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THE MORTGAGE SUBSIDY BOND TAX ACT OF 1979: AN UNWARRANTED ATTACK ON STATE SOVEREIGNTY

John J. Keohane*

I. Introduction

Legal archeologists found several of their theories shaken in the latter half of the 1970's when it was discovered that two concepts, "impairment of contract" and "state sovereignty" long believed extinct were found alive and well and living at the Supreme Court. Apparently unaware of the United States Supreme Court's decision in National League of Cities v. Usery, Representative Al Ullman, chairman of the Ways and Means Committee of the United States House of Representatives, announced in the spring of 1979 the introduction of a bill which again raises the question of state sovereignty in the context of federal taxing power. As introduced, the bill would amend section 103 of the Internal Revenue Code of 1954 by repealing the statutory exemption from federal income tax on the interest paid on bonds or other debt obligations issued by a state or municipality, or an agency acting on its behalf, for the purpose of providing mortgages for residential housing, so-called "mortgage subsidy bonds."3

In an announcement accompanying the introduction of the bill, Representative Ullman stated:

Despite its popularity, the use of tax-exempt revenue bonds to finance these private investments is poor public policy. The primary goal of Federal housing policy has been to provide shelter for lower income families. Any additional Federal resources for housing should be for priority purposes and be subject to the discipline of the budget process.

Use of these bonds ... is an ineffective way to administer a housing program. In fact, it amounts to a subsidized housing program with no exercise of any judgment or restraint over the use of the funds by either the Adminis-

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2. This is at least the eighth time the question has been raised. See Note, The Taxability of State and Local Bond Interest By the Federal Government, 38 U. Cin. L. Rev. 703, 703 n.1 (1969).
3. The legislation is discussed in pt. III. See notes 27-68 infra and accompanying text.
In this statement the issue is squarely drawn: may a state fund a program, which carries out a proper public purpose under state law, through the issuance of debt obligations, the interest on which is exempt from federal taxation? In other words, is the exemption from federal taxation merely a statutory grant subject to congressional review or is it a right of the states inherent in the Constitution? This Article will advocate the latter position and show that any attempt to tax mortgage subsidy bonds would create an unconstitutional burden on the states' exercise of a proper public purpose.

II. The Public Funding of Housing

Governments in the United States have long used public resources to provide housing for certain individuals, whether determined by social or economic class. For example, states provided poor houses in the eighteenth and nineteenth centuries. Additionally, public resources were extended to effect a public purpose, such as the development of the frontier.

Government borrowing for housing, however, was not commonplace prior to the Depression. For a period thereafter, housing assistance was provided for development of public housing funded from current tax revenues or intergovernmental borrowing, buttressed through real estate tax exemptions. Any such borrowings

7. See generally 1 Revised Record of the New York State Constitutional Convention of 1938 (1938), particularly the discussion of Int. 145, the forerunner of N.Y. Const. art. XVIII. See also New York State Constitutional Convention Committee Reports: Problems Relating to Taxation and Finance (1938), particularly the memoranda of I. Robbins, id. at 427-31, and H. Riegelman, id. at 432-37. For a general discussion of revenue financing see L. Moak, Administration of Local Debt (1976).
8. See 2 Revised Record of the New York State Constitutional Convention of 1938 1610 (1938), where there is a statement to the effect that there was no State debt in 1901.
were in furtherance of a public purpose of slum eradication or assistance to a broadly defined category of "low income persons"; that is, persons for whom unassisted private enterprise was unable to provide housing.\(^9\)

Public need and public housing policy soon expanded on both a national and state level. Many of the programs promulgated by the federal government since 1945 were specifically opened to persons other than those traditionally considered low income. Indeed, the National Housing Act of 1949 clearly established as its goal "a decent home and a suitable living environment for every American family" and sought the construction or rehabilitation of twenty-six million housing units, only six million of which were to be for low and moderate income families.\(^{10}\)

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1. This broad definition of "low income" is hypersensitive to downturns in the economy which explains, in part, the increased issuance of mortgage revenue bonds in reaction to inflation occasioned or exacerbated by federal policies. The Housing and Community Development Act of 1974 required the development of mixed-income communities to "avoid concentrations of low-income and deprived families with serious social problems. . . ." 42 U.S.C. § 1437d(c)(4)(A) (1976). In the Housing Act of 1956, 42 U.S.C. §§ 5301 to 5317 (1976), the federal government expanded the secondary mortgage operations of the Federal National Mortgage Association in response to many of the stimuli that continue to confront housing today. As was noted by the House Committee on Banking and Currency:

Your committee fears that the combination of a rising interest rate structure and a restrictive [sic] monetary policy will act to curtail further the flow of funds into mortgage investment. . . .

