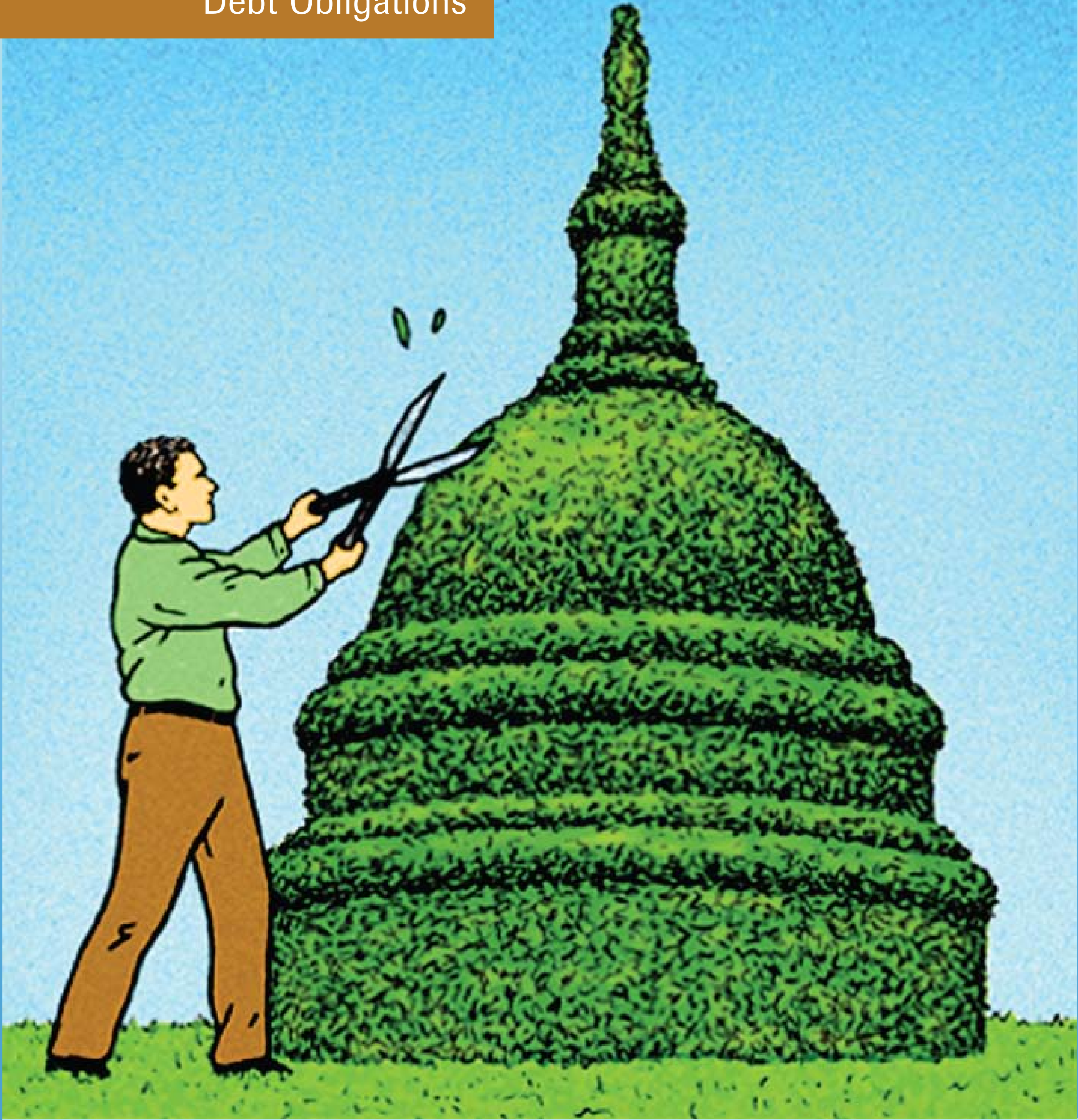
The **Renewed Battle** over Tax Exemption of Interest on **State and Local Government** Debt Obligations



