POWER OF CONGRESS TO TAX THE INTEREST FROM STATE AND LOCAL SECURITIES

AND THE

COMPENSATION OF STATE AND LOCAL EMPLOYEES

REPORT

TO THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

BY ITS STAFF

PURSUANT TO

SECTION 1203, REVENUE ACT OF 1926

PRINTED FOR THE
EXAMINATION AND USE OF THE MEMBERS OF THE COMMITTEE

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by a Federal statute and not through a compact entered into between the Federal Government and the States, would be subject to change at the will of Congress.

Secondly, the plan may work unfairly toward the Federal Government itself if it can be presumed that the waiver, once granted, could not be withdrawn. There would be no corresponding waiver by the States, and the Federal Government would be taking the serious chance of relinquishing its own immunity and securing in return only such breadth of taxing power with respect to the State and local governments as the court might see fit to allow.

Moreover, as the taxing powers of the Federal Government and the States rest on an entirely different basis, and as the rates and tax structures of those units are very dissimilar, it is felt that such a plan could never be truly reciprocal or mutual.

Part IV. Whether Congress Has the Power to Tax These Subjects by Other Methods

Among these methods of reaching tax-exempt interest are:

(1) The taxation, by each level of government, of subsequent issues of its own securities;

(2) The adding of the tax-exempt income to the taxable income for the purpose of determining the rate which would be applicable only to the taxable income;

(3) The entering into a series of mutual compacts or agreements between the Federal Government and the individual States by which each level would be permitted to tax the interest from the securities of the other;

(4) The imposition of an excise tax, based on the exercise of a privilege and measured by net income from all sources;

(5) The subjecting of tax-exempt securities to a higher estate tax than would be applicable to other property, on the theory that such securities had escaped the income tax; and

(6) The adoption of a constitutional amendment.

With regard to each of these methods except the last, there are serious technical and legal difficulties that render them incapable of providing a satisfactory solution to the problem.

With respect to the Federal taxation of the salaries of State and local employees, recent decisions of the Supreme Court have substantially broadened the Federal power. In addition, existing law taxes such compensation to the full extent allowed by the Constitution. However, it is the opinion of this office that an amendment to the Constitution provides the only way in which the compensation of all State and local officers and employees may be effectively subjected to the Federal income tax.

These four major questions will now be discussed in greater detail.

PART I. WHETHER THE CONGRESS HAS THE POWER TO APPLY THE FEDERAL INCOME TAX DIRECTLY TO THE INTEREST ON STATE AND LOCAL BONDS

In consideration of this question, an exhaustive study was made by the Department of Justice in June of 1938. The conclusion reached in that study is that "the Congress apparently has the power, under

the present trend of decisions to tax the net income arising from the interest paid on State bonds." With this conclusion, we are unable to agree.

In treating this question, the subject will be divided into two subparts, following, in this respect, the same line of approach as that contained in the Department of Justice study.

Subpart A will deal with the question independently of the Sixteenth amendment, and subpart B will deal with the question as affected by the sixteenth amendment.

SUBPART A. POWER INDEPENDENT OF THE SIXTEENTH AMENDMENT

(1) No Express Prohibition

There is no provision in the Federal Constitution expressly prohibiting the Federal Government from taxing the obligations or the interest therefrom of a State or political subdivision. This prohibition is implied from the independence of the National and State Governments within their respective spheres and from the provisions of the Constitution looking toward the maintenance of our dual system of government; and was developed through judicial interpretation of the Constitution. The doctrine was first applied to limit State interference with Federal functions, and then extended to limit the Federal Government from interfering with State functions.

(2) Development of Implied Immunity Doctrine

(A) WESTON CASE

In the case of *Weston* v. *Charleston*,[1] the Supreme Court held invalid an ordinance of the City Council of Charleston subjecting to taxation "all personal estate, consisting of bonds, notes, insurance stock, 6- and 7-percent stock of the United States, or other obligations upon which interest has been or will be received during the year, over and above the interest which has been paid (funded stock of this State, and stock of the incorporated banks of this State and the United States bank excepted), 25 cents upon every $100."

Weston owned some of the 6-to-7-percent stock of the United States and claimed that so far as such stock was concerned, the ordinance violated the Constitution of the United States. The majority of the highest court in the State of South Carolina thought this tax was an income tax and held that it was not invalid as applied to the United States stock. The Supreme Court of the United States, in an opinion by Chief Justice Marshall, overruled the State court and held the tax invalid. In this connection, the Court said:

> Congress has power "to borrow money on the credit of the United States." The stock it issues is the evidence of a debt created by the exercise of this power. The tax in question is a tax upon the contract subsisting between the Government and the individual. It bears directly upon that contract, while subsisting and in full force. The power operates upon the contract the instant it is framed, and must imply a right to affect that contract.

And the Court went on to state:

> * * * 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 influ-

[1] 2 Peters 449.

ence on the contract. The extent of this influence depends on the will of a distinct government; to any extent, however inconsiderable, it is a burden on the operations of the Government. It may be carried to an extent which shall arrest them entirely.

Chief Justice Marshall did not rest his opinion upon the conclusion that this tax was not an income tax. He states "that the tax was a tax upon the contract subsisting between the Government and the individual." The promise to pay interest is an essential part of the contract with the Government. Therefore, to tax the interest is not any less a tax on the contract than a tax on the stock itself. For these reasons, we are unable to conclude that the opinion of Chief Justice Marshall can be regarded as holding that the tax was not an income tax, but a property tax. In fact, this tax has been referred to by the Court on several occasions as an income tax and not as a property tax. In the *Pollock case*, Mr. Justice Fuller, in writing the majority opinion, held it to be an income tax. In *Hale* v. *State Board of Assessment and Review*,[2] decided November 8, 1937, Mr. Justice Cardozo, in distinguishing between a tax on the bonds and the inclusion of the income from the bonds in a general income tax, said:

Nothing in this opinion is at war with *Weston* v. *Charleston* (2 Pet. 449) or other cases declaring the immunities of governmental agencies. In the case cited and its congeners the problem for decision was whether a tax upon income, even though not a property tax in strictness or for every purpose, was one in such a sense or in such a measure as to hamper the freedom of the Central Government through the interference of the States or the freedom of the States through the interference of the Central Government. The limitations declared in those decisions were gathered by implication from the structure of our Federal system, and were accommodated, as the Court believed, to the public policy at stake.

Even if the *Weston case* can be regarded as preventing the States from levying an income tax on the income from Federal securities, it did not settle the question as to whether or not the Federal Government could tax the income from State and local securities in the form of a general net income tax.

(B) FIRST POLLOCK CASE [3]

That question was not decided until the *Pollock cases* holding the income-tax provisions of the act of 1894 unconstitutional. The income-tax provisions of the act of 1894 in imposing a general tax on net income, included as income interest from State and local bonds.

In the first *Pollock case*,[3] Pollock a stockholder of the Farmers' Loan & Trust Co., filed a bill in equity to prevent the Trust Co. from making returns and paying income taxes under the act of 1894. The records showed that the net income of the company during the year ended December 31, 1894, amounted to over $300,000; that it derived rental of $50,000 from its real estate, after deducting State and local taxes, and an income of about $60,000 from investments in municipal bonds. The following contentions were made as to the unconstitutionality of the act:

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[2] 302 U. S. 95.
[3] 157 U. S. 429.

1. The law in imposing a tax on the income or rents of real estate imposed a tax upon the real estate itself and, therefore, such a tax was a direct tax and void because imposed without regard to the rule of apportionment.

2. The law in imposing a tax on the interest or other income of bonds or other personal property is a tax upon the personal estate itself and is, therefore, a direct tax and void because imposed without regard to the rule of apportionment.

3. Because the tax on the income from real property and personal property is void, the whole law is invalidated.

4. The law is invalid because imposing indirect taxes in violation of the constitutional requirement of uniformity.

5. The law is invalid so far as imposing a tax upon income received from State and municipal bonds is concerned.

The Court, in a majority opinion by Mr. Justice Fuller, passed upon only two of the contentions raised in the case. It held the income tax provisions unconstitutional insofar as they taxed the rents and income of the real estate and the income from municipal bonds. It did not pass upon the question as to whether a tax on the income from personal property was a direct tax and, therefore, void because of want of apportionment. The decision of the Court in regard to the inability of the Federal Government to levy a tax on the income from municipal bonds, was unanimous. There were eight justices sitting in this case. However, there were two dissents, one by Mr. Justice White and the other by Mr. Justice Harlan, but these justices dissented from the majority opinion only insofar as it held that a tax on the rents or income from real property was a direct tax. While the justices were equally divided as to whether the income from personal property was a direct tax, and therefore, rendered no opinion as to this question, they were in entire agreement that Congress had no power to tax the income from State or local bonds. In this connection, Mr. Justice Fuller, in speaking for the majority, said:

> The law under consideration provides "that nothing herein contained shall apply to States, 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 burthen on the operations of government. It may be carried to an extent which shall arrest them entirely. * * * The tax on Government stock is thought by this court to be a tax on the contract, and 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.

In other words, entirely independent of the question of whether a tax on the income from personal property was a direct tax, it was

held that the general net income tax insofar as it applied to the income from State or municipal bonds was a tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution. With this view, both Mr. Justice White and Mr. Justice Harlan agreed, Mr. Justice White stating:

> In regard to the right to include in an income tax the interest upon the bonds of municipal corporations, I think the decisions of this Court, holding that the Federal Government is without power to tax the agencies of the State government, embrace such bonds, and that this settled line of authority is conclusive upon my judgment here. It determines the question that where there is no power to tax for any purpose whatever, no direct or indirect tax can be imposed. The authorities cited in the opinion are decisive of this question. They are relevant to one case and not to the other, because, in the one case there is full power in the Federal Government to tax, the only controversy being whether the tax imposed is direct or indirect; while in the other there is no power whatever in the Federal Government, and, therefore, the levy, whether direct or indirect, is beyond the taxing power.

And Mr. Justice Harlan concurring in the following statement:

> While property, and the gains, profits, and income derived from property, belonging to private corporations and individuals, are subjects of taxation for the purpose of paying the debts and providing for the common defense and the general welfare of the United States, the instrumentalities employed by the States in execution of their powers are not subjects of taxation by the General Government, any more than the instrumentalities of the United States are the subjects of taxation by the States; and any tax imposed directly upon interest derived from bonds issued by a municipal corporation for public purposes, under the authority of the State whose instrumentality it is, is a burden upon the exercise of the powers of that corporation which only the State creating it may impose. In such a case it is immaterial to inquire whether the tax is, in its nature or by its operation, a direct or an indrect tax; for the instrumentalities of the States—among which, as is well settled, are municipal corporations, exercising powers and holding property for the benefit of the public—are not subjects of national taxation in any form or for any purpose, while the property of private corporations and of individuals is subject to taxation by the General Government for national purposes. So it has been frequently adjudged and the question is no longer an open one in this Court.

(C) THE SECOND POLLOCK CASE [4]

After the decision in the *First Pollock case*, the appellant filed a petition for rehearing for the reason that the Court had expressed no opinion in regard to the following contentions:

1. That the act was unconstitutional as to incomes from personal property as laying direct taxes without apportionment.
2. That the void income-tax provisions invalidate the entire income-tax law.
3. That if any part of the income tax is considered a direct tax it is invalid for want of uniformity.

The Attorney General presented a suggestion that if any rehearing were granted it should embrace the whole case. Treating this suggestion as amounting in itself to an application for rehearing, the Court set down both applications to be heard before a full bench, Justice Jackson, who did not participate in the first decision, being present.

Mr. Justice Fuller also delivered the opinion of the Court in this second case.[4] The majority opinion adhered to the opinion that taxes on real estate being indisputably direct taxes, taxes on the rents or

[4] 158 U. S. 601.

income of real estate are equally direct taxes. So far as the taxation of income from State and local bonds were concerned, the Court also adhered to its opinion in the first case, stating:

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

On the questions upon which the Court had rendered no decision in the first case, it held in the second case—

> (1) That taxes on the income from personal property are direct taxes; and
>
> (2) That the income tax, so far as it fell on the income of real and personal property, being a direct tax within the meaning of the Constitution, and, therefore, unconstitutional and void because not apportioned, the entire income-tax law, constituting one entire scheme of taxation, was necessarily invalid.

Four Justices dissented from the majority opinion. Mr. Justice Harlan dissented from the majority opinion, except insofar as it related to the income from State bonds. He stated that—

> I am of the opinion that with the exception of capitation and land taxes, and taxes on exports from the States and on the property and instrumentalities of the State, the Government of the Union, in order to pay its debts and provide for the common defense and the general welfare, and under its power to lay and collect taxes, duties, imposts, and excises, may reach, under the rule of uniformity, all property and property rights in whatever State they may be found.

Mr. Justice White dissented in regard to the holding that the income on real and personal property was a direct tax, but agreed with the majority opinion as to the inability of the Congress to tax the income from State or municipal bonds. In this connection, he said:

> I deem it unnecessary to elaborate my reasons for adhering to the views hitherto expressed by me, and content myself with the following statement of points.

Mr. Justice Jackson dissented insofar as the Court held the tax on incomes from real or personal property was a direct tax and agreed with the dissents expressed by Mr. Justice White in the *First Pollock case.*

Mr. Justice Brown dissented as to the holding that the income from real or personal property was a direct tax, but he agreed with the majority that an income tax on municipal bonds was invalid. In this connection, he stated:

> The tax upon the income of municipal bonds falls obviously within the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of taxation, but of the power to subject the property to taxation in any form. It seems to be that the cases of *Collector* v. *Day* (11 Wall. 113), holding that it is not competent for Congress to impose a tax upon the salary of a judicial officer of a State; *McCulloch* v. *Maryland* (4 Wheat. 316), holding that a State could not impose a tax upon the operation of the Bank of the United States; and *United States* v. *Railroad Co.* (17 Wall. 322), holding that a municipal corporation is a portion of the sovereign power of the State, and is not subject to taxation by Congress upon its municipal revenues; *Wisconsin Central Railroad* v. *Price* (133 U. S. 496), holding that no State has the power to tax the property of the United States within its limits; and *Van Brocklin* v. *Tennessee* (117 U. S. 151), to the same effect, apply mutatis mutandis to the bonds in question, and the tax upon them must, therefore, be invalid.

