No. 94, Original

IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
PLAINTIFF,

NATIONAL GOVERNORS' ASSOCIATION,
PLAINTIFF-IN-INTERVENTION,

v.

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

PETITION FOR REHEARING

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PETITION FOR REHEARING

Plaintiff presents its petition for a rehearing of the above entitled cause, and, in support thereof, respectfully shows:

GROUNDS FOR REHEARING

The Plaintiff hereby Petitions this Honorable Court for a rehearing pursuant to

Supreme Court Rule 51 upon the following grounds:

1. The Court failed to examine the complete rationale of the theory of intergovernmental tax immunity and erred in overruling the Pollock decision; and

2. The Court erred in addressing federalism issues upon cases decided upon the Commerce Clause - A Standard Irrelevant to Congressional Enactments pursuant to the Taxing Power, and

3. The Court failed to analyze the history of the Sixteenth Amendment.

The Court Fails to Examine the Rationale of the Theory of Intergovernmental Tax Immunity

The Court erred in overruling Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, (1895) rehearing 158 U.S. 601 (1895). Although the doctrine of stare decisis is not applied rigidly to constitutional questions, "any departure from the doctrine of stare decisis demands special justification." Arizona v. Rumsey, 467 U.S. 203, 212 (1984); Oregon v. Kennedy, 456 U.S. 667, 691-92 n. 34 (1982)

(Stevens, J., concurring). "The careful observer will discern that any detours from the straight path of stare decisis in our past have occurred for articulable reasons, and only when the Court has felt obliged 'to bring its opinions into agreement with experience and with facts newly ascertained.'" Vasquez v. Hillery, 474 U.S. 254, 266 (1986).

The Court eschewed this settled principle. The majority opinion claimed that "subsequent case law has overruled the holding in Pollock that state bond interest is immune from a nondiscriminatory federal tax." Op. at 18. With all due respect, the Court is simply wrong. The majority opinion contains misstatements which this Court should correct now.

The majority concludes that the only sustaining theory of Pollock is that a federal tax on a bondholder's income is a tax "on" the state, and that, this theory having been

repudiated, Pollock is no longer acceptable constitutional theory. The Court's rationale descendi collides particularly with James v. Dravo Contracting Co., 302 U.S. 134 (1937) upon which this Court relies and cites. For the Court, Justice Brennan states:

> We see no constitutional reason for treating persons who receive interest on government bonds differently than persons who receive income from other types of contracts with the government, and no tenable rationale for distinguishing the costs imposed on States by a tax on state bond interest from the costs imposed by a tax on the income from any other state contract.

Op. at 18.

James v. Dravo Contracting Co., supra, upheld a state tax on income of independent contractors of the United States. James is a primary decision cited by the Court to illustrate the repudiation of the theory of Pollock; however, the James court expressly disclaimed this Court's conclusion that "no tenable rationale" exists to distinguish

general obligation bond proceeds from other contracts (of employment or independent contractors) with the state.

In James, Chief Justice Hughes, a person uniquely knowledgeable about the Sixteenth Amendment and issues concerning the taxation of state bonds because of his personal involvement in the political debates surrounding the adoption of the amendment[1], expressly recognized for the court the distinction between taxation of state employee income, independent contractor income, and income from state bonds.

> There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the government. That doctrine recognizes the direct effect of a tax which "would operate on the power to borrow before it is exercised" (Pollock v. Farmers' Loan & Trust Co., supra), and

1 See GFOA Amicus Brief generally, and State of South Carolina Brief p. 42-45.

> which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit; considerations which are not found in connection with contracts made from time to time for the services of independent contractors. (emphasis added)

Id. at 152-53.

This distinction continued in Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938) and Helvering v. Gerhardt, 304 U.S. 405 (1938), upon the proposition that "to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power. . .," id. at 417, was unconstitutional. Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939) - cited by Justice Brennan in the majority opinion as supporting the assertion that the doctrine of Pollock had been overruled-makes clear that the doctrine espoused in Pollock is vibrant and rests upon the settled proposition that:

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

306 U.S. at 477-78.

Rather than adhere to the established precedent of Pollock and its rationale which this Court has recognized was distinct from the theory upon which taxation of state employee income or independent contractor income had been approved, the Court overrules Pollock. It does so upon the misapprehension that the theory of Pollock had been rejected. Clearly, this Court's opinions in James v. Dravo, supra, and Graves v. O'Keefe, supra, teach otherwise.

