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COMMENT

TAX-EXEMPT STATE AND LOCAL BONDS:
FORM OF
INTERGOVERNMENTAL IMMUNITY
AND FORM OF
INTERGOVERNMENTAL OBLIGATION

INTRODUCTION

Federal income tax exemption of interest from state and local bonds has traditionally been a source of congressional debate. In recent years, Congress has been successful in enacting legislation which limits the type of industrial development bond that can qualify for the exemption and outlaws the tax exemption of interest from arbitrage bonds. Other proposals by the House of Representatives, attempting to curtail the status of these bonds, were contained in the Tax Reform Act of 1969 which would have placed a limit on the amount of the exemption and treated the excess as a tax preference item. In addition, the proposed act provided for an allocation of deductions between tax-exempt and taxable income and included as tax-exempt income the interest from the tax-exempt bonds. In addition to outlawing arbitrage bonds, a proposal was made to establish United States Government subsidies to states which would voluntarily submit their bonds to income taxation in the hands of the holders. The act as finally passed with respect to exempt interest from state or local bonds only included the proposal to outlaw arbitrage transactions.

4. See H.R. 13270 proposed § 301 of the act as passed by the House of Representatives on July 30, 1969.
5. See H.R. 13270 proposed § 302 of the act as passed by the House of Representatives on July 30, 1969.
7. See H.R. 13270 proposed §§ 601 and 602 as passed by the House of Representatives on July 30, 1969.
Congressional debate and failure to eliminate the tax-exempt character of state and local bonds can stem from the doctrine of intergovernmental immunity\(^9\) and/or state and local pressure on Congress to have its borrowing power enjoy a lower cost in the market place because of the tax-exempt feature.\(^{10}\) Although presently subject to debate as to the applicability of the doctrine to tax-exempt bonds,\(^{11}\) the *Pollock v. Farmers' Loan and Trust*\(^{12}\) case, when specifically confronted with the question of whether an income tax on the interest of the holder was constitutional, held that such was a tax on the power to borrow money and consequently a burden on the state in performing an essential sovereign function. The market advantages to the state arise from the attraction of the tax-exempt feature to private individuals and corporations. For example, a tax bracket of 50% means that your after tax income effective yield of an 8% private bond is 4%. Thus, an investor in the 50% bracket would find it more profitable to invest in a 5% state and local bond than in an 8% private bond.

Despite the problems and debate posed by the constitutional concept of intergovernmental immunity and pressure from state and local government, state and local bonds are essentially financial devices to raise funds for state and local needs. From this perspective it becomes easy to understand the state's reluctance to shed the benefit of the exemption. State and local governments are confronted with increased expenditures while their sources of revenue have become inferior to the federal government's comprehensive income tax.\(^{13}\) Until relatively recent times little economic attention was afforded to the problems of "fiscal federalism (the fiscal relation between hierarchically ordered units) or multi-unit finance (the fiscal relation between coordinate units)."\(^{14}\) However, when one views the fiscal structure of this country, the decentralized nature (state and local expenditures) of civilian fiscal affairs cannot be


\(^{10}\) See Lent, *supra* note 1, at 315; Comment, *The Taxability of State and Local Bond Interest by the Federal Government*, 38 U. Cin. L. Rev. 703, at 709 (effects of the exemption), 716 (state and local opposition creating political pressure) (1969).


ignored. For this reason, federalism in a fiscal sense will have to adopt forms and functions of finance that will confront the problem of rising expenses at the state and local level.

In this fiscal federalist concept state or local bonds must be viewed as a method of finance and an investment. Three relatively recent laws have exemplified the use of state and local bonds in a spirit of state-federal fiscal cooperation. Briefly, these laws make it possible for state and local bonds to be issued to the federal government in return for a loan. The federal government subsequently sells the bonds in the open market; at this point the statutes provide that the purchasers of these bonds will have to include the interest from these bonds in their gross income. The federal government subsidizes the difference between the tax-exempt and the taxable rate because there is no tax-exempt status after the federal government sells to a private investor. In other words, the state, for example, issues to the federal government the bond at 5% (its normal tax-exempt rate), which is the interest the state pays. If in order to sell the bond to private investors, a higher interest rate is required since the interest is taxable, the federal government must pay the excess, which in this example would be the interest rate over 5%.

By this method the federal government avoids losing the tax revenues from the purchaser on the bond, and the state or local government retains its lower interest rate. This is a novel approach to both the highly debated area of tax-exempt bonds and the area of intergovernmental fiscal relations often described as fiscal federalism.

15. Id. at 2.
16. See Wagner, supra note 13, at 21-24; Essays in Fiscal Federalism, supra note 14, at 2. For a short but scholarly discussion of the federalist system vs. a more centralized system, see Maxwell, Financing State and Local Governments 29-32 (1965).
18. See D. Ott and A. Meltzer, Federal Tax Treatment of State and Local Securities, Revenue Implications 62-81 (1963), particularly at 81: “In summary, removing the exemption feature would almost certainly produce revenue to the federal treasury in excess of the interest cost increase to state and local government.”
local bonds have progressed from an initial no taxation of interest income to certain restrictions on the exemption if an industrial development bond or arbitrage bond is used by the state or local government, and most recently, to a form or type of intergovernmental obligation. With industrial development bonds the proceeds of the issue are used directly or indirectly by a person who is not a state or local government,\textsuperscript{20} while with arbitrage bonds the proceeds of the issue are used to invest in higher yielding securities.\textsuperscript{21} Thus, with the industrial development bond the state or local government was in effect selling their tax-exempt privilege to private industry.\textsuperscript{22} In the arbitrage bond situation, the state or local government was not exercising a government purpose in issuing debt, but was merely issuing the bond debt as a conduit to invest in higher yielding federal obligations.\textsuperscript{23} The use of these types of bonds has detracted from the normal use of a state or local bond which is to finance public facilities and social projects. This paper will not examine the more intricate issues behind industrial development\textsuperscript{24} and arbitrage bonds;\textsuperscript{25} rather it will focus on the fundamental doctrine of intergovernmental immunity as developed by case law with emphasis on the federal income tax-exempt status of state and local bonds as being a form of intergovernmental immunity. Further, this paper will explore the latest use of state and local bonds as a device of fiscal federalism and indicate that this use is a form of an intergovernmental obligation.

**INTERGOVERNMENTAL IMMUNITY**

Before discussing the case law which enunciates and interprets the

\textsuperscript{20} INT. REV. CODE of 1954 § 103(c)(2).

\textsuperscript{21} INT. REV. CODE of 1954 § 103(d)(2).

\textsuperscript{22} Surrey, Tax Trends and Bond Financing, 22 TAX LAWYER 123, 127 (1968).

\textsuperscript{23} Id. at 124.