(D) EFFECT OF POLLOCK CASES

From this discussion, it can be seen that the Court, while not unanimous in its conclusion that a tax on the income from real and personal property was a direct tax and subject to the rule of apportionment, was unanimous in its conclusion that the Congress was without power to levy a tax on the income from State or municipal bonds.

It appears from these decisions that regardless of whether the income tax on personal property is regarded as a direct or indirect tax, it is void as applied to the income of State and local bonds because it constitutes an interference with the borrowing power of the States. This conclusion is in harmony with the decision of the Supreme Court in *Collector* v. *Day*[5] and *Springer* v. *United States*.[6] It should be noted that in the *Springer case* rendered under the Civil War Acts, the Court upheld the Civil War income tax as applied to the professional earnings of Springer, an attorney at law, as an indirect tax. The tax on such earnings was recognized as an indirect tax, not only in the *Springer case*, but also in the *Pollock cases*, Mr. Justice Fuller stating that an income tax on gains or profits from business privileges, employments, and vocations could be sustained as an excise tax. In spite of the fact that it has always been recognized that a tax on earnings is not a direct tax, but an indirect tax, the Court, in *Collector* v. *Day*,[7] held that the Civil War net income tax was not applicable to the income of a State judicial officer because it interfered with the essential functions necessary to the existence of the State.

The conclusion to be drawn from the cases up to this point is that the income from State or local bonds could not be taxed, because to do so would interfere with the borrowing power of the States.

(E) THE NATIONAL LIFE INSURANCE CO. CASE[8]

The Revenue Act of 1913, exempted from the Federal income tax, interest upon the obligations of States or their political subdivisions. This exemption was continued in the Revenue Act of 1921 and subsequent revenue acts, except with respect to the special method provided for the taxation of life insurance companies under the Revenue Acts of 1921, 1924, 1926, and 1928. Prior to the enactment of the Revenue Act of 1921, life-insurance companies were taxable like ordinary corporations. Up to that time, gross income included premium receipts and capital gains. The companies were allowed to deduct the amount paid on policies (except as dividends), and the amount required by law to be added to their reserves. At the annual meeting of life insurance presidents in December 1920, it was stated that the law was unsatisfactory both the companies and to the Government. After much sonsideration, Congress, upon consultation with the life-insurance companies and with the approval of at least most of them, substituted a new plan for computing their taxes. The new plan defined gross income as the gross amount of income received during the tax-

[5] 11 Wall. 113 (1870).
[6] 102 U. S. 586 (1880).
[7] 11 Wall. 113.
[8] 277 U. S. 508.

able year from interest, dividends, and rents. This definition automatically excluded from taxation any portion of the premiums paid by the policyholders to the company, as well as capital gains. Included within such definition of gross income was interest derived from tax-exempt securities. From the gross income thus arrived at, there were allowed certain deductions:

(1) Interest derived from tax-exempt securities, if any.

(2) A sum equal to 4 percent of the mean of the company's legal reserves diminished by the amount of the tax-exempt interest, and

(3) Other items not important here.

Under this plan a life-insurance company which had an income from State and municipal bonds was not entitled to the full amount of the deduction of 4 percent of the mean of the reserve funds, but was required to reduce this amount by the interest derived from tax-exempt securities. The reason for allowing the deduction of 4 percent of the reserve is that a portion of the interest, dividends, and rents received have to be used each year in maintaining the reserve; that is, added to it on the basis of a certain interest rate varying from 3 percent to 4 percent, according to the statutes of the several States.

There were two contentions in this case:

First, that the life-insurance companies were discriminated against and made to exact payment on account of their tax-exempt securities, and

Second, that the diminution of the ordinary deduction of 4 percent of the mean of the reserves because of interest received, in effect, defeated the exemption guaranteed to the owner.

The Court held that to directly tax the income from the securities amounted to a taxation of the securities themselves and that the United States may not tax State or municipal obligations. It then concluded that "Congress has no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others."

The following example will show how this system results in taxing the interest from State securities:

COMPANY A

Income from taxable sources		$100,000
Income from tax-exempt interest		20,000
Gross income		120,000
Deductions:		
Miscellaneous sources	$10,000	
Tax-exempt interest	20,000	
4 percent of the mean of the reserves less tax-exempt interest	30,000	
		60,000
Net income subject to tax		60,000

COMPANY B

Income from taxable sources		$100,000
Income from tax-exempt interest		0
Gross income		100,000
Deductions:		
Miscellaneous sources	$10,000	
Tax-exempt interest	0	
4 percent of the mean of the reserve	50,000	
		60,000
Net income subject to tax		40,000

It will be seen that under this system a life-insurance company with tax-exempt securities is forced to pay a higher tax by reason of the ownership of such securities. It has been claimed that the National Life decision must be confined to its discriminatory features. However, the absence of discrimination was relied upon by the dissenting Justices in this case to sustain it. A subsequent decision will show that the denial by the full deduction of 4 percent of the mean of the reserve to companies receiving income from tax-exempt securities was because it, in effect, taxed the income from such securities. This plan of taxing life-insurance companies gave them an advantage of tax exemption in the case of premium receipts and capital gains. This distinction is forcibly brought out in the case of *Helvering* v. *Independent Life Insurance Company.*[9] That case also concerned the plan for taxing life-insurance companies, inaugurated in the Revenue Act of 1921. It was pointed out that the Revenue Act of 1921 defines gross income as that received from interest, dividends, and rents. Premiums and capital gains were excluded and the net income was ascertained by making specified deductions from gross income. These deductions included (1) 4 percent of the company's reserve already discussed in the *National Life case;* (2) taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, and (3) a reasonable allowance for the exhaustion, wear, and tear of property, including a reasonable allowance for obsolescence. This law then provided that the deductions under (2) and (3) should not be allowed on account of any real estate owned and occupied in part by a life-insurance company unless there was included in its return of gross income the rental value of the space so occupied. Such rental value under the law could not be less than a sum which in addition to any rents received from other tenants should provide a net income (after deducting taxes, depreciation, and other expenses) at the rate of 4 percent per annum of the book value at the end of the taxable year of the real estate so owned or occupied.

It was claimed that this limitation on the deductions was unconstitutional because the rental value of the space occupied by the insurance company owning the building was not income, and that the exaction was, therefore, a direct tax on the land itself and void for lack of apportionment. The Court in its opinion specifically held that the rental value of the building used by the owner does not constitute income within the meaning of the sixteenth amendment, but then went on to state:

> Earlier acts taxed life-insurance companies' incomes substantially the same as those of other corporations. Because of the character of the business, that method proved unsatisfactory to the Government and to the companies. The provisions under consideration were enacted upon the recommendation of representatives of the latter. As rents received for buildings were required to be included in gross and expenses chargeable to them were allowed to be deducted, it is to be inferred that Congress found—as concededly the fact was—that the annual net yields from investments in such buildings ordinarily amounted to at least 4 percent of book value. Where an insurance company owns and occupies the whole of a building, it receives no rents therefor and is not allowed to deduct the expenses chargeable to the building. Where part is used by the company and part let, the rents are required to be included in the gross, but expenses may not

[9] 292 U. S. 371 (1934).

be deducted unless, if it be necessary, there is added to the rents received an amount to make the total sufficient, after deduction of expenses, to leave 4 percent of book value. All calculations contemplated by section 245 (b) are made subject to that limitation. Congress intended that the rule should apply only where rents exceed such 4 percent. Where they are less than that, addition of the prescribed rental value and deduction of expenses operate to increase taxable income. The classification is not without foundation.

The company is not required to include in gross any amount to cover rental value of space used by it, but in order that, subject to the specified limitation, it may have the advantage of deducting a part of the expenses chargeable to the building, it is permitted to make calculations by means of such an addition. The statute does not prescribe any basis for the apportionment of expenses between space used by the company and that for which it receives rents. The calculation indicated operates as such an apportionment where the rents received are more than 4 percent of book value, but less than that amount plus expenses. In such cases the addition, called rental value of space occupied by the company, is employed to permit a deduction on account of expenses. That, as is clearly shown in the dissenting opinion, supra, page 473 of 67 F. (2d), is the arithmetical equivalent of lessening the deduction by the amount of the so-called rental value.

The *National Life Insurance Company case* was distinguished on the ground that the effect of the statutory deduction invalidated in that case was to impose a direct tax on the income of exempt securities, whereas the limitation on the deductions discussed in the rental value case was in substance a diminution or apportionment of expenses to be deducted from gross income, and that Congress had the power to condition, limit, or deny deductions. Of course, if the disallowance of the deduction had been regarded as a discrimination against companies owning their own buildings, a different conclusion would have been reached. In other words, in this case, life-insurance companies owning office building and occupying part of them were singled out for special treatment to the same extent that life-insurance companies owning tax-exempt bonds were singled out for special treatment. However, this singling out did not result in discrimination and the provision singling out those with tax-exempt bonds for special treatment was held invalid, not on that account, but on the ground that this special treatment amounted to taxing the income from tax-exempt securities.

(F) CONCLUSION FROM BOTH POLLOCK CASES AND NATIONAL LIFE INSURANCE COMPANY CASE

Unless the *Pollock cases* and the *National Life case* have been modified by subsequent decisions, they stand as authority for holding that the Congress has no power to subject the income from State or local securities to a general income tax.

(3) Analysis of Pollock Cases by Subsequent Decisions

It is contended that the *Pollock cases* were decided on the theory that a tax on the income of municipal bonds was the equivalent of a tax on the bonds themselves. This contention does not appear to be correct. In the first *Pollock case* [10] the Court did not decide the question as to whether or not the income tax on personal property was a direct tax. Despite this, the Court held that the income tax as applied to municipal bonds was invalid because "the tax in question is a tax

[10] 157 U. S. 429.

on the power of the States and their instrumentalities to borrow money, and constantly repugnant to the Constitution."

In the second *Pollock case*[11] Chief Justice Fuller stated in regard to the first *Pollock case:*

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

Clearly, the decision was not unanimous on the theory that a tax on the income from municipal bonds was a tax on the bonds themselves, for at least four of the judges were unable to conclude, even in the second case, that a tax on the income from personal property was a tax on the property itself.

In *Cohn* v. *Graves*,[12] Mr. Justice Stone, who rendered the majority opinion, pointed out that the decision in the *Pollock case*, so far as it related to a tax on the rents of land, did not rest upon the ground that the tax was a tax on the land or that it was subject to every limitation which the Constitution imposes on property taxes. It determined "only that for purposes of apportionment there were similarities in the operation of the two kinds of tax which made it appropriate to classify both as direct and within the constitutional command." So far as the *Pollock cases* concerned the taxation of income from municipal bonds, Mr. Justice Stone said:

> It is by a parity of reasoning that the immunity of income-producing instrumentalities of one government, State or National, from taxation by the other, has been extended to the income. It was thought that the tax, whether on the instrumentality or on the income produced by it, would equally burden the operations of government.

To the same effect was the conclusion of Mr. Justice Cardozo in rendering the decision in *Hale* v. *State Board*.[13] He stated in referring to the *Cohn* v. *Graves* decision:

> *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429; 158 U. S. 601), was considered and distinguished. Two rulings emerge as a result of the analysis. By the teaching of the *Pollock case* an income tax on the rents of land (157 U. S. 429) or even on the fruits of other investments (158 U. S. 601) is an impost upon property within the section of the Constitution (art. I, sec. 2, cl. 3) governing the apportionment of direct taxes among the States (300 U. S. at p. 315). By teaching of the same case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland* (4 Wheat. 316), and *Collector* v. *Day* (11 Wall. 113, 124; 300 U. S. at pp. 315, 316). There was no holding that the tax is a property one for every purpose or in every context. We look to all the facts.
>
> In line with that conception of the *Pollack case* is *Brushaber* v. *Union Pacific R. Co., supra,* where the court pointed out (240 U. S. at pp. 16, 17) that "the conclusion reached in the *Pollock case* did not in any degree involve holding that income taxes generically and necessarily came within the class of direct taxes on property," but that to the contrary such taxes were enforcible as excises except to the extent that violence might thus be done to the spirit and intent of the rule governing apportionment.

By this analysis, it seems clear that a tax on the income from property was treated as a tax on the property *only for the purposes of applying the rule of apportionment* and *that a tax on the interest*

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[11] 158 U. S. 601.
[12] 300 U. S. 315 (1937).
[13] 302 U. S. 95 (1937).

on municipal bonds was condemned as a clog upon the borrowing power of the State.

(4) Effect of Subsequent Decisions on Modifying the Pollock Cases

It has not been established that subsequent decisions have weakened the holding in the *Pollock cases* that the Federal Government has no power to tax the income from State or local bonds. The decisions relied upon as distinguishing the *Pollock cases* are summarized as follows:

(A) BONAPARTE *v.* TAX COURT [14]

In the *Bonaparte case*, the Supreme Court upheld the right of Maryland to levy a property tax on bonds issued by New York, Pennsylvania, and Ohio to one of its own citizens. This case was distinguished in the *Pollock case* itself, as follows:

> The question in *Bonaparte* v. *Tax Court* (104 U. S. 592) was whether the registered public debt of one State, exempt from taxation by that State or actually taxed there, was taxable by another State when owned by a citizen of the latter, and it was held that there was no provision of the Constitution of the United States which prohibited such taxation. The States had not covenanted that this could not be done, whereas, under the fundamental law, as to the power to borrow money, neither the United States, on the one hand, nor the States, on the other, can interfere with that power as possessed by each and an essential element of the sovereignty of each.