Pollock should be affirmed upon settled theories not mentioned by the Court. First, as James v. Dravo notes, immunity from taxation is essential due to the relationship of a state to its investors; and, federal taxation of general

obligation bonds interferes upon the ability of the states to borrow. Further, the immunity doctrine for the states was conceived to protect the States from Congressional influence through the exercise of the taxing power.

The majority opinion analyzed Section 310 of TEFRA on the basis that Congress enjoys the right to tax general obligation bonds. In 1984, state and local governments issued approximately $102 billion of new bonds (revenue and general obligation). Report at 20. The Court recognizes that if these bonds were subject to federal taxation, the cost to the states in interest charges would increase 28% to 35%. The states' relationship with its investors depends upon the value of a bond; a value now dependent upon future Congressional grace of a tax exemption. Op. at 4. Yet, the Court shuns any analysis concerning the effect such a financial burden would have upon the states.

The Court ignores the characteristics of a general obligation bond. A general obligation bond such as is involved in South Carolina's Petition is a pledge of future state taxes backed by the full faith and credit of the State of South Carolina to retire a debt. For constitutional purposes, there should be no difference if the state taxes citizens one hundred million dollars for current operations, or issues bonds of x number of dollars over a period of years to finance operations and retire the bonds solely through future tax collections. In either circumstance, Congress cannot tax the general tax revenue of the state.

In reality Congress has asserted in Section 310 of TEFRA the right to tax South Carolina's tax revenues; therefore, the Court should apply the appropriate guidelines of Massachusetts v. United States, 435 U.S. 444 (1978), and New York v. United States, 326 U.S.

572 (1946). Rather, this Court contents itself with an observation at Footnote 13 that those decisions need not be addressed because the tax is not "directly on a state." As noted in Graves, intergovernmental tax immunity is designed to "forestall undue interference, through the exercise of that (the taxing) power, with the governmental activities of the other (sovereign)." supra, at 3. This theme was echoed by Justice Douglas in New York v. United States, 326 U.S. at 593 (dissenting).

Surely, the constitutional protection envisioned under the tax immunity doctrine deserves a more supple rationale for overruling Pollock than the Court articulates. If Congress may tax general obligation bond proceeds, it could tax state tax revenues, since the state tax revenues are the exact revenues which are collected to retire the bonded indebtedness. Accordingly, the test which should be applied is whether Congress may

enact a onerous but nondiscriminatory tax directly against the state.

In Massachusetts v. United States, supra, the plurality opinion determined that a federal flat-fee registration tax (amounting to $131.43 in 1973) on state aircraft was in the nature of a user fee. The Court concluded more recent decisions produced a "practical construction" of the tax immunity doctrine: neither the taxing power of the government imposing the tax nor the "appropriate exercise of the functions of the government affected by it" can be impaired. 435 U.S. at 459 (quoting from New York v. United States, 326 U.S. at 589-90) (emphasis added). A tax is valid if the subject of the tax is a "natural and traditional source of federal revenue" and if it is "inconceivable" that the tax could "ever" operate to preclude traditional state activities. 435 U.S. at 459-60.

In Massachusetts, the Court reminded us that "the existence of the States implies some restriction on the national taxing power." Further, the Court quoted from New York v. United States: "limitation (on state sovereignty) cannot be so varied or extended as seriously to impair. . . the appropriate exercise of the functions of the government affected." Id. at 459.

The teaching of Massachusetts v. United States and New York v. United States must be applied to the bold assertion by Congress in TEFRA Section 310 - an assertion of power not attempted until at least 1983.[2]

2/ Congress has enacted a so-called minimum tax, which includes within the definition of income the interest on state bonds. Social Security Amendments of 1983, Pub. L. No. 98-21, Section 121, 97 Stat. 65. The 1986 Tax Reform Act, Pub. L. No. 99-514, limits the issuance of tax immune bonds for purposes and amounts approved by Congress. It refers to the "exemption" rather than the "immunity" of the States. Title XIII, Secs. 1301 Y et seq.

