No. 94, Original

In the Supreme Court of the United States

OCTOBER TERM, 1987

STATE OF SOUTH CAROLINA, PLAINTIFF

NATIONAL GOVERNORS' ASSOCIATION,
PLAINTIFF IN INTERVENTION

v.

JAMES A. BAKER, III,
SECRETARY OF THE TREASURY

ON THE REPORT OF THE SPECIAL MASTER

BRIEF FOR THE DEFENDANT

CHARLES FRIED
Solicitor General

MICHAEL C. DURNEY
Acting Assistant Attorney General

ALBERT G. LAUBER, JR.
Deputy Solicitor General

ANDREW J. PINCUS
Assistant to the Solicitor General

MICHAEL L. PAUP
FRANCIS M. ALLEGRA
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTIONS PRESENTED

1. Whether Section 310(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provides in pertinent part that the interest paid on publicly offered long-term bonds issued by state and local governments is exempt from federal income tax only if the bonds are issued in registered form, violates the Tenth Amendment.

2. Whether Section 310(b) of TEFRA, as applied to bonds issued by state and local governments, is invalid under the doctrine of intergovernmental tax immunity.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Cases—Continued: Page

Constitution and statutes: Page

Statutes—Continued: Page

Statutes—Continued: Page

Miscellaneous:

In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 94, Original

STATE OF SOUTH CAROLINA, PLAINTIFF

NATIONAL GOVERNORS' ASSOCIATION,
PLAINTIFF IN INTERVENTION

v.

JAMES A. BAKER, III,
SECRETARY OF THE TREASURY

ON THE REPORT OF THE SPECIAL MASTER

BRIEF FOR THE DEFENDANT

JURISDICTION

The motion for leave to file a bill of complaint was granted on February 22, 1984. *South Carolina* v. *Regan*, 465 U.S. 367. The Special Master was appointed on April 23, 1984. *South Carolina* v. *Regan*, 466 U.S. 948. The Special Master's Report was received on February 23, 1987. The jurisdiction of this Court is invoked under Article III, Section 2 of the Constitution and 28 U.S.C. 1251(b).

STATUTE INVOLVED

Section 310 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 595-600 (originally codified at 31 U.S.C. 3121(g) and 26 U.S.C. 103(j), 163(f), 165(j), 312(m), 1232(c) and 4701), is set out as an appendix to this brief.

STATEMENT

Plaintiffs in this original action challenge the constitutionality of Section 310(b)(1) of the Tax Equity and

Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 596. That section provides that the federal income tax exemption for interest paid on publicly-offered long-term debt obligations [1] issued by state and local governments extends only to interest paid on bonds issued in registered form. The Court appointed a Special Master to develop a record, and he conducted hearings and took evidence over three weeks in November 1985 and January 1986. The Court received the Special Master's Report [hereinafter Report] on February 23, 1987, and set a schedule for the filing of exceptions and briefs. We have not filed any exceptions to the Report; plaintiffs South Carolina and the National Governors' Association,[2] on the other hand, did file exceptions with supporting briefs. We begin our response to those exceptions by summarizing the Special Master's recommended findings of fact and conclusions of law.[3]

1. *The Municipal Bond Marketplace.* The Special Master found that there are "approximately 47,000 issuers of municipal obligations" and that such issuers "range in size from large States and public agencies to small school and sewer districts" (Report 20). The quantity of municipal bonds [4] has increased rapidly in

[1] For purposes of simplicity, we will hereafter refer to publicly-offered long-term debt obligations simply as "bonds."

[2] On June 22, 1984, the NGA moved to intervene as plaintiff, and this Court referred the motion to the Special Master (468 U.S. 1226). He recommended that the motion be granted with the proviso that the NGA satisfy certain conditions designed to prevent delay and duplication of proof. Report of Special Master (Nov. 16, 1984). In his final Report (at 3-4 & n.7), the Master concluded that the NGA had met these conditions. Although we opposed the NGA's intervention before the Special Master, we are not renewing that argument here.

[3] Amicus briefs supporting plaintiffs were filed by Pennsylvania and 22 other States [hereinafter Pennsylvania Br.]; the Public Securities Association [hereinafter PSA Br.]; and the Government Finance Officer Association [hereinafter "GFOA Br."].

[4] We use the term "municipal bonds" to refer to bonds issued by both state and local governments.

recent years, from $23 billion of new issues in 1974 to $102 billion in 1984. The bulk of the dollar volume of such bonds is concentrated in relatively few large issues: 83% of the dollar volume of municipal bonds issued in 1983 was taken up by issues of $10 million or more. The majority of bond issues, on the other hand—76% in 1983—consists of issues of less than $10 million. Report 20-21.[5]

The Special Master found that "[t]he principal investors in municipal securities are commercial banks, casualty insurance companies and individuals" (Report 21). Banks and insurance companies hold approximately 57%-58% of all outstanding municipal securities. The remaining bonds are owned by individuals, and approximately three-quarters of those are held indirectly through mutual funds or bank trust departments. Thus, individuals directly hold only about 10%-12% of all municipal bonds. *Id.* at 22.

Bonds historically have been issued in one of two forms —registered bonds or bearer bonds. The Special Master observed (Report 24) that "[b]earer bonds are characterized by their extreme ease of transfer. They are presumed by law to be owned by the holder, and are negotiated by simple transfer of physical possession." "The central characteristic of a registered bond," on the other hand, "is the existence of a list, or lists, on which ownership of the bond is recorded" (*ibid.*).[6] A change

---

[5] Municipal debt obligations are divided into two general categories: (1) general obligation bonds, which are "backed by the full faith and credit (and the taxing power) of the borrowing government"; and (2) revenue bonds, which are "backed entirely by the revenue produced from some particular facility or activity, usually the revenue of the enterprise funded by the bond issue," such as a hospital or toll road (Report 22). The proceeds of one form of revenue bond—industrial development bonds—are used by a government entity to assist "the trade or business of a private person" (*id.* at 23). These bonds generally are issued by governments desirous of promoting industrial expansion (*ibid.*).

[6] The Special Master observed (Report 25) that "registration can take several forms. Registered bonds can be issued in a certifi-

in the record owner of a registered bond can be effected only by a change in the ownership list maintained by the bond's transfer agent. In some situations, the record owner of a registered bond may differ from the beneficial owner, as where a broker holds a bond in "street name" on behalf of a client, or where a mutual fund holds bonds beneficially owned by its shareholders (*id.* at 26).

Two distinctions between bearer bonds and registered bonds were highlighted by the Special Master. First, the mechanics of interest and principal payments differ. Interest payments on bearer bonds are obtained by the presentation of a bond coupon. The bondholder typically presents the coupon to a bank, which often "charges [him] a fee ranging from $3 to $7 per coupon" for processing it (Report 27). The bank then forwards the coupon to the financial institution designated by the issuer as its "paying agent." The "paying agent" inspects the coupon for authenticity and directs payment to the bank. A similar procedure is used for payment of principal at maturity. *Id.* at 24, 27. In the case of registered bonds, by contrast, payments of interest and principal "are made automatically by check or electronic transfer of funds. These alternatives are available because record owners are always ascertainable. * * * [This] eliminates the need to process coupons" (*id.* at 27).

Second, registered bonds are more easily handled by securities depositories than are bearer bonds. The Special Master explained (Report 28) that "[s]ecurities depositories were established in the late 1960's and early 1970's to reduce the increasing expense associated with physical handling of securities. Prior to the advent of depositories, settlement of bond transactions involved

---

cated form where the debt obligations are evidenced by physical certificates. Registered bonds may also be issued and held in book entry form, which eliminates all but one 'global' certificate. * * * In the pure book entry form, all transfers occur by book entry and investors cannot receive a physical certificate evidencing their ownership."

physical transportation of securities from the seller to the buyer through their respective brokers." Under the depository system, by contrast, "[t]he transfer takes place by computerized entries in the records of the depository rather than by any physical movement of securities" (*id.* at 29). The Special Master found (*id.* at 32) that these automated systems involving immobilization and book entry:

> function more efficiently with registered as opposed to bearer securities. The systems function better because registered bonds do not require physical storage and processing of large volumes of certificates and coupons. Although depositories can handle bearer securities, they are hampered by the storage, security, insurance and coupon clipping functions bearer bonds require.

Indeed, it was largely because of these efficiencies that most large corporations, long before TEFRA was enacted, voluntarily shifted from bearer-form to registered-form bonds (Tr. 1245-1250, 1255-1257).

2. *Congress's Adoption of Section 310.* Spurred by a mounting federal budget deficit, Congress in 1982 considered a range of revenue enhancement measures. Studies conducted by the IRS had revealed that substantial revenues could be obtained through better tax enforcement. The studies estimated that unreported income from legal activities had risen from $29.3 billion in 1973 to $87.2 billion in 1981; that unreported capital-gain income had increased fourfold over the same period; and that income from illegal activity had also grown substantially. Report 11-12.

Congress in 1982 adopted TEFRA, which contains a variety of provisions designed to promote compliance with the tax laws. One of these provisions is Section 310, which establishes strong incentives for the issuance of bonds in registered, rather than bearer, form. Thus, Section 310(a) provides that "registration-required" [7]

[7] Although the term "registration-required" is defined somewhat differently in various provisions of Section 310, it generally refers

obligations of the United States or of any agency or instrumentality thereof must be issued in registered form. Similarly, Section 310(b)(2) and (3) deny private corporations a tax deduction, as well as an adjustment to their earnings-and-profits accounts, with respect to interest paid on "registration-required" corporate bonds not issued in registered form.[8]

Section 310(b)(1) completes this statutory scheme by amending Section 103 of the Code, which generally exempts from federal income tax the interest received by owners of municipal bonds.[9] Under the amended provision, the tax exemption does not extend to interest paid on "registration-required" obligations unless the obligations are issued in registered form.

The Special Master's Report (at 12-19) summarizes the legislative history of Section 310. The Treasury Department's initial proposal regarding incentives for the issuance of municipal bonds in registered form related exclusively to one type of bond—industrial development bonds (IDBs). Under that proposal, the tax exemption for interest on IDBs would have been limited to bonds that were in registered form and that satisfied certain

---

to any debt instrument with a maturity of one year or more that is offered for sale to the public.

[8] In addition, Section 310(b)(4) subjects unregistered corporate obligations to an excise tax; and Section 310(b)(5) and (b)(6) provides that holders of unregistered corporate obligations are not entitled either to deductions for their losses or to capital-gain treatment for their gains.

[9] Section 103 of the Internal Revenue Code of 1954 (I.R.C. or the Code) has been recodified as various sections of the Internal Revenue Code of 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1301, 100 Stat. 2602. Section 310(b)(1) of TEFRA, the provision at issue here, was originally codified as Section 103(j) of the 1954 Code, and is recodified without substantial change in Section 149(a) of the 1986 Code. See Tax Reform Act of 1986, § 1301(b). The Special Master's Report, however, refers to the provisions of the 1954 Code, and for purposes of clarity and consistency we will generally do the same.

conditions upon the use of the borrowed funds. Representatives of state and local governments discussed this proposal with Treasury Department officials and testified about it before Congress. Report 12-13. Their testimony addressed the registration requirement and "Congress was clearly apprised of the arguments against registration" (*id.* at 14).

Representative Rostenkowski subsequently proposed incentives for the issuance of virtually *all* bonds—those issued by the United States and private corporations as well as by state and local governments—in registered form. This proposal was eventually embodied in Section 310 of TEFRA. The reasons for its adoption were set forth in the Senate report (1 S. Rep. 97-494, 97th Cong., 2d Sess. 242 (1982)):

> The committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Furthermore, registration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

3. *The Special Master's Findings Regarding the Burdens and Benefits That Flow From Section 310(b).* The Special Master concluded that "[b]y eliminating the tax exempt status of municipal bonds in bearer form, Section 310(b)(1) * * * effectively requires state and local governments to issue their debt in registered form" (Report 23). Before the provision took effect "almost all

municipal bonds were issued in bearer form"; following the statute's effective date, "no state or local government has issued debt in other than registered form" (*id.* at 23-24). The trial before the Special Master centered upon "the actual impact of TEFRA's registration requirement upon States and localities" and "whether there is an overriding public interest in requiring municipal bond registration" (*id.* at 34, 80). The Special Master concluded that "[t]he burdens of establishing and maintaining a system of registered municipal bonds do not weigh heavily upon the States" and that "registered bonds are helpful to tax enforcement authorities in their collection efforts" (*id.* at 88, 191).

a. With respect to the statute's effect on state and local governments, the Special Master found that, as a general matter, registration "affects the form of state and local debt issues, but does not reach the substance of state and local borrowing. The requirement does not appear to affect either the States' ability to borrow or the States' relative use of their various sources of funds (*e.g.*, borrowing, taxes and federal grants)." Report 35. He further concluded that "the form of municipal bonds —registered versus bearer—is a matter of little intrinsic significance to states and localities" (*ibid.*).