This conclusion is in harmony with the view expressed by the Court in *Burnet* v. *Brooks* [15] pointing out that the Constitution, through the due-process clause, prevented the States from transcending the limits of their authority, and thus destroying the rights of other States, for it is impossible for one State to reach out and tax property in another State without violating the Constitution, for where the power of one ends, the authority of the other begins. If, therefore, the State of domicile of the owner of the bond could not tax the bond or the income therefrom, no tax could be levied at all, not even by the State which issued the bond, for the reason that it had no jurisdiction over the owner of the bond who resided beyond its borders. Thus the relationship existing between the States themselves and the States and the Federal Government, is not subject to the same constitutional limitations or restrictions.

(B) FLINT *v.* STONE TRACY CO. [16]

Flint v. *Stone Tracy Company* does not conflict with the *Pollock cases*. That case construed the corporation excise tax of 1909, which taxed the privilege of carrying on or doing business by corporations. The tax was measured by the net income of the corporation from all sources. Since the subject of the tax was the exercise of a franchise or privilege, the Supreme Court held that Congress had the power to include in the measure of the tax the income from tax-exempt securities, although such income could not be directly taxed. It is

[14] 104 U. S. 592 (1881).
[15] 288 U. S. 378 (1933).
[16] 220 U. S. 107 (1911).

claimed that the *Pollock case* apparently rests upon weak foundations if a distinction so refined as that between the subject and the measure of a tax is sufficient to escape its ruling. However, long before the Pollock decisions, the Court recognized the distinction between a property tax and a tax on franchises and privileges. The Court has uniformly held a tax upon the capital or the assets of corporations invalid unless the value of Government bonds held by the corporation were deducted. But this ruling is not applied to franchises or privilege taxes where the bonds were not taxed directly, but were used as a measure of the tax. For example, in 1867, long before the *Pollock cases*, the Court upheld a franchise tax measured by deposits, even though some of the deposits were invested in tax-exempt securities (*Society for Savings* v. *Coite*[17]). A like decision was rendered in *Provident Institution* v. *Massachusetts*,[18] where the tax was measured by average deposits.

In referring to these cases in the *Stone Tracy Company case*,[19] the Court said:

> It is therefore well settled by the decisions of this court that when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege, it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is nontaxable.

There is, therefore, no more basis for holding that the *Stone Tracy Co. case* permits the income from State or local securities to be taxed directly than for holding that the *Society for Savings and Provident Institution cases* (as well as other cases), permitting nontaxable property to be used as a measure of the tax, authorize the direct taxation of the nontaxable property itself.

The distinction between taxing tax-exempt securities directly or including them as a measure of a privilege tax has also been recognized in inheritance and estate-tax cases.

In *Plummer* v. *Coler*,[20] the Court permitted New York to collect an inheritance tax upon a bequest of United States bonds. The Court also upheld the Federal estate tax as applied to municipal bonds. But it has never been seriously contended that these decisions would permit the taxation of the bonds themselves.

(C) PECK & CO. *v.* LOWE[21]

In this case a domestic corporation was engaged in buying and selling goods. Its income from shipping goods abroad and selling them amounted to approximately $30,000 and its income from local sources amounted to approximately $12,000. Its total net income was held taxable under the Federal Revenue Act of 1913. The Court held it was not a tax on exportation and, at the most, affected exportation indirectly and remotely. It distinguished this case from a case where a taxpayer might have tax-exempt income by stating that a net income tax, although a general tax, cannot be applied to any income which Congress has no power to tax. It then concluded that if

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[17] 6 Wall. 594 (1867).
[18] 6 Wall. 611 (1867).
[19] 220 U. S. 107.
[20] 178 U. S. 115 (1900).
[21] 247 U. S. 165 (1918).

articles manufactured and intended for export are subject to taxation under general laws up to the time they are put in the course of exportation, the conclusion is, therefore, that the net income from the venture when applied, after exportation and sale, is exercised subject to taxation under the general laws and that the status of income is not different from that of the exported article prior to exportation. It will be noted that the facts in this case show that the net income of the taxpayer was not derived exclusively from the shipment and sales of articles abroad.

(D) UNITED STATES GLUE *v.* OAK CREEK [22]

In this case, the Supreme Court upheld a State net income tax on a corporation organized under the laws of the State of Wisconsin, having its principal office and place of business in the town of Oak Creek, where it conducted an extensive manufacturing plant, selling its products throughout the State, in other States, and in foreign countries. Its net business income for the particular year amounted to about $124,000. Its business income for the taxable year was derived from sales within the State and some from sales without the State, and some from foreign countries.

The Court upheld the Wisconsin tax as applied to this case, stating that the net income tax was applied to the net proceeds of the plaintiff's business from interstate commerce together with a like tax imposed upon its income derived from other sources, and in the same way that other corporations doing business within the State were taxed upon that proportion of their income derived from business transacted on property located within the State, whatever the nature of their business. This case, like the *Peck & Co. case*, did not involve a situation where the income of the taxpayer was derived solely from interstate commerce. However, in the case of *Curlee Clothing Co.* v. *Oklahoma* [23] it was held that a foreign corporation doing a purely interstate business was not subject to a State net income tax.

In commenting upon the *U. S. Glue Co. case*, Mr. Justice McReynolds, in writing the majority opinion in *Northwestern Insurance Company* v. *Wisconsin*,[24] stated:

> It is important to observe that although a State statute may properly impose a charge which materially affects interstate commerce, without so unreasonably burdening it as to become a regulation within the meaning of the Constitution, no State can lay any charge on bonds of the United States.

Specifically, the holding of the Court in the *United States Glue Company case* was that the net income tax imposed by Wisconsin was not deemed to so directly burden the plaintiff's interstate business as to amount to a regulation of commerce among the States.

(E) WILLCUTTS *v.* BUNN [25]

In this case, the Supreme Court upheld the right of the Federal Government to subject to the Federal income tax gains from the sale

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[22] 247 U. S. 321 (1918).
[23] 68 P. 2, 534 (1937).
[24] 275 U. S. 136.
[25] 282 U. S. 216 (1931).

of county and municipal bonds. The *Pollock case* was cited with approval, the Court stated:

> In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government.

The Court distinguished a tax upon the interest from a bond from a tax upon the profits derived from the sale of a bond, in the following language:

> The tax upon interest is levied upon the return which comes to the owner of the security according to the provisions of the obligation and without any further transaction on his part. The tax falls upon the owner by virtue of the mere fact of ownership, regardless of use or disposition of the security. The tax upon profits made upon purchases and sales is an excise upon the result of the combination of several factors, including capital investment and, quite generally, some measure of sagacity; the gain may be regarded as the creation of capital, industry, and skill.

In other words, the capital gain arose from a transaction separate and distinct from the transaction with the Government and was created by the taxpayer himself, separate and apart from his contract with the Government.

The Court concluded that the burden upon the States' borrowing power by taxing such capital gain was not real or substantial.

(F) DENMAN *v.* SLAYTON [26]

In this case, the Supreme Court upheld a provision of the Revenue Act of 1921 defining a deduction for interest paid or acrued or indebtedness incurred or continued to purchase or carry tax-exempt securities. The provision was upheld as necessary to prevent the escape from taxation of income properly subject thereto by purchase of exempt securities with borrowed money.

In other words, the taxpayer was not permitted to reduce his taxable income by interest on money borrowed to acquire tax-exempt securities. The Court pointed out that this did not amount to the taxation of the interest from the tax-exempt securities. The *National Life case* was distinguished as follows:

> * * * The circumstances disclosed in *National Life Ins. Co.* v. *United States* were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of section 245 (a), Revenue Act 1921, 42 Stat. 227, 261. While guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the payment of their just share of a burden fairly imposed.
>
> The manifest purpose of the exception in paragraph 2, section 214 (a), was to prevent the escape from taxation of income properly subject thereto by the purchase of exempt securities with borrowed money.
>
> Under the theory of the respondent, "A," with an income of $10,000 arising from nonexempt securities, by the simple expedient of purchasing exempt ones with borrowed funds and paying $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility. The classification complained of is not arbitrary,

[26] 282 U. S. 514 (1931).

makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress. The fact that respondent engaged in the business of buying and selling is not important. See *Willcutts* v. *Bunn*, *ante*, page 216.

(G) HELVERING *v.* INDEPENDENT LIFE INSURANCE CO.[27]

This case has been discussed and distinguished in connection with the *National Life Insurance Company case.*[28]

(H) COHN *v.* GRAVES [29]

The reasoning of the *Pollock case* has not been rejected in the above cited case. In that case, the Court held that the State of New York may tax her citizen upon income he received from land situated in another State and from interest on bonds secured by a mortgage on land situated in another State. It was stated that the incidence of a tax on income differs from a tax on property. Neither tax being dependent upon the possession by the taxpayer of the subject of the other.

The *Pollock case* was distinguished from this situation as follows:

Nothing which was said or decided in *Pollock* v. *Farmers Loan & Trust Co.* 157 U. S. 429), calls for a different conclusion. There the question for decision was whether a Federal tax on income derived from rents of land is a direct tax requiring apportionment under article I, section 2, clause 3 of the Constitution. In holding that the tax was "direct," the Court did not rest its decision upon the ground that the tax was a tax on the land, or that it was subject to every limitation which the Constitution imposes on property taxes. It determined only that for purposes of apportionment there were similarities in the operation of the two kinds of tax which made it appropriate to classify both as direct, and within the constitutional command. See *Pollock* v. *Farmers Loan & Trust Co.*, *supra*, pp. 580, 581; *Brushaber* v. *Union Pacific R. Co.* (240 U. S. 1, 16). And in *Union Transit Refrigerator Co.* v. *Kentucky* (199 U. S. 194, 204), decided 10 years after the *Pollock case*, the present question was thought not to be foreclosed.

It is by a parity of reasoning that the immunity of income-producing instrumentalities of one government, State or National, from taxation by the other, has been extended to the income. It was thought that the tax, whether on the instrumentality or on the income produced by it, would equally burden the operations of Government. See *Collector* v. *Day* (11 Wall. 113, 124); *Pollock* v. *Farmers Loan & Trust Co.*, *supra*, 583; *Gillespie* v. *Oklahoma* (257 U. S 501). But as we have seen, it does not follow that a tax on land and a tax on income derived from it are identical in their incidence or rest upon the same basis of taxing power, which are controlling factors in determining whether either tax infringes due process.

(I) HALE *v.* STATE BOARD [30]

Nothing in the above-mentioned case is in conflict with the *Pollock case.* In that case, Iowa enacted a law exempting its municipal and State bonds from taxation. Subsequently, it passed for the first time a tax on the net income of residents in the State, and the interest derived from such bonds was included in an assessment made against the bondholders. The State court interpreted the exemption from taxation as only applying to taxes laid on property in proportion to its value, and not as touching taxes in the nature of an excise upon

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[27] 292 U. S. 371.
[28] 277 U. S. 508.
[29] 300 U. S. 308 (1937).
[30] 302 U. S. 95 (1937).

net income of the owner. The Supreme Court in an opinion by Mr. Justice Cardozo, upheld the tax, stating:

* * * *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429; 158 U. S. 601), was considered and distinguished. Two rulings emerge as a result of the analysis. By the teaching of the *Pollock case* an income tax on the rents of land (157 U. S. 429) or even on the fruits of other investments (158 U. S. 601) is an impost upon property within the section of the Constitution (art. I, sec. 2, cl. 3) governing the apportionment of direct taxes among the States (300 U. S., at p. 315). By the teaching of the same case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland*, 4 Wheat. 316, and *Collector* v. *Day*, 11 Wall. 113, 124 (300 U. S., at pp. 315, 316). There was no holding that the tax is a property one for every purpose or in every context. We look to all the facts.

In line with that conception of the *Pollock case* is *Brushaber* v. *Union Pacific R. Co., supra*, where the Court pointed out (240 U. S., at pp. 16, 17) that "the conclusion reached in the *Pollock case* did not in any degree involve holding that income taxes generically and necessarily came within the class of direct taxes on property," but that to the contrary, such taxes were enforceable as excises except to the extent that violence might thus be done to the spirit and intent of the rule governing apportionment.

* * * Nothing in this opinion is at war with *Weston* v. *Charleston* (2 Pet. 449), or other cases declaring the immunities of governmental agencies. In the case cited and its congeners the problem for decision was whether a tax upon income, even though not a property tax in strictness or for every purpose, was one in such a sense or in such a measure as to hamper the freedom of the Central Government through the interference of the States or the freedom of the States through the interference of the Central Government. The limitations declared in those decisions were gathered by implication from the structure of our Federal system, and were accommodated, as the court believed, to the public policy at stake. What the Court is now concerned with, however, is not the preservation or protection of any governmental function. Iowa cannot be held to cripple in an unconstitutional way her own privileges and powers when she levies an income or even a property tax upon bonds issued by herself. The Court is now concerned with the meaning and effect of particular contracts of exemption to be read narrowly and strictly. There is no room at such a time for the freer and broader methods that have been thought to be appropriate in the development of the doctrine of implied restraints.

(J) JAMES *v.* DRAVO CONTRACTING COMPANY [31]

This case upheld a 3-percent gross receipts tax imposed by the State of West Virginia upon gross receipts received by an independent contractor for work performed for the Federal Government in West Virginia. This case was clearly distinguished from the bondholder case. Mr. Chief Justice Hughes in the majority opinion, stating:

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 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.

There are also other features involved in the *Dravo case* which distinguish it from a Federal tax on State bonds or employees. In this case, the Federal Government, although not a party to the

[31] 302 U. S. 134 (1938).

proceeding, interceded and informed the Court that the Federal Government did not regard the collection of such a tax as an interference with its governmental functions.