Your committee is apprehensive over the consequences of a further tightening of the mortgage money market upon the rate of housing construction. The annual rate of housing starts has already dropped far below the rate of a year ago.


10. 42 U.S.C. § 1441a(a) (1976). Congress also has stated the intention to "encourage the
As both the economy and the perceptions of the governmental role in housing changed, the federal government led the way in providing housing assistance to persons loosely defined as “low,” “low-moderate,” “moderate,” and even “upper” income. In the 1960’s, states followed the federal example and created multi-family housing programs generally funded through the issuance of revenue bonds.

In 1970, the State of New York adopted a program of mortgage assistance, generally patterned on the Federal National Mortgage Association. The program was designed to pump money into the single-family mortgage market during periods of tight money and to aid the construction industry. The program made money available without regard to the mortgagor’s income. Other states followed with various single-family mortgage programs.

In 1978, the City of Chicago, operating pursuant to a home rule provision in the Illinois state constitution, implemented a $100 million mortgage revenue program for single-family housing, providing assistance to families with incomes of up to $40,000. All information and effective operation of State housing finance agencies and State development agencies which have authority to finance, to assist in carrying out, or to carry out activities designed to provide housing and related facilities . . . for persons and families of low, moderate and middle income. . . .” 42 U.S.C. § 1440(a) (1976).


The first program for multi-family mortgage revenue bonds is generally considered to have been created by the New York State Housing Finance Agency.


The Chicago program has been criticized for its upper-income limit. However, the First National Bank of Chicago has noted in a report on mortgage revenue bonds that of the families receiving mortgages “about 10% had incomes below $10,000, 18% had incomes between $10,000 and $14,999, 26% between $15,000 and $19,999, 20% between $20,000 and
though not the first city program in the nation,\textsuperscript{17} Chicago became the model for many similar local financings. Since then, mortgage bonds have been issued by various state and local governments employing a variety of instrumentalities including government departments,\textsuperscript{18} public corporations,\textsuperscript{19} municipalities operating pursuant to home rule\textsuperscript{20} or specific legislative grants,\textsuperscript{21} public trusts,\textsuperscript{22} and not-for-profit corporations.\textsuperscript{23}

During 1978, local governments issued more than \$550 million in single-family mortgage subsidy bonds.\textsuperscript{24} In the first nine months of 1979, 106 offerings were made totalling more than \$4.2 billion.\textsuperscript{25} Offerings in Arkansas, Louisiana, California, and West Virginia accounted for approximately half the number of issues.\textsuperscript{26}

\section*{III. A Summary of H.R. 5741}

House Resolution 5741 [the "Bill"]\textsuperscript{27} would amend section 103 of the Internal Revenue Code of 1954, by adding a new section, 103A,