\textsuperscript{25} For a comprehensive work on arbitrage transactions, see Lewis and Loftis, The Tax-Exempt Status of Local Government Bonds Used in Arbitrage Transactions, 35 GEO. WASH. L. REV. 574 (1967).
doctrine of intergovernmental immunity, a look at the views of Alexander Hamilton, a great financier and statesman, in a related area is in order. Remember, there is no specific constitutional provision requiring the federal government to refrain from taxing the states and likewise no provision which curtails state taxation of the federal government. With respect to taxation, the Constitution requires that a federal direct tax must be apportioned among the states;\textsuperscript{28} duties, imports and excises have to be uniform throughout the states;\textsuperscript{27} and assessment of duties on imports or exports is an exclusive delegated power of the United States.\textsuperscript{28}

Hamilton believed that the federal government ought to have an indefinite power of taxation.\textsuperscript{29} He was not unaware of the contrary feelings of those who contended that an indefinite power of taxation in the federal government would eventually deprive state and local government of their power to raise revenues.\textsuperscript{30} This argument was deduced by noting that the federal government was the supreme law of the land; and since it has the power to pass all laws “necessary” for its operation, the federal government could abolish state taxing laws under the guise of interference with its own revenue raising taxes.\textsuperscript{31} In reply to this, Hamilton relates that the “supposition of usurpation in the national government” is an argument against power in the federal government caused by imagination rather than reason.\textsuperscript{32} The usurpation of national government argument should be referred to the composition and structure of the government rather than the nature or extent of its powers.\textsuperscript{33} Since the state governments by their original constitutions are sovereigns, the only security the people have against them is their manner of formation and the propriety of those who administer the state government.\textsuperscript{34} This same type of

\begin{footnotes}
\footnote{26. U.S. Const. art. I § 2 clause 3: “Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. . . .”}
\footnote{27. U.S. Const. art. I § 8 clause 1: “The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.”}
\footnote{28. U.S. Const. art. I § 10 clause 2: “No state shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its Inspection Laws. . . .”}
\footnote{29. See The Federalist Nos. 30 and 31 (A. Hamilton).}
\footnote{30. The Federalist No. 31, at 196-197 (J. Cooke ed. 1961) (A. Hamilton).}
\footnote{31. Id. at 197.}
\footnote{32. Id. at 197.}
\footnote{33. Id. at 197.}
\footnote{34. See id. at 197-98.}
\end{footnotes}
security applies to the federal government and should be used to dispel fears of usurpation.\textsuperscript{35} In other words, the federal government has powers similar to the sovereign powers of a state; and the probability of abuse of these powers should not be accorded special attention in the case of the federal government. Further, there exists just as great a possibility that the states will encroach on the federal government's power, since the states are structurally closer to the people, who ultimately have the power.\textsuperscript{36} Thus, as Hamilton said, it is best to remove vague conjectures about federal usurpation and concentrate on the federal powers as delineated in the Constitution, since:

\[\text{everything beyond this, must be left to the prudence and firmness of the people; who as they will hold the scales in their own hands, it is hoped, will always take care to preserve the constitutional equilibrium between the General and the State Governments.}\]

From the preceding analysis, the power of taxation as promulgated by Hamilton should be indefinite in the federal government. Hamilton also conceded that the states should retain an independent and unrestrained power over taxation within their jurisdictions.\textsuperscript{38}

To sum up the views of Hamilton on taxation, two concepts are of importance in the analysis of intergovernmental immunity. First, the ultimate control over state-federal relationships and the usurpation of power by either rests with the people; second, the federal and state powers exercise concurrent or equal unlimited jurisdiction over the objects of taxation except duties on imports and exports which have been exclusively delegated to the federal government. As mentioned, the Constitution does not expressly prevent federal taxation of state objects or state taxation of federal objects (intergovernmental immunity), but case law has developed this concept that qualifies or forbids

\textsuperscript{35} Id. at 198.

\textsuperscript{36} Id. at 198; See also Slaughter House Cases, 83 U.S. (16 Wall.) 36 at 82 (1872). This case interpreted the fourteenth amendment and made the observation that at the time the Constitution was framed there was a general fear of the United States Government interfering with the states. As history turns out, it appears the powers of the state governments may thwart the operation of the national government. The Court, however, took an historical and critical analysis of our federalism and the fourteenth amendment and held that the latter did not change the general system.

\textsuperscript{37} The Federalist No. 31, supra note 30, at 198.

\textsuperscript{38} See The Federalist No. 32, at 199 (J. Cooke ed. 1961) (A. Hamilton); The Federalist No. 33 at 208 (J. Cooke ed. 1961) (A. Hamilton) where this dual power of taxation except for duties on imports and exports is referred to as Concurrent Jurisdiction. In Federalist No. 34 (A. Hamilton) it is shown that this concurrent jurisdiction was the only workable alternative to an entire subordination of the state taxing power to the federal government taxing power.
various forms of intergovernmental taxation. The elements and degrees of the doctrine will become evident as the case law is analyzed; but, at the outset, it can be observed that concurrent jurisdiction over the taxing power creates the factual problem, since both governments (federal and state) have, under their indefinite or unlimited power of taxation, the initial power to tax each other. However, the balancing of the power of taxation is not being controlled solely by the people, as Hamilton suggested, but also by the Court through the use of the implied doctrine of intergovernmental immunity. *McCulloch v. Maryland*\(^{39}\) formulated the doctrine when confronted with a Maryland tax imposed on notes issued by a bank or branch of a bank which was not created by authority of the state.\(^{40}\) Since the United States National Bank was not created or authorized by the state, its notes were taxed by the state. In striking down the tax, the Court took note of the independent sovereignty of each government, yet held that the tax was an unconstitutional interference with a means used by the federal government.\(^{41}\) A point constantly reiterated\(^{42}\) by Justice Marshall in *McCulloch* was that the states are part of the United States; when the United States taxes the state, it is acting under authority granted it via the people through their representatives from that state. However, when the state taxes the United States, only the people of that state have conferred the authority to tax, yet the tax affects the people of all the states. This distinction hints at a different standard applicable to state taxation of the federal government and concurs with Hamilton’s view that the people themselves will control the balance of power in a republic. Since there is an absence of representation when the state taxes the federal government, the tax becomes a dangerous weapon in the hands of a few which can affect many.