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"To place the borrowing capacities of the state and its governing agencies at the mercy of the federal taxing power would be an impairment of the essential right of state which, as its officer, I am bound to defend," New York Governor Charles Evans Hughes said in his 1910 Message of Submission of the Proposed Sixteenth Amendment to the State Legislature.[1] Thus, even before the passage of the Sixteenth Amendment, the question had been raised about how an income tax would affect the ability of state and local governments to finance infrastructure and essential governmental services as they deemed appropriate. Hughes' words could be uttered today by any governor of any state or any mayor of any city. In times of economic downturn, federal, state, and local governments all need to find additional sources of tax revenues. When the traditional sources of tax revenue, income, sale, property, and business activity are in decline, the federal government typically explores "creative solutions," and recently, it has renewed interest in revisiting the traditional exemption of state and local debt obligations from federal income tax — a line the federal government has not chosen to cross for more than 200 years.[2]

The ability of state and local governments to incur debt in order to finance the uneven flow of tax revenues, infrastructure, or other essential governmental services is well established and fundamental to their basic operation. Without that access, decisions about necessary infrastructure or services could not be made, funded, or implemented locally without the approval, or possibly the interference, of other governmental entities. That would be a fundamental change in the form and substance of government as we know it, which has provided the nation's extensive and sophisticated public works system on a state and local level.

Further, while everyone appreciates the need for the federal government to find new sources of revenue and the difficulty of cutting costs and increasing tax rates, taxing interest on state and local government debt would not, as a practical matter, increase federal revenues or address the problem. Rather, taxing interest on municipal bonds merely shifts the cost of tax expenditures, creating unfunded mandates on the state and local government level. Unfunded mandates have increased over the past 50 years, as federal assistance has decreased, and it has become more apparent that states and local governments have weathered economic downturns (11 since 1949) successfully, for the most part, without federal assistance.[3] Further, the cost of roads, highways, water and sewer systems, and other forms of infrastructure and public improvements over the past 50 years has increasingly been borne by state and local governments, which now pay more than three quarters of those costs, with decreasing participation by the federal government. In past history, the equation was almost the reverse.

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When the federal government considers its options for cutting overall indebtedness, the resulting solutions should not shift new burdens to the state and local governments. Further, real solutions should not threaten to increase state and local governments' costs and expenses or adversely affect their ability to make local decisions regarding the matters reserved to them. Any other result would adversely affect state and local governments' access to and cost of borrowing, and their ability to address local matters and concerns, infrastructure, and services.

Accordingly, in reviewing the practical realities, the legal bases, and the appropriate relationship between co-sovereigns, the federal government, and the states with their sub-sovereigns, the true philosophy of the Constitution should not be altered or modified by legislation. (Given our unique form of federalism in the United States, the federal government and states are co-sovereigns, and municipalities are the sub-sovereigns of our state governments.) The Constitution recognizes the essential rights of states and their citizens to deal with the matters reserved to them without inappropriate interference or influence on those decisions. Imposing a heretofore non-existent tax on the interest on state and local government debt payments raises the fundamental question of whether such legislation is a fundamental change in the form of government that can only be accomplished by amending the Constitution; no court would be justified in assuming the people intended to permit a drastic alteration in the structure of government unless that intention was unmistakably expressed in an amendment approved by the people.

THE COURT BATTLES

The Tenth Amendment and Sovereign Tax Immunity. The roots of the constitutional restriction on taxation of municipal bonds can be traced to the Tenth Amendment to the Constitution, which states that all powers not expressly granted to the national government under the Constitution are reserved to the states and the people. This amendment embodies the doctrine of state sovereignty, the dual system of government that provides for two distinct governmental entities: a national government and state governments as co-sovereign. This principle received an important judicial test following the enactment of a federal income tax law.

