FEDERAL TAXATION OF INCOME FROM STATE BONDS

A Special Senate Committee under the chairmanship of Senator Brown held extensive hearings in 1939 on the Taxation of Government Bondholders and Employees. There were presented before this committee, among other things, a 219 page legal "study" made by the Department of Justice and a 420 page "answer" by the Attorneys General of several States. The former favored Federal power to tax the income from State bonds, the latter favored exemption.

Leaving aside considerations of policy and detailed discussions of various cases, there are summarized below the Constitutional arguments for and against Federal power to tax the income from State bonds.

Argument for Exemption

Reciprocal Immunity. - The argument for the exemption is generally stated in terms of reciprocal State-Federal immunities: State taxation may not interfere with appropriate functions of the Federal Government and, reciprocally, Federal taxation may not interfere with appropriate functions of the States.

The doctrine is not expressly stated in the Constitution but is claimed to follow from the general purposes and organization of our Constitutional system.

It is argued that a Federal tax on the income from State bonds would increase the State's cost of borrowing, and that this increased cost would burden the State in violation of the principle of reciprocal immunity.

Arguments for Taxability.

There are several different arguments for the taxability of such income. Each argument is, in effect, a reply in one way or another to the argument for the exemption. These arguments for taxability may be considered separately as, 1. Argument that immunity is not fully reciprocal, 2. Argument that the proposed tax would not burden the States, and 3. Argument that sixteenth amendment specifically provides for taxability.

1. Immunity Not Fully Reciprocal. - It is argued that the reasons for Federal immunity from State action do not apply with equal force to State immunity from Federal action. Federal immunity is the only practicable way to protect the whole against one of its parts. But all the States are represented in the Federal Government and can adequately protect themselves against oppresive Federal action.

McCullock v. Maryland, the original tax exemption case, dealt with a State tax. It denied the power of the State of Maryland to tax a branch of the Bank of the United States, a Federal instrumentality. In his famous opinion in that case Chief Justice Marshall recognized this difference between State and Federal immunities. The recent case of Helvering v. Gerhardt again referred to this difference.

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History also gives some support for the reasonableness of this view. When the courts have denied the States power to tax Federal instrumentalities Congress has usually granted permission for the States to levy non-discriminatory taxes. An example is the provision for States to tax national banks.

Those who favor taxing income from State bonds under this theory also favor having the Federal Government grant permission for the States to tax income for Federal bonds.

2. State Not Burdened by Tax. - Another argument for taxability admits the doctrine of reciprocal immunity, but says that it applies only when there is a burden, and that a State would not be burdened by a non-discriminatory tax on the income from its bonds.

It is to be noted that the tax involved in McCulloch v. Maryland not only was levied by a State rather than the Federal Government, but also was clearly discriminatory and clearly a burden.

The present Supreme Court shows a strong tendency to examine the facts of Constitutional questions rather than proceed merely on the basis of legal analogy or precedent. It might, therefore, be inclined to examine the factual operations of a non-discriminatory income tax.

It is by no means clear that a State would in fact be burdened by a non-discriminatory tax on the income from its bonds. The exemption probably is a bounty (and one that interferes seriously with the Federal tax structure) instead of taxability being a burden.

This can be seen by examining the effects of a similar tax. Suppose a tax of 10 per cent was placed on a given article that had a relatively fixed demand. The 10 per cent tax would be borne by the purchasers. If Mr. Jones' production of the article was exempted from the tax it would be worth just as much to purchasers as that manufactured by others. Mr. Jones, therefore, could get 10 per cent more for his products than if there was no tax at all. Mr. Jones' interest in keeping the exemption for his product would be no greater than his interest in keeping the tax on his competitor's product.

The exemption of State bonds from the Federal income tax is not far different. A non-discriminatory tax on income is borne by the purchaser of the income, i.e., the purchaser of the bond. The price of exempt income (i.e., a State bond paying tax-exempt interest) rises. The exempt State bonds therefore sell at a higher price (lower yield) than comparable non-exempt investments, and the State's borrowing cost is reduced. This difference in borrowing cost is a bounty to the State. Its removal would merely place the State on a parity with other borrowers. Far from imposing a burden, the elimination of the exemption would merely remove a bounty.

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Any such analysis of the probable results of a tax necessarily cannot be exact. However, this is clearly the most likely effect. If the tax placed any burden at all on the State it would clearly be problematical and highly speculative -- hardly the type of "burden" to justify a rigid Constitutional exemption that seriously interferes with the Federal tax structure.

The Supreme Court recently indicated a similar view of the situation when it permitted Federal taxation of the salaries of State employees in Helvering v. Gerhardt and State taxation of the salaries of Federal employees in Graves v. O'Keefe. In the latter case the court stated:

> "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable . . ."

Sixteenth Amendment. - The sixteenth amendment authorizes the Federal Government to tax "incomes, from whatever source derived, without apportionment among the several States." Proponents of taxability claim that the words "from whatever source derived" specifically cover the question and supersede any arguments based on earlier general language of the Constitution. They point also to events contemporaneous with the adoption of the amendment. At about that time the Supreme Court held that similar language in a statute included income from State bonds. Chief Justice Hughes, then Governor of New York, opposed ratification of the amendment on precisely the ground that it would permit Federal taxation of income from State bonds.

Those who favor this interpretation also favor having the Federal Government grant permission for the States to tax income from Federal bonds.

The opponents of this interpretation emphasize the words: "without apportionment among the several States". They claim that the amendment merely eliminated the previous Constitutional requirement that an income tax, as a direct tax, be apportioned among the States in accordance with population. They also cite various events connected with the adoption of the amendment as tending to show that it was not intended to permit Federal taxation of income from State bonds.

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