direct tax shall be laid unless in proportion to the census or enumeration before directed to be taken."

For more than a hundred years after the adoption of the Constitution various tax laws of Congress were from time to time brought before the courts upon objections that they imposed direct taxes in violation of the rule of apportionment. The decisions of the courts uniformly sustained these laws, from the Hylton case, in 1796, which sustained an unapportioned tax on carriages (3 Dallas, 171), to the Springer case, in 1880, which sustained an unapportioned tax on incomes. (102 U.S., 586.)

In the meantime numerous laws were passed and enforced imposing taxes on incomes without apportionment,

and a great part of the means for carrying on the Civil War was derived from such taxes.

In the year 1895, however, an income tax law included in the Wilson tariff act of 1894 was brought before the Supreme Court in the case of Pollock against the Farmers' Loan & Trust Co., and in that case the court decided against the law. The case was heard twice. On the first hearing a majority of the court held that a tax on income derived from real estate must be apportioned as a direct tax, because a tax on real estate itself would be direct, and the judges divided equally as to whether a tax on income derived from personal property must be apportioned. (157 U.S., 429.)

Upon the second hearing of the case the court, by a majority of five to four, held that a tax upon income derived from personal property must be considered a direct tax and must be apportioned (158 U.S., 601). All the judges agreed, however, that taxes on incomes derived from business or occupations need not be apportioned. The effect of these decisions was thus described in one of the minority opinions:

> "But the serious aspect of the present decision is that by a new interpretation of the Constitution it so ties the hands of the legislative branch of the Government that without an amendment of that instrument, or unless this court at some future time should return to the old theory of the Constitution, Congress can not subject to taxation—however great the needs or pressing the necessities of the Government—either the invested personal property of the country, bonds, stocks, and investments of all kinds, or the income arising from the renting of real estate or from the yield of personal property, except by the grossly unequal and unjust rule of apportionment among the States. Thus, undue and disproportioned burdens are placed upon the many, while the few, safely entrenched behind the rule of apportionment

> among the States on the basis of numbers, are permitted to evade their share of responsibility for the support of the Government ordained for the protection of the rights of all."

It was so evidently impossible to collect an income tax apportionment among the States according to population that the general judgment of the country confirmed the opinion that the decision in the Pollock case had practically taken away from the Congress a power of vital importance to the General Government—a power the exercise of which had, at least in one time of peril, proved essential to the Nation's life.

The attention of the country was sharply called to the need of more Government revenue for the first time after the Pollock case by the decrease of customs and internal revenue receipts and the rapidly mounting deficit which followed the financial panic of 1907; and in the extraordinary session of Congress which began March 15, 1909, when the revised tariff bill came into the Senate, an amendment to the bill was introduced reproducing in substance the old income tax provisions of 1894 which the Supreme Court had held to be invalid both as to income derived from real estate and as to income derived from personal property. The avowed and necessary effect of including such provisions in the new tariff law would be to present again to the Supreme Court the same questions which had been decided in the Pollock case and to challenge a reversal of their decision. Thereupon the resolution for the submission of this amendment was introduced in the Senate and was passed by Congress.

The proposal followed the suggestions of the Supreme Court in the Pollock case.

The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal

property, although it could be taxed when derived from business or occupation.

The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived.

There was no question in Congress or in the courts or in the country about the taxation of State securities. No one claimed that the inability of the General Government to tax them was an evil. The inability to tax them did not arise from the terms of the Constitution, but from the fact that, being the necessary instruments of carrying on other and sovereign governments, they were not the proper subject of national taxation, and that, therefore, no provisions of the Constitution, however wide the scope of their language, could be held to apply to such securities or to the income from them. Judge Cooley, in his work on Constitutional Law, says:

> "The power to tax, whether by the United States or by the States, is to be construed in the light of, and limited by, the fact that the States and the Union are inseparable, and that the Construction contemplates the perpetual maintenance of each with all its constitutional powers, unembarrassed and unimpaired by any action of the other. The taxing power of the Federal Government does not therefore extend to the means or agencies through or by the employment of which the States perform their essential functions, etc."