\begin{itemize}
  \item $24,999, 15\% \text{ between} \$25,000 \text{ and} \$29,999 \text{ and} 11\% \text{ had incomes above} \$30,000." \textit{First National Bank of Chicago, First Chicago World Report: Restricting Mortgage Revenue Bonds} 11-12 (Nov./Dec. 1979).
  \item Apparently the City of Minneapolis was the first. See Freilich, Rushing \& Noland, \textit{Review of Local Government Law, Municipal Bonds: The Tax-Exempt Issue to Finance Single Family Homes}, 11 \textit{Urb. Law.} 547, 583 n.238 (1979) [hereinafter cited as \textit{Urban Lawyer}].
  \item \textit{E.g.}, the Maryland Community Development Administration. See \textit{Md. Ann. Code} art. 41, § 266DD-1(b) (1978).
  \item \textit{E.g.}, Chicago, Ill., see \textit{Ill. Const.} art. VII; various municipalities in Kansas, see \textit{Kan. Const.} art. 12, § 5.
  \item \textit{See \textit{Urban Lawyer, supra} note 17, at 583 ("approximately \$550 million"); Tax-Free Housing Bonds Cost More Than They Are Worth, \textit{Fortune}, July 2, 1979, at 86 ("more than \$600 million").
  \item Tax-Exempt Housing Issues Top \$3 Billion in Quarter, 250 \textit{Daily Bond Buyer} 293 (1979).
  \item \textit{Id.}
entitled “Mortgage Subsidy Bonds.” Section 103 currently reads in pertinent part: “Gross income does not include interest on—(1) the obligations of a State, a Territory, or a political subdivision of any of the foregoing or of the District of Columbia. . . .”

Subject to certain exceptions, the Bill excludes mortgage subsidy bonds from section 103(a).29

The Bill defines a mortgage subsidy bond as “any obligation which is issued as part of an issue a significant portion of the proceeds of which are to be used directly or indirectly for mortgages on owner-occupied residences.”30 From this definition, the Bill excludes two types of bonds: “qualified mortgage bonds,”31 and “qualified veterans’ mortgage bonds.”32 The Bill sets up ten criteria for a “qualified” mortgage bond.33 However, under a sunset provision, qualified mortgage bonds would not be exempt two years after the Bill’s enactment.34

A. The Ten Criteria

The Bill creates an elaborate statutory scheme defining what constitutes a qualified mortgage bond. The ten criteria can be summarized as:

1. All proceeds of the mortgage bond issue, exclusive of reserves and issuance costs, must be used to finance owner-occupied residences;35

28. I.R.C. § 103(a). Two types of obligations, industrial revenue bonds and arbitrage bonds, were specifically excluded from the exemption in § 103(a), see §§ 103(b) & 103(c), by prior amendments, see Pub. L. No. 90-364, § 107(a), 82 Stat. 251, 266-68 (1968) (industrial revenue bonds); Pub. L. No. 91-172, § 601, 83 Stat. 487, 656-57 (1969) (arbitrage bonds). H.R. 5741 further amends the restrictions on industrial revenue bonds. See H.R. 5741, § 3. These bonds are discussed briefly in pt. IV. See note 105 infra and accompanying text.

30. § 103A(b)(1).
31. § 103A(b)(2)(A).
32. § 103A(b)(2)(B). This Article focuses on the more general mortgage bonds. It should be noted however that the Bill requires that veterans’ bonds be secured by the general obligation of the issuing state. § 103A(c)(3)(B). For a general description and discussion of these bonds see § 103A(c)(3) and the committee report, H.R. Rep. No. 678, 96th Cong., 1st Sess. 46 (1979).
33. See §§ 103A(c)(2)(A) & (c)(2)(A)(ii). The ten criteria are discussed immediately below.
34. § 103A(c)(1)(B).
35. § 103A(c)(2)(A)(i). Reserves generally are established equivalent to one year’s maximum debt service on the bonds and one percent of the amount of the mortgages, to provide additional security. The largest portion of the issuance cost is the underwriter's discount,
2. The property mortgaged must be the principal residence of the mortgagor and be located within the jurisdiction of authority issuing the bond; \(^{36}\)

3. With certain exceptions, \(^{37}\) the mortgagor may not have had an ownership interest in a residence for the three years prior to the time the mortgage is signed; \(^{38}\)

4. The purchase price of the residence is limited; \(^{39}\)

5. Three-quarters of the financing provided by the issue must be used for mortgages where the down payment is small, usually five-percent; \(^{40}\)

6. The median family income of the mortgagor may not exceed 115 percent of the median family income for the area in which the residence is purchased, \(^{41}\) and at least half of the issue's proceeds must be used to finance residences purchased by mortgagors whose median family income is not greater than ninety percent of the median family income for the area in which the residence is purchased; \(^{42}\)

7. No issuing authority may issue in one year more than five percent of the average annual amount of all single family mortgages written within the issuing authority's jurisdiction over the preceding three years. \(^{43}\) However, a minimum of

but costs include printing, legal, and administrative expenses. Approximately 83% of the proceeds are available for making mortgages.