Despite this supremacy argument, the Court, in discussing conflict of sovereignties, emphasized the repugnance of a tax on the means employed by the Union in carrying out its constitutional powers.\(^{43}\) This reasoning provided a vehicle for the doctrine of reciprocal intergovernmental immunity. Perhaps if the cases which followed *McCulloch* would have used the supremacy argument rather than the interference argument, a one-sided immunity would have developed in favor of the federal government. The significant cases following *McCulloch* even had similar

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40. *Id.* at 320-21.
41. *Id.* at 429-30 and 436-37; see also *Osborn v. Bank of United States*, 22 U.S. (9 Wheat.) 738 (1824) particularly at 865-68 where *McCulloch* is reaffirmed.
fact patterns in that they involved a state tax on the federal government. *Weston v. Charleston*\(^{44}\) held that a tax on government stock which was issued for loans made to the federal government was void because:

> [t]he tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently, to be repugnant to the Constitution.\(^{48}\)

A nondiscriminatory state tax on offices, trades, professions and occupations similarly was invalid when applied to an officer of the United States.\(^{46}\) As part of their holding, the Court interpreted *McCulloch* and *Weston* as relating that state governments cannot lay a tax upon a constitutional means used by the federal government to carry out its constitutional powers.\(^{47}\)

If the doctrine enunciated in *McCulloch* was truly reciprocal, then one would expect the Court to hold that a federal tax on state bank issued notes would also be void. When the Court was confronted with this situation (a reverse *McCulloch* fact situation—federal tax on state bank notes), it took another approach by noting that the bank was not an agency of the state,\(^{48}\) and that the bank was simply a corporation franchised by the state and thus not an instrument of the state in the performance of a power reserved to the state.\(^{49}\) The decision rendered—if a defeat to reciprocal intergovernmental immunity on a fact basis—was certainly no defeat to reciprocal intergovernmental immunity on a conceptual basis. The Court merely decided that the power to regulate a state national bank was not reserved to the state; it found no fault with the general proposition that the reserved rights of the state cannot be subject to congressional taxation.\(^{50}\) Just exactly what constitutes the reserved powers of the state is confusing, but the Court, in *Collector v. Day*,\(^{51}\) shed some light in its holding that the salary of a state judge cannot be subject to a federal income tax, since the judiciary constitutes

\(^{44}\) 27 U.S. (2 Pet.) 449 (1829).

\(^{45}\) *Id.* at 469.

\(^{46}\) Dobbins v. The Commissioners of Erie County, 41 U.S. (16 Pet.) 435 (1842).

\(^{47}\) *Id.* at 449; *See also* Thomson v. Pacific R.R., 176 U.S. (9 Wall.) 579 (1899), which did not dispute the proposition that a state cannot tax the means employed by the federal government in exercising a constitutional power, but held that a railroad company organized under state law and merely doing business with the federal government was not a means exempt from state taxation.

\(^{48}\) Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533, 535 (1869).

\(^{49}\) *Id.* at 547-48.

\(^{50}\) *Id.* at 547-48.

an essential governmental function, entitled to tax-exempt status resting on a necessary implication of self-preservation.52

At no point did the doctrine of intergovernmental immunity become more reciprocal or stronger than when announced in Collector v. Day. The Court rejected the federal government's contention that the doctrine enunciated in McCulloch was based on the supremacy of the United States government and, instead, considered the state and federal governments on an equal basis for purposes of applying the McCulloch doctrine.53 With this dual restriction on both federal and state taxation clearly stated, the doctrine of intergovernmental immunity became established as an element of state-federal relations and a vehicle for state-federal litigation.54

After Collector v. Day the Court applied the immunity to the interest received from a railroad company on a mortgage executed by the railroad company in favor of the city of Baltimore.55 This complicated transaction involved the city of Baltimore issuing five million dollars worth of bonds to aid in the construction of a railroad.56 The railroad received the proceeds from the issue and executed a mortgage on its road franchises and revenues.57 A congressional statute imposed the tax on the interest payable; but the Court still found it to be a tax on the holder-creditor (the City of Baltimore), since the law allowed the railroad to withhold from the creditor the amount paid to the government.58 The Court had no difficulty in extending intergovernmental immunity to a municipal corporation, since it was merely a part of a state and entitled to the same privilege providing the revenue was municipal in character (within the range of municipal powers).59 In determining the transaction to be within the scope of municipal duties, the Court contrasted a transaction of this nature where the city would receive a commercial benefit to a situation where a municipal corpora-

52. Id. at 127.
53. Id. at 126.
54. For a federal-state economic relations discussion see K. Gemmill, Federal-State Local Tax Correlation (1953); and for a legal analysis having exhaustive text and footnote coverage of Supreme Court cases, see Comment, supra note 11.
56. Id. at 329.
57. Id. at 329.
58. Id. at 327. The Court example was that if the interest were 7% and there were no tax, it would pay the full 7% to the creditor. If, however, there were a 5% tax, it would pay 2% to the creditor and 5% to the government.
59. Id. at 328-29 (for extension to a municipal corporation), 332 (requirement for municipal revenue), 333 (present transaction within municipal duties).
tion was merely acting as an agent or trustee of an individual. Thus, *United States v. Railroad Company*, 60 not only affirms reciprocal immunity in principle but also logically extends immunity to subdivisions of states.

What about intergovernmental immunity among the states? Can one state tax the public debt of another state, when the chose in action representing the debt of another state is owned by a resident of the taxing state? In *Bonaparte v. Tax Court*, 61 the Court answered these questions in this manner:

It is true, if a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced rates; inasmuch as it cannot secure such exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals. While the Constitution of the United States might have been so framed as to afford relief against such a disability, it has not been, and the States are left free to extend there comity which is sought, or not, as they please. 62

In not extending the intergovernmental immunity to state-state relations, this case has probably avoided many problems among taxation experts, bond market analysts and constitutional lawyers. In addition, this 1881 observation that the Constitution provides no guarantee of lower interest rates to states certainly has applicability to a 1972 discussion of tax-exempt state and local bonds.

To return more specifically to tax-exempt interest from state and local bonds and their relation to state-federal intergovernmental immunity, it is hard to determine whether the *Pollock v. Farmers' Loan & Trust Co.*, 63 case is a luxury as a precise case in point or an outdated holding. Decided in 1895, the *Pollock* case specifically held that the United States Government could not tax the income from state and local bonds. 64

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60. Supra note 55.


62. Id. at 595.

63. 157 U.S. 429 (1895).

64. Eight years prior to the *Pollock* decision, in *Mercantile Bank v. New York*, 121 U.S. 138 (1886) the Court said at 162: "Bonds issued by the State of New York or under its authority by its public municipal bodies, are means for carrying on the work of the government, and are not taxable even by the United States, and it is not a part of the policy of the government which issues them to subject them to taxation for its own purposes." *Pollock*, supra note 63, quoted this at 585. To a degree, this is dicta since the facts contained in the *Mercantile* case involved the nondiscriminatory taxation of a United States bank which Congress had consented to be taxed, but required the tax to be no greater than is assessed on other moneyed capital in the hands of individuals. The statute in question imposing the tax, exempted state and local bonds among other things as money capital. The exemption in dollar amount was almost immaterial, but the Court did say that they would constitute money capital. However, their exemption was proper under the previously quoted immunity.
The Court found the immunity quite reciprocal and relied on the cases previously mentioned. If Pollock is to be criticized, it must be done on some other grounds than not following precedent. Once immunity became reciprocal, as in Collector v. Day, no problem in terms of precedent exists with extending the doctrine of intergovernmental immunity to the interest on state and local bonds received by the holder of the bonds. For one thing, Weston v. Charleston, as previously mentioned, determined that a tax upon U.S. securities was unconstitutional since it would "operate upon the power to borrow before it is exercised, and have a sensible influence on the contract," thus amounting to a tax on the contract and a tax on the power to borrow money. In view of the reciprocal immunity firmly announced in Collector v. Day and United States v. Railroad Company plus the previous determination that a tax on government securities was a tax on the borrowing power, precedent-wise, Pollock's job was easy.