This rule of construction has been maintained for generations. It is undisputed; it was referred to with approval by the justices who wrote and delivered the opinions in the Pollock case both for and against the judgment. It has been declared again and again by the Supreme Court to be not open to question. It is a rule of construction just as controlling in defining the scope of the proposed amendment as it is in defining the scope

of the existing provisions. Under it, from the earliest times of our Government, the apparently unlimited taxing power conferred by the terms of the Constitution has been held not to apply to the instrumentalities of the State. Under it acts of Congress which by their express terms appeared to include instrumentalities of State government have uniformly been held not to include them; this uniform, long-established, and indisputable rule applied to the construction of our Constitution—a rule which has been declared to be essential to a continuance of our dual system of government—forbids that the words of that instrument conferring the power of taxation shall be deemed to apply to anything but the proper subjects of national taxation. Under it we are forbidden to apply the words "from whatever source derived" in the proposed amendment to any of the instrumentalities of State government.

This amendment will be no new grant of power. The Congress already has power to impose taxes on incomes from whatever source derived subject to the rule of construction which excludes State securities from the operation of the power, but the taxes so imposed must be apportioned among the States. Under the proposed amendment there will be the same and no greater power to tax incomes, from whatever source derived, subject to the same rule of construction, but relieved from the requirement that the tax shall be apportioned.

It appears, therefore, that no danger to the powers or instrumentalities of the States is to be apprehended from the adoption of the amendment.

It would be cause for regret if the amendment were rejected by the Legislature of New York.

It is said that a very large part of any income tax under the amendment would be paid by citizens of New York. That is undoubtedly true, but there is all the more reason why our legislature should take special care to exclude every narrow and selfish motive from influence

upon its action and should consider the proposal in a spirit of broad patriotism and should act upon it for the best interests of the whole country.

The main reason why the citizens of New York will pay so large a part of the tax is that New York City is the chief financial and commercial center of a great country with vast resources and industrial activity. For many years Americans engaged in developing the wealth of all parts of the country have been going to New York to secure capital and market their securities and to buy their supplies. Thousands of men who have amassed fortunes in all sorts of enterprises in other States have gone to New York to live, because they like the life of the city or because their distant enterprises require representation at the financial center. The incomes of New York are in a great measure derived from the country at large. A continual stream of wealth sets toward the great city from the mines and manufactories and railroads outside of New York. The United States is no longer a mere group of separate communities embraced in a political union; it has became a product of organic growth, a vast industrial organization covering and including the whole country; and the relation of New York City to the whole organization of which it is a part is the great source of her wealth and the chief reason why her citizens will pay so great a part of an income tax. We have the wealth because behind the city stands the country. We ought to be willing to share the burdens of the National Government in the same proportion in which we share benefits.

The circumstances that originally justified the establishment of the rule of apportionment in the Constitution have long since passed away. It is universally conceded that its application to existing conditions would be so unjust and inequitable as to be impossible. The power of taxation which the rule makes it impossible for the Nation to exercise may be again, as it has once been, vital to the preservation of national existence. It would be

most unfortunate if the several States of the Union were to insist upon the continuance of this unjust and useless limitation upon the necessary powers originally and wisely granted to the National Government.

With kind regards, I am always

Faithfully yours,

ELIHU ROOT

To: Hon. Frederick M. Davenport,
Senate Chamber, Albany, N.Y.

On February 15, 1910, a resolution had been introduced in the New York State Senate requesting that Senator Root be invited to address the State Legislature on the proposed amendment, *New York State Senate Journal*, 133rd Session, 1910, vol. 1, p. 147. Senator Davenport presented the above letter to the Senate on February 28, 1910 and copies were ordered printed and referred to the Committee on the Judiciary. Id. at 236.

APPENDIX C

REPORT OF SENATOR AUSTIN

During the September 19, 1940 discussion with Senator Brown, Senator Austin requested permission to insert the following matter in the Record, 86 Cong. Rec. 12294. It appears at pages 12297-12298.

Governor Plaisted said:

"In approving the proposed amendment we are not conferring any new right on the Nation, nor are we taking any right now reserved to the State."