Plaintiffs' claims about the burdens allegedly imposed by Section 310(b) fell into four basic categories. They first argued that States and localities incurred additional costs because they had to amend statutes and alter administrative procedures in order to issue registered bonds. The Special Master observed that "[t]he time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant" (Report 36). But he concluded that "the evidence taken as a whole indicates that the expenditures were not so great nor the activities so qualitatively different from those ordinarily required of state legislative and executive officials so as to detract from the accomplishment of the ordinary tasks of state and local government. The effort required to comply with TEFRA did

not prevent [those] governments from accomplishing other priorities" (*ibid.*).

Second, plaintiffs argued that the transaction costs incurred in connection with bond issues increase when bonds are issued in registered form. The Special Master found that "[o]riginal issuance costs," such as printing, bond counsel fees, and other such costs, "are not significantly different for registered and bearer bonds" (Report 41). As to ongoing administrative costs, such as fees charged to an issuer in connection with interest payments, the Special Master found that there were some cost differences. For large issues—those of $25 million or more, which comprise the bulk of the municipal bond market by dollar volume—administrative costs are *lower* for registered bonds. For medium-sized issues—those between $10 and $25 million—there is hardly any difference in such costs. For smaller issues—those of less than $10 million, which comprise only 17% of the market by dollar volume—administrative costs are slightly higher for registered bonds. For example, the Master found that "the cost difference per million dollars for a $1 million bond issue is approximately $3,300 in favor of bearer bonds over the assumed twenty year life of the issue." *Id.* at 42. That would work out to $165 per year.

Third, the Master evaluated plaintiffs' central contention regarding the economic burdens allegedly imposed by Section 310(b)—that the interest-rate cost to the issuer of a registered bond is higher than the cost for a comparable bearer bond.[10] The Master found that this claim necessarily rested on two premises: "(1) investors prefer bearer bonds over registered bonds such that (2) investors will extract an interest rate penalty or 'premium' for state and local debt issued in registered form"

---

[10] In its complaint (Exh. B, para. 8), South Carolina had asserted that this supposed interest-rate differential was 25 basis points (0.25%). At trial, however, plaintiffs reduced their claim, asserting that the differential was between 5 and 15 basis points (Report 45).

(Report 45). The Master found both premises insupportable.

As to the first premise, the Master observed that "large institutional investors hold the majority of outstanding municipal bonds" and that "[t]hese institutions have no preference to handle bearer bond certificates and clip coupons" (Report 47). In the case of individual investors, the Master refused to accept plaintiffs' image of "an older, wealthy individual * * * who cherishes the familiarity of the bearer system" and who would therefore demand a higher interest rate before agreeing to purchase a registered bond (*ibid.*). Rather, because "the handling of bearer securities is demonstrably more expensive and inconvenient for an investor than the handling of registered securities," he found it unlikely that individuals would have "a preference of sufficient strength to create an interest rate differential" (*ibid.*). Indeed, as the Master noted, most individuals do not take physical possession of the bonds they own—and hence do not care what form the bonds are in—because their investments increasingly are mediated by institutions like mutual funds, bank trust departments, and unit investment trusts (*ibid.*). In sum, "[t]he record does not support any strong or consistent investor preference for bearer municipal bonds"; instead, the dominance of bearer bonds in the municipal market prior to the enactment of Section 310(b) "appears to have been due not to investor preference, but to the absence of an impetus or motivation to change." Report 47, 48.

As to the second premise of plaintiffs' argument—that investors have acted on their supposed preference for bearer bonds by exacting an interest-rate penalty from issuers of registered bonds—the Master found that the testimony of several market participants, whose views constitute "an excellent guide to actual investor preferences and market demand," flatly contradicted plaintiffs' position (Report 53). In particular, the Master cited the testimony of one witness, employed by a major municipal bond underwriter, who stated that, with the pos-

sible exception of certain Florida issues, there was "no evidence of any yield differential between registered and bearer form * * * anywhere in the market" (*id.* at 51). This witness indicated that bond traders do not inquire about the form of a municipal bond prior to sale, and do not differentiate between bond forms when making a bid. Other municipal bond specialists provided similar testimony. *Id.* at 51-53. The Special Master concluded that the testimony of these market participants "undermines the foundation for plaintiff's interest rate contention" because "[n]either investors nor traders exact such a penalty" on registered bonds (*id.* at 54).

The Special Master noted that the parties placed considerable emphasis upon statistical evidence designed to prove or disprove the existence of an interest-rate differential. He painstakingly evaluated the parties' statistical studies (Report 54-76), but concluded that "[e]ach of the econometric studies rested on assumptions that ultimately proved unreliable and unsupported. The studies attempted to measure a very small and perhaps ephemeral effect with highly imprecise data and tools that proved too blunt for the task. Ultimately the various studies * * * do not provide an unequivocal or definitive answer to the question whether the registration requirement resulted in an interest rate penalty for municipal issuers" (*id.* at 76-77).

Plaintiffs' fourth and last contention regarding the costs allegedly imposed by Section 310(b) was that it effected "a diminution of the sovereign status of the States" (Report 77). The Master recognized that the power to raise funds is "essential to the States' ability to exercise sovereignty within the federal system," but found that the statute had no effect on their ability to borrow funds or on their fiscal condition in general. Although Section 310(b) "did change the form in which state debt is issued," the Master concluded that "the decision to issue debt in one form or another is essentially a practical one: it is tied to the issuer's perception of the desires of the marketplace. The totality of the

record indicates that, prior to TEFRA, the States did not attach any special importance to the form in which their bonds were issued" (*id.* at 77-78).[11]

---

[11] The Special Master also observed that "[p]rior to TEFRA, the United States had taken steps to restrict the issuance of tax-exempt state and local government debt securities" (Report 8). In 1980, Congress had required that several species of municipal bonds be issued in registered form as a condition to their tax-exempt status (*id.* at 9-11). Even earlier, the Internal Revenue Code had established an exhaustive set of extremely complicated criteria with which the States must comply if they wish to secure tax exemption for the interest paid on bonds issued for other than strictly governmental purposes, such as "industrial development bonds" and "mortgage subsidy bonds." See I.R.C. §§ 103(b)(1) through (18), 103(c)(1) through (7) and 103A(a) through (o). These provisions regulate both the amount of bonds that the States are permitted to issue and the uses to which the proceeds of the bonds may be put. These provisions apply to such diverse obligations as "qualified scholarship funding bonds" (I.R.C. § 103(e)), "obligations of certain volunteer fire departments" (I.R.C. § 103(i)), "consumer loan bonds" (I.R.C. § 103(o)(2)), "qualified student loan bonds" (I.R.C. § 103(o)(3)), and bonds used to fund rental housing projects (I.R.C. § 103(b)(4)(A) and (12)), sports facilities (I.R.C. § 103(b)(4)(B)), convention facilities (I.R.C. § 103(b)(4)(C)), airports and parking facilities (I.R.C. § 103(b)(4)(D)), pollution control facilities (I.R.C. § 103(b)(4)(F) and (11)), hydroelectric generating facilities (I.R.C. § 103(b)(4)(H) and (8)), "qualified mass commuting vehicles" (I.R.C. § 103(b)(4)(I) and (9)), "local district heating and cooling facilities" (I.R.C. § 103(b)(4)(J) and (10)), and "facilities for the furnishing of water for any purpose" (I.R.C. § 103(b)(4)(G)). State and local governments are required to refrain from issuing "arbitrage bonds" (I.R.C. § 103(c)(1), (2) and (3)); they are required to comply with elaborate information reporting requirements concerning their industrial development bonds (I.R.C. § 103(*l*)); they are required to comply with strict limitations on the aggregate amount of "private activity bonds" issued during any calendar year (I.R.C. § 103(m)); and they are required to obtain "public approval," often in the form of a "voter referendum," for each industrial development bond that they issue (I.R.C. § 103(k)(2)(A) and (B)(ii)). Even more substantial regulatory requirements on the issuance of state and local bonds were enacted by Congress in the Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1301-1318, 100 Stat. 2602-2711. The inducement for compliance with all of these regulatory requirements, like the inducement for compliance with the TEFRA regis-

b. Turning to the benefits flowing to the federal government from Section 310(b), the Master rejected plaintiffs' contention that bearer municipal bonds are unrelated to the problem of tax noncompliance and that Section 310(b) therefore does not further any public interest. He found (Report 84) that

> the fundamental attributes of bearer bonds are enormously helpful to individuals desiring to evade the tax laws and to conceal unreported income. Bearer bonds are convenient to transport and hide, are easily negotiable at published prices, involve anonymity and minimal reporting requirements, and are capable of supporting substantial amounts of cash. Moreover, bearer municipal bonds—unlike other cash substitutes—earn interest, and tax-exempt interest at that.

The Master noted that bearer municipal bonds had been found to be an important element of many tax avoidance schemes (*id.* at 86-87). "Given the inherent characteristics of bearer bonds," he stated, "Congress's conclusions that they facilitate tax avoidance and income concealment seem altogether reasonable" (*id.* at 84).

The Master further concluded that the registration of municipal bonds provides significant assistance to tax collection efforts. It "create[s] an audit trail which * * * enable[s] tax authorities to trace the ownership of municipal bonds for estate and gift tax purposes" (Report 85). In addition, registration helps to foil capital gains tax evasion and income concealment because "[r]egistered securities * * * provide some additional information concerning when changes in ownership occurred" (*id.* at 88). Thus, although the registration system is not tamperproof, "registered bonds are helpful to tax enforcement authorities in their collection efforts" (*ibid.*).

4. *The Special Master's Legal Conclusions.* After setting forth his recommended factual findings, the Master

---

tration requirement, is the threatened loss of tax exemption on the interest paid on the bonds. Compare I.R.C. §§ 103(a)(1), (b)(1) and (c)(1) and 103A(a) with § 103(j).

turned to a discussion of the legal principles governing plaintiffs' claims.

a. The Master first considered whether the registration provision exceeds "the affirmative limits that our constitutional structure places upon the ability of Congress to exercise its delegated, enumerated powers to affect the States and their political subdivisions" (Report 89). The Master noted that this Court's decision in *Garcia* v. *San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), overruling *National League of Cities* v. *Usery*, 426 U.S. 833 (1976), "altered the landscape of federalism jurisprudence, but left the judicial mapping of the new terrain of federalism to future cases." He concluded, however, that "the facts established during the hearing indicate that adjudication of the federalism questions presented here does not * * * require an extensive probe of uncharted areas. Under well established principles, TEFRA's registration requirement is a permissible exercise of federal regulatory power over the States" (Report 117).

The Master evaluated each of plaintiffs' contentions regarding the costs allegedly imposed by Section 310(b) to determine whether those costs had any effect upon the States' autonomy and independence. He first concluded that the alleged "administrative and legislative transition costs" were irrelevant because plaintiffs had not shown that those costs "detracted from the States' ability to perform any significant governmental functions, much less from achieving critical priorities" (Report 128). The Master next concluded that plaintiffs' position was not aided by the alleged (but unproven) interest-rate differential or by marginal increases in some transaction costs. "Problems of proof aside," the Master stated, "these burdens are purely financial in nature" (*id.* at 130). Such costs are not "legally cognizable" because "[o]f themselves, increased costs traceable to federal regulation are insufficient to establish a threat to state autonomy and independence" (*ibid.*).

The Special Master also rejected plaintiffs' claim that "the 'sovereignty costs' of the registration requirement

are so great as to offend principles of constitutional federalism" (Report 123). Plaintiffs' argument was that Section 310(b) "invades a uniquely and peculiarly sovereign function—the raising of revenue—and does so without achieving its intended national purpose of facilitating federal tax compliance" (Report 123). The Master rejected both prongs of that argument, finding that registration was reasonably designed to promote tax compliance [12] and that it had no perceptible impact on state sovereignty.

"Plaintiffs acknowledge[d] that their ability to borrow by selling bonds continue[d] undiminished * * * after passage of TEFRA," the Master noted, and he found "no suggestion that control over the form of their bonds was of any intrinsic significance to the States." "Control over municipal bond form," he concluded, "has none of the symbolic resonance for state autonomy that, for example, controlling the location of the state capital has." Report 124 (citing *Coyle* v. *Smith*, 221 U.S. 559 (1911)). Since "[a]bsent the federal registration requirement, States would choose the form of their bonds solely according to considerations of efficiency and market demand," the Special Master found no improper intrusion on the States' autonomy "[e]ven under a *National League of Cities* level of scrutiny" (Report 124).