Pollock, in addition to its holding on the income from state or local bonds, determined that the first federal income tax was invalid with respect to rent income derived from real estate; and that for the purposes of the Constitution which requires direct taxes to be apportioned, an income tax, although called indirect, is essentially direct and must conform with the apportionment rule. On the other hand, Weston determined that a tax on all personal property (in which the statute specifically includes six and seven percent stock of the United States) was invalid with respect to the United States stock. It can be argued that the determination in Pollock that an income tax was direct for purposes of the direct tax-apportionment requirement infiltrated Pollock's reasoning in exempting state and local bonds. If a tax is direct, such as a real estate tax, then the tax is on the real estate itself. If Pollock determined that rents from real estate constituted a direct tax on the real estate and thus a tax on the source, then the taxation of interest income from state and local bonds is likewise a tax on the source which ultimately is the state and local bond. To complicate the direct versus indirect definition of an income tax further, the sixteenth amendment granted Congress the power to tax incomes from whatever source derived without apportionment. This not only rendered Pollock's

66. See Pollock, supra note 63, at 583; aff'd on rehearing 158 U.S. 601 (1895).
68. U.S. Const. amend. XVI: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."
reasoning obsolete with respect to the direct nature of an income tax for the apportionment requirement, but it also raised questions as to how much additional taxing power was granted to Congress by virtue of the sixteenth amendment.

In summing up, first, Pollock factually is a case in point and has never expressly been overruled. Second, Pollock was soundly decided based on prior precedent, which consists of the initial principle of McCulloch that a means employed by the United States in carrying out a constitutional power cannot be taxed by the state, and likewise under the principle announced in Collector v. Day and the United States v. Railroad Company, the federal government cannot tax the means employed by a state government in carrying out its reserved powers. Third, the fact that Pollock also decided that an income tax as applied to rents and income from real estate was direct for purposes of apportionment may have influenced an interpretation of intergovernmental immunity with respect to the interest on state and local bonds. Fourth, since Pollock was decided prior to the sixteenth amendment and interest from bonds is income, the effect of the sixteenth amendment must be considered.  

Although nearly every work on tax-exempt bonds includes a discussion of intergovernmental immunity, it seems that the importance of a precise case in point is overlooked. This is not a criticism but a question of vogue or style. Since the law has changed quite drastically in so many areas of federal-state relations, an atmosphere of disrespect is created for an 1895 case. In this analysis, however, Pollock will be considered the law unless subsequent case law can indicate a more appropriate constitutional rationale; to determine this, a review of subsequent significant decisions on intergovernmental immunity follows.

With respect to the nature of the income tax problem (direct or indirect), Flint v. Stone, prior to the passage of the sixteenth amendment which allowed Congress to tax gross income, held a federal tax on various private business organizations for the privilege of doing business could use net income (including tax-exempt income from state or local bonds) as a basis for measuring the privilege. A fine distinction can

70. See e.g., Lent, supra note 1; Martori and Bliss, supra note 24, but see McCollom, supra note 24; Comment, supra note 11; Comment, supra note 10.
71. For a dramatic and well-researched discussion of Supreme Court dilution of state government powers, see Burns, The Death of E. Pluribus Unum, 19 DePaul Law Rev. 651 (1970).
72. 220 U.S. 107 (1911).
73. Id. at 165. For privilege taxes based on other measuring devices which
be made between a pure income tax which directly taxes income from all sources derived and a privilege tax which uses net income as a device to measure the amount of business done within that state. To this extent, Flint lacks relevance to our present income tax structure in relation to tax-exempt bonds; but what Flint does is remove any absolutist approach to interest income from state and local bonds. It distinguishes Pollock as being a direct tax on the property solely because of ownership and the tax in question as essentially an excise or privilege tax.

More specifically, tax-exempt bond interest income could be included in the computation of net income for the basis of a privilege tax. Whether Flint was proper in distinguishing Pollock so casually as being a direct tax with respect to the exempt bond issue is questionable in view of the fact that Pollock made no express statement to that effect and also treated the exempt bond issue separately in the opinion. In any event, the thrust of Flint did not depend on a direct-indirect view of an income tax but only on the use of net income as a measuring device for a common privilege tax.

After the sixteenth amendment was passed, naturally there was litigation surrounding what powers the amendment did confer on Congress. In Eisner v. Macomber the Court was presented with the problem of whether a stock dividend can be taxed as income by virtue of the sixteenth amendment. In response the Court said: "As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income." When the Court was faced with the reverse facts of Collector v. Day (that being state taxation of the salary of a federal judge), the Court dismissed any contention that the sixteenth amendment conflicted with their holding that under article III, section 1, establishing the independence of the judiciary, the salaries of federal judges could not be taxed. This Court reiterated the view of included tax-exempt funds or capital, see Home Ins. Co. v. New York, 134 U.S. 594 (1890); Society for Savings v. Coite, 73 U.S. (6 Wall.) 594 (1867).

74. Flint v. Stone Tracy Co., supra note 72, at 162.
75. See Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 583-86 (1895) and compare this to the casual treatment in Flint v. Stone Tracy Co., supra note 72, at 162.
76. 252 U.S. 189 (1920).
77. Id. at 206; see also Peck & Co. v. Lowe, 247 U.S. 165 (1918); Stanton v. Baltic Mining Co., 240 U.S. 103 (1916); Brushaber v. Union Pacific R.R., 240 U.S. 1 (1916).
Eisner that the sixteenth amendment's purpose only eliminated the need for apportionment among the states as previously required under Pollock's interpretation of an income tax as being direct. 79 In view of the sixteenth amendment and its interpretation, Pollock's interpretation as to the direct versus indirect nature of an income tax has become irrelevant, but the amendment did not go beyond this. It merely removed the obstacle created by Pollock which was that for purposes of interpreting the constitutional requirement that direct taxes must be apportioned, an income tax is a direct tax.

Although cases dealing with intergovernmental immunity have haphazardly asserted the proposition that a tax on income is a tax on its source, 80 more recent cases have dispelled this theory. 81 In 1937, an interesting argument was made before the Supreme Court on the theory that an income tax is a tax on its source. Appellant, a resident of New York, brought action for refund of taxes paid on income which was produced from rents on New Jersey real estate and interest earned on bonds physically within New Jersey and secured by New Jersey real estate. 82 The argument was basically that tax on income was in effect a tax on the source, real estate outside the state, and therefore violated the fourteenth amendment. 83 In analyzing the argument the Court took notice of how one government possessed the right to tax property within its borders, and at the same time another government had the right to tax the receipt and enjoyment of income from that property. In other words, the protection offered to one state by virtue of the property being in that state does not deprive a second state from taxing the receipt or enjoyment of the income from that property. 84 The Court interpreted Pollock only to hold that for purposes of determining whether an income tax is direct under article I, section 2, clause 3 which requires apportionment of direct taxes, an income tax on rents or income earned from property is more direct and was direct in terms of what the Framers

79. See id. at 260-64.
83. Id. at 311.
84. Id. at 314.
desired this clause to protect. Again, the Court was confronted with whether interest from bonds could be taxed by a general state income tax when such state bonds were issued pursuant to state statutes providing unequivocally that they should not be subject to property taxation. The Court found an income tax to be in the nature of a privilege or excise tax and not within the scope of the exemption, since the statute only included taxes on property. The Court quite clearly stated that Pollock’s holding can only be read in the context of the constitutional clause which it was interpreting and that its holding in no way requires an interpretation of income taxes to be generally or necessarily a direct tax on property.