36. § 103A(d)(1).

37. The exceptions are for (i) residences in "target areas," defined in § 103A(m); (ii) qualified home improvements, defined in § 103A(n)(6); and (iii) qualified rehabilitation loans, defined in § 103A(n)(7).

38. § 103A(e).

39. § 103A(f). The purchase price may not exceed 80% of the "average area purchase price," defined in § 103A(f)(2), or, if the residence is located in a targeted area, 110% of the average area purchase price, § 103A(f)(4).

40. § 103A(g). The down payment minimum does not apply to qualified home improvement or rehabilitation loans. § 103A(g)(1). Larger down payments are permitted in some circumstances. See § 103A(g)(3).

41. § 103A(h)(1)(B).

42. § 103A(h)(1)(A). Again, exceptions are made for mortgages by purchasers of residences in targeted areas. See § 103A(h)(3). "Family income" and "medium family income" are to be defined by regulations to be issued by the Secretary of the Treasury and insofar as they are consistent with the purposes of the Bill, are to be consistent with regulations promulgated under § 8 of the United States Housing Act of 1937. § 103A(h)(2). The Housing Act definitions are contained in 24 C.F.R. § 880 (1979).

43. § 103A(i)(2).
$50,000,000 may be issued in a particular state each year;\textsuperscript{44}

8. At least twenty percent of the proceeds of the issue must be used to finance residences in targeted areas for at least one year after the financing is first made available to targeted areas.\textsuperscript{45} However, the issue need not account for more than forty percent of the total mortgages written in a targeted area;\textsuperscript{46}

9. The rate of interest on the mortgage may not be more than one percentage point over the yield on the bond.\textsuperscript{47} Additionally, any gain realized by the issuing authority, either through arbitrage or investment, must be used to reduce the mortgagors' cost of financing;\textsuperscript{48} and,

10. The appropriate state agency, after reviewing the issue's official statement, must give an opinion that the issue meets the criteria set forth in 7. and 8., above,\textsuperscript{49} the bonds must be in registered, rather than bearer, form,\textsuperscript{50} more than one lender must be involved,\textsuperscript{51} and, with certain exceptions, the mort-
gages must be new rather than assumed. 52

As can be seen, the Bill does not make the interest paid on mortgage bonds non-exempt per se although that is the practical effect. Rather, it makes any bond issue that does not follow the Bill’s enunciation of federal housing policy non-exempt and thus more expensive for the issuing authority. 53 By so doing, the Bill coerces states to aid housing only when it coincides with particular federal policy.

B. Particular Exemptions

Certain bond issues are exempted from the Bill’s coverage. This gives rise to interesting political considerations. As noted above, 54 general obligation bonds for veterans’ housing are exempted. However, only three states have such a program: 55 Oregon, Wisconsin, 56 and California. The first two states are represented by Representatives Ullman and Reuss respectively, the cosponsors of the bill.

52. § 103A(l)(4)(A). The exceptions are contained in §§ 103A(l)(4)(B) & (l)(5).

53. The effect of the loss of the exemption on housing provided by municipal financing has been considered by Congress. See S. Rep. No. 2140, 76th Cong., 3d Sess. (1940). A minority report attacked the proposal to tax state securities as an attempt to impose federal control, id. at 1-3, and asserted that the loss of the exemption would add materially to the cost of low-income housing and thus prevent attaining the goals of the National Low Cost Housing Act. Id. at 21. The Senate, by a vote of 44 to 30, adopted the minority report. 86 Cong. Rec. 18621 (1940).

The economic effect of the “inefficient subsidy” occasioned by the current exemption generally is used as a basis for curtailing the exemption. See H.R. Rep. No. 678, 96th Cong., 1st Sess. 22 (1979). However, the economic analysis and assumptions underlying this position recently have been criticized strongly. See M. Musa & R. Kormendi, The Taxation of Municipal Bonds: An Economic Appraisal (1978). The authors, economists at the University of Chicago, criticize certain of the federal government studies for ignoring, among other things, the effect of inflation.