The *Pollock* Case and the Federal Income Tax Law. In 1894, Congress enacted a federal income tax law. Not unexpectedly, this law was challenged on a number of grounds, including that imposing a tax upon income received from state and municipal bonds made the law invalid. The challenge was ultimately reviewed by the United States Supreme Court in the case of *Pollock v. Farmers' Loan & Trust Co., et. al* (1895). The court focused on the principle of co-sovereignty underlying the U.S. Constitution and embodied in the Tenth Amendment, noting that the states "still retain their jurisdiction over all persons and things within their territorial limits, except where surrendered to the general government or restrained by the Constitution, they were careful to see to it that taxation and representation should go together, so that the sovereignty reserved should not be impaired…" The court reaffirmed that the Constitution contemplates the independent exercise by the nation and the state of their constitutional powers. As the states cannot tax the powers, the operations, or the property of the United States, nor the means employed to execute its powers, so too, the United States has no power under the Constitution to tax either the instrumentalities or the property of the states. Accordingly, the court noted, it was long ago determined that the property and revenues of states and their sub-sovereign municipal corporations are not subjects of federal taxation.

Significantly, the court focused on the relationship between taxation and the ability to incur indebtedness, quoting Chief Justice John Marshall (from *Weston v. City Council of Charleston*, 1829):

> …the right to tax the contract to any extent when made must operate upon the power to borrow before it if exercised, and have a sensible influence on the contract … 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 contracts 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.

Therefore, the court concluded that the federal government could not tax income on state and municipal bonds. In the concurring opinion, Justice Stephen J. Field noted:

> …the taxing power of the federal government does not therefore extend to the means or agencies through or by the employment of which the states perform their essential functions; since if these were within its reach, they might be embarrassed, and perhaps wholly paralyzed by the burdens it should impose … that the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance in conferring on one government the power to control the constitutional measures of another, which other in respect to those very measures is declared to be supreme over that which it exerts the control, a proposition not to be denied … the Constitution contemplates no such shackles upon state powers and by implication forbids them.

The interest invalidated by the court in Pollock would be taxable to the bond purchasers and not a direct tax on the states.

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The Sixteenth Amendment. Article I, Section 2, of the Constitution requires that direct taxes be apportioned among the states by population. In addition to the issue of the federal government's ability to tax income on state municipal bonds, the *Pollock* case also held that there could be no direct tax on real or personal property or income therefrom by the federal government without meeting

the apportionment test in the United States Constitution. In the *Pollock* case, income tax on rents, dividends, and interest were ruled to be direct taxes. The Sixteenth Amendment to the Constitution was a response to the *Pollock* decision. The amendment provides that: "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 remuneration."

The intention of the amendment was to permit the federal government to tax income without having to go through an apportionment. Thus, the Sixteenth Amendment allowed Congress to levy an income tax without apportioning it among the states or basing it on census results. The language of the Sixteenth Amendment was criticized by New York Governor Charles Evans Hughes before he joined the high court; he noted that the words "from whatever source derived" implied that the federal government would have the power to tax state and municipal bonds, which he believed would excessively centralize governmental power and "make it impossible for the state to keep any property."

The Senators who sponsored the Amendment stated that it was not intended to expand the power to tax state and local government debt. While the plain language could be read to do so, there is no contrary statement that can be found in the Congressional Record supporting taxation of interest on state and local government debt as part of the consideration of the Sixteenth Amendment.

The question with respect to any proposed legislation was whether the bill violated the Constitution, the principles of federal and state government tax immunity, and the requirements of apportionment. To ensure that concerns were unjustified, the Revenue Act of 1913, the Revenue Act of 1938, and all those thereafter contained a provision expressly exempting such interest from income tax, stating that "Interest received by the taxpayer, upon obligations of the state, or any political subdivision of the state, has been expressly exempted from income tax" (the derivation of Section 103 of the Federal Income Tax Code).