The Court's opinion is a pulsating departure from the theory of tax immunity applied only last year. The rationale of the tax immunity doctrine, insofar as it touches upon taxation of bond proceeds, was described in Rockford Life Ins. Co. v. Ill. Dept. of Revenue, 107 S.Ct. 2312 (1987):

> That doctrine is based on the proposition that the borrowing power is an essential aspect of the federal Government's authority and, just as the Supremacy Clause bars the States from directly taxing federal property, it also bars the States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability.

Id. at 2317.

In the case at bar, the majority opinion summarizes the relationship of the state and federal immunity doctrine as follows:

> The rule with respect to state tax immunity is essentially the same (as immunity of the United States from state taxation), see, e.g., Graves, supra, at 485; Mountain Producers Corp., supra, at 386-87, except that at least some nondiscriminatory federal taxes can be collected directly from the States even though a parallel state tax could not be

collected directly from the Federal Government.

Op. at 17.

The majority opinion fails to analyze the impact of Congressional taxation upon the ability of the States to borrow; an equally essential attribute of sovereignty to the states recognized by the tax immunity doctrine. The majority "shirks" its responsibility to evaluate the practical effect of federal taxation upon the ability of the States to borrow. Op. (O'Connor, J., dissenting, at 2).

In Rockford, the unanimous Court concluded that a critical purpose of the governmental tax immunity doctrine was to assure the ability of a sovereign to borrow. Thus, the majority opinion, simply overruling Pollock as being outdated, fails to address the constitutional theory upon which Pollock and the tax immunity doctrine are premised. In so doing, the majority opinion sustains the constitutionality of Section 310 of TEFRA upon the assumption

Congress may subject all general obligation tax proceeds to federal taxation.

It is respectfully submitted that this Court should grant the Petitioner's request for a rehearing, for the purpose of analyzing whether Congress may tax, consistent with the teaching of Massachusetts v. United States and New York v. United States, over $100 billion of state bonds outstanding in 1984 alone at an increased cost to the states of between $25 and $38 billion.

The Court Addresses Federalism Issues Under the Commerce Clause - a Standard Irrelevant to the Assertion of Congressional Authority Pursuant to the Taxing Power

The conceptual basis for South Carolina's attack upon Section 310 resides not only in the express provisions of the Tenth Amendment, but in the principles of federalism embraced within the scheme of the Constitution, as well as the Sixteenth Amendment's specific application to Section 310. The Court erred when it applied

Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985), a case dealing with the relationship of Congress to the States when Congress exercises its power pursuant to the Commerce Clause.

What is incredible in the majority opinion is not that the Court simply misreads the history of the Tenth Amendment and the principles of federalism as it relates to the power of one sovereign to tax the other; rather, it is the majority's conclusion that the right of the United States to tax the States may be analyzed purely upon resort to Garcia, a Commerce Clause case. Such an analysis may have been appropriate if all that were at issue was the right of Congress to prohibit completely bearer bonds in interstate commerce. However, the Court correctly rejected the attempt by the Solicitor General to defend Section 310 on such basis when it stated:

> The United States cannot convert an unconstitutional tax into a constitutional one simply by making the tax conditional. Whether Congress could have imposed the condition by direct regulation is irrelevant; Congress cannot employ unconstitutional means to reach a constitutional end. Under Pollock, a tax on the interest income derived from any state bond was considered a direct tax on the State and thus unconstitutional. 157 U.S. at 585-86. If this constitutional rule still applies, Congress cannot threaten to tax the interest on state bonds that do not conform to congressional dictates.

Op. at 10.

Rather than heed the admonition of Justices Douglas and Black that "[t]he Constitution is a compact between sovereigns. The power of one sovereign to tax another is an innovation so startling as to require explicit authority if it is to be allowed," New York v. United States, 326 U.S. at 595, the majority fails to analyze the difference between the exercise of the taxing power - as contrasted with the exercise of the Commerce Clause - when Congress is dealing with the States.