In this connection, the Court said:

> Respondent has no constitutional right to immunity from nondiscriminatory local taxation and the mere fact that the tax in question burdens respondent is no defense. The defense is that tax burdens the Government and respondent's right is at best a derivative one. He asserts an immunity which, if it exists, pertains to the Government and which the Government disclaims.

Of course, in the case of an action by the Federal Government to collect an income tax from a State bondholder, we cannot rely upon the proposition that the State will disclaim that the levying of such a tax interferes with its borrowing powers.

Another point which distinguished the two classes of cases is brought out in the following quotation from the majority opinion:

> There is the further suggestion that if the present tax of 2 percent is upheld, the State may lay a tax of 25 percent or 50 percent or even more, and make it difficult or impossible for the Government to obtain the service it needs. The argument ignores the power of Congress to protect the performance of the functions of the National Government and to prevent interference therewith through any attempted State action. In *Thomson* v. *Pacific Railroad*, *supra*, the Court pointedly referred to the authority of Congress to prevent such an interference through the use of the taxing power of the State.

This indicates that the Court was of the opinion that if a State should lay a tax, even though nondiscriminatory, which would make it difficult or impossible for the Federal Government to obtain the service it needed, the Federal Government still had a remedy. This remedy from the Court's reference to the case of *Thomson* v. *Pacific Railroad Company* [32] appears to be by means of legislation preventing the State tax from applying. But the States would have no corresponding remedy to prevent a nondiscriminatory Federal tax from burdening their functions to obtain services or borrow money, for the Federal law, being the supreme law of the land, would override any State law exempting such activities from the Federal tax. The sole protection of the States in a matter of this kind. is the Constitution.

(K) HELVERING *v.* MOUNTAIN PRODUCERS CORPORATION [33]

In the above cited case, it was held that the income received from a State lease by a lessee from the sale of his share of oil produced was subject to the Federal income tax. The Court overruled certain former cases in reaching this conclusion, stating:

> * * * These decisions in a variety of applications enforce what we deem to be the controlling view—that immunity from nondiscriminatory taxation sought by a private person for his property or gains because he is engaged in operations under a Government contract or lease cannot be supported by merely theoretical conceptions of interference with the functions of government. Regard must be had to substance and direct effects. And, where it merely appears that one operating under a Government contract or lease is subject to a tax with respect to his profits on the same basis as others who are engaged in similar businesses, there is no sufficient ground for holding that the effect upon the Government is other than indirect and remote. We are convinced that the rulings in *Gillespie* v. *Oklahoma*, *supra*, and *Burnet* v. *Coronado Oil*

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[32] 9 Wall. 579.
[33] 303 U. S. 376.

& Gas Company, supra, are out of harmony with correct principle and accordingly they should be, and they now are, overruled.

But, in reaching this conclusion, the Court distinguished the situation from the *Pollock cases*, as follows:

> * * * While a tax on the interest payable on State and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government (*Weston* v. *Charleston*, 2 Pet. 449, 468, 469, 7 L. Ed. 481; *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 586, 15 S. Ct. 673, 39 L. Ed. 759), the sale of the bonds by their owners after they have been issued by the State or municipality is regarded as a transaction distinct from the contracts made by the Government in the bonds themselves, and the profits of such sales are subject to the Federal income tax.

In other words, the income in this case arose from transactions separate and distinct from contracts made with the Government. Therefore, they are clearly distinguishable from the above case where the interest is received as a part of the contract with the Government.

(L) HELVERING *v.* GERHARDT [34]

This case held that the Federal income tax as applied to the salaries of employees of the Port Authority, a bi-State corporation created by compact between New York and New Jersey, was valid on the theory that the tax neither precluded nor threatened unreasonably to obstruct any function essential to the continued existence of the State government. In that case, the Court distinguished this situation from taxing the income from State bonds, stating that the immunity doctrine was applied where the function involved was thought to be essential to the maintenance of a State government, as where the intent was "to tax income received by a private investor from State bonds, and thus threaten impairment of the borrowing power of the State, *Pollock* v. *Farmers' Loan & Trust Company* (157 U. S. 429; cf.); *Weston* v. *Charleston*, *supra* (465, 466).

(M) ALLEN *v.* REGENTS OF THE UNIVERSITY SYSTEM OF GEORGIA [35] (MAY 23, 1938)

This case upheld the right of the Federal Government to collect an admissions tax on admissions charged by the University of Georgia to its athletic contests. The Court pointed out that, although the university was an instrumentality of the State of Georgia, if the State embarks on a business which would normally be taxable, the fact that in so doing it is exercising a governmental power, does not itself render the activity immune from Federal taxation. In this connection, the Court stated:

> Under the test laid down in *Helvering* v. *Gerhardt*, *ante* (p. 405), however essential a system of public education to the existence of the State, the conduct of exhibition for admissions paid by the public is not such a function of State government as to be free from the burden of a nondiscriminatory tax laid on all admissions to public exhibitions for which an admission fee is charged.

Mr. Justice Black concurred in the opinion "except insofar as it approves the reasoning of the Court on the question of State immunity from interference by Federal taxation." It will be noted that the

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[34] 304 U. S. —— (May 16, 1938).
[35] 304 U. S. —— (May 23, 1938).

reasoning of the Court recognizes that there are certain functions of State government which are free from the burden of a nondiscriminatory tax, and in the *Gerhardt case* pointed out that one of these functions was the power of the State to borrow money and that the taxation of income received by a private investor from State bonds threatened impairment of such function.

SUBPART B. POWER AS AFFECTED BY THE SIXTEENTH AMENDMENT

(1) Legislative History

The sixteenth amendment to the Constitution, which became effective February 25, 1913, provides as follows:

> The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Supreme Court has held that this language does not extend the Federal taxing power to new objects and does not give the Congress authority to tax income which before the ratification of the amendment was beyond its powers. It was decided that the purpose of the amendment was to remove the necessity of apportioning such income taxes as are direct; and further, that the amendment is not to be extended beyond the meaning clearly indicated by the language used.

Nevertheless the meaning of the phrase "from whatever source derived" has furnished grounds for continued controversy and debate. It must be admitted by the most persevering protagonists that there is a possible basis for two interpretations of this language; the first, that it was intended by those proposing and ratifying the amendment that these words would bring within the Federal taxing power all incomes from every source, including interest on State and local securities, and the second, that the language was intended simply to remove the apportionment requirement with respect to income arising from property, a tax upon which was a "direct" tax under the decision in the *Pollock case*.

A study of the history of the amendment discloses numerous arguments upholding each position—from the time the amendment was first proposed eminent lawyers and brilliant legal minds have differed as to the proper interpretation of the debated phrase. It is extremely difficult to weigh even the approximate effect these pro and con arguments had upon the minds of those proposing and ratifying the amendment.

The outstanding events in the legislative history of the amendment may be briefly related. By 1909, the popularity of the income tax had grown to the point where it could no longer be denied. The attempt made in the act of 1894 to levy such a tax had met with general approval and the Pollock decision, rendering that act ineffective, created widespread resentment. After the *Pollock case* there arose a demand that the necessary steps be taken to overcome the effect of this decision, which clearly meant the adoption of a constitutional amendment.

In the *Pollock case* income had been divided into three general classes: The first, composed of income from property; the second,

of interest upon bonds of State and local governments; and the third, of income from all other sources (the question of salaries of State and local officers and employees was not before the Court).

With regard to income of the first class, the Court found that a tax thereon was a "direct" tax for the purposes of the constitutional requirement that direct taxes must be apportioned in accordance with the census or enumeration. Upon this point the Court was divided, the majority being five Justices, while four dissented. Upon the question of the power of the Federal Government to tax the interest from State and local securities the Court found that this was "a tax upon the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution." As to this point the decision of the Court was unanimous.

The date of the Pollock decision was April 8, 1895. From that date to 1909 there was an ever-increasing growth of public opinion favorable to the income tax. Agitation became acute and the demands were so insistent that when a special session of the Congress was called in 1909 to consider the subject of tariff revision it soon developed that the question of an effective income tax and a constitutional amendment was uppermost in the legislative mind. Proposed amendments in several forms were presented. On April 27, 1909, Senator Brown, of Nebraska, introduced one providing that "The Congress shall have power to lay and collect taxes on incomes and inheritances." He apparently became convinced that this language added nothing to the Federal taxing power, as on July 17 he introduced a second proposal as follows: "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several States according to population."

During this time the tariff bill of 1909 was under consideration by the Congress. Several amendments were offered to this bill to provide an income tax. Senator Daniel, of Virginia, proposed a special excise tax on corporations to be measured by their gross income. Senator Bailey, of Texas, introduced a general income tax which, with the exception of the State and local bond interest issue, fully challenged the *Pollock case*. The Bailey proposal provided for a flat rate and applied to both individuals and corporations. Senator Cummins submitted a bill providing for a graduated income tax upon individuals, but containing provisions exempting salaries of State and local officers and employees and the interest upon State and local securities.

Of particular interest are two bills which were submitted by Mr. Cordell Hull, of Tennessee, in the House. The first provided for a general income tax which would apply to income from property but which exempted State and local bond interest. The second, instructed the Treasury Department and the Department of Justice to proceed upon the collection of taxes under the 1894 act (except as they applied to State and local bond interest), regardless of the decision in the *Pollock case*.

It will be noted that there ran through these proposals a general disregard of the *Pollock case* insofar as it related to income from property. From statements by the Members, and from the debates on the floor, it will appear that among a considerable element in both Houses there existed a strong resentment toward that portion of the Pollock decision, and a belief that, considering the importance of the decision and the majority of only 1 vote, that a reversal might be had

upon another case involving the same point. However, with regard to the portion of the decision relating to State and local bond interest, upon which point the Court was unanimous, there was evidenced a general acquiescence and a desire to make all proposed legislation conform to that part of the decision.

On June 16, President Taft in a message to the Congress, submitted two proposals: The first of which recommended that the Congress submit to the States a constitutional amendment "conferring the power to levy an income tax upon the National Government without apportionment among the States in proportion to population." The second recommended the adoption of a corporation excise tax based upon net income. It was generally conceded that this move on the part of the President and the party leaders was made in an effort to "placate the insurgents" and bring about a compromise reasonably acceptable to all of the conflicting elements in the Congress, and, above all, to remove the hindrances to the passage of the tariff bill.

Senator Brown then offered his second proposal for a constitutional amendment already referred to, i. e., "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several States according to population." This proposal had the serious fault, from the point of view of a great number of the Members who so strongly resented the Pollock decision, of seeming to admit, by the use of the word "direct," the full implication of the majority's position with respect to a tax on income from property.

Senator Brown's proposal was referred to the Committee on Finance where 10 days later it emerged in the form finally adopted, namely—

> 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.

Thus the Brown proposal was amended by eliminating the despised word "direct" and by adding the phrase "from whatever source derived."

While the Brown proposal was under the consideration of the Finance Committee, Senator McLaurin made the suggestion on the floor that Senator Brown could have secured the same result by simply striking out the words "and direct taxes" in clause 3, section 2 of the Constitution, which provides,

"Representatives and direct taxes shall be apportioned among the several States, etc.," and the words "or other direct" in clause 4, section 9, which provides:

> No capitation, or other direct tax shall be laid, unless in proportion to the census or enumeration, etc.

This suggestion, however, did not take into account the fact that Senator Brown's proposal removed the apportionment requirement only with respect to income taxes, while the elimination of these two phrases would have nullified this requirement with regard to all other direct taxes with the exception of capitation taxes. There was no desire to go this far.

There seems little doubt but that the genesis of the debated phrase lies completely in the word "direct" as used in the Brown proposal. This conclusion seems particularly likely when viewed in the light

of the following facts: First, there was a substantial group of Members of Congress who were greatly incensed over the portion of the Pollock decision relating to taxes on incomes from property. As is demonstrated by the bills they introduced and the speeches on the floor, they were anxious to fully challenge this part of that decision. There was another group who favored an income tax but were willing to conform to the decision and wanted to pass an income-tax act that would be acceptable to the Court until an amendment could be secured that would allow a broadened tax. Then, there were, of course, those who were not agreeable to an income tax and did not desire an amendment.

These facts throw light on the compromise language eventually agreed upon. Second, the stimulii for action on the income tax came from the insurgent group. The conservative element was anxious for the passage of the tariff bill. The income-tax issue was a popular one and the agitation and pressure for definite action was acute. It cannot be doubted that almost all Members were sensible to these demands. Thus, when the second proposal for a constitutional amendment was submitted by Senator Brown, who certainly did not come from the most conservative group, the necessity for a compromise upon some generally acceptable language became apparent.

The membership of the Finance Committee at this time was as follows: Senators Aldrich (chairman), Burrows, Penrose, Hale, Cullom, Lodge, McCumber, Smoot, and Flint were on the Republican side; the Democrats were Senators Daniel, Money, Bailey, Taliaferro, and Simmons. From these names a majority could be obtained made up of Senators as conservative as any then in office. It is inconceivable that the Finance Committee so constituted would have taken Senator Brown's proposal and extended it to fields clearly not contemplated in its language.

It seems much more reasonable to assume that the word "direct" was stricken out and the phrase "from whatever source derived" inserted, purely to remove the necessity for distinguishing between "indirect" income taxes which were constitutional, and such taxes as were "direct" and thus barred by the Pollock decision. The changed language was undoubtedly a conciliatory gesture on the part of the Finance Committee toward the insurgent element to whom, in their indignation over the *Pollock case* the word "direct" was an affront. Further evidence of the compromise nature of the committee's change in wording is contained in Senator Aldrich's request, upon reporting the bill to the Senate, that the amendment be disposed of without debate.