***South Carolina v. Baker*, TEFRA, and the Desire to Outlaw Bearer Bonds to Avoid Tax Evasion.** In passing the Tax Equity and Fiscal Responsibility Act of 1982, Congress provided that interest paid on state and local bonds will be subject to federal income taxes unless the bonds are issued in registered form. Congress could have just outlawed bearer

bonds, but it did not. The purpose of TEFRA was to identify bondholders of tax-exempt bonds and avoid evasion of income tax by indirectly outlawing bearer bonds. The State of South Carolina challenged that law in 1987, invoking the original jurisdiction of the U.S. Supreme Court and claiming that Congress violated the principles laid down by the Supreme Court in the *Pollock* decision and the Tenth Amendment. The Supreme Court overruled the past holding in *Pollock* and found that TEFRA did not violate the Tenth Amendment and that interest on state and local government bond debt is not immune from non-discriminatory federal tax.

In *South Carolina v. Baker*, the Supreme Court examined the constitutionality of the TEFRA registration requirement. This statute required that all long-term state and local bonds be registered to qualify for a tax exemption, purportedly to limit tax evasion. *South Carolina* argued that this part of the law interfered with its Tenth Amendment sovereign power to raise capital and sought to invalidate the bond registration requirement. The Supreme Court found that TEFRA did not violate federalism principles under the Tenth Amendment or contravene the tax immunity doctrine.

The question presented in *South Carolina v. Baker* was whether *Pollock* was still good law. In *South Carolina v. Baker*, the Supreme Court held that, over the years between 1916 and 1982, the court had eroded the basic principles of *Pollock*

so that the scope of the judicially created doctrine of reciprocal immunity from taxation of sovereigns had been virtually eroded by the judiciary itself. The court stated that the only reason it had delayed overruling *Pollock* explicitly was that Congress had never before taxed interest on state and local bonds. While the Supreme Court upheld the *Pollock* case in *National Life Insurance Company v. The United States* (1927), there are cases that, according to the *South Carolina v. Baker* court, eroded that principle, such as *Wilcox v. Bunn* (1931), which upheld a federal tax as applied to profits realized from state sale of municipal bonds; *Greiner v. Lewellyn* (1922), which sustained the application of tax-exempt securities to federal estate tax; and *Hale v. State Board* (1937).

The argument in *South Carolina v. Baker* was that the tax was being levied on the person receiving the interest payment, not on the state or local government itself making the interest payment. Therefore, the requirement should be permitted because it is not a tax by one sovereign on another. In her dissent, Justice Sandra Day O'Connor noted that the state's autonomy is an important factor to be considered when reviewing the national government's exercise of its enumerated powers. She concluded that interest on federal tax on state and local government debt obligations is, in essence, a tax on the power of the state and local governments to borrow. O'Connor noted that the action of the Court in *South Carolina v. Baker* represented a step on the road to the deterioration of state sovereignty. This is a road that courts should not travel because any fundamental change in the relationship of co-sovereigns (federal and state) should be the sole province of the people.

IS *POLLOCK* DEAD?

Any tax Congress might enact on state and local government bond interest payments would strike at the very heart of state and local government powers and activities. Such a tax might, in essence, interfere with or impair the functions of state and local government and their decisions in funding necessary infrastructure (roads, schools, public buildings, sewer systems, and public improvements) as well as providing essential governmental services as determined locally to be required. Such a result would violate not only the principles of reciprocal sovereign tax immunity but also the essence of the Tenth Amendment. While the Supreme Court in *South Carolina v. Baker*, by an overwhelming number of justices, felt that the Tenth Amendment and the immunity from non-discriminatory federal tax was not violated, that may not be the last word. The word "conduct" can have two different meanings, depending upon where you place the emphasis, and the same is true for the question of the tax exemption for state and local government interest. In *South Carolina v. Baker*, the court failed to place the emphasis on what effect such a tax will have on state and local government's ability to exercise their power of issuing debt to pay for structures and services the community deems important, without help from any other governmental body. Key to this power is the local government's ability to borrow money in the capital markets at a low cost to implement its essential and vital government decisions.