Governor Hadley said:

"I do not believe that objection therein urged is likely to arise as a result of this power by the National Congress if conferred, and, if it should arise, it is my opinion that under the decisions of the Supreme Court of the United States, it is not well founded in law. And this is the position that has been taken by some of the most prominent representatives in the National Congress in the discussions of this question."

Governor Fort said:

"Nor am I inclined to accept the statement that the Supreme Court * * * might construe the words 'from whatever source derived' * * * as justifying the taxing of the securities of any other power."

* * * * *

"I think the principle thus quoted, which is founded upon public policy, would obtain, in construing a constitutional provision, equally as firmly as in the construction of an act of Congress."

Governor Noel said:

"I do not concur in either the view or the recommendation of Governor Hughes in opposition to the income-tax amendment. I do not believe the courts would hold that

authority to tax incomes would authorize any action that would impair any instrumentality of the State or municipal governments."

Governor Harmon said:

"I have recommended ratification of the income-tax amendment. Comity between kindred sovereignties should require the amendment to be taken as applying to incomes from private sources only * * *."

Still other Governors showed doubts as to Governor Hughes' view. Thus, for example, Governor Baldwin, of Connecticut, said:

"It is unfortunate that the wording of the proposed amendment is such as to raise upon its face a doubt as to its meaning in respect to a material point. In the view of some lawyers, it would authorize Congress to tax holders of State securities * * *. In the view of other lawyers, the amendment would not affect the existing rule * * *."

Governor Marshall, of Indiana, said:

"* * * It may be conferring upon the General Government a larger power in the nature of taxation than the States have ever intended to confer, * * *."

Governor Norris, of Montana, said:

"Some objections have been made to the adoption of the amendment on the ground that the words 'from whatever source derived' permit the levy of a tax on incomes received from State * * * indebtedness * * *."

Governor Burke, of North Dakota, said:

"Some of the ablest lawyers in the land object to the broad terms in which the language giving the power to tax is couched. * * * While on the other hand just as able lawyers insist that the Constitution contemplates the independent exercise by the Nation and the States of their constitutional powers and the obligations of the State cannot be impaired by this grant of power."

To sum up, the situation with respect to the ratifying States was this: Mr. Hughes, as Governor of the State of New York, voiced fears that the proposed amendment might be interpreted as possibly opening the door to the taxation of the income from State and municipal bonds. This view, however, was officially controverted by Senators Borah, Root, and Brown. Of these three, Senator Borah was the leading spirit behind the amendment. Senator Brown officially introduced it and Senator Root was credited, by at least one authority, with being the actual author of the amendment; and, moreover, he was one of Governor Hughes' two representatives in the Senate. Following their respective interpretations, no one in the Senate or House rose to challenge their views. John Phillip Wenchel, chief counsel, Bureau of Internal Revenue, has inadvertently created the impression that the opposition to the Borah-Root-Brown views was voiced on the floor of the Senate. Thus, in the paper entitled "Legal Discussion," which he filed before the Senate Committee on Intergovernmental Taxation, he quoted language from Senator Edmunds, of Vermont, which would indicate that the latter gentleman disagreed with or challenged the Borah-Root-Brown views on the floor of the Senate. What happened is this: Former Senator Edmunds, of Vermont, addressed a letter to a then Senator. In this letter the former Vermont Senator strongly condemned the possible taxation of State and munincipal securities, as well as the whole theory of the income tax. The latter was printed in the RECORD, without discussion. Thus the States can reassert the proposition that the Borah-Root-Brown views of the amendment were not challenged in the Senate or House.

The Department of Justice erroneously and fallaciously concludes that when the States ratified the amendment without referring to either of two diverse schools of thought, the States must have accepted the view most favorable to the contentions urged by the Department of Justice. This is, of course, absurd on its face. And moreover if silence may be regarded as acquiescence (in some

circumstances) it is absurd to argue that in this case it amounted to an acceptance of Governor Hughes' fears. If silence gives rise to acquiescence, surely it is acquiescence in the latest views expressed in a controversy. After Governor Hughes voiced his fears, others said they were groundless and unjustified under the language and intent of the amendment. The States submit, therefore, that it cannot be argued with force that because of a State's omission to challenge Governor Hughes' fears, it acquiesced in the surrender of its sovereignty.