The Court correctly assumes that Section 310 can withstand constitutional scrutiny only if Congress could directly tax all state and local bonds. Approximately $102 billion of such bonds were outstanding in 1984. The cost to the states to issue such bonds would rise 28% to 34% if Congress taxed the bond proceeds. Thus, the cost to the states for bonds issued in 1984 alone would rise dramatically.

Rather than analyze the impact upon the States if Congress exercised its taxation power, which the Court assumes Congress could do, the Court contents itself with a suggestion that the entire constitutional theory forbidding such taxation as espoused in Pollock was premised upon the "fiction" that the tax was "on" the state government. Constitutional decisions do not exist as a theoretical abstraction; nor should the decisions casting constitutional doctrine be based upon

theoretical postulates without regard to practical consequences.[3]

The lifeblood of the Constitution, insofar as federalism issues are concerned, is the balance the constitution strikes between the competing needs in the national and state government. The theory of the Commerce Clause as interpreted in Garcia is not applicable to state taxation issues; thus, the Court erred in concluding that the Tenth Amendment is "structural, not substantive-i.e., that States must find their protection from congressional regulation through the national political process, not through judicially defined spheres of unregulable state activities". Op. at 5, 6.

3/ Further, the Court overrules a precedent of almost 100 years because the "theory" is no longer in vogue. However, as this Court has often said, "[T]he Constitution is 'intended to preserve practical and substantial rights, not to maintain theories.'" City of El Paso v. Simmons, 379 U.S. 497, 516 (1965).

When Congress exercises its power through the Commerce Clause, it invokes "a specific and plenary one authorized by the Constitution itself." Heart of Atlanta Motel, Inc. v. United States, 379 U.S. 241, 258 (1964). The only question concerning the appropriate exercise of that power is whether Congress had a rational basis for finding the activity affected Commerce, and if it had such a basis, whether the means it selected to eliminate the evil are reasonable and appropriate. Id. at 258.

The framers of the Constitution conceded the necessity of concurrent jurisdiction between the federal and state governments to raise revenue. The Federalist No. 30 at 188 (A. Hamilton) (Mentor ed. 1961). Hamilton was aware of the possibility of friction between the national and state governments, each with a sovereign revenue-raising power:

> The particular policy of the national and of the state systems of

> finance might now and then not exactly coincide, and might require reciprocal forbearances. It is not, however, a mere possibility of inconvenience in the exercise of powers, but an immediate constitutional repugnancy that can by implication alienate and extinguish a pre-existing right of sovereignty. (emphasis added)

Id. No. 32, at 200.

Hamilton also noted that the states retained the authority to raise revenue for their wants and that the States were to "retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national Government to abridge them in the exercise of it would be a violent assumption of power unwarranted by any article or clause of its Constitution." Id. No. 32, at 197-98.

If the Court wishes to dispose of this Constitutional issue because it is not in keeping with the "modern rule," the appropriate constitutional analysis is to evaluate the exercise of Congressional power under the

Taxing Clause, rather than the Commerce Clause. The majority failed to accord any deference to the distinction recognized historically between the taxing power and the commerce power, as illustrated in decisions of this Court in Hill v. Wallace, 259 U.S. 44 (1922) and Chicago Board of Trade v. Olsen, 262 U.S. 1 (1923).

In 1921, Congress enacted the Future Trading Act, which imposed a prohibitive tax on grain futures transactions that were not consummated on an exchange designated as a "contract market" by the Secretary of Agriculture. The 1921 statute was held unconstitutional in Hill as an improper exercise of the taxing power, but its regulatory provisions were promptly re-enacted in the Grain Futures Act and upheld under the Commerce Clause power in Chicago Board of Trade. See Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 360-61 (1984).

Moreover, the Court erred in applying Garcia because Garcia is premised upon the history of federal sensitivity to the burdens imposed upon state and local governments when Congress regulates commerce. When Congress exercises its taxing power, because the two sovereigns are competing for revenues, it is folly to suggest that the political process affords the States protection. Review of this Court's decisions since M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), reveals the friction between the federal and state governments in areas of taxation.