If a future United States Supreme Court reviews this issue, it may change the emphasis from the person who receives the interest payment to the effect the tax has on an equal sovereign or its sub-sovereign. It may focus on the impairment of the local government to provide necessary infrastructure and government services because of increases in borrowing costs and more limited access resulting from the change in market perception and the other competing financial products. If the focus is thus altered, there should be only one conclusion. States and local governments, as the *Pollock* case ruled, should not have interest on their bonds and notes

taxed by the federal government because that would impair and interfere with their power and ability to borrow and finance their infrastructure, improvements, and ability to provide essential governmental services as they locally determine are necessary and proper without federal government involvement.

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South Carolina vs. Baker could have limited the scope of its holding to the proposition that Congress may regulate how bonds are issued in registered versus bearer form, but the court refused to follow that limitation on its ruling and choose instead to overrule *Pollock* by claiming subsequent case law held a "tax on income is legally or economically a tax on the source is no longer tenable" (*Grower v. New York*, 1938) and the fact that a tax on the government "may increase the cost to government … would not invalidate the tax (*James v. Drano Contracting Co.*, 1937). Subsequent cases were noted by the court as consistently reaffirming the principle that a non-discriminatory tax collected from private parties contracting with another government is constitutional even though part or all of the financial burden falls on the other government (see *Washington v. United States*, 1983).

However, the above analysis by the Supreme Court in *South Carolina v. Baker* may overlook the real issue of constitutional limits. The tax on interest on state and local government bonds may actually be impairing and interfering with the power to decide and fund infrastructure locally and essential governmental services. This is not a mere tax on government but rather an impairment of governmental powers to exercise the ability to borrow to control the government's own fate. It is an impairment of the ability and right of state and local governments to be unfettered in any decision relating to essential state or local governmental matters without interference in any manner, even as to the implementation thereof. The unconstitutional discriminatory nature of the "tax" by the federal government puts limitation on state and local governments where no limitations are permitted.[4] In times of economic downturn, when the federal government, just like the state and local governments, is looking for more tax revenue, it is an economic illusion to suggest such taxes on interest on state and local government bonds provide any overall benefit, but rather such taxes shift burdens to the states and their citizens and interfere and impair the state and local government decisions in a fashion that is economically harmful and at least constitutionally questionable.

CONCLUSIONS

Since World War I, whenever the federal government has sought additional revenues, it has raised the issue of taxing interest on state and local government debt.[5] Each time, the cost to the state and local governments and to our structure of government, has been deemed too great and the benefit insufficient to make such a fundamental and basic change in the relationship between the federal and the state and local governments. It long has been recognized that the power to tax is the power to destroy. The concern that the federal government might inappropriately attempt to influence state and local governments by asserting the power to levy taxes on the interest income from their debt has been an issue every time the matter has been raised. The recent experience with Build America Bonds raised questions by government finance officers as to whether or not the subsidy proposed by the federal government can be altered or changed to influence or to adversely affect state and local governments. That question was answered as a result of the 2011 Joint Select Committee in creating what we now refer to as the "fiscal cliff" and sequestration; in September 2012, the Office of Management and Budget reported that $322 million in subsidy payments to the Recovery Act bond issuers in fiscal year 2013 — a 7.6 percent decrease — would be proposed if sequestration is activated.

Investors throughout the country have become somewhat upset regarding the proposal of the federal government to levy taxes upon the income derived from state and municipal bonds. Indeed, the states themselves have become so concerned about it that they have organized a nationwide association joined by 40 states to protect themselves against the threat of invasion of their sovereign rights. This concern would seem to be justified, for the president of the United States suggested that Congress should enact a statute levying taxes on income derived from the state and municipal bonds thereafter issued, and the Department of Justice prepared and published an elaborate brief that purportedly sustains the constitutionality of such legislation.[6]