It is, of course, absurd to suppose that the States intended—in ratifying the sixteenth amendment—to give up their immunity from tax by the Federal Government without the Federal Government in turn giving up its immunity. It is ridiculous to suppose that the States would have intended to ratify the amendment under such circumstances.

The record fails to support any conclusion that the amendment was ratified by the States in acceptance of the view that it was intended to vest Congress with the power to tax State and municipal bonds.

APPENDIX D

REMARKS OF REPRESENTATIVE CORDELL HULL

The following exchange accompanied introduction of the Tariff-Income Tax Bill, H.R. 3321, 93rd Cong., 1st Sess. (1913):

> Mr. HULL: . . . Paragraph C exempts from the law salaries of State and local officers and interest upon State and local bonds. The Supreme Court has often held that under our form of government the States have no power to tax the instrumentalities of the Federal Government, and conversely that the Federal Government has no power under the Constitution to tax the instrumentalities of the States; not desiring to raise any constitutional question, or to arouse the antagonism of any of the States, this provision was inserted.
>
> Mr. BARTLETT: May I interrupt the gentlemen?
>
> Mr. HULL: Certainly.
>
> Mr. BARTLETT: It is a fact that in my State and in a number of other States, when this amendment was up before the legislature for adoption, many people opposed the adoption of the amendment because there was nothing specifically said in the amendment that excepted State, municipal, and other subdivisions of State bonds from taxation under the proposed amendment: but the friends of the amendment felt justified in assuring them that except in great stress, except in time of war, Congress would never think it wise to tax the bonds of the State or the subdivisions thereof.
>
> Mr. HULL: Mr. Chairman, I think the suggestion of the gentleman is entirely pertinent.
>
> MR. BARTLETT: In other words, the people were assured by the friends of this measure that it would be only in rare cases that Congress would ever be

called upon to enact any law which would tax the instrumentalities of a State or a subdivision thereof.

Mr. HULL: I do not undertake to express an opinion either way upon the power of Congress to impose such tax by virtue of the recent constitutional amendment. It does not necessarily arise in view of the provision in the bill.

50 Cong. Rec. 508 (1913).

APPENDIX E

REMARKS OF SENATOR THOMAS

After passage by the House of Representatives, Senator Thomas greeted a pending revenue bill with the following remarks:

> While constitutional questions have during the war became recondite, their intrusion upon novel and comprehensive schemes of legislation can not be prevented. Here they lie upon the very surface of the bill. The House report reveals and briefly disposes of them upon considerations of justice and equity. That is an easy method. If sound, we shall have no difficulty in removing restraints upon our legislative powers. We can relegate the Constitution to the limbo of things that were, and measure our authority by our discretion, should we care to retain that faculty. Personally, I am unable to reconcile my oath of office with this new standard of construction, although in the given instance it negatives the conclusion asserted.
>
> The pending bill is obnoxious to the Constitution in not less than three important particulars. I refer to the proposed taxation . . . of State, and municipal securities and salaries . . . .
>
> The bill also includes on [sic] gross incomes the "interest from the obligations of States and political subdivisions thereof issued after its passage," together with the compensation of State and municipal officers. These items have also been excluded either expressly or by judicial decision from previous income tax legislation. Of the unconstitutionality of this proposed imposition, I entertain no doubt whatever.

56 Cong. Rec. 10,628-29 (1918).

APPENDIX F

STATEMENT OF SENATOR BAKER

On June 28, 1968, President Johnson signed into law as Section 107 of the Revenue and Expenditure Control Act of 1968 a measure to eliminate the tax-exempt status of industrial development bonds. The amendment which I introduce is an attempt to correct the present distorted definition of "industrial development bonds," which is not limited to bonds for industrial development, but rather is so broad as to include bonds for many acknowledged and traditional state and local governmental functions.