Thus if Pollock had decided that state and local bonds could not be subject to the income tax because the income tax was a direct tax on the source, then it follows its holding could not stand in view of the present legal holdings that an income tax is not a direct tax on its source. However, a careful reading of Pollock states otherwise. The separate opinion on the taxation of income from state or local bonds says nothing about direct taxes, and in order to make this point clear, the following extensive quote from Pollock is in order:

The law under consideration provides “that nothing herein contained shall apply to State, counties or municipalities.” It is contended that although the property or revenues of the States or their instrumentalities cannot be taxed, nevertheless the income derived from state, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason, and that reason is given by Chief Justice Marshall in Weston v. Charleston 2 Pet. 449, 468, where he said: “The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence, depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operation of government. It may be carried to an extent which shall arrest them entirely . . . . The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution.” Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution.

85. Id. at 315.
87. See id. at 106-08.
88. Id. at 107.
89. Pollock v. Farmers' Loan and Trust Co., supra note 75, at 585-86. Rehear-
This language represents the critical reasoning behind Pollock's decision; and other than the brief quote from Weston to the effect that this is a "tax on the contract," there is no reference to directness as the basis of the decision. It should be remembered that Weston did involve a property tax; therefore, the language "tax on contract" is appropriate for the facts in Weston. The Pollock Court emphasizes the tax as having an influence on the power to borrow money before it is exercised. Thus, the Court does not conclude unconstitutionality on the basis of a technical direct tax (tax on income = a tax on the source); rather it decided the case on an impact analysis (the result of the tax is to burden the state's borrowing power).

The conclusions which follow from the preceding analysis are that: (1) The sixteenth amendment has not given Congress any additional powers over the subjects of taxation; and (2) the interpretation that an income tax was direct for purposes of the apportionment clause did not infiltrate the Court's reasoning in holding interest income from municipal bonds exempt from taxation. Subsequent cases which use the direct nature of an income tax to bolster an infringement of intergovernmental immunity have not done Pollock justice. Fortunately, these cases do not represent the criteria or standards for judging a violation of intergovernmental immunity. Thus, the question turns to whether Pollock can survive the trend in intergovernmental immunity. It is to this question that the following analysis addresses itself.

If a state instrumentality or means of carrying out a governmental function is tax-exempt under the doctrine of intergovernmental immunity, what would happen if a state using the "laboratory" approach—meaning that federalism as originally formed in the Constitution allowed a state wide discretion in establishing institutions and procedures for the betterment of its citizens—decides via the citizens of the state

90. See cases cited in note 80 and compare with Pollock v. Farmers' Loan and Trust Co., supra note 75, at 583-86.

91. New State Ice Co. v. Liebmann, 285 U.S. 262, 311. Justice Brandeis wrote: "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country."
to take outright control of all the business in that state? Would intergovernmental immunity protect the businesses within that state from federal taxation? Even a novice in the study of intergovernmental immunity could guess that there is no precise case in point. However, this analogy was made in South Carolina v. United States[^92] where the Court held that a federal special tax on a liquor business was not invalid against South Carolina when that state conducted the liquor business. The exemption for state agencies is limited to those involved in an operation of a governmental character and not to situations where the state is carrying on a private business.[^93] From this case, it is apparent that some type of a state governmental function must be present in order to shield the proceeds from the function from taxation under intergovernmental immunity.

After South Carolina v. United States outlawed tax exemption where a state operates a liquor business, the Court stated that a limitation, while at times appearing concrete, is generally difficult to articulate in a particular fact situation.[^94] Until Helvering v. Gerhardt,[^95] no particular standard other than the need for a governmental function was enunciated by the Court for granting immunity. In some instances the Court simply stated that an income tax is a tax on its source, and if the particular source happens to be a federal or state bond, there can be no taxation.[^96] Other times the Court found a taxing scheme merely to be a device to tax indirectly what it could not tax directly.[^97] Prior to Helvering v.

[^92]: South Carolina v. United States, 199 U.S. 437 (1905). The particular analogy to state controlled business is discussed *id.* at 454-55.

[^93]: *Id.* at 461. *Id.* at 461-63, the Court analogized to negligence wherein the municipality has sovereign immunity when performing public functions, but a municipality may also just be a private corporation when acting for private persons.

[^94]: South Carolina v. United States, supra note 92; *aff'd* by Ohio v. Helvering, 292 U.S. 360 (1934). On the same philosophy, the state management of a street railway business was not immune: Helvering v. Powers, 293 U.S. 214 (1934).

[^95]: 304 U.S. 405 (1938).

[^96]: *See* Northwestern Mut. Life Ins. Co. v. Wisc., 275 U.S. 136 (1927); National Life Ins. Co. v. United States, 277 U.S. 508 (1928). In Willcuts v. Bunn, 282 U.S. 216 (1931), the Court held a gain from the sale of a tax-exempt bond could be the subject of an income tax. Instrumental in this holding was the theory that an income tax on interest amounted to a direct tax on ownership, while an income tax on the gain resulting from the sale was merely an excise tax on the sale.

[^97]: *See* Miller v. Milwaukee, 272 U.S. 713 (1927). In Missouri *ex rel.* Missouri Ins. Co. v. Gehner, 281 U.S. 313 (1930), the Court did not expressly find a scheme to directly tax exempt bonds, but held for purposes of a state tax imposed on the net asset value of insurance companies, the ownership of United States Bonds cannot be used as a basis for denying a reserve deduction. The Court found no discrimination with respect to an Internal Revenue Code provision
Gerhardt, the Court occasionally would not even consider the degree of burden the tax put upon the government but simply voided the tax as an interference. Following the strict interpretation of intergovernmental immunity, salaries of officers of various state and federal government agencies were receiving tax-exempt status. A familiar fact pattern involved a gross revenue or income tax imposed on the lessee of state or federally owned property on income derived from the lease. After an initial grant of immunity to the lessee, the Court reversed this position and held the tax on the lessee valid, since its effect on the government is only indirect and remote. Consistent with this remote theory, the Court held that proceeds from a construction contract with the United States and copyright and patent royalties were subject to state gross receipts taxes.

which disallowed a deduction for interest on loans used to purchase tax-exempt bonds. Notice, that without this provision, the holder would acquire a double tax advantage—the exclusion of interest from the bond and the deduction of the interest on the loan to purchase the bond—Denman v. Slayton, 282 U.S. 514 (1931).