Senator Brown, in April 1910, in the Editorial Review, made the following comment with regard to the words "from whatever source derived":

> The sole question, therefore, presented by the amendment, and the sole consideration involved in its ratification or rejection is whether or not the United States, the foremost Nation of the world, shall be clothed with this prerogative of national sovereignty—the power to tax incomes according to their value and without regard to apportionment among the several States according to population.

And further—

Recently the question has been raised by those who are opposed to the ratification of the amendment that with the amendment ratified the powers of the States will in some way be impaired and their strength and vitality, in some way not specified, destroyed.

The objection is not sound. The amendment in no way changes the existing relation between the State and the Federal Government. Whether the amendment is ratified or not, the rights of the State as a State and those of the Federal Government in their relation to each other will remain the same. Each sovereignty is now wholly independent of the other in the exercise of certain governmental functions and the proposed amendment neither adds to nor takes away from the independence now enjoyed by each. But it is the argument of some who oppose its adoption that the amendment will alter that relation by conferring upon the Federal Government the power to tax the incomes arising from investments in State and municipal securities. I do not agree with that argument because the language of the amendment and the occasion for its submission by Congress and the Constitution itself do not warrant that interpretation. Under the existing Constitution, the Federal Government is without the power to tax State or municipal securities. And the State is without the power to tax Federal securities. Each may tax its own securities but neither is subject to the jurisdiction of the other in taxation matters. The proposed amendment in not the remotest degree suggests any change in that regard. Each sovereignty is left to the independent and exclusive privilege of taxing its own securities without interference by the other.

While there were a number of references made by Members on the floors of both the House and the Senate to the desirability of taxing the interest from State and local bonds, there is nothing in the legislative history of the sixteenth amendment from which it could be concluded that it was the intention of the Congress to frame the amendment so as to provide for the taxability of State and local bond interest. The language "from whatever source derived" seems more properly to have been used to eliminate the use of the word "direct."

Thus the Senator introducing the amendment and Chairman Aldrich, who was in charge of the bill on the floor, gave no intimation that the momentous step of subjecting State and local bond interest to the Federal income tax, was contemplated. In fact, they denied this to be the intention of the Congress and declared that the only purpose of the language was to remove the necessity for apportionment with regard to such income taxes as might be direct.

Mr. Harry Hubbard, in an article published in the Journal of the Americal Bar Association, quotes from a letter written to him by Senator Knute Nelson, of Minnesota, in 1920. Senator Nelson was a member of the Committee on the Judiciary. He wrote Mr. Hubbard that "the words 'from whatever source derived' were inserted in the amendment in the Senate at my instance and on my insistence." Later he wrote Mr. Hubbard that "the record may not show it but I introduced the amendment and the facts are that at that time Mr. Aldrich was chairman of the Finance Committee and I discussed the matter with him and insisted on the amendment being inserted and he concurred with me and reported the bill with the phrase 'from whatever source derived.'" With regard to the decision in *Evans* v. *Gore*,[36] Senator Nelson said, in this letter:

I have been very sorry to see that the Supreme Court in its decision has utterly ignored the phrase; in fact, treated the amendment as though this phrase were not a part of it.

[36] 253 U. S. 245.

The Record discloses that Senator Nelson was present in the Senate at the time the debates on the amendment were taking place. It also discloses that in 1910 when Senator Borah made his often-quoted speech with regard to the interpretation of the amendment, that Senator Nelson was also present. It seems very strange that he should sit through these debates in which the contrary view was so definitely and forcibly stated, without arising to make his own position clear with regard to the disputed phrase.

When the amendment came before the States for ratification, a number of people, including eminent legal authorities, governors, and others in positions of influence, expressed grave doubts as to the proper construction of the disputed phrase. Governor Hughes, of New York, in a message to his General Assembly, pointed out that the phrase could be construed so as to include not only incomes from property, but also interest from State and local securities. His message was given wide circulation, and his popularity coupled with a very general respect for his clarity of mind and legal ability, undoubtedly made his views of considerable weight in the minds of State legislators. Senator Borah and the able and learned Elihu Root, took issue with the Governor and, in a clear and very forceful manner, pointed out that there was no substantial ground upon which anyone could conclude that the Congress intended to do any more than to remove the apportionment requirement with respect to income taxes.

Senator Borah pointed out further, that from the beginning the Federal taxing power had been plenary and complete except for the express restraints imposed by the provisions requiring apportionment of direct taxes and the uniformity of all taxes, and the implied restraint, under Court decisions, against diminution of the salaries of judges, the burdening or infringement of State powers, the impairment of contracts, denial of due process, and the like—by use of the taxing power. In other words, that except for the requirement for the apportionment of direct taxes and the uniformity of taxation that the Federal taxing power was just as broad and as all inclusive as any other express power granted to the Congress by the Constitution; but, just as were all of the other powers, the taxing power was subject to the general limitations and restraints provided in the Constitution.

Others joined in the general debate and a number of very forceful opinions were expressed and circulated among the State legislatures. However, no one can say just what effect these statements had in determining the choice of the State legislators.

Whatever was intended, the choice of language was unfortunate. Considering the atmosphere of doubt that surrounded the amendment during the time of its ratification, there is little reason to assume that such an important step as the removing of the ban on a Federal tax of State bonds would have been undertaken or completed in such ambiguous and uncertain terms and in the absence of a general agreement as to just what the language really meant. This seems doubly certain when it is considered that, had the intention been definitely and ascertainably to include State bond interest, the States would have been giving up a valuable immunity without receiving in return any comparable compensation.

This point has been ably summed up by Mr. William Anderson in an article on tax exempt securities in the Minnesota Law Review for March 1934, as follows:

> Can it be assumed that Congress, without discussion of the question, by the clumsy use of four words in the middle of an amendment, intend to introduce a change of so tremendous significance? New and fundamental powers are not usually conferred by a single phrase found in a provision having a different purpose. If the broad construction would be applied to the amendment, it might be even construed broad enough to tax the incomes or revenues of the State or municipal government themselves. Furthermore, this broad construction, if taken literally, would authorize the impairment of the obligations of contracts.
>
> It is entirely improper to take out a single provision of the Constitution and construe it without reference to other parts of the document. It is equally unjustifiable to take the bare words and construe them with an uncompromising literality. When the letter is the law, the people become victims of the unskilled draftsman and the careless copyist. The official or strict construction of the Constitution is preferable, first, because it considers the Constitution as a whole; second, it is not misled into disregarding the form of the amendment for its substance, and third, it does not open the door to such results as impairment of obligations of contracts, it preserves the fundamental rule that the Federal Government may not tax the governmental instrumentalities of the State.

In this connection, the decision in the case of *Fairbank* v. *United States*[37] is of interest. The validity of a Federal stamp tax on foreign bills of lading was before the Court. In fixing the scope to be allotted to the provision limiting the taxing power, by prohibiting taxes on articles exported, the Court laid down the following general rule with regard to powers and restrictions thereon:

> We are not here confronted with a question of the extent of the powers of Congress but one of the limitations imposed by the Constitution on its action, and it seems to us clear that the same rule and spirit of construction must also be recognized. If powers granted are to be taken as broadly granted and as carrying with them authority to pass those acts which may be reasonably necessary to carry them into full execution; in other words, if the Constitution in its grant of powers is to be so construed that Congress shall be able to carry into full effect the powers granted, it is equally imperative that where prohibition or limitation is placed upon the power of Congress that prohibition or limitation should be enforced in its spirit and to its entirety. It would be a strange rule of construction that language granting powers is to be liberally construed and that language of restriction is to be narrowly and technically construed.

With regard to the power of Congress to tax the interest on State and local securities, the limitation was no less exacting, because it was implied rather than expressed as in the above case.

Looking back over the history of the amendment, the following points stand out:

First, that with regard to the portion of the Pollock decision dealing with incomes from property, the Court's majority was 5 to 4; but, as to the power of the Federal Government to tax State and local bond interest, it was unanimous.

Second, that in order to levy an effective income tax, it was necessary to remove the constitutional requirement for apportionment of direct taxes.

Third, that Senator Brown's second proposal sought to do just that, and that nothing more was contemplated or possibly to be inferred from the language used.

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[37] 181 U. S. 283.

Fourth, that it is extremely unlikely that the conservatively constituted Committee on Finance had in mind extending the scope of the Brown proposal to include tax-exempt interest when it struck out the word "direct" and inserted the phrase "from whatever source derived."

Fifth, that it is clear from the statements of Senators Brown, Borah, and Aldrich that there was no intention on the part of the Congress to include State bond interest by the use of the disputed phrase.

Sixth, that in spite of Senator Nelson's statement (made in a letter in 1920) that the change of words was made at his insistence and that he understood them to include State bond interest, it seems strange that he should sit silent through the debates without making his position clear.

Seventh, that the origin of the phrase undoubtedly arose in the use of the word "direct" by Senator Brown in his proposal, and it was used to avoid the necessity for using this unpopular word.

Eighth, that even if there were doubt as to the proper construction of the phrase and the intention of its framers, an ambiguous amendment should not have been construed so as to infringe the powers of the State unless such a step was unquestionably and incontrovertibly authorized.

(2) Judicial Interpretation

The second question to be considered is whether the Federal Government has the power to tax the income from State bonds by reason of the sixteenth amendment. This amendment provides that:

> 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.

It is stated that the purpose of the sixteenth amendment was to overcome the decision of the Supreme Court in the *Pollock case*.[38] However, it should be remembered that it was only the majority opinion of the *Pollock case* which was criticized, not the minority. Both the majority and minority opinions were unanimous in holding that the Congress was without power to apply a nondiscriminatory Federal income tax to the income from State or municipal bonds. Moreover, that case did not involve the taxation of State officers or employees for the reason that their salaries were specifically exempted by Congress in the act before the Court in the *Pollock case*. Mr. Justice Fuller, in referring to the income from State and municipal bonds in the rehearing on the *Pollock case*, said:

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

He then went on to state:

> But if, as contended, the interest when received has become merely money in the recipient's pocket and taxable as such without reference to the source from which it came, the question is immaterial whether it could have been originally taxed at all or not. This was admitted by the Attorney General with characteristic candor; and it follows that, if the revenue derived from municipal bonds cannot be taxed because the source cannot be, the same rule

[38] 157 U. S. 429; 158 U. S. 601.

applies to revenue from any other source not subject to the tax; and the lack of power to levy any but an apportion tax on real and personal property equally exists as to the revenue therefrom.

In construing this opinion, the study of the Department of Justice holds that:

The majority view was that the Court either looks to source for all purposes or must accept the income concept for all purposes (Department of Justice Study, p. 118).

and then continues:

The sixteenth amendment was written into the Constitution because of the effect of this decision upon the power of the Congress. It is believed that the amendment, in giving to the Congress the power to tax incomes "from whatever source derived" without apportionment, abolishes the governing principle in the *Pollock case*, i. e., that a tax on income is equivalent to a tax on the several sources from whence such income is derived. This makes an income tax a tax on income without regard to the sources from whence derived. As the Chief Justice pointed out in the opinion on rehearing, if an income tax is not considered as the legal equivalent of a tax on the source, then the interest on State and municipal obligations would be subject to a general, nondiscriminatory income tax.

The Chief Justice in this case was showing the result which would follow if the source of the income was disregarded for all purposes. Under such a theory, the Congress would be unable to classify income, that is, it would be unable to tax capital gains at one rate and earned income at another rate or to determine a distribution was capital or an ordinary dividend in the hands of the shareholder. It would also be unable to levy an income tax on wages, which tax has recently been upheld by the Supreme Court in connection with the Social Security Act. If the only income tax authorized by the sixteenth amendment is "a tax on income without regard to the source from whence derived," all of our income-tax laws, beginning with the Revenue Act of 1913, would be unconstitutional. That this was not the view of the Supreme Court as to the purpose of the sixteenth amendment is made evident by the first decision arising under the sixteenth amendment, construing the Revenue Act of 1913. This was the case of *Brushaber* v. *Union Pacific Railroad Co.*,[39] decided January 24, 1916.

In the Revenue Act of 1913 Congress classified incomes and allowed certain exemptions. Proceeds from life-insurance policies or from life-insurance endowments or annuity contracts were not included in income. The interest upon the bonds of State or political subdivisions, the compensation of the President of the United States, the judges of the Supreme and inferior courts, and the compensation of officers or employees of a State or political subdivision were exempt. Individuals were entitled to deduct from their gross income dividends received from corporations. To determine whether or not the amounts in the hands of the individual were exempt or deductible under the law, it was necessary to look into the source from which such income was derived.

The first point raised in the *Brushaber case* was that the effect of the sixteenth amendment was merely to waive the requirement of apportionment among the States in its application to a general and uniform tax upon incomes from whatever source derived and that the income-tax law of 1913, except insofar as the tax thereby imposed

[39] 240 U. S. 1.

was in reality such a general and uniform tax on incomes, it derived no support from the sixteenth amendment. It was contended in that case that—

Discriminations, inequalities, exemptions, and artificial rules of computation are excluded from any income-tax law which purports to derive its authority from the sixteenth amendment, because they necessarily involve the taxing of something other than income.

It was also contended that, under the sixteenth amendment, a tax could not be imposed on particular kinds of income, such as the tax on income from gold mines or upon rates received from leasehold estates. It was further contended that the tax to be imposed under the sixteenth amendment must be a general tax upon incomes from whatever source derived, merely because they were incomes and not because of their size or their source or any other quality or incident whatsoever.

The Court summed up the contentions as to the invalidity of the act on these points as follows:

(*a*) The amendment authorizes only a particular character of direct tax without apportionment, and therefore if a tax is levied under its assumed authority which does not partake of the characteristics exacted by the amendment, it is outside of the amendment and is void as a direct tax in the general constitutional sense because not apportioned.

(*b*) As the amendment authorizes a tax only upon incomes "from whatever source derived," the exclusion from taxation of some income of designated persons and classes is not authorized and hence the constitutionality of the law must be tested by the general provisions of the Constitution as to taxation, and thus again the tax is void for want of apportionment.