Members of Congress who supported the taxation of "industrial development bonds" now realize that by means of the definition employed in the Act, they have gone much further than they intended. Chairman Wilbur Mills of the House Ways and Means Committee acknowledged this fact on the floor at the time of passage of the Act and invited the National Governors Conference and others to propose corrective legislation. Without such correction, the 90th Congress will have challenged the exemption of state and local governmental bonds issued for a host of acknowledged governmental functions wholly unrelated to the industrial development bond problem.

The amendment which I offer is basically a portion of a bill introduced by Congressman Mills in the House of Representatives and by Senator Curtis in the Senate after passage of the Revenue and Expenditure Control Act. A few technical refinements have been made to dispose of minor objections. This amendment has the support of the National Governors Conference; the National Association of Attorneys General; the National Association of State Auditors, Comptrollers and Treasurers; the Council of State Governments; the National League of Cities; the United States Conference of

Mayors; the Municipal Finance Officers Association; and the National Institute of Municipal Law Officers.

I recognize that this is a complex area and that hearings on this question would be desirable. In fact, I believe we are confronted with the present distorted definition because no hearings were held prior to the enactment of the Ribicoff Amendment. I believe that the definition which I offer is far superior to the present statutory language and that, at the very least, it will serve as a corrective measure until this question can be fully aired during the next legislative session.

The practical effect of the present definition is to include within that definition bonds for practically any state or local governmental purpose if the financed facility would have private occupants paying to use it. Thus, the enacted definition includes, among other, bonds for markets, nursing homes, piers, fairs, and recreational facilities.

It is true that the present act does not tax all of the bonds it labels "industrial development bonds." What the present act does is set up a list of approved purposes labeled "exceptions." Bonds for these purposes remain exempt and those for all other state and local governmental purposes are taxable when private occupants pay to use the financed facilities. Thus, the Congress purported to classify as good or bad all the legitimate functions of state and local government, rewarding good purposes with exemption and penalizing bad purposes with taxation. Among the bad purposes are such fundamental governmental functions as education and health care, which are totally unrelated to the development of new industrial plants.

The present list of enacted exceptions presents substantial difficulties. For example, as originally passed by the Senate, there was an exception for property "to provide entertainment (including sporting events) or recreational facilities for the general public." As enacted, this

was cut down to "sports facilities" with the result that an exemption is currently provided for bonds to finance a stadium built for rental to a professional baseball team shopping for a more lucrative franchise, but no exemption is provided for a public theater for lease to a company providing concerts and drama.

As another example, the exception in the present act for terminal facilities includes airports and piers for air and marine vehicles, but does not include terminals for land vehicles such as buses, trucks, or railroads.

Finally, facilities for education or health care are not among the listed exceptions in Section 103(c)(4).

This type of continuing regulation by selection of state and local governmental functions has no proper place in our federal system and accordingly should be abandoned.

The amendment which I introduce would provide a general redefinition of "industrial development bond" in accordance with the generally accepted meaning of the term. Section 1 requires that some private person who is not an "exempt person" must be the apparent "beneficial obligor" and that the bond be issued to finance "industrial property" or "independent wholesale or retail property." "Industrial property" would be limited to its natural meaning of factory-type structures and equipment. It would not include facilities in factories for the abatement of air or water pollution, waste disposal, or other health or safety functions. "Industrial wholesale or retail property" includes structures for shops as well as retail department stores and similar mercantile establishments. The definition of "exempt person" is retained from the present act and includes governmental units and educational, charitable, and other tax-exempt institutions.

The requirement of a private, taxable, "beneficial obligor" is critical. So long as the Congress does not propose to challenge the long-standing Constitutional rule of

the states' and local governments' immunity from taxation of their obligations, the *only* basis for taxing any bonds issued by state or local governments is that they are the issuers' obligations in name only, that the issuer is disassociated from the obligation and from the facility financed, and the investor considers the private user as the true obligor.

The attributes of such a disassociation, as set forth in the amendment are: (1) the putative private obligor will be using the property financed under lease or other contractual arrangement which requires him to pay all or most of the funds needed to meet debt service on the obligations, and (2) the putative private obligor and his contractual arrangement are identified in the bond agreement or in the offering prospectus, and his payments thereunder and/or the financed property are specifically pledged or mortgaged to secure the bonds.