98. Panhandle Oil Company v. State of Mississippi ex rel. Knox, 277 U.S. 218 (1928); Indian Motocycle Co. v. United States, 283 U.S. 570 (1931). In Trinity-farm Construction Co. v. Grosjean, 291 U.S. 466 (1934), the Court contended that once the doctrine of intergovernmental immunity applied, it was an absolute. However, in the facts of that particular case, the Court held that a contractor who consumed gasoline in the performance of his contract with the United States was not an instrumentality of the United States and therefore not immune to an excise tax based on sales of gasoline. Graves v. Texas Co., 298 U.S. 393 (1936) followed Panhandle in holding an excise tax based on sales of gasoline void when the sales were made to the United States Government.

99. See New York ex rel. Rogers v. Graves, 299 U.S. 401 (1937) (General Counsel for the Panama Railroad Company which had been acquired by Congress to operate a railroad across the isthmus of Panama); Brush v. Commissioner, 300 U.S. 352 (1937) (The Court found the Bureau of Water Supply of the City of New York to be an essential governmental function and therefore the salaries of its officers were exempt from the federal income tax); but see Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) (One offering mere professional services performed for a state was not considered an officer or employee of that state); Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938) (An attorney appointed by virtue of a state statute for liquidation of a corporation was not an officer of that state nor was this function of an essential nature.).


101. Helvering v. Mountain Producers Corp., supra note 100, which expressly overruled: Gillespie v. Oklahoma, supra note 100; Burnet v. Coronado Oil and Gas, supra note 100; and Burnet v. Jergins Trust, supra note 100.


103. Fox Film Corp. v. Doyal, 286 U.S. 123 (1932).
Helvering v. Gerhardt involved the resistance to the federal income tax by a construction engineer and two assistant general managers of the Port of New York Authority which is a bi-state corporation. In holding their salaries were not immune from taxation, the Court laid down specific tests for the operation of intergovernmental immunity. The Gerhardt Court made specific reference to the McCulloch v. Maryland distinction between when the federal government taxes the state and when the state taxes the federal government. Thus, a state has a built-in protection via their representatives in Congress as to the degree of taxation on the states. In view of this political limitation the judicial limitation will only be imposed when the state function involved is essential to the maintenance of a state government, and the burden imposed by the tax is substantial or severe. Shortly after this case, Graves v. New York ex rel. O'Keefe applied the same standard to the federal government when the salary of an examining attorney for The Home Owners' Loan Corporation (a congressionally created corporation) was asserted as being exempt from a state income tax. The Court held the salary taxable under the Gerhardt principles and further hinted that if Congress desires a different standard with respect to salaries of a congressional instrumentality, Congress should expressly declare this.

Graves expressly overruled Collector v. Day and New York ex rel. Rogers v. Graves "so far as they recognized an implied constitutional immunity from income taxation of the salaries of officers or employees of the national or a state government or their instrumentalities." Two years later the Court upheld a sales tax on purchases made by a contractor while performing a contract with the United States. The mere fact that the economic burden was shifted did not make it a tax upon

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104. For an interesting argument that the Port of New York Authority should not be considered the type of government agency which can issue tax-exempt bonds, see Commissioner v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944) cert. denied, 323 U.S. 792 (1945).

105. Helvering v. Gerhardt, supra note 95, at 417-20. For cases decided after Gerhardt upholding a tax for a lack of showing an essential government function: see Allen v. Regents of the University of Georgia, 304 U.S. 439 (1938) (state operated football stadium) and New York v. United States, 326 U.S. 572 (1946) (state extraction and sale of mineral waters).


108. Id. at 485-87.


110. Supra note 107, at 486.

the United States. With this approach the legal incidence of a sales tax and not simply the economic incidence must be upon the government before immunity is applied. In short, the government must be liable for the sales tax as the purchaser. Relatively recent cases have shown no problem with state taxation for the use of tax-exempt property (e.g. federally owned land), but the general rule that lands owned by the United States are immune from state property taxes is intact.

Of particular subject matter interest is United States v. Atlas Life Insurance Co., a 1965 case, which held that the owner of tax-exempt bonds is not constitutionally entitled to pay less tax than those who do not hold such securities. Note, however, this case has nothing to do with the power to tax exempt interest from state and local bonds, but only deals with the allocation of tax-exempt interest to the non-taxable policyholder's reserve instead of a full deduction for all tax-exempt interest.

Oddly but appropriately enough, the most recent case dealing with intergovernmental immunity concerns an old-time McCulloch v. Maryland-type fact situation (state taxation of national banks). Despite the dissent's urging for a reevaluation of the doctrine of intergovernmental immunity, a doctrine which the dissent indicates rests more on the Supreme Court's notions of federalism than on any particular constitutional provision, the Court's majority found a solid legislative history for congressional control of state taxation of national banks. Thus, the majority did not reach the constitutional question and stated accordingly that any change in state taxation of national banks must come from Congress.

Can Pollock stand the turbulent test of time? First, the major argument against immunities for interest income from state and local bonds is that this exemption provides an advantage to private individuals. As the previous review of recent cases reveal, there is a strong trend against shielding private individuals by way of tax immunity. Second,

112. Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110 (1954) recognized this principle, but found in the contract at issue that the contractors were made purchasing agents of the United States. Thus, the United States Government was the purchaser.


115. 381 U.S. 233 (1965). In this case, Atlas Insurance Company argued that they were entitled to a full deduction for all their tax-exempt interest in spite of the fact that only a portion of their gross income was subject to the income tax.

no express constitutional provision provides for any tax immunity, let alone the immunity of interest income on state and local bonds.

On the other hand, if the modern standards of Gerhardt are applied, the borrowing power of a state is essential to the maintenance of a state; and the increase in interest costs is a substantial burden on the state. Further, the power to borrow can be equated with the power to tax as one of the most essential elements of sovereignty; thus the power to borrow can be distinguished from the taxable routine operations of government, such as the payment of salaries to state officials and contractors purchasing materials to perform contracts with the federal government. This position stemming from the application of the modern Gerhardt standards to the same fact pattern as in Pollock sounds remarkably close to the same rationale used in Pollock's holding. Therefore, if Pollock is overruled it will not be for lack of precedent prior to its decision nor for failure to meet the modern standards, but simply because it is old.

**INTERGOVERNMENTAL OBLIGATION**

A legal approach to the constitutional doctrine of intergovernmental immunity will often lead one astray from the basic function of state and local bonds. In a functional sense, state and local bonds represent debts owed by the state and local governments. State and local governments enter debt arrangements to raise funds for projects, facilities and expenses incurred on behalf of their citizens. As with any organization, funds borrowed represent a supplement to basic revenues which in the case of government would be revenues from state and local taxes. Thus, the power to borrow is closely related to the power to finance needed social projects and services for the state or local government's citizenry.