[W]e find that for inflation rates of greater than 2 percent the “efficiency ratio” of the exemption is more than 90 percent. In other words, municipal governments enjoy more than ninety cents of benefit for each dollar of tax revenues lost by the federal government. Moreover, at inflation rates of 5 to 6 percent, the efficiency ratio of the exemption rises to 97 percent. In comparison with other federal subsidy programs, this is a very high efficiency ratio, particularly for a program that provides assistance in such a desirable form, without strings and constraints on municipal governments. Id. at 9-10.

54. See note 32 supra and accompanying text.


56. However, Wisconsin has reached its authorized debt limit on general obligation veterans’ bonds and has had to implement a revenue bond program. The realization of this may explain why Representative Reuss failed to cosponsor the Bill.
which originated the exception. 57

In like manner, section 4 of the Bill exempts issues on which cer-
tain "official actions" have been taken. 58 However, the Bill ignores
state law provisions regarding the proper official to take particular
actions. 59 Section 4 also contains exceptions based upon specific
criteria which limit their application to localities in Alaska, 60 non-
charter cities in California, 61 the State of New York Mortgage
Agency, 62 certain public trusts in Oklahoma, 63 localities in Tennes-
see, 64 Atlanta, Georgia, 65 Alton, Illinois, 66 localities in Texas, 67 and
the New York City Housing Development Corporation. 68

IV. The Constitutional Limitation

In elementary, government it is taught that the republic was
formed pursuant to a constitution drafted by representatives of the
states and subsequently ratified by the states. In that Constitution
certain powers were ceded to the federal government and others
were reserved to the states or the people. 69 The concept of federal
instrumentalities' sovereign immunity from taxation by the states

59. In certain charter cities in Tennessee, for example, the governmental powers are exer-
cised by a strong mayor. However, debt is actually issued by the council of the city. Hence,
under a strict construction of the Bill, which apparently is favored by the committee staff,
see H.R. Rep. No. 678, 96th Cong., 1st Sess. § 51 (1979), actions taken by such mayor, which
would otherwise constitute "official action," would not comply. Senator Sasser of Tennessee,
after reporting on a study conducted by the Senate Subcommittee on Intergovernmental
Relations which, while finding a lack of substantial abuse in mortgage revenue bond pro-
grams, recommended a "capping" of issuance on a state by state basis, observed that the
county government of Shelby County, Tennessee, was unable to issue bonds because of the
uncertainty of their status under the Bill. See 126 Cong. Rec. S1537-39 (daily ed. Feb. 19,
1980). The experience to date in the House and remarks like those of Senator Sasser increase
the likelihood that if any bill were passed it would resemble a Christmas tree.
61. Id. § 4(b)(5). This reference may also apply to certain localities in Minnesota and
Maine.
62. Id. § 4(c)(4).
63. Id. § 4(d)(1).
64. Id. § 4(d)(2).
65. Id. § 4(d)(3).
66. Id. § 4(d)(4).
67. Id. § 4(d)(5).
68. Id. § 4(l).
69. See U.S. Const. amend. X. See also 1 A. de Tocqueville, Democracy in America
118-19 (P. Bradley ed. 1945).
was recognized early. It is the complementary doctrine whereby a state or its instrumentality is immune from federal taxation which is of concern here. While reciprocal sovereign immunity has gone in and out of favor, with the effect of continually narrowing the doctrine, recent court opinions have reaffirmed its place as a constitutional limitation on federal taxing power.

A. The Early Cases

In Pollock v. Farmers' Loan & Trust Co., the Supreme Court noted that the federal government has an unlimited power of taxation with one exception, it could not tax imports, and two qualifications, direct taxes must be imposed by rule of apportionment, and indirect taxes by the rule of uniformity. The Court was divided on whether the tax on the net profits of the defendant was a direct tax not apportioned among the states in accordance with article 1, section 2 of the Constitution. However, the entire Court agreed that the attempt to tax the interest on state obligations was beyond the competence of Congress.