Finally, the Special Master noted that this Court's decision in *Garcia* "suggests that judicial review must be attuned to possible failings in the national political process" (Report 133). Here, "[t]he clarity of Congress's intent to regulate the States, the political history of prior substantive congressional regulation of municipal bond issuance, and the breadth of application of the TEFRA

[12] The Master declined to second-guess Congress's judgment that the registration provision furthers an important federal interest: "the judiciary is not empowered to undertake a free wheeling inquiry into the adequacy of the evidence before Congress or its political motives in passing legislation" (Report 125). That determination "'is ordinarily a matter committed to legislative judgment,'" and the Special Master found nothing in the record suggesting that "judicial review of Congress's factual predicate" was either "appropriate or required" (*id.* at 126 (citation omitted)).

registration requirement leave little room for an inference that [Section 310] is a product of the federal political process's failure to heed or safeguard vital state interests" (*id.* at 139). The Master accordingly concluded that the enactment of Section 310(b) did not imply a defect in the political process; to the contrary, the "general structural features of the legislation" instead showed that "the political process [had] performed as intended" (*id.* at 140).

b. The Master next turned to plaintiffs' claim that Section 310(b) violates the doctrine of intergovernmental tax immunity. He first noted that the issue in this case is not whether Congress may completely eliminate the tax exemption for interest on municipal bonds. "The more narrow issue presented," rather, "is whether the intergovernmental tax immunity doctrine requires Congress to maintain the exemption for municipal bond interest intact and sacrosanct—regardless of the burden (or lack thereof) imposed upon the States by the use, as a regulatory incentive, of the threatened loss of that exemption" (Report 143).

Following a comprehensive analysis of this Court's decisions concerning the intergovernmental tax immunity doctrine (Report 144-180), the Master summarized the modern contours of that doctrine, and the obstacles facing plaintiffs thereunder, as follows (*id.* at 181):

> To prevail on their claim that the tax sanction violates the States' constitutional tax immunity, plaintiffs must show that the sanction operates to discriminate against the States. Failing that, plaintiffs might still prevail if they could demonstrate that the actual impact of the sanction threatens the continued existence of the States or interferes unduly with their ability to perform essential government functions.

He concluded that plaintiffs had made neither of these showings.

The Master first pointed out that the registration provision does not discriminate against the States because "Congress applied [it] to all issuers of debt obligations"

(Report 182). Separate provisions of TEFRA, he noted, require the United States to issue its bonds in registered form, and provide private corporations with strong incentives to do the same; the latter incentives, moreover, are analogous to and, indeed, more onerous than the incentives that operate on municipal issuers (*ibid.*). And far from posing "a danger to the States' continued existence," the challenged statute, the Master had previously found, imposed no appreciable burdens on the States at all (*id.* at 181-182).

Finally, the Special Master rejected plaintiffs' reliance on *Pollock* v. *Farmers Loan and Trust Co.*, 157 U.S. 429 (1895), in which this Court held that the federal government may not tax the interest income received on municipal bonds. The *holding* of that case, he noted, is not at issue here because Congress in 1982 did not purport to repeal the tax exemption for municipal bond interest. Although plaintiffs also sought to deduce from *Pollock* a broader rationale to support their contention that the interest exemption must remain absolute and unqualified, the Master found their effort unsuccessful. The reasoning of that 1895 decision, he explained, had been expressly renounced by this Court during its substantial reshaping of the tax immunity doctrine in the intervening 92 years. "[S]ince tax immunity for [municipal bond interest] cannot be regarded as abstract and complete, as it was when *Pollock* was decided, the States are required to show that the tax sanction was discriminatory or destructive of their independent existence. They have not carried that burden." Report 184.[13]

---

[13] The Special Master rejected two other contentions advanced by plaintiffs. First, he found that the economic costs of complying with Section 310 did not constitute a "tax" upon the States. "If the compliance costs of TEFRA are viewed as a direct tax upon the States," the Special Master stated, "then any number of federal regulatory statutes that impose such costs upon the States must be viewed as tax measures. The Supreme Court has never viewed the costs of statutory compliance or the regulatory statutes themselves in that light" (Report 185). Thus, "[a]s long as these costs do not rise to a level that threatens the States' separate and

INTRODUCTION AND SUMMARY OF ARGUMENT

The principle of federalism embodied in the Constitution defines "a system in which there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States" (*Younger* v. *Harris*, 401 U.S. 37, 44 (1971)). Implementing the federalism principle in particular cases is often difficult and complex, as this Court's decisions show. See, *e.g.*, *Garcia* v. *San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), overruling *National League of Cities* v. *Usery*, 426 U.S. 833 (1976); *FERC* v. *Mississippi*, 456 U.S. 742 (1982). Plaintiffs suggest that the instant case raises similar questions of great moment as to the appropriate relationship between the States and the federal government. Plaintiffs are simply wrong.

What is actually at issue here is an insignificant, even trivial, condition on the broad exemption from federal income tax for the interest paid on municipal bonds. Congress in 1982 took numerous steps to bolster tax collection. Because evidence before Congress indicated that bearer bonds were often used to conceal income and evade taxes, Congress enacted the statute challenged here, which provides strong incentives for the issuance of *all* bonds—federal, corporate, and municipal—in regis-

---

independent existence—and there has been no showing that they do [here]—there is no basis for considering them an impermissible direct tax upon the States" (*id.* at 186-187) .

Second, the Special Master concluded that Section 310(b) does not impose an unconstitutional regulatory tax. He stated that "a tax that is purely regulatory in purpose and effect is not, for that reason alone, unconstitutional. The tax is invalid only if the regulatory goal sought to be fostered is otherwise beyond Congress's power" (Report 188-189). Since Section 310 can be sustained as an exercise of Congress's regulatory authority under the Commerce Clause or "as a necessary and proper means of protecting the national taxing power," the Special Master found it to be a permissible regulatory tax (*id.* at 190).

tered form. The particular incentive for issuers of municipal bonds is that only registered bonds qualify for the federal income tax exemption.

Plaintiffs raise two constitutional objections to this provision. First, they assert that it exceeds the Tenth Amendment limitations upon Congress's authority to regulate the States. Second, they contend that Section 310(b) violates the intergovernmental tax immunity doctrine. The Special Master painstakingly reviewed these claims in a 193-page Report whose thoughtfulness and thoroughness make this brief largely superfluous. He correctly found that, as a factual matter, plaintiffs had failed to present any evidence tending to show that Section 310(b) violates these constitutional principles.

ARGUMENT

I. THE SPECIAL MASTER'S RECOMMENDED FINDINGS OF FACT SHOULD BE ADOPTED BY THIS COURT

The Special Master's findings of fact fill more than 80 pages of his Report; each finding is amply supported by citations to the evidentiary record. We urge the Court to adopt those findings in full. See *Colorado* v. *New Mexico*, 467 U.S. 310, 317 (1984) (Special Master's factual findings "deserve respect and a tacit presumption of correctness").

Plaintiffs have filed half-hearted exceptions to a few of the Master's factual findings. The NGA contends (Br. ii-iii, 15), although it advances no argument to support its contention (see Br. 21-44), that the Master erred in finding that there is no interest-rate differential between comparable registered and bearer bonds. South Carolina has included a laundry list of exceptions in its brief, but it actually discusses only two: the Master's finding regarding the supposed interest-rate differential (Br. 11, 86-89), and his determinations about the administrative costs entailed by registered bonds (Br. 10, 82-85).[14] Nei-

[14] Since South Carolina has failed to discuss the basis for its other exceptions, we simply submit that the Master's recommenda-

ther of these findings is critical to the Master's legal conclusions. See Report 123, 130-132. But both findings are plainly correct.

1. As to the supposed interest-rate differential, the Master emphasized that the ultimate inquiry is whether investors have such a strong preference for bearer bonds that they will extract a "premium" interest rate when purchasing registered bonds. He then evaluated the three categories of evidence submitted by the parties on this point: (1) evidence relating to the reasons why investors would (or would not) prefer bearer bonds; (2) evidence from market participants about the existence of an interest-rate differential; and (3) the parties' ill-fated statistical studies. He concluded that there was no evidence supporting the existence of an investor preference for bearer bonds and hence that plaintiffs had failed to carry their burden of proof. Report 46-77.

South Carolina first argues (Br. 87-89) that the record does contain some evidence of an investor preference for bearer bonds. The gist of the State's position is that the existence of such a preference may be inferred from the fact that most municipal bonds were issued in bearer form before 1982. But the Master found such an inference to be factually insupportable. Instead, he found that the municipal bond market before 1982 operated "by custom and without central direction. * * * The dominance of bearer securities appears to have been due not to investor preference, but to the absence of an impetus or motivation to change" (Report 48).[15]

---

tions in those respects should be adopted on the basis of the analysis in his Report.

[15] Most corporate and Treasury securities had been shifted to registered form well before TEFRA was enacted, and municipal bonds were thus the only category of bonds that were still issued largely in bearer form at that time (Tr. 1211-1212, 1216, 1223-1226, 1245-1250, 1255-1257). The Special Master found (Report 32-33) that "[t]he municipal bond market in all probability would have moved to a registered book entry system on its own even if TEFRA had not been enacted. TEFRA merely hastened the trend toward automation."

More generally, the Master concluded that "[t]he record does not support any strong or consistent investor preference for bearer municipal bonds" (Report 47). He found that (1) the added expense and inconvenience associated with bearer bonds weighs against such a preference; (2) the entities that hold most municipal bonds—institutional investors and institutions that hold bonds for individuals' accounts—do not prefer bearer bonds, and (3) the only investors whom plaintiffs even claim to prefer bearer bonds—individual investors who take physical possession of the bonds that they purchase—comprise a very small proportion (about 10%-12%) of the market. "The indifference of so many investors to physical possession of their municipal bonds undermines plaintiffs' contention that there exists an investor preference for bearer bonds of sufficient strength and breadth to give rise to an interest rate differential" (*id.* at 48).

South Carolina next argues that the Special Master should have accepted the testimony of its Treasurer (testimony unsupported even by the NGA's experts) that registered bonds carry an interest-rate penalty of 0.25% over comparable bearer bonds (Br. 86). The Treasurer of South Carolina, however, could provide no basis for his assertion "other than conversations with market participants whom he could not name" (Report 49). The Special Master's disinclination to credit this testimony is amply supported by the record. The Treasurer of Delaware stated that, "based on her discussion with bond underwriters and others involved in public finance, * * * there was no interest rate differential on Delaware bonds" (Report 50). New Jersey's Assistant Treasurer reached the same conclusion, stating in a memorandum that " '[i]nvestors are not attaching a special economic value to the bearer obligation' " (*ibid.*).

Several municipal bond underwriters and dealers also testified: (a) that there is no interest-rate differential, (b) that traders do not inquire about the form of a bond when making a purchase or sale, and (c) that traders' price lists do not distinguish between registered and

bearer bonds (Report 49-53). The Special Master properly observed (*id.* at 53-54) that this testimony:

> is an excellent guide to actual investor preferences and market demand. Those who make their livelihood in the municipal bond markets will familiarize themselves thoroughly with customer preferences and underlying bond price determinants or soon be out of business. If the market imposed a penalty on registered bonds of sufficient size to be significant in the aggregate and over the long term, major market participants would know of the differential. Indeed, these participants would, at least in part, impose it.

Third, the NGA asserts (Br. 14-15), and South Carolina appears to argue (Br. 87), that the government's statistical study, adjusted to account for certain errors in matching pairs of registered and bearer bonds, proves the existence of an interest-rate differential. The Special Master rejected this contention, concluding that all of the parties' elaborately-detailed statistical studies were hopelessly flawed both in their premises and in their conclusions (Report 76-77). The Master further observed that, even if the statistical studies had indicated an interest-rate differential, it was "as likely as not a result of a preference for bearer bonds by tax evaders and those seeking to conceal proceeds of illegal activities in anonymous, interest bearing instruments" (*id.* at 131). Plaintiffs introduced no evidence to explain *why* investors would legitimately prefer bearer bonds, and "the evidence suggest[ed] that illegal users of those bonds [would be] the most likely source of any such preference" (*id.* at 132). We agree with the Special Master that "[i]t is surely no infringement of state autonomy or independence to deny the States any interest benefits that may accrue to them from unlawful investor use of or demand for their bearer debt securities" (*ibid.*).

2. South Carolina seems to contend (Br. 83-85) that the Special Master also erred in assessing the administrative costs associated with the issuance of registered bonds. The Master divided such costs into two categories. With respect to the costs of originating a bond issue, he found

no difference as between bearer bonds and registered bonds. Ongoing administrative costs, on the other hand, did differ: registered bonds produced slightly *lower* administrative costs for large issuers and slightly *higher* costs for small issuers. Report 40-44.

The precise nature of South Carolina's challenge to these findings is not at all clear. The State may mean to argue that the Master underestimated the costs of issuing registered bonds, and it appears to proffer the alleged average cost of its own bond issues to support that position (see Br. 85). But the Master's conclusions on this point were based upon a report, prepared jointly by experts from both sides, that "effectively resolved factual disputes regarding this issue" (Report 40). Moreover, evidence at trial showed that the administrative costs associated with registered bonds issued by South Carolina just before the trial were substantially *lower* than they would have been had the bonds been in bearer form (Tr. 469-470, 2150), an experience shared by New Jersey and Michigan (Tr. 279-290, 322, 758, 797, 2151, 2155; DX 31).