It is clear, therefore, that the Supreme Court had before it in the *Brushaber case* the question as to whether or not the income tax authorized by the sixteenth amendment was "a tax on income without regard to the source from whence derived."

The Court, before taking up the text of the amendment, made a brief statement of the legislative and judicial history of the subject with which the amendment was concerned. The following is quoted from the opinion of the Court as to these matters:

* * * That the authority conferred upon Congress by section 8 of article I "to lay and collect taxes, duties, imposts, and excises" is exhaustive and embraces every conceivable power of taxation has never been questioned, or, if it has, has been so often authoritatively declared as to render it necessary only to state the doctrine. And it has also never been questioned from the foundation, without stopping presently to determine under which of the separate headings the power was properly to be classed, that there was authority given, as the part was included in the whole, to lay and collect income taxes. Again, it has never moreover been questioned that the conceded complete and all-embracing taxing power was subject, so far as they were respectively applicable, to limitations resulting from the requirements of article I, section 8, clause 1, that "all duties, imposts, and excises shall be uniform throughout the United States," and to the limitations of article I, section 2, clause 3, that "direct taxes shall be apportioned among the several States," and of article I, section 9, clause 4, that "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." In fact, the two great subdivisions embracing the complete and perfect delegation of the power to tax and the two correlated limitations as to such power were thus aptly stated by Mr. Chief Justice Fuller in *Pollock* v. *Farmers' Loan & Trust Company, supra*, at page 557: "In the matter of taxation, the Constitution recognizes the two great classes of direct and indirect taxes, and lays down two rules by which their imposition must be governed, namely: The rule of apportionment as to direct taxes, and the rule of uniformity as to duties, imposts, and excises." It is to be observed, however,

as long ago pointed out in *Veazie Bank* v. *Fenno* (8 Wall. 533, 541), that the requirement of apportionment as to one of the great classes and of uniformity as to the other class were not so much a limitation upon the complete and all-embracing authority to tax, but in their essence were simply regulations concerning the mode in which the plenary power was to be exerted. In the whole history of the Government down to the time of the adoption of the sixteenth amendment, leaving aside some conjectures expressed of the possibility of a tax lying intermediate between the two great classes and embraced by neither, no question has been anywhere made as to the correctness of these propositions. At the very beginning, however, there arose differences of opinion concerning the criteria to be applied in determining in which of the two great subdivisions a tax would fall * * *.

* * * Upon the lapsing of a considerable period after the repeal of the income-tax laws referred to, in 1894 an act was passed laying a tax on incomes from all classes of property and other sources of revenue which was not apportioned, and which therefore was of course assumed to come within the classification of excises, duties, and imposts which were subject to the rule of uniformity but not to the rule of apportionment. The constitutional validity of this law was challenged on the ground that it did not fall within the class of excises, duties, and imposts, but was direct in the constitutional sense and was therefore void for want of apportionment, and that question came to this court and was passed upon in *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429; 158 U. S. 601). The Court, fully recognizing in the passage which we have previously quoted the all-embracing character of the two great classifications, including, on the one hand, direct taxes subject to apportionment, and on the other, excises, duties, and imposts subject to uniformity, held the law to be unconstitutional in substance for these reasons: Concluding that the classification of direct was adopted for the purpose of rendering it impossible to burden by taxation accumulations of property, real or personal, except subject to the regulation of apportionment, it was held that the duty existed to fix what was a direct tax in the constitutional sense so as to accomplish this purpose contemplated by the Constitution (157 U. S. 581). Coming to consider the validity of the tax from this point of view, while not questioning at all that in common understanding it was direct merely on income and only indirect on property, it was held that considering the substance of things it was direct on property in a constitutional sense, since to burden an income by a tax was from the point of substance to burden the property from which the income was derived and thus accomplish the very thing which the provision as to apportionment of direct taxes was adopted to prevent. As this conclusion but enforced a regulation as to the mode of exercising power under particular circumstances, it did not in any way dispute the all-embracing authority possessed by Congress, including necessarily therein the power to impose income taxes if only they conformed to the constitutional regulations which were applicable to them. * * *

Then the Court, after quoting the amendment, went on to state:

* * * It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the *Pollock case*, and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock case* was decided; that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment. From this in substance it indisputably arises, first, that all the contentions which we have previously noticed concerning the assumed limitations to be implied from the language of the amendment as to the nature and character of the income taxes which it authorizes find no support in the text and are in irreconcilable conflict with the very purpose which the amendment was adopted to accomplish. * * *

And then the Court concluded:

* * * the amendment contains nothing repudiating or challenging the ruling in the *Pollock case* that the word "direct" had a broader significance since it embraced also taxes levied directly on personal property because of its ownership, and therefore the amendment at least impliedly makes such wider significance a part of the Constitution—a condition which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended; that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties, and imposts and place it in the class of direct taxes.

The same contentions were raised in the case of *Stanton* v. *Baltic Mining Company.*[40] In that case, the appellant in its brief pointed out that income derived from the exercise of essential governmental functions of States or their political subdivisions were among the exemptions granted by the 1913 act. This case also raised the point that the tax on mining companies was a tax on the gross production and not on the net production of the working of the mine by the corporation and that, for that reason, the tax was not within the purview of the sixteenth amendment. In answering this question, the Court said:

But aside from the obvious error of the proposition intrinsically considered, it manifestly disregards the fact that by the previous ruling it was settled that the provisions of the sixteenth amendment *conferred no new power of taxation* but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged and being placed in the category of direct taxation subject to apportionment by a consideration of the sources from which the income was derived; that is, by testing the tax not by what it was—a tax on income—but by a mistaken theory deduced from the origin or source of the income taxed. Mark, of course, in saying this we are not here considering a tax not within the provisions of the sixteenth amendment; that is, one in which the regulation of apportionment or the rule of uniformity is wholly negligible *because the tax is one entirely beyond the scope of the taxing power of Congress and where consequently no authority to impose a burden direct or indirect exists.* In other words, we are here dealing solely with the restriction imposed by the sixteenth amendment on the right to resort to the source whence an income is derived in a case where there is power to tax for the purpose of taking the income tax out of the class of indirect, to which it generically belongs, and putting it in the class of direct, to which it would not otherwise belong, in order to subject it to the regulation of apportionment.

It will be noted that this case held that the right to disregard the source existed in a case where there was a power to tax only for the purpose of not applying the rule of apportionment. Of course, in the case of income from State or municipal bonds, there was no power to tax.

The next case involving the sixteenth amendment in connection with the Revenue Act of 1913 was that of the *Tyee Realty Co.* v. *Anderson.*[41] Since all of the contentions in this case had already been decided by the *Brushaber case*, the Court held that case to dispose of the issues here involved.

The conclusion from the cases construing the Revenue Act of 1913 seems inescapable that the Court did not accept the interpretation that an income tax, to meet the requirements of the sixteenth amend-

[40] 240 U. S. 103.
[41] 240 U. S. 115.

ment, must be a tax on incomes without regard to the source from whence derived. It concluded that the source was to be disregarded by that amendment only where there was a power to tax, and then only for the purpose of preventing the application of the rule of apportionment. The provisions of the Revenue Act of 1913 exempting the interest upon obligations of State or political subdivisions were inserted according to Mr. Cordell Hull, who was in charge of the bill in the House, to prevent the injection of any more constitutional questions or controversies on the bill. On the Senate side, it was stated that these exemptions were inserted to foreclose the doubt which was regarded as improbable that such revenues might be subject to Federal taxation. Of course, at that time, the decisions in the *Brushaber case* and related cases had not been rendered. These exemptions were continued through the Revenue Acts of 1916 and 1917. The Revenue bill of 1918, as introduced in the House, attempted to tax the interest on State and municipal obligations, but this provision failed of passage. This bill included in gross income—

> the interest from obligations of States, Territories, political subdivisions thereof, or the District of Columbia, issued after the passage of this act, unless authorized by law prior to the passage of this act or unless issued for the purpose of funding or refunding interest-bearing indebtedness outstanding at the time of the passage of this act or for the performance of a contract entered into prior to the passage of the act.

The reason for taxing this interest, which had been free of tax under the prior acts, was according to the committee report, that—

> the committee was of the opinion that, although there is doubt as to the constitutionality of including the interest on these obligations, justice requires that at least in time of war the holders of these securities should share the burdens equally with the holders of Liberty bonds.

In regard to the provision subjecting the interest on new issues of State and municipal bonds to taxation, the Senate Finance Committee struck out the House provision specifically taxing them, the report stating that—

> Apart from the constitutional question, it seems unwise for Congress to attempt to impose this tax upon obligations of States and municipalities so long as these States are not free to tax in a similar manner the obligations of the United States.

The conference committee agreed to the Senate amendment and restored the exemption. However, there was a provision inserted in the Revenue Act of 1918 which specifically taxed the salaries of the President and judges of the United States Supreme Court and the inferior courts of the United States. This was the situation existing until 1920, when the case of *Evans* v. *Gore*[42] was decided. This case involved the taxation of the salary of a Federal judge for the western district of Kentucky, who was appointed by the President with the advice and consent of the Senate in 1899. The Government taxed his salary under the Revenue Act of 1918, which specifically included as income the salary of such a judge. There were two questions presented to the Supreme Court for decision: (1) Whether in subjecting the salary of a Federal judge to a net income tax amounted to a diminution of his compensation under article III, section 1, of the Constitution; and (2) if the levying of a net income

[42] 253 U. S. 245.

tax does amount to a diminution of a judge's salary, does the sixteenth amendment modify this express provision of the Constitution so as to render such salary subject to the income tax? The Court concluded that the levying of an income tax would diminish the compensation of a Federal judge within the meaning of the Constitution, and then went on to state:

> Does the sixteenth amendment authorize and support this tax and the attendant diminution; that is to say, does it bring within the taxing powers subjects theretofore excepted? The Court below answered in the negative; and counsel for the Government say:
>
> "It is not, in view of recent decisions, contended that this amendment rendered taxable as income anything that was not so taxable before."
>
> We might rest the matter here, but it seems better that our view and the reasons therefor be stated in this opinion, even if there be some repetition of what recently has been said in other cases.

After reviewing the *Pollock case*, the *Brushaber case*, and other cases, and the legislative history of the sixteenth amendment, the Court concluded that the sixteenth amendment did not extend the taxing power to new or excepted subjects but merely removed all occasion otherwise existing for an apportionment among the States of taxes laid on income derived from one source or another. In other words, this question was reconsidered, and the view in the *Baltic Mining Company case* and other cases was adhered to, which, in effect, meant that the sixteenth amendment would not authorize such a tax.

In *Peck & Company* v. *Lowe*,[43] relating to the application of the income tax imposed by the Revenue Act of 1913 to exports, the argument was made that the sixteenth amendment had not enlarged the taxing power of Congress so that it could levy a net income tax on exports. Mr. Justice Van Devanter, in delivering the opinion of the Court, held that the sixteenth amendment had no real bearing on the case, but stated—

> that this amendment does not extend the taxing power to new and excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another.

In the case of *Eisner* v. *McComber*,[44] the Court in determining whether or not a stock dividend was income within the meaning of the sixteenth amendment, said:

> The sixteenth amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributable to them before the amendment was adopted.

And then restated the conclusions referred to in the former opinions that the amendment 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. Also, in *Metcalf & Eddy* v. *Mitchell*,[45] Mr. Justice Stone in writing the majority opinion referred to the cases holding that the sixteenth amendment did not extend the taxing power to any new classes of subjects.

The only case directly involving the taxation of the income from State and local bonds after the passage of the sixteenth amendment

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[43] 247 U. S. 165 (1918).
[44] 252 U. S. 189 (1920).
[45] 269 U. S. 514 (1926).

was that of the *National Life Insurance Co. case*,[46] already discussed in the first part of the report. In that case the Court did not consider the sixteenth amendment directly but held that Congress was without power to impose such a tax.

It is reasonably clear, therefore, that the Court, both by dicta and decisions, has come to the conclusion that items of income which were not taxable before the adoption of the sixteenth amendment are not taxable after such adoption.

PART II. WHETHER CONGRESS HAS THE POWER TO APPLY THE FEDERAL INCOME TAX DIRECTLY TO THE SALARIES OF OFFICERS AND EMPLOYEES OF STATES AND THEIR POLITICAL SUBDIVISIONS

In discussing this question, the subject will be divided into four subparts. Subpart A will deal with the legislative history; subpart B, with the executive interpretation; subpart C, with the judicial interpretation; and subpart D, conclusion.

SUBPART A. LEGISLATIVE HISTORY

(1) Prior to the Sixteenth Amendment

Prior to the sixteenth amendment the Civil War Income Tax Acts contained language broad enough to embrace salaries of State and municipal employees. These acts taxed the "income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever." The Supreme Court held in *Collector* v. *Day*,[47] that this language was broad enough to include the salary of a State judge, but that such income could not be reached under the Constitution. In the next income tax act, that of 1894, Congress specifically exempted the salaries of State, county, or municipal officers. Doubtless because of this exemption, the power of Congress to tax the salaries of State employees was not before the Court in the *Pollock cases* holding the 1894 income-tax provisions unconstitutional.