Certainly, state and local governments have enough needs and expenditures to require financing. The environment, public health, safety, and welfare and demands for public transportation services name only a few of the many expenditures which face state and local governments. To meet these ends, state and local governments have used their tax revenue, proceeds from tax-exempt bonds and funds received from federal grants; however, this has not been enough. It can be

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117. For a defense of the tax-exempt status based on increased costs and other problems posed by the complexities of the market place and the intricacies of intergovernmental finance, see Healy, *The Assault on Tax-Exempt Bonds*, 36 Tax Policy 2 (July-August 1969).


119. *Id.* at 36: "In sum, neither the income tax nor additional borrowing
alleged that a fiscal imbalance exists in American Federalism, since the national government has control over the most productive revenue-producing tax (the federal income tax) while the state is confronted with public service needs most in need of financial support.\(^{120}\) To alleviate this strain, several proposals have been made involving federal aid to states. In a financial sense, these proposals can be categorized as: (1) bloc or consolidated grants, (2) reduction in national taxes, (3) increases in national expenditures, (4) tax credits, and (5) federal revenue sharing.\(^{121}\) A common denominator of these programs is that they involve a total budget approach to the problem of channeling more funds to state and local governments. Although this is a commendable approach, federal-state fiscal aid and cooperation must also develop on a program-by-program basis and also on more mundane levels.\(^{122}\) At this level, state and local bonds, consistent with the spirit of revenue sharing, grants-in-aid, and other proposals, have assumed a new role in the area of intergovernmental financial relations.

During 1970, three congressional acts involving federal loan programs used state and local bond financing in an imaginative fashion.\(^{123}\) These loan programs provide in essence that the federal government can make a loan to the state or local government. The state issues a bond to evidence this debt, and the interest rate which they pay on the bond or debt to the federal government is the tax-exempt rate. When the federal government sells the bond to a private investor, the acts provide offers any real hope of solving the financial crisis of local government which faces the future with huge demands on its purse and no immediately obvious way of increasing revenues." See also W. Heller, Revenue Sharing and the City 10-14 (1968).

120. R. Wagner, The Fiscal Organization of American Federalism 21-22 (1971); Benson, Revenue Sharing: An Analysis of Alternative Statutory Approaches, 8 Harv. J. Legis. 221 (1971). These authors do not necessarily vouch for the soundness of this position, but merely describe the alleged fiscal imbalance. For a direct support of the fiscal imbalance argument, see Brazer, Federal Government and State—Local Finances, 20 Nat'l Tax J. 155 (1967); but see Musgrave and Polinsky, Revenue Sharing: A Critical View, 8 Harv. J. Legis. 197 (1971) concluding in part that the real problem is both a scarcity of federal funds as well as state funds.

121. R. Wagner, supra note 120, at 24.

122. Compare general description of types of programs in text at note 121 with Turner, Federal-State Cooperation in Tax Administration, 9 Wm. & Mary L. Rev. 958 (1968).

for no tax-exempt privilege.\textsuperscript{124} It is as if the federal government issued a new bond which was not tax-exempt. As a result, the private investor will demand and receive a higher interest rate; and the difference between the two interest rates (rate received by investor—rate paid by local government) is paid by the federal government. In short, the federal government subsidizes the difference between the taxable interest rate and the tax-exempt interest rate.

These loan programs are in response to a four prong situation: (1) State and local governments have tremendous financial needs;\textsuperscript{126} (2) the state and local bond is an important financial device for these governments;\textsuperscript{126} (3) the doctrine of intergovernmental immunity protects the interest from state and local bonds from federal income taxation;\textsuperscript{127} and (4) the loss of revenues to the federal government because the tax-exempt feature on a federal-state fiscal relationship basis makes financing solely by state and local bonds somewhat inefficient.\textsuperscript{128} For example, Congress was faced with the critical needs of both public and private hospitals for hospital and medical care construction and modernization of facilities.\textsuperscript{129} Originally, the Committee on Interstate and Foreign Commerce of the House realized the importance of the state and local bonds as a means of financing these medical needs and considered these needs of such magnitude that the federal government should make guaranteed loans to state and local governments without


\textsuperscript{125} See text and footnotes at notes 118-19.

\textsuperscript{126} See e.g. Lewis, The Case for the Urban Development Bank in Financing State and Local Governments in the 70's, proceedings of a conference sponsored by the Federal Reserve Bank of Boston at Nantucket Island (1970), particularly at 179, Table II (Source: The Bond Buyer, 1970) which indicates in 1968—a 16.4 billion dollar gross long-term issue increase by way of municipal bonds and in 1969, an 11.4 billion dollar long-term issue increase. See also 116 Cong. Rec. S5239 (daily ed. April 7, 1970) which contains Table XI Supply and Demand for State and Local Securities (prepared by Solomon Brothers & Hulzer from their 1969, Annual Review of the Bond Market) which indicates similar figures for gross new long term issues of 16.1 billion dollars for 1968 and 11.5 billion dollars for 1969.

\textsuperscript{127} See text discussion of intergovernmental immunity.

\textsuperscript{128} See D. Ott and A. Meltzer supra note 18.

any taxable feature.\textsuperscript{130} With this approach, a new type of bond would hit the market place—a state or local bond not only with the tax-exempt interest feature provided by intergovernmental immunity but also a bond backed by the credit of the United States. Among other things this type of security could have a sensitive influence on the state and local bond market, since these bonds would be most attractive to investors.\textsuperscript{131} In addition, the Treasury Department opposed this type of financing. For one thing, the bond interest tax exemption is an inefficient form of subsidy, since the federal tax revenue lost by the tax-exempt feature exceeds the interest savings to the borrower.\textsuperscript{132} Faced with this situation, Congress eventually developed the loan program as previously described, wherein the interest income from the federally guaranteed state or local bond becomes taxable when sold to a private investor.

Once again the state and local need for resources to develop new communities\textsuperscript{133} and in local rural areas to develop adequate water and waste facilities\textsuperscript{134} activated the use of the federally guaranteed taxable state and local obligation. Without belaboring the point, the transaction which takes place in one of these congressional loan programs is initially that the federal government makes a loan to the state or local government. They, in turn issue an evidence of indebtedness (a bond) to the federal government which the federal government guarantees; further, the loan programs provide that the interest from the federally guaranteed state or local obligation becomes taxable when subsequently sold by the federal government to an investor. This is not a precedent for taxing state and local securities, since the transaction between the federal government and the private purchaser can be viewed simply as a separate contract whereby the private purchaser agrees to report the interest for federal income tax purposes. Also, technically the interest is actually paid by the federal government after a sale to a private investor and not by the state or local government, even though the state or local government pays to the federal government the interest on the original loan at the original tax-exempt rate.\textsuperscript{135} A more transaction-oriented approach is to say that the federal guarantee has created “a new

\textsuperscript{132} 116 Cong. Rec. S5239 (daily ed. April 7, 1970) (Formal statement by the treasury department pt. (4)).
\textsuperscript{133} See Housing and Urban Development Act of 1970, Pub. L. No. 91-609, Title VII § 710.
\textsuperscript{134} 116 Cong. Rec. 1058 (daily ed. April 7, 1970) (remarks of Representative Byrnes).
type of obligation." By having the federal guarantee on the instrument, the note is in the nature of a federal obligation which is not tax-exempt. Thus, in a compromising sense, the obligation can be described as an intergovernmental obligation, since it is state-oriented in origin and purpose, but federal by way of subsequent sale and guarantee. In any event, a description as an intergovernmental obligation is consistent with the spirit of cooperation in intergovernmental fiscal relations.