II. SECTION 310(b) DOES NOT VIOLATE THE CONSTITUTION

Plaintiffs have raised two distinct constitutional challenges to Section 310(b). The complaint initially filed by South Carolina (at paras. 4, 7), and the complaint in intervention filed by the NGA (at para. IX), asserted that Section 310(b) exceeded the Tenth Amendment limitations upon Congress's authority discussed in *National League of Cities* and its progeny. When this Court in *Garcia* overruled *National League of Cities*, plaintiffs altered their argument, contending that Section 310(b) could not withstand scrutiny under the standard set forth in *Garcia*. In addition, plaintiffs have asserted that Section 310(b) is invalid for the separate reason that it violates the intergovernmental tax immunity doctrine.

Although plaintiffs now disagree among themselves about which doctrine—Tenth Amendment immunity or tax immunity— provides the proper framework for anal-

ysis, the selection makes little practical difference. The outcome of the constitutional inquiry is the same in either event. The Special Master observed that "[a]lthough the doctrine of limits on Congress's delegated powers flowing from state sovereignty and the doctrine of intergovernmental tax immunity have developed separately, they have a common source. Their source is the Constitution's recognition of the separate and independent existence of the States" (Report 90). Not surprisingly, therefore, analysis under the two doctrines turns upon similar factors—basically an examination of the burden imposed upon the States by the federal enactment. See *id.* at 112-113, 181. The Special Master correctly determined that Section 310(b) easily falls within the limitations that these two doctrines place on Congress's power.

A. Section 310(b) Does Not Exceed The Limits Upon Congress's Regulatory Authority Grounded In The Tenth Amendment And Principles Of Federalism

Section 310(b) is perhaps most conveniently analyzed under the Tenth Amendment principles that this Court has used to evaluate federal statutes that regulate the States. The instant statute, of course, is not literally cast as a regulation; instead, it gives state and local governments the choice of issuing tax-exempt bonds in registered form or issuing taxable bonds in bearer form, and municipal issuers have unanimously chosen the former alternative. But if Congress would have the power simply to require the States to issue *all* their bonds in registered form—banning bearer bonds from the national marketplace altogether—Congress certainly could take the lesser step of allowing the States the option of continuing to issue such bonds, but conditioning that option upon surrender of the tax-exempt feature. See *FERC* v. *Mississippi*, 456 U.S. at 765-767 (because Congress could preempt state regulation through the exercise of its Commerce Clause authority, it could condition continued regulation by a State upon the State's willingness to consider adopting federal standards); cf. *South Dakota* v. *Dole*, No. 86-260 (June 23, 1987). If the Tenth Amend-

ment would not prevent Congress from directly regulating the form of municipal bonds, in other words, it follows a fortiori that the Tenth Amendment does not prevent Congress from encouraging the States to adopt a particular bond form by means of a tax incentive. For purposes of Tenth Amendment analysis, therefore, Section 310(b) must be upheld as a permissible exercise of federal authority if Congress could constitutionally have required the States, in common with all other bond issuers, not to issue bearer bonds.

It cannot seriously be disputed that Congress has the authority to bar private entities from issuing bearer bonds in interstate commerce. See Report 127-128, 190-191. Such a bar would represent a valid exercise of Congress's Commerce Power and a valid regulation in aid of Congress's Taxing Power. The question here is whether a decision by Congress to extend such a regulatory bar to include *municipal* bearer bonds would transgress some limit imposed by the Tenth Amendment on Congress's authority under the Commerce Clause or the Taxing Clause.[16]

---

[16] This Court has never addressed whether the Tenth Amendment restricts Congress's regulatory authority under the Taxing Clause. In *National League of Cities*, 426 U.S. at 852 n.17, the Court cautioned that the standard against which it measured statutes enacted under the Commerce Clause might not apply to statutes enacted under other provisions of the Constitution. Indeed, Justice Stevens observed in his dissenting opinion at the complaint stage of the present case (465 U.S. at 418) that "Article I, § 8 specifically delegates to Congress the 'Power to lay and collect Taxes,' and the Sixteenth Amendment removes any possible ambiguity concerning the scope of the power exercised by Congress." "[B]ecause the power to tax private income has been expressly delegated to Congress," Justice Stevens concluded, "the Tenth Amendment has no application to this case." The Court need not here determine, however, the precise relationship between the Tenth Amendment and the Taxing Power. Plaintiffs do not suggest that the Tenth Amendment limits, if any, that apply to the regulatory component of the Taxing Power would be *more stringent* than the limits that apply to the Commerce Power. Thus, if Congress could absolutely bar the issuance of municipal bearer bonds under the Commerce

Ascertaining the constitutional limits upon Congress's power to subject the States to federal regulatory authority has frequently proved to be a difficult task that has sharply divided this Court. But the Tenth Amendment issue here is neither difficult nor complex. We submit that a blanket prohibition by Congress on the States' issuance of bearer bonds would easily satisfy either the standard set forth in *Garcia* or the rule previously set forth in *National League of Cities*. The lesser restriction accomplished by Section 310(b)(1) is thus necessarily valid.

1. *This Court's decision in* Garcia *is dispositive of plaintiffs' Tenth Amendment claim*

This Court concluded in *National League of Cities* that the Tenth Amendment imposed "an affirmative limitation" on Congress's power to legislate under the Commerce Clause (426 U.S. at 841). The Court there held that Congress could not constitutionally apply federal minimum-wage laws to the States because to do so "would directly impair their ability to structure integral operations in areas of traditional governmental functions." *EEOC* v. *Wyoming*, 460 U.S. 226, 237 (1983); *National League of Cities*, 426 U.S. at 852.

Nine years later, a closely-divided Court expressly overruled *National League of Cities* in *Garcia* v. *San Antonio Metropolitan Transit Authority*, *supra*. The Court in *Garcia* rejected as unworkable the "traditional governmental function" test, concluding that "[a]ny rule of state immunity that looks to the 'traditional,' 'integral,' or 'necessary' nature of governmental functions inevitably invites an unelected federal judiciary to make decisions about which state policies it favors and which ones it dislikes" (469 U.S. at 546). The Court found "no license to employ freestanding conceptions of state sovereignty when measuring congressional authority under the Commerce Clause" (*id.* at 550).

Power, it follows *a fortiori* that Congress can discourage the issuance of such bonds under the Taxing Power, as it has done in Section 310(b)(1).

The Court emphasized in *Garcia* that it "continue[d] to recognize that the States occupy a special and specific position in our constitutional system and that the scope of Congress's authority under the Commerce Clause must reflect that position" (469 U.S. at 556). The Court concluded, however, that "the principal and basic limit on the federal commerce power is that inherent in all congressional action—the built-in restraints that our system provides" through state participation in the national political process (*ibid.*) "The political process," the Court found, "ensures that laws that unduly burden the States will not be promulgated" (*ibid.*).

Although the Court in *Garcia* concluded that the political process is the primary safeguard for protecting the States' vital interests, it did not foreclose all judicial review to determine whether Congress in a particular case has impermissibly infringed state sovereignty. The Court found no need in the *Garcia* case "to identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States under the Commerce Clause" (469 U.S. 556). However, in citing *Coyle* v. *Smith*, 221 U.S. 559 (1911), which had invalidated an attempt by Congress to condition Oklahoma's admission to the Union upon its agreement to establish its capital at a location of Congress's choosing, the Court suggested that extraordinary interferences with the structure of a state government would indeed be constitutionally impermissible. The Special Master thus correctly concluded (Report 117 n.394) that the *Garcia* opinion does not "abdicat[e] all judicial review of Commerce Clause legislation affecting the autonomy and independence of the States," but "merely suggests that the courts view the national political process with deference, and deploy the shield of the Constitution" only in "the extraordinary case."

While recognizing that *Garcia* "altered the landscape of federalism jurisprudence," the Master concluded that the instant case furnishes no occasion for "judicial mapping of the new terrain" (Report 117). Relying on the facts established at trial, the Master explicitly found that

Section 310(b) "would not have warranted judicial intervention even under the standards of *National League of Cities*." He thus properly concluded that the statute's constitutionality "[u]nder the more deferential review of congressional power mandated by *Garcia* * * * seems beyond peradventure" (Report 192).

We adopt the Special Master's approach in addressing the Tenth Amendment issue. As we discuss below, there can be no doubt that plaintiffs' claim fails to satisfy the *National League of Cities* standard. Indeed, Justice Stevens aptly described plaintiffs' claim as "frivolous" at the time the Court granted leave to file the bill of complaint (465 U.S. at 418-419 & n.18). As in *Garcia* itself, therefore, the Court here need not "identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States under the Commerce Clause" (469 U.S. at 556). Because Section 310(b) passes muster under *National League of Cities*, the statute *a fortiori* does not infringe the limits upon Congress's authority outlined in *Garcia*.

Before turning to the *National League of Cities* analysis, however, we pause briefly to address South Carolina's contention, based on *Garcia*, that Section 310(b) should be invalidated because "the political process failed to perform as intended" here (Br. 101). As we have noted, the Court stated in *Garcia* that the political process provides the "principal and basic" assurance that Congress will not intrude upon the States' prerogatives (469 U.S. at 556); the Court then said that "[i]n the factual setting of [*Garcia*] the internal safeguards of the political process performed as intended" (*ibid.*). South Carolina argues that the political process that led to the adoption of Section 310(b) did not satisfy the test that it believes the Court enunciated in *Garcia*.

To begin with, we doubt that plaintiff's proposed test is the one that the Court in *Garcia* contemplated. The Court surely did not mean that Tenth Amendment immunity should come and go, depending on an ad hoc, case-by-case evaluation of either (1) the quantum of the

States' input into the drafting and enactment of a particular federal law, or (2) the correctness of the substantive congressional findings underlying the decision to adopt a law. In noting that "[t]he political process *ensures* that laws that unduly burden the States will not be promulgated" (469 U.S. at 556 (emphasis added)), the Court's opinion suggests a *generic* reliance on the political process as an adequate safeguard for the States' legitimate concerns.[17] Indeed, this Court frequently has eschewed judicial inquiry into whether and to what extent a legislature on a particular occasion in fact heard and considered the views of particular competing parties. See, *e.g.*, *Schlesinger* v. *Reservists Comm. to Stop the War*, 418 U.S. 208, 221 n.10 (1974); cf. *United States* v. *O'Brien*, 391 U.S. 367, 383-384 (1968) (difficulties of inquiry into congressional motive).[18]

If some sort of particularized inquiry is called for, we think that the Special Master adopted a sensible approach. He examined "the general structural features of the legislation and the specific aspects of its implementation" to determine whether there was some unusual defect in the political process (Report 140). The Master correctly found that three separate characteristics of the legislative process leading to Section 310(b)'s enactment show that there was no such defect here.

First, the registration provision did not surface late in the legislative process so as to "sandbag" the States and

---

[17] The Court's reference to the States' participation in the federal legislative process is likewise an *institutional* point, as the Court's citations clearly show. See 469 U.S. at 551 n.11.

[18] The question whether the legislative process "performed as intended" in connection with the adoption of a duly enacted statute is a classic example of a political question that courts are ill-equipped to address. It is hard to see what standards—other than its own view regarding the proper functioning of the legislative process or the merits of the particular legislation—could possibly guide a court charged with making such an inquiry. And it is obvious that an Act of Congress cannot be invalid merely because it embodies a decision that differs from the views espoused by the States on a particular occasion.

prevent them from presenting their views to Congress. "Congress's early and explicit statement that it intended to pass legislation requiring registration of securities and affecting the States insured the States ample opportunity to resort to the political process to protect their vital interests" (Report 134).

Second, Section 310(b) was not the first federal statute that imposed conditions on the availability of a tax exemption for municipal bond interest. The Internal Revenue Code for many years had restricted the purposes for which tax-exempt bonds might be issued and, indeed, more recently had required that certain types of tax-exempt bonds be issued in registered form. See Report 8-11; pages 12-13 note 11, *supra*. The fact that the States had "accepted without challenge 15 years of far more intrusive congressional regulation of analogous aspects of their debt issuance functions," the Master explained, weighs strongly against South Carolina's argument that Section 310(b) "resulted from some extraordinary political process failure requiring judicial intervention" (Report 136-137).[19]

Finally, the Special Master observed that Congress in Section 310(b) did not single out the States, but also amended the law to require the United States, and to encourage private corporations, to issue only registered bonds. "[W]here Congress—in pursuit of a general regulatory objective—legislates universally and fails to exempt the States, it is * * * difficult to contend that the political process has failed to protect vital state interests" (Report 137). For these reasons, there is no basis for finding a defect in the legislative process that led to the adoption of Section 310(b).[20]

---

[19] South Carolina asserts (Br. 106-108) that the Special Master erred in concluding that the States have acquiesced in these previous regulatory requirements, but it does not point to any evidence of prior challenges to them.

