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## Some Aspects of the Taxation of Federal and State Instrumentalities

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## SOME ASPECTS OF THE TAXATION OF FEDERAL AND STATE INSTRUMENTALITIES

ONCE again the problem of taxing state and federal instrumentalities is being discussed pro and con. The President in making his recent tax proposals<sup>1</sup> suggested a constitutional amendment to eliminate tax exempt securities. Newspapers have discussed the question in editorials, Congress has been quite concerned over the problem, although in framing the Revenue Act of 1935 no action was taken on the subject of Tax Exempt Securities, and one article in a recent periodical<sup>2</sup> took up the problem under the title, "The Menace of Tax Exempt Bonds."

On February 8, 1933, Mr. Cordell Hull offered in the Senate of the United States a proposed amendment to the Constitution of the United States to do away with the exemption from taxation of government instrumentalities.<sup>3</sup>

It would seem that a restatement of the problem is in order, approached from a legal point of view, on the basis of principles of taxation and constitutional law as these stand today.

Taxation has been defined as "the enforced proportional contributions from persons and property, levied by the state by virtue of its sovereignty for the support of government and for all public needs."<sup>4</sup> This may appear elementary, but the soundness of the proposition needs emphasis. While this contribution is compulsory, it is nevertheless exacted for value received, since the taxpayer does receive the protection of the State—at least in the United States—to his life, liberty, and property, and in the increase to the value

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<sup>1</sup> N. Y. Times, June 20, 1935, at 1.

<sup>2</sup> The Nation, Vol. CXLI, Aug. 28, 1935, at 241.

<sup>3</sup> SEN. JOINT RES. 251, 72d Cong., 2d Sess.: "Income derived from securities issued and from salaries and fees paid by or under the authority of the United States or any state may be included in any tax on income levied by the United States or in any tax on income of its residents levied by any state, except to the extent that prior to the ratification of this article income from any such securities has been exempted from taxation at the time of their issuance by the Government issuing or authorizing them: PROVIDED, That the Congress may exempt from any such tax, Federal, State or local, for a period not exceeding five years, income from any securities hereafter issued under the exigencies of war."

<sup>4</sup> 1 COOLEY, THE LAW OF TAXATION (4th ed.) 61.

of his possessions.<sup>5</sup> From a sense of civic responsibility alone, the taxpayer should not, and in most instances does not, resent the imposition of taxes.

But the definition posited above speaks of a proportional contribution from persons and property. This implies a principle of equality in taxation. The injustices that follow any distortion of equality in taxation are strongly resented by the sensitive taxpayer, and rightly so, and the clamor heard these days from sensitive overtaxed taxpayers may be traced directly to inequalities that are unfortunately prevalent under our taxing laws. A disturbance of the ideal balance of equality is in fact protected by specific provision in the Federal Constitution.<sup>6</sup> The Fourteenth Amendment would prevent any person or group of persons from being singled out as a special subject for discriminating legislation,<sup>7</sup> or allow an arbitrary classification for unequal taxation.<sup>8</sup> As Cooley<sup>9</sup> puts it, "the rule of equality requires \* \* \* that the same means and methods be applied impartially to all the constituents of each class, so that the law shall operate equally and uniformly upon all persons in similar circumstances." Almost all states provide in their constitutions for equality and uniformity in taxation and this relates to the rate of taxation, and the inclusion of all property as the subject of taxation.

The ideal principle of equality in taxation would permit of no exemptions, since to do so adds a greater burden of tax on those persons and on that property not specially favored. Exemptions from tax must therefore be expressly conferred by the constitution, and while of course constitutions and legislatures do provide for exemptions from tax for purposes that are most worthy, as a rule, yet such exemptions may develop inequalities in the sharing of burdens. In some cases, the exemption features in the federal income tax law have aroused a hostility to the tax on the part of

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<sup>5</sup> *Supra* note 4, at 83.

<sup>6</sup> U. S. CONST. AMEND. XIV. No state shall deny " \* \* \* to any person within its jurisdiction the equal protection of the laws."

<sup>7</sup> *Fallbrook Irrigation District v. Bradley*, 164 U. S. 112, 17 Sup. Ct. 56 (1896).

<sup>8</sup> *Shaffer v. Carter*, 252 U. S. 37, 40 Sup. Ct. 221 (1920).

<sup>9</sup> *Supra* note 4, at 535.

taxpayers that makes it necessary to re-examine the basis of these exemptions. Specifically the exemption of federal and state instrumentalities from income taxation has resulted in a serious distortion of the principle of equality in the distribution of the tax burden.