Interestingly, the above statement is not a quote from November or December 2012. It is a quote from 1939, when

the 75th and 76th Congress was holding hearings on proposed legislation relating to the tax exemption of government securities.[7] The simple problem is that taxing interest income on municipal bonds and state and local government debt will, in essence, provide limited increased revenue to the federal government. At the same time, it has been well-recognized throughout the decades that if a tax were imposed on the income of state and local government debt securities, that cost would be factored into the borrowing cost. The increase in borrowing cost would certainly outweigh any benefit to the federal government, and the increased tax burden placed on the ordinary taxpayer in the state and local government would outweigh any benefit that any government receives from such tax.[8]

It has been no accident that so far every effort to tax interest income on state and local government debt securities since the enactment of the Sixteenth Amendment resulted in preserving the tax exemption for state and local government debt securities. The collective wisdom has been that any such change in the form of taxing interest income on state and local government debt obligations would result in:

- Structural change and impairment to a fundamental governmental power and an adverse effect on the rights of state and local governments to borrow and decide what infrastructure and services to provide to their citizens. (Such a change should only be implemented based upon the will of the people through a constitutional amendment.)
- No real benefit to the federal government or the nation, but only shift additional tax expenditures to the states and local governments by increasing the taxes of ordinary citizens to pay the additional cost of borrowing.
- Limitations or obstacles to needed infrastructure financing by the state and local governments, which will be faced with increased borrowing costs and be forced to either forego local infrastructure improvements or downsize and deprive their citizens of improvements and services locally determined to be necessary.[9]

These factors demonstrate that the tax exemption of state and local government securities is no historical accident, but the intended result of what has existed for more than 200 years, which has allowed state and local governments to do what they do best — finance locally needed infrastructure and governmental services that have been second to none. So why change?

Notes

1. New York Times, January 6, 1910.
2. The origin for the justification of tax exemption of interest on government securities and bonds dates back to our nation's founding fathers and the belief that taxes levied against the Nation's own debt securities would destroy its foreign credit. See Robert P. Huefner, *Taxable Alternatives to Municipal Bonds: An Analysis of Issues*, Research Report No. 53, Federal Reserve Bank of Boston, June 1973 at 14-15.
3. James E. Spiotto, Appendix A — Economic Downturns and Recovery Charts, Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies, Chapman and Cutler LLP, 2012.
4. The cost to state and local governments for a federal tax on interest on their bonds, given a $3.7 trillion municipal bond market at an average 4 percent tax-exempt interest rate, is an added cost due to the market required gross up for the cost of taxation at 35 percent (current highest tax bracket) or $51.8 billion annually or over $1.2 trillion over 30 years. While current estimates of annual tax expenditures (the loss of tax revenues) is approximately $26.2 billion in 2011 (see Congressional Research Service, Steven McGuire, Tax Exempt Bonds: A Description of State and Local Government Debt (June 19, 2012), the market also would adjust (gross up) for the tax cost to the highest tax payer rate and would also factor in the inefficiencies in the market due to competing with other taxable products and therefore penalize the taxable state and local bonds at an even higher level.
5. 65 Congressional Record 10373, 10409 (1918), House Hearings on Tax Exempt Securities, 67th Cong., 102, 211, 231, 232 (1922), Conference Committee, 73rd Cong., 5420-21, 5857 (1933) and Hearings on Proposed Legislation Relating to Tax Exempt Securities, 76th Cong. (1939).
6. Daniel M. Woods, Taxation of Tax Exempt Securities 25 A.B.A.J. 186 (1939).
7. See Hearings of the Committee on Ways and Means House of Representatives 75th Congress (1939) and Hearings on Proposed Legislation Relating to Tax Exempt Securities, 76th Congress (1939).
8. For example, see Hearings before the House Ways and Means Committee, 76th Congress (1939).
9. Such taxation of interest on state and local government bond debt would adversely affect the means by which the greatest infrastructure of governmental services has been built at time when more than $2.5 trillion of structural improvements mandated over the next five years to maintain it and would suppress the desire to improve current infrastructure and services to stimulate the economy and to attract, create and maintain employment opportunities exists. See American Society of Civil Engineers, 2009 Report Card for American's Infrastructure, available at http://www.infrastructurereportcard.org.

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