[20] South Carolina argues (Br. 95-105) that the political process failed because Congress assertedly made a mistake in analyzing the benefits that would inure to the federal government from

2. *Plaintiffs could not prevail under the* National League of Cities *balancing test*

The Tenth Amendment standard described in *National League of Cities* and its immediate progeny directed courts to evaluate several factors in considering whether a federal regulation impermissibly intrudes upon state autonomy. First, "there must be a showing that the challenged statute regulates the 'States as States.'" Second, "the federal regulation must address matters that are indisputably 'attribute[s] of state sovereignty.'" Third, "it must be apparent that the States' compliance with the federal law would directly impair their ability 'to structure integral operations in areas of traditional governmental functions.'" Fourth, the intrusion upon state autonomy must not be outweighed by the interest served by the federal statute. *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 287-288 & n.29 (1981) (citations omitted); see also *EEOC* v. *Wyoming*, 460 U.S. at 236-237; *United Transp. Union* v. *Long Island R.R.*, 455 U.S. 678, 684 & n.9 (1982); Report 104-105 & n.383.

Section 310(b)(1) is obviously directed against the "States as States." The statute also touches upon a subject—governmental borrowing for governmental purposes—that is an important attribute of state sovereignty. Report 124. Under a *National League of Cities* analysis, therefore, the questions here would concern the extent of the burden on the States and the significance of the benefits derived from the federal regulation.

---

registration of municipal bonds. But this Court has made clear that it will not second-guess Congress's determinations regarding the efficacy of legislation. See, *e.g.*, *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 283 (1981); *Heart of Atlanta Motel, Inc.* v. *United States*, 379 U.S. 241, 262 (1964); Report 125-126. Nothing in *Garcia* suggests that this basic principle is somehow inoperative where the legislation affects the States. In any event, the Master correctly rejected South Carolina's contentions as a factual matter, finding that registration actually would provide significant assistance in tax collection. See Report 83-88.

a. The Special Master found it to be an undisputed fact that Section 310(b) "has not changed how much the States borrow, for what purposes they borrow, how they decide to borrow, or any other obviously important aspect of the borrowing process" (Report 118). Thus, the basic effect of the statute is that "States and localities (or their agents) must, in some form or another, maintain a list of the owners of their bonds" (*id.* at 119). Moreover, the Special Master found that "plaintiffs did not demonstrate any connection between the decision to issue bonds in bearer form and any aspect of state autonomy or independence." To the contrary, the record showed that the form of a bond, from the States' standpoint, was a mere "technical detail designed to facilitate bond sales and accommodate the desires of the market." *Id.* at 119-120.

These factual findings completely dispose of plaintiffs' Tenth Amendment claim. The inquiry under *National League of Cities* is whether the challenged federal statute has a "qualitative impact * * * upon the States' ability to choose the manner in which they would structure delivery of vital services." Report 121; see *EEOC* v. *Wyoming*, 460 U.S. at 240 (inquiry focuses on the "direct and obvious effect of the federal legislation on the ability of the States to allocate their resources"); *National League of Cities*, 426 U.S. at 847, 851-852 & n.17. The Special Master correctly concluded that because "municipal bond form does not affect the States' revenue raising function in any material way, and since bond form does not appear to be linked to any other important aspect of state governmental operations," Section 310(b) does not "threaten[] to impair state autonomy and integrity in any meaningful sense" and therefore does not implicate the Tenth Amendment. Report 120, 191-192; see also *South Carolina* v. *Regan*, 465 U.S. 367, 418-419 & n.18 (1984) (Stevens, J., dissenting) (characterizing plaintiffs' claim under *National League of Cities* as "frivolous").

Plaintiffs do not dispute the foregoing findings. South Carolina discusses in some detail (Br. 89-93) the importance of the States' ability to borrow money, but it simply ignores the Master's finding that Section 310(b) has had no effect on the States' ability to do so. Beyond this, South Carolina simply reiterates (Br. 80-89) its argument that the economic costs that it allegedly must incur in issuing registered bonds constitute a burden on state autonomy under *National League of Cities*. But the Special Master found as a factual matter that these costs are either small or nonexistent (Report 40-77, 120-133), and such speculative burdens cannot possibly suffice to establish "a threat to state autonomy and independence." *Id.* at 130; see *EEOC* v. *Wyoming*, 460 U.S. at 240-241; *FERC* v. *Mississippi*, 456 U.S. at 770 n.33; *Hodel*, 452 U.S. at 292; *National League of Cities*, 426 U.S. at 847, 851. South Carolina, in short, "made no effort to demonstrate" that the supposed cost increases, which had no effect on the States' ability "to perform any significant governmental function," had the sort of impact on state policy choices that is relevant under *National League of Cities*. Report at 128, 130-133 (discussing the complete absence of such evidence).

b. Even if Section 310(b) were found to impose on the States a burden cognizable under *National League of Cities*, the important interests underlying the federal statute would amply justify its virtually imperceptible intrusion upon state autonomy. Congress enacted Section 310(b) because it concluded that registration "reduce[s] the ability of noncompliant taxpayers to conceal income and property" and limits "the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities" (1 S. Rep. 97-494, 97th Cong., 2d Sess. 242 (1982)). Simply put, bearer bonds are attractive to those who seek to evade the tax laws because they may be purchased and negotiated without recordation of the owner's identity. And, while carrying all the advantages that cash possesses, bearer bonds also pay interest. The

interest payments on *municipal* bearer bonds, moreover, are not reported to the Internal Revenue Service by the payor, thus eliminating (from the tax evader's point of view) a tell-tale sign that afflicts many other income-producing investments. Congress thus reasonably concluded that the elimination of bearer bonds, including municipal bearer bonds, would promote tax compliance.

The federal interest in enforcement of the tax laws is extremely weighty. See *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 734 (1979) ("[C]ollection of taxes is vital to the functioning, indeed existence, of government."). Under a *National League of Cities* approach, therefore, the federal interest, when balanced against the minimal intrusion upon the States' autonomy, would plainly dictate the constitutionality of Section 310(b). See *South Carolina* v. *Regan*, 465 U.S. at 419 n.18 (Stevens, J., dissenting) ("[T]he federal interest in eliminating a practice which undermines the enforceability of the federal tax system and laws surely is sufficient to outweigh the modest fiscal burdens imposed upon the States by this measure.").

3. *Section 310(b) does not impermissibly "commandeer" state legislative and administrative processes*

The NGA's argument against the validity of Section 310(b) rests not upon *Garcia*, nor upon a *National League of Cities* balancing approach, but rather upon an entirely different and unprecedented theory of the Tenth Amendment. The NGA asserts that Section 310(b) "usurp[s] state political and deliberative processes, requiring the states to pass laws and devote significant administrative resources to implementing the federal plan" favoring registration of municipal bonds (Br. 30). According to the NGA, this "interference" with state government is prohibited by the Tenth Amendment. In making this contention, the NGA does not appear to refer to the *economic* costs incident to a State's passing a law or promulgating a regulation; the Master in any event

found that such economic costs, to the extent they even exist, are not significant. See pages 8-12, *supra*. Rather, the NGA seems to be saying that it is unconstitutional for Congress to pass a law which has the incidental effect of requiring a state governor, or any other state officer, to do *anything* in his or her official capacity.

The NGA's theory, which would impose a limit upon congressional authority far more restrictive than the rule set forth in *National League of Cities*, reflects a complete misunderstanding of this Court's Tenth Amendment jurisprudence. An inevitable consequence of *any* federal regulation of the States' activities is that state governments—through legislative changes, administrative action, or both—must bring their rules into compliance with the applicable federal standard. In *EEOC* v. *Wyoming*, for example, this Court held that the Age Discrimination in Employment Act barred Wyoming from discharging an employee pursuant to a state law that authorized the discharge of an employee who reached the age of 55. The federal law thus required Wyoming to amend both its statute and its administrative standards in order to bring its procedures into compliance with federal requirements. 460 U.S. at 240; see also *id.* at 253-254 n.2 (Burger, C.J., dissenting) (noting that more than half the States had retirement laws that did not comply with the federal statute). *EEOC* v. *Wyoming*, of course, was decided when *National League of Cities* was still the law, and the Court's decision plainly shows that the NGA's theory is untenable.

Indeed, the *National League of Cities* analysis *presupposes* that a State may be required to alter its laws or policies pursuant to a federal standard. The first factor under the *National League of Cities* test, after all, is whether the federal statute regulates the "States as States." A federal law regulates the "States as States," obviously, only if it requires them to alter their conduct in some way, and that alteration will almost invariably entail some change in the relevant state statutes and procedures. This first factor, however, simply triggers the

inquiry under *National League of Cities;* the validity of the federal law depends on the balance of the relevant federal and state interests. The NGA's test, by contrast, would make this initial factor both the beginning and the end of the inquiry. On that approach, any federal statute that regulates the States would be per se unconstitutional.[21]

The NGA's theory, if adopted, would work a revolutionary change in the scope of Congress's regulatory

---

[21] The NGA bases its remarkable proposal to expand the Tenth Amendment upon a single decision, *FERC* v. *Mississippi, supra.* But even a cursory examination of the Court's decision in that case makes clear that it will not bear the NGA's tortured reading. The federal statute at issue there required inter alia that state utility commissions consider adopting certain federal standards or cease regulating public utilities. The Court noted that the question posed by that statute was not, as in *National League of Cities,* "the extent to which state sovereignty shields the States from generally applicable federal regulations." The federal statute at issue in *FERC,* rather, "attempt[ed] to use state regulatory machinery to advance federal goals." 456 U.S. at 758-759. The Court ultimately declined to address Congress's power to control the manner in which the States exercised their authority to regulate private parties; instead, the Court upheld the federal statute on the ground that a State was free to cease regulating public utilities if it did not want to consider the federal proposal. See 456 U.S. at 758; see also *id.* at 764 (noting that the issue before the Court concerned the "federal power to compel state regulatory activity"); *id.* at 791 (O'Connor, J., dissenting) (objecting that the federal statute required the "surrender [of] state legislative power" to the federal government). In the instant case, by contrast, the challenged federal statute does not seek to control the manner in which States regulate private parties; the question here, rather, as in *National League of Cities,* is whether the States themselves should be "shield[ed] * * * from generally applicable federal regulations" (*FERC* v. *Mississippi,* 456 U.S. at 758-759). The NGA's argument thus ignores the crucial distinction drawn by the Court in the very decision on which it relies. See also *Bowen* v. *American Hosp. Ass'n,* No. 84-1529 (June 9, 1986) (plurality opinion), slip op. 30 n.29 (quoting *FERC* v. *Mississippi,* 456 U.S. at 783 (O'Connor, J., dissenting)) ("Important principles of federalism are implicated by any 'federal program that compels state agencies * * * to function as bureaucratic puppets of the Federal Government.' ").

power. That theory would require reconsideration of this Court's decisions in *Fry* v. *United States*, 421 U.S. 542 (1975), *EEOC* v. *Wyoming*, *supra*, and countless other cases. And it would invite the striking down of federal regulatory requirements whose validity was settled long ago. In the tax area alone, for example, state and local governments have long been required to perform a variety of duties that require them to adopt specific statutes and administrative procedures. State and local governments, for example, must withhold federal income taxes from their employees' wages and remit those taxes to the Treasury. See I.R.C. §§ 3402(a) and 3404. They are required to honor IRS levies issued to collect delinquent taxes from their employees' salaries. *Sims* v. *United States*, 359 U.S. 108, 110-113 (1959). They are required to process "withholding exemption certificates," or "W-4 Forms," furnished by their employees (I.R.C. § 3402(f)), and to supply "W-2 Forms" to their workers by January 31 of each year (I.R.C. § 6051(a)). And they are required to file reports with the IRS, and mail corresponding statements to their residents, concerning the payment of state and local income tax refunds (I.R.C. § 6050E). All of these statutes presumably would be unconstitutional under the NGA's theory.[22]

The expansive rule suggested by the NGA is not supported by precedent or policy and should be rejected by this Court. Section 310(b) does not attempt to harness state power to regulate private parties, but rather is simply a "generally applicable federal regulation[]" that regulates the States themselves (*FERC* v. *Mississippi*, *supra*, 456 U.S. at 759). And because the balance of state and federal interests so clearly favors the federal government, Section 310(b) would not come close to violating

---

[22] Many other types of federal statutes have the same effects. For example, federal environmental laws subject state-owned facilities to a variety of federal regulations. See, *e.g.*, 42 U.S.C. 7602(e) (defining "person" under the Clean Air Act to include States and their political subdivisions).

the Tenth Amendment under a *National League of Cities* approach; it is thus valid, *a fortiori*, under *Garcia*.

B. Section 310(b) Does Not Violate The Doctrine Of Intergovernmental Tax Immunity

As we have discussed, Section 310(b) offers a choice to States and localities. They may issue bonds in registered form and retain the benefits of the tax exemption for the interest that they pay. Or they may issue bearer bonds, the interest on which will be taxable. We believe that the statute, by affording this choice to municipal issuers, is *less* burdensome than would be a statute that simply barred them from issuing bearer bonds altogether. Thus, if a statute that effected such a blanket bar would be valid—and we have just demonstrated that it would be—it seems to us that the validity of Section 310(b)(1) follows *a fortiori*.