The sovereignty retained by each state to have an independent basis for raising revenue is inconsistent with a notion that each state must assert its sovereignty through persuasion in the political processes. The Taxing Power of the national government is not an economic cudgel granted to Congress to defeat the sovereign right of a state to an independent

basis for fund raising through taxation. Thus, the Court erred in refusing to analyze the affect of the power asserted by Congress in Section 310.

The Majority Opinion Fails to Analyze the History of the Sixteenth Amendment

South Carolina and the Government Finance Officers Association amicus curiae argued that the Congressional history of the Sixteenth Amendment manifests an intention to exempt state bond interest from federal taxation. The Court fails to consider the overwhelming history which supports South Carolina's position. The Court cavalierly rejects the argument with a sickly footnote and citation only to Brushaber v. Union Pacific Railroad Co., 240 U.S. 1 (1916), and reference to three pages in the Congressional Record.

The Court's discussion of the legislative history is not only disturbing for this case, but disparages the amendment process. This

Court has frequently commented upon the significance of the legislative debate surrounding an amendment as being appropriate to the Court's interpretation of the amendment. Yet, the Court fails to consider the thorough exposition of the legislative history of the Sixteenth Amendment presented in the Brief of the Government Finance Offices Association, and incorporated by reference by South Carolina in its brief.

The Special Master noted that "the principal sponsors of the Sixteenth Amendment took pains to assure the Congress that passage of the Sixteenth Amendment would not, in and of itself, authorize federal taxation of municipal Bonds." Special Master's Report at 162-63. The Special Master was of the opinion that the amendment did not purport to address the scope of federal taxing powers as applied to the activities of the State. However, neither the Special Master, the Solicitor General, nor this

Court has addressed the basic premise of South Carolina and the Government Finance Officers Association: The Sixteenth Amendment would not have been ratified without assurances that state bond proceeds were immune from federal taxation. Specific assurances were made by Congressional leaders to the states that bond income would be immune from taxation under the Sixteenth Amendment. The States were entitled to rely upon such assurances, and this Court should not reject the history of the Amendment interpreting this important issue. See, Government Finance Officers Association Brief.

SUMMARY

The majority opinion strikes down the Pollock decision - a precedent of almost 100 years - and does so without addressing much of the theory upon which the Pollock decision was based. Rather than analyze the independent, underlying theory of Pollock relating to state bonds which has in no wise been undermined by

subsequent decisions, the Court simply proclaims that Pollock cannot withstand the modern theory of intergovernmental tax immunity. Further, the Court's allegiance to Garcia is decidedly misplaced when applied to Congressional legislation made pursuant to its taxing power.

The majority opinion reaches a result expressly disavowed by all parties and the amicus curiae. Even the Solicitor General, on behalf of the United States, admitted that "I suspect there very well may be a constitutional limit (to the removal of freedom from federal income taxation on these bonds)." Transcript at 25. The Solicitor General felt the guiding principle would be the Tenth Amendment and principles of federalism, and not Pollock.

The majority opinion authorizes wholesale federal taxation of state bonds without regard to the consequences of this taxation and without due regard to the legislative history

of the Sixteenth Amendment; nor does the Court articulate an appropriate constitutional principle for its holding. Congress' assertion of the right to tax all state bonds arrogates unto Congress power which has no limits, and destroys the constitutional equipose between the national and state government envisioned by that compact known as the United States Constitution.

CONCLUSION

For the foregoing reasons, the Petitioner respectfully requests pursuant to Supreme Court Rule 51 that the Court grant a rehearing in this matter, rather than postpone to another day the correction of the far-reaching and patently incorrect opinion of the majority of the Court.[4]

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4 The Court has "replace(d) what is ideally a sense of guaranteed right with the uneasiness of unsecured privilege." Patterson v. McLean Credit Union, 56 U.S.L.W. 3735, 3736 (1988) (Stevens, J., dissenting).

Respectfully submitted,

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CERTIFICATE OF COUNSEL

I, John P. Linton, counsel for the above-named Plaintiff, do hereby certify that the foregoing Petition for Rehearing is presented in good faith and not for delay, and that it is restricted to the grounds specified in Rule 51 of the Rules of this Court.

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