To understand the grounds of this exemption it is necessary for a moment to give some consideration to such questions as sovereignty, and the state, and also to analyze the peculiar sovereignty under which this government functions. As far back as 1819, in *McCulloch v. Maryland*,<sup>10</sup> Chief Justice Marshall most emphatically laid down the proposition, as one imbedded in the Constitution, that the federal government is superior to that of the states and that therefore the states could not tax an instrumentality of the federal government, in that case the Bank of the United States. To say that the federal government is superior is to say that it is supreme, *i. e.*, sovereign. Sovereignty is defined<sup>11</sup> as the quality of being supreme or highest in power; superior in position to all others; possessing original and independent authority or jurisdiction; as a sovereign state, *i. e.*, one exercising the usual powers of self government and of declaring peace and war without outside control. Axiomatically, the federal government is sovereign. Can it be said that the several states too are sovereign? Logically this would lead to an absurdity, since there cannot be two supreme powers in one place at the same time, nor can there be two equal supreme powers. If it means anything to speak of the several states as sovereign, it must be understood in the sense of an inferior sovereign, subordinate to the federal sovereignty. Chief Justice Marshall develops the idea of the supremacy of the federal sovereignty not only in the case of *McCulloch v. Maryland*,<sup>12</sup> but also in *Brown v. Maryland*,<sup>13</sup> *Weston v. The City of Charleston*<sup>14</sup> and in *The Providence Bank v. Billings*.<sup>15</sup> The claim that the several states enjoy a sovereignty equal to that of the federal government was

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<sup>10</sup> 4 U. S. 415 (1819).

<sup>11</sup> WEBSTER, NEW INTERNATIONAL DICTIONARY.

<sup>12</sup> *Supra* note 10.

<sup>13</sup> 7 U. S. 262 (1827).

<sup>14</sup> 8 U. S. 171 (1829).

<sup>15</sup> 9 U. S. 171 (1830).

definitely rejected in *Veazie Bank v. Fenno*.<sup>16</sup> These cases are ample authority for the proposition that federal instrumentalities are immune from taxation by the several states, on the theory of sovereignty, but they cannot be used to bolster up the converse proposition that state instrumentalities are immune from taxation by the federal government.

The latter proposition finds authority in the case of *Collector v. Day*,<sup>17</sup> and this case may be considered as a complete reversal of the doctrine enunciated in *McCulloch v. Maryland*<sup>18</sup> and also of the principle of *Veazie Bank v. Fenno*.<sup>19</sup> *Collector v. Day* held that the salary of a state judge was not subject to a federal law taxing all incomes, since an instrumentality of the state is on an *equality* with an instrumentality of the federal government. It is submitted that the decision in *Collector v. Day* is unsound and that its implications have been most unfortunate in the results that have followed, particularly in the effect it has had on sound principles of taxation. With *Collector v. Day* must be mentioned *Pollock v. Farmer's Loan & Trust Co.*,<sup>20</sup> which first decided that income derived from municipal bonds is a tax on a state instrumentality, and so unconstitutional. It was in this case that the Supreme Court decided that Congress had no power to tax incomes without apportionment, a decision that cannot possibly be justified on logical grounds and that resulted in a universal exemption from any income tax of all the wealth that was amassed during the most productive period in the history of the United States, from 1894 to 1913. This major exemption (*sic!*) ended with the ratification of the Sixteenth Amendment<sup>21</sup> on February 25, 1913. But wealth, in the form of so-called tax exempt securities, continues to be exempt from tax, until today there has been built up an accumulation of over thirty-one billions of dollars

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<sup>16</sup> 75 U. S. 533 (1869).

<sup>17</sup> 78 U. S. 113 (1870).

<sup>18</sup> *Supra* note 12.

<sup>19</sup> *Supra* note 16.

<sup>20</sup> 157 U. S. 429, 15 Sup. Ct. 673 (1895).

<sup>21</sup> "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." Adopted by Congress in 1911.

of tax exempt securities.<sup>22</sup> Peculiarly, those who can best bear the burden of taxation are the very ones who can avoid all payment of income taxes by investing in such tax exempt securities. In this way the burden is shifted to less fortunate taxpayers, with the accompanying inequality and injustice that must follow the creation of specially favored groups.

It has been indicated that the exemption of state instrumentalities is based upon an unsound decision of the Supreme Court<sup>23</sup> in a case that upset the law as it had been most ably developed by Justice Marshall and as it had stood for about one hundred years. This aspect of the problem has been so ably developed and so adequately presented by a foremost scholar<sup>24</sup> in the field of Constitutional Law, that there is very little left for the writer to add to his analysis.