South Carolina seems to agree that Congress could bar the issuance of all bearer bonds and simply require "registration of state bond issues" (Br. 66-67). Plaintiff nevertheless argues that the lesser step represented by Section 310(b) is unconstitutional, on the theory that the sanction chosen by Congress to encourage registration of state bond issues—loss of tax exemption on the interest if the States do otherwise—is a sanction that Congress has no power to threaten. This argument is based on the notion that, under the doctrine of intergovernmental tax immunity, the tax exemption for municipal bond interest must remain absolute and unconditional.

South Carolina's argument has a highly abstract quality. As we have noted, municipal bond issuers without exception have elected to comply with the incentive that Section 310(b) provides, so that all municipal bonds issued since the statute's effective date have been in registered form (Report 23-24). In practical effect, therefore, Section 310(b) has produced a "bottom line" identical to that which would have been produced by a simple regulatory prohibition of the sort South Carolina concedes to be permissible. Under these circumstances, we

do not believe that it is necessary for the Court even to consider South Carolina's intergovernmental tax immunity argument, an argument that the NGA has in our view wisely abandoned. See NGA Br. 23-25.

If one assumes that resolution of South Carolina's tax-immunity claim is necessary to a decision here, it is essential at the outset to define the true scope of that question. In enacting Section 310(b)(1), Congress did not purport to abolish the federal tax exemption for municipal bond interest. Rather, Congress simply placed a minor and nonburdensome limitation on the exemption's availability. In deciding this case, therefore, there is no need for the Court to decide whether the tax immunity doctrine would prevent Congress from repealing the interest exemption altogether. Rather, as the Special Master observed (Report 143):

> The more narrow issue presented is whether the intergovernmental tax immunity doctrine requires Congress to maintain the exemption for municipal bond interest intact and sacrosanct—regardless of the burden (or lack thereof) imposed upon the States by * * * the threatened loss of that exemption.

South Carolina contends (Br. 27) that the controlling guidepost in resolving that issue is *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), in which this Court invalidated a statute imposing a federal income tax on municipal bond interest. South Carolina's basic position is that *Pollock*'s holding and rationale prevent Congress from restricting the interest exemption in any manner whatsoever. We agree with Justice Stevens and the Special Master that the rationale on which *Pollock* was based cannot stand today, and that the minor restriction effected by Section 310(b)(1) is valid under the intergovernmental tax immunity doctrine as it has been developed in this Court's modern decisions. See *South Carolina* v. *Regan*, 465 U.S. at 407, 415 (Stevens, J., dissenting) ("[T]he conceptual basis for *Pollock* ha[s] been undermined" by the Court's modern jurisprudence

and "[t]here is simply nothing left of *Pollock* on which South Carolina can base a claim."); Report 141-184.[23]

1. *The rationale enunciated in* Pollock *no longer governs the scope of state immunity from federal taxation*

The Special Master's Report (at 148-181) discusses the evolution of the intergovernmental tax immunity doctrine in great detail. We will attempt to summarize that story —a rather long and complex story—here, paying particular attention to the evolution of the doctrine's *rationale*. As our summary shows, the repudiation of the reasoning enunciated in *Pollock* is absolutely unmistakable from this Court's subsequent decisions.

a. The *Pollock* decision was one of several cases, all decided during the last third of the Nineteenth Century and the early years of the Twentieth, that accorded the doctrine of state immunity from federal taxation an extremely broad scope. This series of decisions began with *Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1871). The Court there held that it was unconstitutional for Congress "to impose a tax upon the salary of a judicial officer of a State" (78 U.S. at 122). The Court reasoned that a state judicial officer "was a means or instrumentality employed for carrying into effect * * * the legitimate powers of the government"; that "the salary or compensation for the service of [such an] officer was inseparably connected with the office"; and that "if the officer, as such, was exempt, the salary assigned for his support * * * was also, for like reasons, equally exempt" (*id.* at 122-123). A federal tax upon a state officer's salary, the Court surmised, would unconstitutionally threaten the "unimpaired existence" of the States (*id.* at 127).

---

[23] Because the federal tax laws, from the enactment of the modern income tax in 1913 to the present, have continuously provided an explicit statutory exemption for most municipal bond interest (compare, *e.g.*, Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168, with I.R.C. §§ 103 and 103A), this Court has not found it necessary to consider whether the holding of *Pollock* remains good law.

In *Pollock*, the Court employed similar reasoning to invalidate a tax imposed "upon the income derived from municipal bonds" (157 U.S. at 583) by the Act of August 27, 1894, ch. 349, § 28, 28 Stat. 553. The Court cited *Collector* v. *Day*, *supra*, for the proposition that "Congress ha[s] no power, even by an act taxing all incomes, to levy a tax upon the salaries of judicial officers of a State" (157 U.S. at 584). The Court held in *Pollock* that there was a similar want of congressional power to levy a nondiscriminatory income tax upon the interest earned by a state's lenders (*id.* at 585-586).

The Court in *Pollock* rejected any distinction between a tax imposed directly upon the property or revenues of a State and a tax upon the income that investors "derive[] from state, county, and municipal securities" (157 U.S. at 585). A tax upon the interest income, the Court reasoned, was in essence " 'a tax on the contract' " between the government and its bondholders (*id.* at 586, quoting *Weston* v. *City Council*, 27 U.S. (2 Pet.) 449, 468 (1829)). " 'The right to tax the contract to any extent,' " the Court continued, " 'must * * * have a sensible influence upon the contract' " and hence must be " 'a burthen on the operations of government' " (*ibid.* (quoting *Weston*, 27 U.S. at 468)). The Court accordingly held that a federal tax on municipal bond interest, because it "would operate on the power to borrow before it is exercised" and have a "sensible influence on the [State's] contract" with its lenders, was in substance "a tax on the power of the States and their instrumentalities to borrow money, and consequently [was] repugnant to the Constitution" (157 U.S. at 586).[24]

---

[24] The expansive conception of state tax immunity embraced in *Pollock* and *Collector* v. *Day*, *supra*, survived (albeit only barely) into the 1930s. In *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. 393 (1932), the Court invalidated a federal tax on the income derived by a corporate lessee from the production of oil and gas on lands leased from a State. Over strong dissents by Justices Brandeis, Stone, Roberts and Cardozo (285 U.S. at 401-413), the Court reasoned that the lease was "an instrumentality of the State" for the exploitation of lands dedicated to public purposes—in that case,

b. The Court has not had occasion expressly to reconsider its holding in *Pollock*. See note 23, *supra*. As Justice Stevens has pointed out, however, the Court's recent decisions make it unmistakably clear that "*Pollock* [is] no longer good law" (*South Carolina* v. *Regan*, 465 U.S. at 407 (Stevens, J., dissenting)). The Court has not cited the holding of *Pollock* since 1938 and has not relied on *Pollock* for a holding since the passage of the Sixteenth Amendment. See 465 U.S. at 412 n.10 (Stevens, J., dissenting). The Court has explicitly overruled *Collector* v. *Day*, *supra*, the precedent on which *Pollock* chiefly relied. See *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466, 486 (1939). And the Court has explicitly overruled one of *Pollock*'s principal progeny. See *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 387 (1938), overruling *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. 393 (1932) (discussed in note 24, *supra*).

Of special relevance here, the Court has repeatedly limited *Pollock* in subsequent cases involving federal taxation of municipal bonds. Thus, the Court has held that the testamentary transfer of municipal bonds may be subjected to federal estate tax (*Greiner* v. *Lewellyn*, 258 U.S. 384 (1922)). It has held that the inter vivos transfer of municipal bonds may be subjected to federal gift tax (see *Willcuts* v. *Bunn*, 282 U.S. 216, 230 (1931)). And it has held that capital gains realized on the sale of municipal bonds may be subjected to federal income tax (*Willcuts* v. *Bunn*, 282 U.S. at 227-234). Indeed, the interest paid on several species of municipal bonds—certain industrial development bonds, arbitrage bonds,

---

the support of public schools (285 U.S. at 398). "To tax the income of the lessee arising" from the lease, the Court held, "would amount to an imposition upon the lease itself" and hence "would burden [the State] in the performance of [its] governmental function" (285 U.S. at 398, 400-401). Citing *Pollock* and *Collector* v. *Day*, the Court ruled (285 U.S. at 400) that any burden upon " 'the instrumentalities, means and operations whereby the States exert [their] governmental powers' " was forbidden by the Constitution (*ibid.*, quoting *Indian Motocycle Co.* v. *United States*, 283 U.S. 570, 575 (1931)).

and mortgage subsidy bonds—is now and has for many years been subject to federal income tax (see note 11, *supra*), and the constitutionality of these provisions has never been seriously questioned.

Most importantly, the Court has explicitly and repeatedly repudiated the conceptual basis on which *Pollock* rested. The *Pollock* decision, in common with the other decisions spawned by *Collector* v. *Day*, *supra*, advanced two theories, closely related yet logically distinct, to support its holding that taxation of a State's bondholders was tantamount to taxing the State itself. The first may be called the "immunity of the source" doctrine. This doctrine was based on the notion that the income generated by certain kinds of state contracts—such as employment contracts, debt obligations, and leases—was "inseparably connected" with the contract itself (*Collector* v. *Day*, 78 U.S. at 122). Since the ultimate source of the income generated by such contracts—the State's power to employ judges, to borrow money, or profitably to administer its lands—was concededly immune from federal tax, it was said that the income generated must necessarily be immune from tax as well. See *Collector* v. *Day*, 78 U.S. at 122-123, 127; *Pollock*, 157 U.S. at 586; *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. at 398, 400-401.

The second theory on which *Pollock* relied has been aptly described as the " 'intergovernmental burden' " doctrine. *South Carolina* v. *Regan*, 465 U.S. at 406 (Stevens, J., dissenting). The rationale of that doctrine was that, "even though a tax is not laid directly upon another government, if it has a 'sensible influence' on the costs incurred by that government, it must fall" (*ibid.* (quoting *Pollock*, 157 U.S. at 585-586)). The Court in the *Pollock* line of cases surmised that a tax on the income derived by an individual from his dealings with the State would cause the latter to experience either increased costs (*e.g.*, higher salaries or interest rates) or decreased revenues (*e.g.*, lower leasehold income). In either event, it was said that the tax would impermissibly

"burden [the State] in the performance of [its] governmental function." *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. at 398; see also *Pollock*, 157 U.S. at 586.

Both the "immunity of the source" theory and the "intergovernmental burden" theory have been expressly abandoned by the Court in its modern jurisprudence. The repudiation of those doctrines is perhaps most clearly shown in the Court's decisions allowing the federal government to tax the income of state officers, employees, and contractors. *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514 (1926); *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938); cf. *James* v. *Dravo Contracting Co.*, 302 U.S. 134 (1937) (allowing state governments to tax the income of federal contractors); *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466 (1939) (allowing state governments to tax the income of federal employees). It is to a discussion of that line of cases that we now turn.

c. In *Metcalf & Eddy*, the Court sustained the constitutionality of a federal income tax on the compensation earned by consulting engineers for services rendered under contracts with state and local governments (269 U.S. at 518-519). The Court noted that, under *Pollock* and *Collector* v. *Day*, certain contracts and other "instrumentalities" of a state government were deemed to be "so intimately connected with [its] necessary functions" that the immunity from federal taxation "extend[ed] not only to the instrumentality itself but to income derived from it" (269 U.S. at 522). The Court, however, drew a distinction (*id.* at 524-525) between income taxes on independent contractors and the income taxes involved in those earlier cases:

> [H]ere the tax is imposed on the income of one who is neither an officer nor an employee of government and whose only relation to it is that of contract * * *. The tax is imposed without discrimination upon income whether derived from services rendered to the state or services rendered to private individuals. In such a situation it cannot be said that the tax is imposed upon an agency of government in any technical sense, and the tax itself cannot be deemed

> to be an interference with government, or an impairment of the efficiency of its agencies in any substantial way.

The Court accordingly held (269 U.S. at 526) that "one who is not an officer or employee of a state does not establish exemption from federal income tax merely by showing that his income was received * * * under a contract with the state."

In *Helvering* v. *Gerhardt*, 304 U.S. at 417, 424, the Court confined *Collector* v. *Day* to its facts and sustained the constitutionality of a federal income tax on the salaries of state employees. The Court acknowledged that the tax would "deprive[] the states of the advantage of paying less than the standard rate for the services which they engage" and would "increase somewhat the cost of state governments because * * * the taxation of income tends to raise * * * the price of labor and materials" (304 U.S. at 420-421). The Court noted, however, that various classes of taxpayers—those deriving income from the performance of state contracts, from the lease of state lands, and from the profitable resale of state bonds—had recently "been held subject to federal income tax notwithstanding its possible economic burden on the state" (*id.* at 418-419 n.6), and the Court held that a nondiscriminatory tax laid on the net income of state employees was similarly invulnerable to constitutional challenge (*id.* at 420). "The mere fact that the economic burden of such taxes may be passed on to a state government and thus increase * * * the expense of its operation," the Court wrote, "infringes no constitutional immunity. Such burdens are but the normal incidents of the organization within the same territory of two governments, each possessed of the taxing power" (*id.* at 422).