(2) After the Sixteenth Amendment

The first income tax enacted after the sixteenth amendment was the Revenue Act of 1913. That act specifically exempted from Federal taxation the compensation of all officers or employees of a State of any political subdivision thereof except where such compensation was paid by the United States Government. It also exempted from the income tax the compensation of the President of the United States and Judges of the Supreme and inferior courts of the United States. This exemption was continued in the Revenue Acts of 1916 and 1917. In the revenue bill of 1918, the Ways and Means Committee inserted a provision stiking out the exemption from tax

[46] 277 U. S. 508.
[47] 11 Wall. 113 (1871).

granted to State officers and employees and specifically taxing them. The Ways and Means Committee report stated the reason for this provision as follows:

> The compensation of the President of the United States and of the Judges of the Supreme and inferior courts of the United States and all officers and employees of any State, Territory, or political subdivision thereof or the District of Columbia, is made subject to income tax. The compensation of these officials under existing law is not subject to income tax. Your committee realizes that there is a great difference of opinion among the best legal talent with reference to the constitutionality of this provision, but feels that in all equality and justice such officials should be subject to income taxes and that, if necessary, this matter should be definitely decided by the Court.

The bill passed the House in this form, but changes were made by the Senate Finance Committee. The Finance Committee amended the law so that it did not specifically refer to the salaries of State officers or employees as such, but it taxed all gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and whatever form paid, leaving the constitutional question as to the authority of Congress to tax certain salaries to be settled by the courts in any case in which the question was raised.

When the bill reached conference, the provision in regard to State officers or employees was changed according to the following explanation contained in the conference report:

> Amendment No. 36: The House bill specifically provides that the term "gross income" should include the salaries of the President of the United States, the Judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States or of any State, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia. The Senate bill struck out this provision. The House recedes with an amendment making the salaries of the President of the United States, the Judges of the Supreme and inferior courts of the United States, and all officers and employees of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, subject to the income tax.

The only substantial difference between the Senate bill and the amendment agreed to in conference was that the conference amendment specifically mentioned Federal officers and employees, whereas the Senate bill left them with State employees to be covered by the general provision taxing all salaries.

The exemption granted to State officers and employees under the earlier acts was not restored. The provisions of the Revenue Act of 1918, as finally enacted, defined gross income as including—

> gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, in the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

It is clear that, so far as State officers or employees were concerned, they were left to be covered by the broad provisions taxing the income derived from salaries, wages, or compensation for personal serv-

ices of whatever kind and in whatever form paid or gains or profits and income derived from any source whatever.

In regard to State officers and employees, this language has been continued in all subsequent revenue acts, the present Revenue Act of 1938, section 22 (*a*), providing that—

"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

That this language is broad enough to cover the salaries of State officers or employees to the extent permitted under the Constitution, is shown (1) by the legislative history already referred to, (2) by the decisions of the Court taxing officers or employees not engaged in the exercise of essential governmental functions, and (3) by the Treasury regulations subsequently discussed. In this connection, it is interesting to note that Mr. Justice Stone in the majority opinion in the *Gerhardt case* [48] stated in referring to the provisions of the 1932 Act that they "do not authorize the exclusion from gross income of the salaries of employees of a State or a State-owned corporation."

It is also interesting to note that the provisions inserted in the Revenue Act of 1918 and continued in the Revenue Acts of 1921, 1924, and 1926 specifically taxing the President of the United States, the Judges of the Supreme and inferior courts, and other Federal officers and employees was omitted as surplusage in the Revenue Act of 1928. The House committee report explains that "insofar as any such compensation may be taxed under the Constitution, it is already included within the general definition in the bill." The Finance Committee objected to this, but the House provision was agreed to in conference. The Revenue Act of 1932, (sec. 22), restored the provision taxing the President and the judges of the courts of the United States, but made it applicable only to those taking office after June 2, 1932, the date of the Revenue Act of 1932. To overcome the constitutional prohibition against diminishing the compensation in such cases, the law provided that all acts fixing the compensation of such Presidents and judges should be amended accordingly.

SUBPART B. EXECUTIVE INTERPRETATION

(1) Prior to the Sixteenth Amendment

As already pointed out, the Civil War acts taxed the salaries of State officers and employees. The act of 1894 in exempting the salaries of State, county, and municipal employees was construed by the regulations under that act to apply to "all salaries paid by States, counties, or municipalities to their public officers, whether paid in fixed amounts or by fees.

[48] 304 U. S.—(May 16, 1938).

(2) After the Sixteenth Amendment

The Revenue Acts of 1913, 1916, and 1917 specifically exempted the salaries of State officers and employees. The regulations under the 1913 act (regulation 33, art. 5) provided that this exemption embraced "The compensation of all officers and employees of a State or any political subdivision thereof, including public school teachers, etc." The only exception was made where such officers or employees were compensated by the United States, in which case such compensation was made taxable. This same language was continued in the regulations under the 1916 and 1917 acts (regulation 33, art. 5) except that public-school teachers were not specifically mentioned.

The Revenue Act of 1918 was the first revenue act which did not specifically exempt the salaries of State officers and employees. In construing the Revenue Act of 1918, the Attorney General held that, in spite of the language of the act, Congress was without power to subject to the income tax the salaries of State officers and employees. Accordingly, article 85 of Treasury Regulations 45, promulgated under the Revenue Act of 1918, provided that compensation paid its officers and employees by a State or political subdivision thereof was not taxable. This same exemption was continued in the regulations under the Revenue Act of 1921 (art. 88, regulation 62); the same exemption was also continued in the regulations under the Revenue Act of 1924 (art. 88, regulation 65).

Subsequently, the Treasury Department changed its position and held the exemption only applied to those officers and employees who were engaged in the exercise of an essential governmental function. Those who were not engaged in the exercise of an essential governmental function, which included employees engaged in rendering service in connection with municipal waterworks, lighting plants, and similar branches of municipal activities, were held liable for tax, and an attempt was made to assess taxes as far back as the statute of limitations would permit upon this class of employees. This, of course, provoked consternation among the employees, and litigation was started with varying results. Before the Supreme Court had a chance to pass upon the question, many of the municipal employees who had relied upon the old regulations exempting them from taxation induced Congress to pass a special provision (sec. 1211 of the Revenue Act of 1926), exempting the compensation of all State officers and employees from income tax for 1924 and prior years. The regulations of the Treasury Department issued under the Revenue Act of 1926 and applicable to 1925 and subsequent years limited the exemption to those officers or employees of a State or political subdivision who were engaged in the exercise of an essential governmental function (art. 88, regulation 65).

The regulations under the act of 1928 continued the exemption for services rendered in connection with the exercise of a governmental function of a State or political subdivision thereof, but specifically provided that compensation received for services rendered to a State or political subdivision is included in gross income unless the person receives such compensation as an officer or employee of a State or political subdivision and the services are rendered in con-

nection with the exercise of an essential governmental function (art. 643, regulation 74). The regulations under the Revenue Act of 1932 follow those under the Revenue Act of 1928 (art. 643, regulation 77). The regulations under the Revenue Act of 1934 continued the exemption contained in the prior regulations (art. 116–2, regulation 86).

The regulations under the Revenue Act of 1936 were the same as those under the prior laws until January 7, 1938, when they were amended (art. 116–2, Reg. 94) to provide that "compensation received for services rendered to a State is to be included in gross income unless the person receives such compensation from the State as an officer or employee thereof and such compensation is immune from taxation under the Constitution of the United States."

This last regulation makes it clear that under the existing law, which has not been changed from that contained in the Revenue Act of 1918 (except with respect to the provision against retroactivity applied to 1925 and prior years and contained in section 1211 of the Revenue Act of 1926), officers and employees of States and political subdivisions are now taxable to the extent permitted by the Constitution. This situation is, therefore, different from that relating to the income from State and local bonds, which are specifically exempt from taxation by the Congress.

If, as the Department of Justice's study seems to indicate, the Court has in its recent decisions narrowed the immunity of State officers and employees from Federal taxation, the law in its present form is broad enough to permit the taxation of such income to the extent not immune from taxation under the Constitution.

SUBPART C. JUDICIAL INTERPRETATION

(1) Prior to the Sixteenth Amendment

The principle that the Federal Government had no power to tax the salaries of State employees was first decided in *Collector* v. *Day*,[49] where the salary of a State officer, a probate judge, was held to be immune from the Federal income tax. This case was decided in 1871, the Court stating:

> It is admitted that there is no express provision in the Constitution that prohibits the General Government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that Government. In both cases, the exemption rests upon the necessary implication, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, is subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?

This decision limiting the Federal power of taxation with respect to the States followed a decision rendered by the Supreme Court in 1842 in the case of *Dobbins* v. *Commissioner*,[50] holding that a State had no power to levy a tax upon the salary or emoluments of an officer of the United States. These decisions were, of course, rendered prior to the adoption of the sixteenth amendment.

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[49] 11 Wall. 113.
[50] 16 Peters 435.

(2) After the Sixteenth Amendment

After the adoption of the sixteenth amendment, there arose a line of cases which indicated that this immunity existed only with respect to State officers or employees and only with respect to functions which were regarded as essentially governmental. Thus, in *Metcalf & Eddy* v. *Mitchell*,[51] it was held that consulting engineers engaged to advise State and political subdivisions with reference to water and sewerage projects were not State officers or employees but independent contractors and, therefore, subject to the Federal income tax. This same principle was applied where an attorney was specially engaged by a State to handle a tax controversy, he being held not to be a State officer or employee.[52] These were the so-called independent contractor cases, and they arose under the revenue acts passed after the sixteenth amendment.

In the *Metcalf & Eddy* v. *Mitchell case*, the Court decided that "one who is not an officer or employee of a State does not establish exemption from Federal income tax merely by showing that his income was received as compensation for service rendered under a contract with the State; and when we take the next step necessary to a complete disposition of the question, and inquire into the effect of the particular tax, on the functioning of the State government, we do not find that it impairs in any substantial manner the ability of plaintiffs in error to discharge their obligations to the State or the ability of a State or its political subdivisions to procure the services of private individuals to aid them in their undertaking."

In this case, Mr. Justice Stone quoted with approval the decisions of the Court, holding that the sixteenth amendment did not extend the taxing power to any new class of subjects. In the *Dravo case*,[53] the Court upheld the West Virginia 3-percent gross sales tax as applied to the compensation received by an independent contractor from the Federal Government, but in that case the Federal Government stated that the tax did not interfere with its functions.

In addition to the independent contractor cases, there grew up a line of cases which held that a State or political subdivision cannot escape Federal taxation by engaging in businesses which constitute a departure from the usual governmental functions, even though such enterprises are undertaken for what the State concedes to be a public benefit. For example, Federal occupational taxes were held valid as applied to the agents of the State of South Carolina engaged in distilling liquors,[54] and a similar conclusion was reached in *Ohio* v. *Helvering*,[55] where the State had established a department of liquor control and sought an injunction to restrain the enforcement of Federal statutes imposing a tax upon dealers in intoxicating liquors.

This same principle was applied to the Federal income tax in the case of *Helvering* v. *Powers*,[56] in which the Supreme Court held that the compensation of the members of the board of trustees of the Boston Elevated Railway was subject to taxation by the Federal Government.

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[51] 269 U. S. 514 (1926).
[52] *Lucas* v. *Reed*, 281 U. S. 699 (1930).
[53] 302 U. S. 134.
[54] *South Carolina* v. *United States*, 199 U. S. 437.
[55] 292 U. S. 360.
[56] 293 U. S. 214.

Continuing along this same reasoning, that is, distinguishing between essential and nonessential governmental functions of a State, the Court in *Brush* v. *Commissioner*[57] held that the maintenance of the New York City water supply system was an essential governmental function of the State. Under the Treasury regulations applicable to that case, the compensation of State officers and employees for services rendered in connection with the exercise of an essential governmental function was exempt from the income tax. The Government did not attack the regulation, and its validity was, therefore, not before the Court.

The Supreme Court had considerably restricted the immunity of State officers or employees from Federal taxation in the recent case of *Helvering* v. *Gerhardt*.[58] While the Court actually only held that employees of the Port of New York Authority were subject to the Federal income tax, the opinion indicated that the Court believed that the State functions to which this immunity should apply were only those necessary to the existence of the State itself. The Port Authority was a bi-State corporation, created by compact between New York and New Jersey. The Court pointed out that employees of the Port Authority were not employees of a State or political subdivision within the meaning of the Treasury regulation, even as applied to the *Brush case*, and for that reason that regulation, even before its change in 1938, was ineffectual to exempt such salaries.

The reasoning of the Court in the *Gerhardt case* indicates that, if a State is performing a function which could have been undertaken by a private person, the employees of the State engaged in the performance of such function are not immune from the Federal taxing power. Under this theory it seems that school teachers, State hospital employees, and other employees performing functions which are not indispensable to the existence of the State government are subject to the Federal income tax. However, this case does not go so far as to permit the taxation of State judges, State legislators, State tax commissioners, State cabinet commissioners, and other persons engaged in any function essential to the existence of a State government. Furthermore, the Court indicates that it has never ruled expressly on the precise question whether the Constitution grants immunity from Federal income tax to the salaries of State employees performing at the expense of the State, services of the character ordinarily carried on by private citizens. This leaves open the question as to whether or not a stenographer, a bookkeeper, or a person who is not an officer of a State or political subdivision, is entitled to exemption from the Federal income tax.

The Court in the *Gerhardt case* did not overrule *Collector* v. *Day*,[59] which involved the salary of an officer engaged in the performance of an indispensable function of the State which could not be delegated to private individuals.

SUBPART D. CONCLUSION

It is, therefore, proper to conclude that the present law does tax the salaries of State officers and employees to the extent permitted by the Constitution and that no additional legislation is necessary.

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[57] 300 U. S. 352 (1937).
[58] 304 U. S.—(May 23, 1938).
[59] 11 Wall. 113.

However, if it is believed that those officers and employees, who have relied on executive interpretations that they were exempt as to the back years ought not to be subject to retroactive taxation. Legislation could be passed, similar to that contained in section 1211 of the Revenue Act of 1926, exempting from tax for 1938 and prior years amounts received as compensation for personal services as officer or employee of any State or political subdivision if such compensation was exempt under Treasury rulings in force prior to the Gerhardt decision.