Exemptions in tax laws that lead to inequalities and injustices, and it is in the very nature of exemptions to do just this, have a way of coming back to plague the government in its everlasting search for revenue, particularly at times when such revenue is most urgently needed. This was true after the Supreme Court declared the Income Tax Law of 1894 unconstitutional.<sup>25</sup> That decision did not eliminate the government's constant need for raising revenue. As this necessity persisted, Congress in 1909 was driven to a subterfuge, and passed an income tax law under the guise of an excise tax<sup>26</sup> on corporations. It could not wait for the slower process *via* an amendment to the Constitution.<sup>27</sup> In the meantime, the Supreme Court,<sup>28</sup> again confronted with the question of whether Congress could pass what was in effect an income tax law, held that it was constitutional where it was called an excise tax, even though it did indirectly what it could not do directly.

The present fiscal needs of the government, of necessity on the alert to tax all things not yet taxed, make imperative

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<sup>22</sup> NATIONAL TAX ASSOCIATION REPORT.

<sup>23</sup> *Supra* note 17.

<sup>24</sup> Louis B. Boudin, *The Taxation of Governmental Instrumentalities*, 22 GEO. L. J. No. 1, p. 1, and No. 2, p. 254.

<sup>25</sup> *Supra* note 20.

<sup>26</sup> CORPORATION EXCISE ACT, enacted Aug. 5, 1909.

<sup>27</sup> This was not finally accomplished until Feb. 25, 1913. *Supra* note 21.

<sup>28</sup> *Flint v. Stone, Tracy Co.*, 220 U. S. 107, 31 Sup. Ct. 342 (1911).

a re-examination of major exemptions with a view to their elimination. It has now become a question of undoing the harm done by the Supreme Court in straying from the straight and narrow path laid down by Marshall, and of the best and most expeditious method of doing so.

So far as federal instrumentalities are concerned, Congress could reach these for taxation, by eliminating the specific provision contained in the current revenue act exempting such instrumentalities from income taxation.<sup>29</sup> They would then be on a par with salaries of federal government employees which, though instrumentalities, are subject to an income tax and always have been.<sup>30</sup>

It may be more difficult to reach state instrumentalities, although the way is open for a simpler method, and perhaps, under increased fiscal pressure, this road may be taken. The Court could overrule its decision in *Collector v. Day* and reaffirm the supremacy of the federal sovereignty as Marshall correctly developed it. The Court has on occasion overruled itself.<sup>31</sup> This, however, should not be necessary. The Sixteenth Amendment states quite simply, that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived." As terms are used in common speech, this Amendment is quite inclusive and in the opinion of the writer covers income from state instrumentalities. The Court itself has in fact ruled that for a clear definition of income, it is sufficient to have recourse to the use of the term in common speech.<sup>32</sup> It is true that the Supreme Court has held<sup>33</sup> that the Sixteenth Amendment did not extend the taxing power to new subjects. This, it is believed, was a gratuitous interpretation made necessary by the impasse in which the Court found itself, as a result of some specious and metaphysical reasoning leading to the conclusion that the Income Tax Law of 1894 was unconstitutional.<sup>34</sup> Such an interpretation of the Amendment, it is

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<sup>29</sup> REV. ACT OF 1934 §22 (b) (4).

<sup>30</sup> REV. ACT OF 1934 §22 (a); Reg. 86, art. 22 (a) (2).

<sup>31</sup> Fox Film Corp. v. Doyal, 286 U. S. 123, 52 Sup. Ct. 526 (1932) specifically overruling Long v. Rockwood, 277 U. S. 142, 48 Sup. Ct. 463 (1928).

<sup>32</sup> Eisner v. Macomber, 252 U. S. 189, 40 Sup. Ct. 189 (1920).

<sup>33</sup> Brushaber v. Union Pacific R. R., 240 U. S. 1, 36 Sup. Ct. 236 (1916).

<sup>34</sup> *Supra* note 20.

submitted, is a bit strained, and it may be that the time is appropriate for the Court to realize this and correct its earlier error. To the reader it may seem like a confession of naïveté to expect the Supreme Court to overrule one decision and to reinterpret a change in the fundamental law of the land. If so, then there is only one way out, and that is the onerous and expensive as well as the dilatory method of a constitutional amendment.

So far as the federal government is concerned, all methods should be attempted in a serious effort to restate the fundamental law of the land, that the federal sovereignty is supreme and that the Sixteenth Amendment means exactly what it says. The conclusion is then inescapable that the federal government may tax instrumentalities of the state.

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