I recognize that there has been some abuse in some local industrial development bond projects. This amendment would require the taxation of bonds for industrial development in cases of acknowledged abuse but would not include bonds issued for traditional state and local governmental functions. I strenuously object to any legislation which attempts to repeal outright the tax exemption on state and local bonds or to any legislation which penalizes or rewards the states by taxation or exemption, depending on whether the federal government approves or disapproves of the purpose for which the bond is issued. The method of classifying various bond issues as acceptable or unacceptable to the federal government is a dangerous development and an unwise precedent.

I do not believe that Congress should have, in a cavalier fashion and in the absence of hearings, revoked the tax-exempt status of industrial development bonds. At the very least, I believe this redefinition in accordance with the generally accepted meaning of the term should be adopted.

114 Cong. Rec. 30980 (October 11, 1968).

APPENDIX G

REMARKS OF REPRESENTATIVE DAN ROSTENKOWSKI

During the Congressional discussion on the Municipal Taxable Bond Alternative Act of 1976, Representative Dan Rostenkowski stated his reluctant opposition to such proposal:

> My opposition to this legislation is based not on the present structure of the bill but on what I conceive to be a potential development that would result from extensive use of the subsidized taxable bond option. Under present law, the use of tax-exempt bond financing by cities and states is strictly a local matter. Decisions to issue bonds as well as decisions on how and where to spend the resulting revenue are strictly local decisions made either by the voters directly or indirectly, through officials chosen to represent them.
>
> On the surface, H.R. 12774 does nothing to alter that situation, State and local governments will continue to issue bonds for projects they feel are necessary . . .
>
> My concern rests with the interest subsidy paid by the federal government. To the extent municipalities come to be reliant on the interest subsidy, they expose themselves to the risk of further federal control.
>
> Although this particular legislation offers the federal payment with no strings attached, it would be premature—and I believe somewhat naive—for local governments to believe that federal strings or conditions could not at some time in the future be attached—through either congressional legislation, bureaucratic regulation or judicial interpretation. It is not inconceivable to me to visualize the day

> when the interest subsidy would be withheld if the purpose of the bond issue were either inconsistent with or in violation of some federal policy that was fashionable at that particular time . . .
>
> In the end, cities that lose control of their finances, lose control of their destinies.

MUNICIPAL TAXABLE BOND ALTERNATIVE ACT OF 1976, Report from the Committee on Ways and Means to accompany H.R. 12774, 94th Cong., 2d session, Report No. 94-1016.

APPENDIX H

REMARKS OF SENATOR RUSSELL LONG

During the 1983 Senate discussions concerning the Social Security Commission recommendations and a proposal to include tax exempt income from municipal securities in determining whether or at what level social security payments were to be taxed, Senator Long criticized the proposal as an indirect attack on what he described as a constitutionally derived right of state sovereignty. Senator Long stated:

> We had this same issue before us on the TEFRA bill, and the Senate voted by a clear margin to strike out the proposal that would put the minimum tax on State and municipal bonds. It recognized the same principal which has been upheld by great Justices down through the years, including Justice Charles Evans Hughes, that we do not have the power to do that. And the Congress, Mr. President, has in the main denied the Internal Revenue Service the right to take the States to court to try to prove that they could tax these bonds under the Constitution. Congress has expressly put in the law up to this point that the income from these State and municipal bonds is not taxable, and that it is not our purpose to tax them. The Congress has also kept the faith that the sponsors of the constitutional amendment permitting the income tax made when they passed that amendment and assured the State legislatures that it did not tax these bonds, that it was not their intention to do that, and that they did not do that.
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> Cong. Rec. S3730, 3735 (daily ed. Mar. 23, 1983).

The Social Security proposal was subsequently adopted after assurances by Senator Dole and others that the intent was not to "tax tax-exempt income", *id.* at S3736, but rather to avoid increased incentives for the buying

of tax exempt obligations, *id.* at S3737. It should be noted that Senator Moynihan inserted in the record a memorandum to the effect that such taxation would be constitutional, *Id.* at S3738.