In *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at 486, the Court explicitly overruled *Collector* v. *Day* and held that both the federal and the state governments may constitutionally impose nondiscriminatory income taxes upon the salaries of the other's officers. The Court noted that such taxes are "measured by income which becomes

the property of the taxpayer when received as compensation for his services" and that such taxes are "paid from [the employee's] private funds and not from the funds of the government, either directly or indirectly" (306 U.S. at 480). "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source" was, the Court held, "no longer tenable" (*ibid.*). Thus, the Court continued, "the only possible basis for implying a constitutional immunity from [an] income tax [on an officer's] salary [was] that the economic burden of the tax is in some way passed on" to the government providing him with the job (*id.* at 481). The Court, however, explicitly rejected that intergovernmental-burden argument, concluding that "[i]n no case is there basis for the assumption that any such tangible or certain economic burden is imposed on the government concerned as would justify a court's declaring that the taxpayer is clothed with the implied constitutional tax immunity of the government by which he is employed" (*id.* at 486). "In this respect," the Court said, "we perceive no basis for a difference in result whether the taxed income be salary or some other form of compensation" (*ibid.*).

d. As Justice Stevens has correctly observed (*South Carolina* v. *Regan*, 465 U.S. at 408 (Stevens, J., dissenting)), the line of decisions culminating in *Graves* makes "the repudiation of *Pollock* * * * unmistakable." For purposes of analysis under the doctrine of intergovernmental tax immunity, a State's bondholders and other lenders stand in precisely the same position vis-a-vis the State as do its officers, employees and independent contractors. Each has entered into a contract with the State, be it an employment contract or a negotiable bond. Each derives income from his contractual dealings with the State, representing a return either upon his labor or upon his capital. The economic effect of taxing each taxpayer's income is to increase the State's cost, whether its cost of acquiring capital or of acquiring labor, by some indefinite amount. And the result of transferring

such an increased cost to the State is arguably to burden it in the exercise of its sovereign powers, be it the power to borrow money or the power to hire officials to administer its laws.

In the *Gerhardt* line of cases, the Court held that a state officer or employee cannot immunize his salary from a nondiscriminatory federal income tax either on the "immunity of the source" theory, by arguing that his contract with the State is immune from tax, or on the "intergovernmental burden" theory, by arguing that the federal tax would have the effect of increasing his state employer's costs. A state bondholder has no better claim under either theory to any constitutional immunity from tax on his interest income. As Justice Stevens has noted, the costs imposed on the States by compliance with Section 310(b), as well as the costs that would be imposed on the States by elimination of the tax exemption for municipal bond interest, are surely small when "compared to the costs imposed on States and localities because their employees' salaries are federally taxed—a burden that the Federal Government unquestionably has the constitutional power to impose" (*South Carolina* v. *Regan*, 465 U.S. at 415-416 (Stevens, J., dissenting)).[25]

[25] South Carolina attempts to distinguish the *Gerhardt* line of cases (Br. 53) on the ground that interest paid to a State's bondholders is somehow more "essential" to the maintenance of a state government than salaries paid to its officers and employees. See also Pennsylvania Br. 12. This argument is altogether meritless. The premise of *Collector* v. *Day*, which held that a state judge's salary was immune from federal tax, was that "the establishment of [a] judicial department" and "the appointment of [judges] to administer their laws" were "sovereign and reserved rights" of the States without which "no one of the States under the form of government guaranteed by the Constitution could long preserve its existence" (78 U.S. at 126). The immunity of such salaries from federal taxation was said to be necessitated "by the great law of self-preservation" (*id.* at 127). It can scarcely be contended that the interest a State pays its lenders is more central to preservation of its sovereignty than the salaries it pays to its policemen, firemen, legislators, judges, and governor. Yet *Collector* v. *Day* has nevertheless been overruled.

2. *Section 310(b) does not violate modern principles of intergovernmental tax immunity*

a. The present contours of the intergovernmental tax immunity doctrine appear perhaps most clearly in this Court's decisions concerning *federal* immunity from *state* taxation. The course of those decisions has closely paralleled the line of decisions concerning state tax immunity discussed above. The Court has held, for example, that the States may constitutionally impose a nondiscriminatory tax on the salaries of federal employees,[26] on the income of federal contractors,[27] and on the profits of federal lessees.[28] The Court's recent decisions make clear that " 'immunity may not be conferred simply because the tax has an effect on the United States, or even because the Federal Government shoulders the entire economic burden of the levy.' " *Washington* v. *United States*, 460 U.S. 536, 540 (1983) (quoting *United States* v. *New Mexico*, 455 U.S. 720, 734 (1982)). To the contrary, "[s]o long as the tax is not directly laid on the Federal Government, it is valid if nondiscriminatory." *United States* v. *County of Fresno*, 429 U.S. 452, 460 (1977).

The Court's recent cases thus teach that the federal government can claim immunity from a state tax in only two circumstances. The first is where "the levy falls on the United States itself, or an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities." *United States* v. *New Mexico*, 455 U.S. at 735. The second is where the state tax, while not falling directly on the United States, falls in discriminatory fashion upon those who deal with the United States, thus transferring to the federal government an economic burden whose asym-

---

[26] *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at 492 (overruling *Dobbins* v. *Commissioners*, 41 U.S. (16 Pet.) 435 (1842)).

[27] *James* v. *Dravo Contracting Co.*, 302 U.S. at 149-157.

[28] *Helvering* v. *Mountain Producers Corp.*, 303 U.S. at 387 (overruling *Gillespie* v. *Oklahoma*, 257 U.S. 501 (1922)).

metricality makes it unfair. "[T]he economic burden * * * of a state tax imposed on those who deal with the Federal Government," in other words, "does not render the tax unconstitutional so long as the tax is imposed on the other similarly situated constituents of the State." *United States* v. *County of Fresno*, 429 U.S. at 462 (footnote omitted).[29]

Since the federal government's immunity from state taxation is based upon the Supremacy Clause (*McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819)), it is obvious that the States' immunity from federal taxation can have no greater compass.[30] As a result, "an economic burden on traditional state functions without more is not a sufficient basis for sustaining a claim of immunity." *Massachusetts* v. *United States*, 435 U.S. at 461 (plurality opinion). Rather, South Carolina could prevail on its challenge to Section 310(b) under the intergovernmental tax immunity doctrine only by demonstrating *either* that the statute imposes a tax directly upon the States *or* that the statute discriminates against the States. South Carolina has not seriously attempted to prove either of these things, and it is obvious that it cannot do so.[31]

---

[29] The Court emphasized in the *Graves* line of cases that the income taxes there upheld applied nondiscriminatorily to income earned by persons in both public and private employment. See *Graves*, 306 U.S. at 484-486; *Gerhardt*, 304 U.S. at 420-421; *Metcalf & Eddy*, 269 U.S. at 524. In the case of such nondiscriminatory taxes, a plurality of this Court has recently explained (*Massachusetts* v. *United States*, 435 U.S. 444, 458-459 (1978) (citations omitted)), the tax "will no more preclude the States from performing traditional functions than it will prevent private entities from performing their missions."

[30] Any other conclusion, of course, would turn the Supremacy Clause upside-down. The Court in *Helvering* v. *Gerhardt*, *supra*, firmly rejected any such notion, pointing out (304 U.S. at 412) that federal immunity from state taxation, if anything, has a greater scope than its state counterpart.

[31] The Special Master suggested that a tax immunity might be available in a third situation—if a State could show that "the

First, Section 310(b)(1) does not impose a "tax" on South Carolina or its agencies. South Carolina may have incurred some minor transaction costs incident to issuing its bonds in registered form, but those compliance costs, contrary to the State's assertion (Br. 60-62), are plainly not a "tax." See Report 185-187. And even if South Carolina had elected to continue issuing its bonds in bearer form, thus forfeiting the tax exemption pursuant to Section 310(b)(1), there would still be no tax on the State or its agencies. Rather, the tax would fall on those with whom the State deals—its bondholders. While the effect of such a tax on the bondholders might be to transfer an economic burden to the State, that fact, as we have just explained, is constitutionally irrelevant. *Massachusetts* v. *United States*, 435 U.S. at 461 (plurality opinion).

Second, Section 310(b), despite South Carolina's assertion to the contrary (Br. 57), does not "discriminate" against the States. Rather, the statute's registration provision applies to *all* issuers of bonds—state and local governments, private corporations, and the United States

---

actual impact of [a federal tax] threaten[ed] the continued existence of the States or interfere[d] unduly with their ability to perform essential government functions." Report 181; see also *id.* at 184 n.486. This standard, which does not appear in this Court's decisions construing the tax immunity doctrine, seems to be borrowed from the Commerce Clause context in general, and from the *Garcia* decision in particular. We are not at all sure that this additional test is either a necessary or an appropriate component of a tax immunity doctrine. Other than as the product of a tax imposed directly upon a State—which would be precluded by the existing tax immunity doctrine—it is difficult to imagine how a burden of the sort contemplated by the Master ever could result from a nondiscriminatory tax. And if the onerous federal tax hypothesized by the Master were *not* imposed directly on the State, consideration of any purely economic burden transferred to the State would be foreclosed by *Gerhardt*. In any event, debate about the existence of such a third basis for tax immunity is entirely hypothetical. The Master expressly found that the factual predicate—a burden on the States that threatens their continued existence—is wholly lacking in this case. See Report 181-182.

itself. See Report 137, 181-182. The incentives that Congress has created to induce private and municipal issuers to register their bonds, of course, necessarily vary because of the different tax status of the respective issuers. But the sanctions that attend noncompliance are essentially analogous and are of comparable severity in economic terms.[32] Under these circumstances, it cannot seriously be contended that the registration requirement discriminates as between States and private issuers—unless it discriminates in favor of the States.

The nondiscriminatory nature of the challenged statute is even more clearly shown by the fact that the federal government has imposed upon itself the same registration requirement that it has imposed upon the States. See Pub. L. No. 97-248, § 310(a), 96 Stat. 595-596 (mandating registration of substantially all long-term bonds issued by the United States, its agencies and instrumentalities). Moreover, even if a State were to refuse to comply with the registration requirement, and were thus to incur loss of tax exemption for the interest paid on its bonds, there would still be no discrimination between federal and state obligations. The interest paid on most federal bonds has long been subject to federal income tax. Public Debt Act of 1941, ch. 7, § 4(a),

---

[32] In the case of private corporations, Congress provided that noncompliance would entail loss of ability to deduct the interest against corporate gross income, loss of ability to offset the interest against corporate earnings-and-profits accounts, and a heavy excise tax upon issuance of the bonds. Pub. L. No. 97-248, § 310(b)(2), (3) and (4), 96 Stat. 596-598. Since States do not pay income tax and do not have earnings-and-profits accounts, the first two of those incentives obviously could have no possible application to the States. The incentive that Congress instead chose to encourage compliance by the States (inclusion of the interest in the bondholder's income) is essentially reciprocal to one of the corporate sanctions (denial of a deduction against the issuer's income) and is of comparable severity in economic terms. In fact, the *aggregate* sanctions for noncompliance are greater in the case of private corporations, for they risk a substantial excise tax that noncompliant municipal issuers are spared. See I.R.C. § 4701(a) and (b)(1).

55 Stat. 9. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(17), 90 Stat. 1765-1766 (repealing 26 U.S.C. (1970 ed.) 103(a)(2) and (3)).[33]

In *Massachusetts* v. *United States*, the Court held that a federal aviation tax was nondiscriminatory and hence not violative of state tax immunity, noting that the tax applied not only to aircraft owned by States and private users "but also to civil aircraft operated by the United States" (435 U.S. at 467). These facts, the Court held, "minimize, if not eliminate entirely, the basis for a conclusion that [the levy] might be an abusive exercise of the taxing power" (*ibid.*). Justice Stevens correctly reached the same conclusion, for similar reasons, in the instant case. "Even in the heydey of *Pollock*," he noted, "the Court never held that the Federal Government impermissibly infringed state sovereignty by imposing a burden on States that it also imposed on itself. If Congress has destroyed some protected concept of state sovereignty through [I.R.C.] § 103(j)(1), then it has destroyed the sovereignty of the United States as well." *South Carolina* v. *Regan*, 465 U.S. at 417 (Stevens, J., dissenting).[34]

---

[33] The interest paid on federal obligations is exempt from *state* income tax by statute. See 31 U.S.C. 3124(a). Under the Supremacy Clause, Congress has the power to create tax immunities for the federal government and for its agencies and instrumentalities. See, *e.g.*, *Carson* v. *Roane-Anderson Co.*, 342 U.S. 232, 234 (1952).

[34] In contending that a federal income tax on municipal bond interest would be unconstitutional, South Carolina (Br. 42-45) and amicus GFOA (Br. 7-23) rely on the legislative history of the Sixteenth Amendment. That legislative history shows that Congress in 1913, as was natural in view of *Pollock*, entertained doubts about its power to tax municipal bond interest; the Amendment's sponsors, furthermore, assured Congress that the Amendment's passage would not, in and of itself, authorize taxation of such interest. See Report 163 n.463; GFOA Br. 10. Amicus argues, in essence, that the view of the tax immunity doctrine current in 1913 was somehow "frozen" into the text of the Sixteenth Amendment, assertedly making this Court's more recent decisions—which have

undermined *Pollock* and rewritten the tax immunity doctrine—irrelevant in determining whether a federal tax on municipal bond interest would be valid.