PART III. MUTUAL TAXATION PLAN

The plan considered by the Department of Justice would (1) subject to the Federal-income tax the interest paid on future issues of Federal, State, and municipal bonds, and the salaries of the State and municipal employees and (2) permit State taxation of holders of future issues of Federal bonds and of Federal officers and employees within the taxing jurisdiction. This plan provides for a waiver by the Federal Government of the immunity of Federal bond holders, officers, and employees. It is concluded in the study that such a waiver will materially aid in upholding the validity of the legislation.

The difficulty about this feature of the plan is that the States will be unable to rely upon the mutuality of such a proposal. It affords no such protection to the States as that referred to in *Choate* v. *Trapp*,[60] in which the Court held that certain Indian allottees had acquired a vested right to tax exemption in giving up certain territory to the Federal Government and that such tax exemptions could not be taken away without violating the due process clause of the fifth amendment. In other words, the exemption being granted in a Federal statute and not through any compact entered into with the several States would be subject to change at the will of Congress. In any case, where the Federal Government was of the opinion that the imposition of a nondiscriminatory State income tax unduly burdened its right to obtain services or to market its bonds, it could pass legislation preventing the State tax from applying to these subjects. No such protection is afforded the States. Since the Federal Constitution makes the Federal law the supreme law of the land, a Federal statute exempting Federal bondholders or employees from State income taxes would override a State statute taxing them. This waiver on the part of the Federal Government, therefore, affords no real protection to the States and may be removed at the will of Congress. On the other hand, if it could be assumed that such a waiver was binding on the Federal Government, the plan would work unfairly towards the Federal Government itself.

By this plan, the Federal Government is giving the States the right to tax the income of Federal bondholders, officers, and employees but requires no corresponding waiver from the States. The Federal Government is taking its chances in the courts that they will uphold a Federal income tax on State officers, employees, and bondholders. It is admitted even in the study by the Department of Justice that there is doubt as to whether the courts will uphold legislation of this

[60] 224 U. S. 655.

character. If such a waiver is to be binding on the Federal Government for all purposes, it would seem dangerous to grant it under such circumstances. If the Supreme Court should reaffirm its earlier opinions that the Federal Government has no power to tax the income of State bondholders, the Federal Government will be in a position of having granted to the States the power to tax its own bondholders, officers, and employees, whereas it could not tax the income of State bondholders, officers, and employees. It might take considerable time before a constitutional amendment could be adopted to equalize this situation. This is especially true where the States, on the basis of expected money from this source, have entered into commitments for State and local expenditures.

The plan would also not be reciprocal, in that the States would have no right to subject to their nondiscriminatory income tax the salaries of judges of the Federal courts in office at the time of the enactment of the legislation. This is because the immunity of a Federal judge, secured by section 1 of article 3 of the Constitution, is designed to protect his salary from diminution and safeguards the recipient in contrast to the Government. No such protection would be afforded to the State judges from paying a nondiscriminatory Federal income tax on their salaries, even though the State constitution provided that their salaries shall not be diminished during their term of office. This is because a Federal law, being the supreme law of the land, would override a State constitution or a State law, provided, of course, such Federal law was in pursuance of the Federal Constitution.

Under the plan, the legislation will be designed to operate only in the future. This is explained in the Department of Justice's study to mean that "the interest paid on Government bonds will be taxed only with respect to subsequent issues and the Government officer or employee will be taxed only as to future salaries." It will be noted that this plan does not exempt from the tax those State and local employees now in office, although it does exempt the future income from bonds now issued. Again, the States have no assurance that, if legislation of this character is sustained, legislation will not be proposed which will reach the future income of bonds already issued. Moreover, the plan does not exempt income from bonds issued by the States for refinancing or refunding their existing debt.

In discussing the question as to whether the sixteenth amendment permitted the levying of an income tax upon the income from State and local bonds, Governor Kitchin of North Carolina, in his message to the legislature of January 5, 1911, on the ratification of the sixteenth amendment, said:

> The fear expressed in some quarters that Congress under this amendment would burden State obligations should be completely allayed when it is remembered that the Senators and Representatives in Congress reside in the States, have their primary interest in the States, and the most controlling purpose which inspires them is to serve their respective States and the people. We should assume that the State bonds and their interest are as safe from burdens in the hands of Congress as on national bonds and their interest. * * * As a 2 percent income tax would reduce the net income from $1,000 of North Carolina bonds 80 cents a year, this being an interest rate reduction from 4 percent to 3.92 percent, even if the income from nontaxable bonds, National and State, should by Congress be taxed, which is against the probabilities, it could not be reasonably considered a hardship on those on whom it would be imposed, or would seriously impair the market value of these securities.

It will be noted that Governor Kitchin was referring to a Government tax of 2 percent and not to a Federal-income tax with a maximum effective rate like we have today of 68 percent. A somewhat similar thought was expressed by Governor Hadley of Missouri when he said in his message of January 12, 1911:

> I believe the people could safely trust to their Representatives in Congress not to exercise the power herein conferred in a way that would be unjust or unfair to the State governments or to any political subdivision thereof. The National Congress is composed of Representatives selected by the people of the several States, and they are as much the Representatives of the people of the several States as are their Representatives in State government.

The argument is, therefore, made that, if this Congress attempts to subject to the Federal-income tax future issues of State obligations, the next step will be to tax the future income of past obligations. In this connection, should be remembered that Justice Cordozo, in *Burnet* v. *Welles*,[61] in holding that income from an irrevocable trust used to pay premiums on policies of settlers' life could be taxed, even though the trust was created prior to the enactment of the taxing provision, said:

> Congress does not play the despot in ordaining that trusts for such uses, if created in the future, shall be treated for the purpose of taxation as if the income of the trust had been obtained by the grantor. It does not play the despot in ordaining a like rule as to trusts created in the past, at all events when in so doing it does not cast the burden backward beyond the income of the current year.

Finally, the argument is made that the States are necessarily limited in the rates of income tax which they may impose. If the rates are too high, they may result in forcing wealth from the State. On the other hand, the Federal Government is not faced with the same situation, because it is much easier to move from one State to another than to a foreign country. The figures show that the maximum rate in the case of most of the States imposing income taxes does not exceed 5 percent, whereas in the case of the Federal Government, the maximum rate is 79 percent.

PART IV. WHETHER CONGRESS HAS THE POWER TO TAX THESE SUBJECTS BY OTHER METHODS

This discussion will be divided into two subparts. Subpart A will deal with tax-exempt securities and subpart B will deal with State officers and employees.

SUBPART A. TAX-EXEMPT SECURITIES

The methods suggested are as follows so far as tax-exempt securities are concerned:

First. The Federal Government could tax the income from subsequent issues of its own securities and the States could tax the income from subsequent issues of their securities. This would not violate the constitutional provision. Of course, the States could not tax the income from past issues which were specifically exempt from the income tax when issued, as the Constitution specifically provides that

[61] 289 U. S. 670.

no State shall impair the obligations of a contract. Furthermore, the Federal Government could not tax the income from its past issues, to the extent exempt from the income tax when issued, for to do so would constitute a violation of the due process clause of the fifth amendment. This plan also has certain practical difficulties, for unless both the States and the Federal Government acted simultaneously it would permit one government to gain an additional field for revenue at the expense of the other.

Second. The rate of tax might be computed upon the total income of the taxpayer, including his income from tax-exempt securities, and then applied only to the taxable income. While this plan has possibilities, it is believed that it violates the principle announced by the Supreme Court in the *National Life Insurance Company case*, cited supra, in which the Court said:

> One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free.

It also appears to conflict with *Miller* v. *Milwaukee*,[62], where a State statute was held invalid which taxed corporate dividends only to the extent the corporation received tax-exempt income. Some support for the plan is found in *Maxwell* v. *Bugbee*,[63] where New Jersey in levying an inheritance tax on a nonresident measured the tax on the property within the State by taking into account property located outside the State. If the property located in New Jersey had alone been considered, the rate would have been only 2 percent, but by considering all of the property, the rate applied to the taxable property amounted to 3 percent. That case, however, did not involve the protection or preservation of a function affecting the sovereignty of government. Moreover, the plan, even if approved, would only solve part of the problem. The individual who derived his income wholly or chiefly from tax-exempt securities could not be reached under such a plan.

Third. Congress might grant to the States the power to tax the income from Federal securities if the States would grant a similar privilege to the Federal Government. This plan appears to be constitutional in view of the case of *United States* v. *Bekins*,[64] in which the Court said:

> While the instrumentalities of the National Government are immune from taxation by a State, the State may tax them if the National Government consents (*Baltimore National Bank* v. *State Tax Comm.*, 209, 211), and by a parity of reasoning the consent of the State could remove the obstacle to the taxation by the Federal Government of State agencies to which the consent applied.

And then the Court, in referring to its decision in the *Steward Machine Co. case*,[65] upholding the right of a State to consent to the deposit of moneys received by the State for a State unemployment fund with the Secretary of the Treasury in a special unemployment trust fund, said:

> As the States were at liberty upon obtaining the consent of Congress to make agreements with one another, we saw no room for doubt that they may do the like with Congress if the essence of their statehood is maintained without impairment.

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[62] 272 U. S. 713.
[63] 250 U. S. 525.
[64] 304 U. S. 53.
[65] 301 U. S. 548.

However, this plan has certain practical objections. In the first place, many of the States would have to amend their constitutions in order to permit their legislatures to enter into such agreements with the Federal Government. In the recent New York Constitutional Convention, a proposal was made to do this very thing by amending the New York State Constitution, but this proposal was defeated. There would, therefore, be considerable difficulty in securing compacts of this kind. Unless all the States entered into such compacts, the plan would fail, for it would permit those States which refrained from entering into such agreements to profit at the expense of the Federal Government and the other States. Therefore, the plan would be more difficult to put in effect than a constitutional amendment, which requires a ratification not by all but only by three-fourths of the States. Moreover, the plan would not be entirely reciprocal, as the Federal Government would probably not have the right to permit the States to tax the income of Federal judges now in office. The Constitution provides that the salaries of Federal judges of constitutional courts shall not be reduced during their term of office, and in the case of *Evans* v. *Gore*,[66] the Supreme Court held that an income tax does reduce the salary of a judge. This right to tax-exemption may be regarded as personal to the Federal judge and not subject to waiver by the Federal Government. Yet the Federal Government could tax the salaries of State judges under such an agreement.

Fourth. There is a possibility that the income from tax-exempt securities might be reached through an excise tax measured by the net income from all sources. In the case of corporations, it seems clear that this can be done. As already pointed out, the corporation excise tax of 1909 taxed the privilege of carrying on or doing business by corporations. The tax was measured by the net income of the corporation from all sources. Since the subject of the tax was the exercise of a franchise or privilege, the Supreme Court held that Congress had the power to include in the measure of the tax the income from tax-exempt securities, although such income could not be directly taxed. Moreover, some of the States through corporation excise taxes are now taxing the income from Federal securities by measuring the excise by the net income of the corporation from all sources. In at least two of the States, namely, California and New York, their power to do this has been upheld by the Supreme Court. In the California case,[67] the Supreme Court made the following statement as to this point:

> The owner may enjoy his exempt property free of tax, but if he asks and receives from the State the benefit of the taxable privilege as the implement of that enjoyment, he must bear the burden of the tax which the State exacts as its price.

So far as individuals are concerned, there is a possibility that the income received by them from tax-exempt securities may also be reached through an excise. To do this, we must first find a taxable privilege upon which to base the excise. It seems clear that all trades, avocations, and employments by which individuals acquire a livelihood, may be made the subject of an excise or privilege tax.

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[66] 253 U. S. 245.
[67] *Pacific Co.* v. *Johnson*, 285 U. S. 480.

Accordingly, if Congress levied an excise on individuals engaged in any business, occupation, trade, avocation, or employment, it seems entirely possible that such tax could be measured by the net income of the individual from all sources, including the income from tax-exempt securities. As stated by the Supreme Court in the *Stone Tracy Co. case*[68]—

> there is no rule which permits a court to say that the measure of a tax for the privilege of doing business, where income from property is the basis, must be limited to that derived from property used in the business.

It is up to Congress to determine the measure of the excise, and it seems entirely possible that the measure of such excise could be the net income of the individual from all sources, including tax-exempt securities.

By this scheme, most of the income from tax-exempt securities could be reached. But those persons that would escape would be those who do not engage in any trade, avocation, or employment, but merely hold securities. This scheme would also not extend to State employees engaged in governmental functions of the State, for such occupations, being governmental in character, could not be reached even through an excise.

Fifth. Tax-exempt securities might be subject to a higher estate tax than other property of the decedent on the theory that such securities had escaped income tax during the decedent's lifetime. However, this plan might be objectionable from a constitutional standpoint in view of the case of *Miller* v. *Milwaukee*[69] where a State statute was held invalid which taxed corporate dividends only to the extent that the corporation received tax-exempt income.

Sixth. An amendment could be passed to the Federal Constitution giving the Federal Government and the States the power to tax the income from securities issued by the other. This would undoubtedly overcome all legal objections and appears to be the only method by which the Federal Government and the States could be placed upon a parity and all of this tax-exempt income reached.

SUBPART B. STATE AND LOCAL EMPLOYEES

In regard to State and local employees, it appears that many of their salaries could be reached under the existing law in view of recent Supreme Court decisions. The legislation already enacted by the Congress taxes such salaries to the full extent authorized by the Constitution. However, under the Supreme Court decisions, it does not appear that the Constitution will permit the Congress to tax the salaries of State judges, legislators, and other officers performing functions necessary to the existence of the State or political subdivisions, although such salaries are taxable under the existing law. It appears that the only way all of the salaries of State and political subdivision officers and employees could be reached by the Federal Government, and all the salaries of Federal officers and employees could be reached by the State governments, is by a constitutional amendment.

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[68] 220 U. S. 107.
[69] 272 U. S. 713.

TABLE OF CASES CITED

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