Relatively recent bills in Congress have evidenced a development on both a program-by-program basis and, on a larger scale, by means of a national bank designed to guarantee and deal with these federal loans to state and local governments. On a program basis, one bill provides for an Environmental Financing Authority which would purchase any obligation issued by a state or local public body which was issued to finance that government's share of a construction project in which the Secretary of Interior is authorized to provide grants. This bill would function similar to the guaranteed taxable bond approach, since the agency would issue a federal taxable bond of its own at a higher interest rate to finance the purchase of the state and local bonds—the difference in interest rates being subsidized by the Treasury.

House bill 9688 in one section implements the federal guaranteed taxable approach to finance state and local activities consistent with the purposes of housing and urban development, but also proposes an Urban Development Bank which would make long term development loans and provide technical assistance to state and local governments for the construction of essential public works and community facilities. Similarly, Senate bill 580 would establish a National Development Bank which would make or guarantee long term loans at reasonable interest rates to state and local governments for the construction of public works and facilities. An interesting, although not particu-

137. Id. at H 6345.
139. See H.R. 2151, 92d Cong. 1st Sess. § 8 (1971). For a recent bill using a contrary approach, maintaining the tax-exempt status of the state or local agency in spite of being secured by a pledge of a loan by the federal government, see H.R. 9331, 92d Cong., 1st Sess. Title II—Public Housing Assistance Program § 12 (1971).
140. H.R. 9688, 92d Cong., 1st Sess. § 703(a) (1971).
142. S. 580, 92d Cong., 1st Sess. § 2 (1971); see also H.R. 1521, H.R. 3550, S. 1958, 92d Cong., 1st Sess. (1971) which also were proposed to establish national development or domestic development banks.
larly relevant, aspect of this bill is that the Bank could make loans to individuals or corporations to establish or expand a business. With respect to the concept of an intergovernmental obligation, both bills provide that any and all of the bank’s obligations shall be subject to federal, state, and local taxation. 148 With the taxable feature, the bank merely performs on a more general banking scale what the loan programs enacted in 1970 accomplished individually. For example, the bank would make a loan to a state at a tax-exempt rate, indirectly if not directly the loan to the state would be financed by the bank’s own obligations which are taxable; thus, the bank would end up subsidizing the difference between the tax-exempt rate and the taxable rate.

In an economic federal-state fiscal relationship, the National Development Bank appears productive. It will expand the state and local bond market, since the present market only appeals to individuals and institutions (such as commercial banks) in the high tax bracket. 145 For example, a 50% bracket taxpayer finds a 6% municipal bond very lucrative, since this would be the equivalent of a 12% private taxable bond. However, a taxpayer in the 25% bracket would find a 6% municipal the equivalent to a 8% private (8% − .25 (8%) = 6%). In addition to this rather straightforward mathematical test, it must be kept in mind that investors seeking tax advantages from investment in state and local bonds will also consider other tax shelters, such as capital gain, depreciation and depletion allowances. 146 Thus, the state and local bond competes with other tax shelters as well as private bonds. In this context, the state and local bond is not receiving its economic due in the market place, especially when the post-war default record of state and local bonds is second only to the United States Government. 147 These observations may not offer an overwhelming argument for the establishment of a National Development Bank; 148 but at the same time

144. Theoretically, this would have to be true, since if the bank rate were higher than the regular market interest rate for state and local bonds, then the state or local government would simply not borrow from the bank. However, this is somewhat of an oversimplification because some small local governments have little credit reputation and in spite of their tax-exempt feature have trouble borrowing. In addition, the increasing use of what amounts to a taxable state or local bond will have its effect on state and local tax-exempt interest rates.
145. See 116 Cong. Rec. S9661 (daily ed. June 22, 1971) (article by L.R. Gabler, a senior analyst with the Advisory Commission on Intergovernmental Relations summarizing that commissions findings); Lewis, supra note 126, at 165.
146. 116 Cong. Rec. supra note 145.
147. Lewis, supra note 126, at 168.
148. For an article which criticizes a large scale approach such as the Develop-
they offer enough support to commend the initial concept as an imaginative approach to federal-state relations. Particularly commendable is the way a program such as this, like the guaranteed taxable state and local bond (intergovernmental obligation), preserves the sound constitutional concept of intergovernmental immunity and at the same time removes some of the economic inefficiencies created by the use of tax-exempt bonds to finance programs for social needs.

CONCLUSION

The constitutional doctrine of intergovernmental immunity and the use of federally guaranteed state and local debt as an intergovernmental obligation both stem from concepts of federalism. Intergovernmental immunity was implied from principles of self-preservation essential to the existence of dual sovereigns. In using the intergovernmental obligation approach to finance needed social projects, an economic, federal-state or fiscal federalism is being employed.

For imaginative forms of fiscal federalism, such as the intergovernmental loan obligation or the National Development Bank to work, there must be some assurance that intergovernmental immunity developed from a constitutional federalism will continue to shield the interest income from federal taxation. Since Congress has already created loan programs which utilize the federally guaranteed state and local obligation (intergovernmental obligation), it is doubtful that they will wage another campaign against the tax exemption afforded to the bonds. However, as this paper previously pointed out with respect to the intergovernmental immunity issue: Do not underestimate the Supreme Court's assurance of tax-exempt state and local bonds contained in Pollock v. Farmer's Loan and Trust, just because it is of 1895 vintage.

Frank Foster

ament Bank and further develops the financial problems facing both the public and private sector around the lack of savings, see Wallich, Discussion, Financing State and Local Governments, proceedings of a conference sponsored by the Federal Reserve Bank of Boston at Nantucket Island (1970). For sophisticated pro and con economic discussions of the guaranteed state or local bond or a national development bank approach, see Surrey, Federal Income Taxation of State and Local Government Obligations, 36 Tax Policy 3 (1969); Healy, supra note 117; Huefner, Municipal Bonds: The Cost and Benefits of an Alternative, 23 Nat'l Tax J. 407 (1970); Ackerman & Ott, Analysis of the Revenue Effects of Proposed Substitute for Tax Exemption of State and Local Bonds, 23 Nat'l Tax J. 397 (1970). Apparently, the economic arguments against an Urban Development Bank or National Development Bank have been persuasive with Congress, since there has been no legislation passed. For the economic rationale before Congress against these development banks, see Hearings on H.R. 9688 Before the Subcomm. on Housing of the Committee on Banking and Currency House of Representatives, 92d Cong., 1st Sess. 780-838 (1971).