The Special Master correctly rejected this argument (Report 162-163 & n.463). The Sixteenth Amendment had no effect, one way or the other, on the scope of the federal taxing power; the Amendment was designed merely to abolish the apportionment requirement for so-called "direct taxes." See *Brushaber* v. *Union Pac. R.R.*, 240 U.S. 1, 12-19 (1916). Thus, as the Special Master explained (Report 163 n.463):

> [T]he Sixteenth Amendment did not purport to address the scope of the federal taxing power as applied to activities of the States. That the sponsors of this constitutional amendment shared the then prevailing view of the scope of intergovernmental tax immunity is not surprising; however, their endorsement of that interpretation can neither transform the Sixteenth Amendment into an adoption of that interpretation, given the wholly unrelated purpose of the Amendment, nor detract from [this Court's more recent] cases limiting the scope of intergovernmental tax immunity.

The correctness of the Master's conclusion is shown by this Court's decisions permitting federal taxation of state employees' salaries. Congress at the time of the Sixteenth Amendment entertained grave doubts about its power to tax such salaries, as was again natural in view of this Court's decision in *Collector* v. *Day*. See, *e.g.*, 50 Cong. Rec. 508 (1913) (Rep. Hull); 56 Cong. Rec. 10628 (1918) (Sen. Thomas). It was in part because of those misgivings that Congress included in the first modern income tax law an explicit exemption for such salaries. Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168. After Congress repealed the exemption for state employees' salaries (compare, *e.g.*, Revenue Act of 1928, ch. 852, § 22, 45 Stat. 797-798, with War Revenue Act of 1917, ch. 63, § 201(a), 40 Stat. 303), this Court sustained the constitutionality of the tax as thus applied, and did so without even mentioning the legislative history of the Sixteenth Amendment. See *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at 475-487; *Helvering* v. *Gerhardt*, 304 U.S. at 410-424. Obviously, if the view of the tax immunity doctrine current in 1913 had been "frozen" into the text of the Sixteenth Amendment, federal taxation of state employees' salaries would be unconstitutional. This Court's decisions permitting such taxation, as well as the Court's oft-repeated admonition that "[e]xemptions from taxation do not rest upon implication" (*United States Trust Co.* v. *Helvering*, 307 U.S. 57,

CONCLUSION

The exceptions to the Special Master's Report should be overruled, the recommendations of the Special Master approved, and judgment entered for defendant.

Respectfully submitted.

CHARLES FRIED
Solicitor General

MICHAEL C. DURNEY
Acting Assistant Attorney General

ALBERT G. LAUBER, JR.
Deputy Solicitor General

ANDREW J. PINCUS
Assistant to the Solicitor General

MICHAEL L. PAUP
FRANCIS M. ALLEGRA
Attorneys

JULY 1987

---

60 (1939) (citing cases)), thus show that amicus's theory is insupportable.

Finally, we view with great skepticism that principle underlying amicus's argument—that this Court's authority to reconsider constitutional doctrine has in essence been "repealed by implication" even though there is nothing in the text of the Sixteenth Amendment to support that result. Considerably more than a few ambiguous comments in legislative history should be required before this Court is divested of its discretion to perform its " 'gravest and most delicate duty' " (*Rostker* v. *Goldberg*, 453 U.S. 57, 64 (1981) (citation omitted))—assessing the constitutional limits upon the authority of Congress.

APPENDIX

Section 310 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 595-600 (originally codified at 31 U.S.C. 3121(g) and 26 U.S.C. 103(j), 163(f), 165(j), 312(m), 1232(c) and 4701) provides:

SEC. 310. OBLIGATIONS REQUIRED TO BE REGISTERED.

(a) UNITED STATES OBLIGATIONS.—The Second Liberty Bond Act is amended by adding at the end thereof the following new section:

"SEC. 28. (a) Every registration-required obligation of the United States (or of any agency or instrumentality thereof) shall be in registered form.

"(b) For purposes of this section—

"(1) Except as provided in paragraph (2), the term 'registration-required obligation' means any obligation other than an obligation which—

"(A) is not a type offered to the public, or

"(B) has a maturity (at issue) of not more than 1 year.

"(2) The term 'registration-required obligation' shall not include any obligation if—

"(A) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

"(B) in the case of an obligation not in registered form—

"(i) interest on such obligation is payable only outside the United States and its possessions, and

"(ii) on the face of such obligation there is a statement that any United

States person who holds such obligation will be subject to limitations under the United States income tax laws.

"(c) (1) For purposes of subsection (a), a book entry obligation shall be treated as in registered form if the right to principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary of the Treasury.

"(2) The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purpose of subsection (a) where there is a nominee or chain of nominees.".

(b) OTHER OBLIGATIONS.—

(1) OBLIGATIONS MUST BE IN REGISTERED FORM TO BE TAX-EXEMPT.—Section 103 (relating to interest on certain governmental obligations) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) OBLIGATIONS MUST BE IN REGISTERED FORM TO BE TAX-EXEMPT.—

"(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation unless the obligation is in registered form.

"(2) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' means any obligation other than an obligation which—

"(A) is not a type offered to the public,

"(B) has a maturity (at issue) of not more than 1 year, or

"(C) is described in section 163(f)(2)(B).

"(3) SPECIAL RULES.—

"(A) BOOK ENTRIES PERMITTED.—For purposes of paragraph (1), a book entry obligation shall be treated as in registered form if the right to the principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary.

"(B) NOMINEES.—The Secretary shall prescribe such regulations as may be necessary to carry out the purpose of paragraph (1) where there is a nominee or chain of nominees."

(2) DENIAL OF DEDUCTION FOR INTEREST IF OBLIGATION NOT IN REGISTERED FORM.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) DENIAL OF DEDUCTION FOR INTEREST ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

"(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for interest on any registration-required obligation unless such obligation is in registered form.

"(2) REGISTRATION-REQUIRED OBLIGATION.—For purposes of this section—

"(A) IN GENERAL.—The term 'registration-required obligation' means any obligation (including any obligation issued by a governmental entity) other than an obligation which—

"(i) is issued by a natural person,

"(ii) is not of a type offered to the public,

"(iii) has a maturity (at issue) of not more than 1 year, or

"(iv) is described in subparagraph (B).

"(B) CERTAIN OBLIGATIONS NOT INCLUDED.—An obligation is described in this subparagraph if—

"(i) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

"(ii) in the case of an obligation not in registered form—

"(I) interest on such obligation is payable only outside the United States and its possessions, and

"(II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

"(C) AUTHORITY TO INCLUDE OTHER OBLIGATIONS.—Clauses (ii) and (iii) of subparagraph (A), and subparagraph (B), shall not apply to any obligation if—

"(i) such obligation is of a type which the Secretary has determined by regulations to be used frequently in avoiding Federal taxes, and

"(ii) such obligation is issued after the date on which the regulations referred to in clause (i) take effect.

"(3) BOOK ENTRIES PERMITTED, ETC.—For purposes of this subsection, rules similar to the rules of section 103(j)(3) shall apply."

(3) DENIAL OF EARNINGS AND PROFIT ADJUSTMENT FOR INTEREST ON REGISTRATION-REQUIRED OBLIGATIONS NOT IN REGISTERED FORM.—Section 312 (relating to earnings and profits) is amended by adding at the end thereof the following new subsection:

"(m) NO ADJUSTMENT FOR INTEREST PAID ON CERTAIN REGISTRATION-REQUIRED OBLIGATIONS NOT IN REGISTERED FORM.—The earnings and profits of any corporation shall not be decreased by any interest with respect to which a deduction is not or would not be allowable by reason of section 163(f), unless at the time of issuance the issuer is a foreign corporation that is not a controlled foreign corporation (within the meaning of section 957), a foreign investment company (within the meaning of section 1246(b)), or a foreign personal holding company (within the meaning of section 552) and the issuance did not have as a purpose the avoidance of section 163(f) of this subsection".

(4) EXCISE TAX ON ISSUERS OF REGISTRATION-REQUIRED OBLIGATIONS WHICH ARE NOT IN REGISTERED FORM.—

(A) IN GENERAL.—Subtitle D (relating to miscellaneous excise taxes) is amended by adding after chapter 38 the following new chapter:

"CHAPTER 39—REGISTRATION-REQUIRED OBLIGATIONS

Sec. 4701. Tax on issuer of registration-required obligation not in registered form.

"SEC. 4701. TAX ON ISSUER OF REGISTRATION-REQUIRED OBLIGATION NOT IN REGISTERED FORM.

"(a) IMPOSITION OF TAX.—In the case of any person who issues a registration-required obligation which is not in registered form, there is hereby imposed on such person on the issuance of such obligation a tax in an amount equal to the product of—

"(1) 1 percent of the principal amount of such obligation, multiplied by

"(2) the number of calendar years (or portions thereof) during the period beginning on the date of issuance of such obligation and ending on the date of maturity.

"(b) DEFINITIONS.—For purposes of this section—

"(1) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the same meaning as when used in section 163(f), except that such term shall not include any obligation required to be registered under section 103(j).

"(2) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f)."

(B) CONFORMING AMENDMENT.—The table of chapters for subtitle D is amended by inserting after chapter 38 the following:

"CHAPTER 39. Registration-required obligations."

(5) DENIAL OF DEDUCTION FOR LOSSES ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—Section 165 (as amended by this Act) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) DENIAL OF DEDUCTION FOR LOSSES ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

"(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for any loss sustained on any registration-required obligation unless such obligation is in registered form (or the issuance of such obligation was subject to tax under section 4701).

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

"(B) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f).

"(3) EXCEPTIONS.—The Secretary may, by regulations, provide that this subsection and subsection (d) of section 1232 shall not apply with respect to obligations held by any person if—

"(A) such person holds such obligations in connection with a trade or business outside the United States,

"(B) such person holds such obligations as a broker dealer (registered under Federal or State law) for sale to customers in the ordinary course of his trade or business,

"(C) such person complies with reporting requirements with respect to ownership, transfers, and payments as the Secretary may require, or

"(D) such person promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form, but only if

such obligations are held under arrangements provided in regulations or otherwise which are designed to assure that such obligations are not delivered to any United States person other than a person described in subparagraph (A), (B), or (C)."

(6) DENIAL OF CAPITAL GAIN TREATMENT FOR GAINS ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—Section 1232 (relating to bonds and other evidences of indebtedness) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) DENIAL OF CAPITAL GAIN TREATMENT FOR GAINS ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

"(1) IN GENERAL.—If any registration-required obligation is not in registered form, any gain on the sale or other disposition of such obligation shall be treated as ordinary income (unless the issuance of such obligation was subject to tax under section 4701).

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

"(B) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f)."

(c) TECHNICAL AMENDMENTS.—

(1) Subparagraph (A) of section 103(b)(4) (relating to certain exempt activities) is

amended by striking out "if each obligation issued pursuant to the issue is in registered form and".

(2)(A) Paragraph (1) of section 103(h) (relating to certain obligations must be in registered form and not guaranteed or subsidized under an energy program) is amended by striking out subparagraph (A) and by redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively.

(B) The subsection heading for subsection (h) of section 103 is amended by striking out "MUST BE IN REGISTERED FORM AND NOT" and inserting in lieu thereof "MUST NOT BE".

(3)(A) Subsection (j) of section 103A (relating to other requirements) is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(B) Subparagraph (B) of section 103A(c)(2) (defining qualified mortgage issue) is amended by striking out "and (f) and paragraphs (2) and (3) of subsection (j)" and inserting in lieu thereof "(f), and (j)".

(C) Subparagraph (C) of section 103A(c)(2) is amended by striking out ", and paragraph (1) of subsection (j)".

(D) Subparagraph (C) of section 103A(c)(3) (defining qualified veterans' mortgage bond) is amended by striking out "subsection (j)(2)" and inserting in lieu thereof "subsection (j)(1)".

(4) Subparagraph (A) of section 103A(c)(3) (defining qualified veterans' mortgage bond) is amended by striking out "in registered form".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to obligations issued after December 31, 1982.

(2) LONG-TERM U.S. OBLIGATIONS. — The amendment made by subsection (a) shall apply to obligations issued after the date of the enactment of this Act under the first section of the Second Liberty Bond Act.

(3) EXCEPTION FOR CERTAIN WARRANTS, ETC.—The amendments made by subsection (b) shall not apply to any obligations issued after December 31, 1982, on the exercise of a warrant or the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982. A rule similar to the rule of the preceding sentence shall also apply in the case of any regulations issued under section 163(f)(2)(C) of the Internal Revenue Code of 1954 (as added by this section) except that the date on which such regulations take effect shall be substituted for "August 10, 1982",

☆ U. S. GOVERNMENT PRINTING OFFICE: 1987 181483 40443