As the States cannot tax the powers, the operations, or the property of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States have no power under the Constitution to tax either the instrumentalities or the property of the

70. See McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819). The ability of the state to tax a federal instrumentality was questioned in a logical fashion by reference to certain political propositions, to wit: (i) the power to create implies the power to preserve; (ii) a power to destroy, if wielded by a different hand, is both hostile to and incompatible with the powers to create and to preserve; and (iii) where such hostility exists the power which is supreme must control. Id. at 426.

71. See Collector v. Day, 78 U.S. (11 Wall.) 113 (1870). There is no express limitation in the Constitution on the federal taxing power. Rather, one has been implied to ensure "the continued existence of the states as government entities." Helvering v. Gerhardt, 304 U.S. 405, 414 (1938). In National League of Cities v. Usery, 426 U.S. 833 (1976), the Court implicitly recognized this principle as a constitutional imperative. Id. at 843 n.14.


73. See, e.g., National League of Cities v. Usery, 426 U.S. 833 (1976). See also notes 131-33 infra and accompanying text.

74. 157 U.S 429 (1895).

75. Id. at 586.

76. Id. at 584-87; id. at 601-08 (Field, J., concurring); id. at 652 (White, Harlan, JJ., dissenting); id. at 653 (Harlan, J., dissenting).
[A tax on the interest of state and municipal obligations] 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.\footnote{77}

Upon rehearing, the Court further stated that a tax on the receipts from municipal bonds could not be sustained because it is a direct tax "on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution."\footnote{78}

In response to Pollock, the sixteenth amendment was enacted.\footnote{80} The amendment granted Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment."\footnote{81} While the amendment appears straightforward and absolute, it simply abrogated one of the qualifications on the federal taxing power noted above; it did not extend the power to new subjects.\footnote{82}

\footnote{77} Id. at 584. The Court stated: "A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of federal taxation." Id.

\footnote{78} Id. at 586.

\footnote{79} Pollock v. Farmers’ Loan & Trust Co., 158 U.S. 601, 630 (1895).


\footnote{81} U.S. Const. amend. XVI.


[T]he genesis and words of the [sixteenth] Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another. And we have so held in other cases. 253 U.S. at 261-62 (footnotes omitted); accord, Eisner v. Macomber, 252 U.S. 189, 206 (1920). "As repeatedly held, [the sixteenth amendment] did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for unapportionment among the States of taxes laid on income." Id.

Evans and Eisner are consistent with the legislative history accompanying the sixteenth amendment. Senator Brown, the legislative sponsor of the amendment, stated:

The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state
B. A Turning Point

Subsequent to World War I, the Supreme Court began to limit the broad immunity from federal taxation theretofore enjoyed by the states. Notably, however, there has been no decision upholding a direct federal income tax on the interest of state or local bonds.

In *National Life Insurance Co. v. United States*, the Supreme Court considered a provision of the 1921 federal tax law which, while permitting insurance companies to exclude policy premiums from gross income, required that interest from state and local obligations be included in gross income. The interest received from such obligations was deductible but another deduction, equal to four percent of the company’s legal reserve, was diminished by the interest deducted. The effect of this law was that the tax paid was the same as if all the interest income were taxable. The Court refused to uphold this method of taxing interest on municipal bonds. The Court held: “One may not be subjected to greater burdens upon his taxable property solely because he owns something that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted.”

*Willcuts v. Bunn* is not inconsistent with the earlier case of *National Life*. Here, the Court held proper a tax on the capital gain realized on the sale of a municipal bond. *Pollock* was cited with approval for the proposition that the interest on “obligations of a State or of its political subdivisions [is] exempt from federal taxation.” A tax on the profits derived from the sale of such bonds was distinguished on the grounds that it would not impose a burden on the borrowing power of the state. “No facts as to the actual conse-
quences are brought to our attention, either by the record or by argument, showing that the inclusion in the federal tax of profits on sales of state and municipal bonds costs any appreciable burden on the States' borrowing power. 87

This distinction between a direct versus an indirect burden is consistent with the Court's earlier decisions in Flint v. Stone Tracy Co. 88 and Greiner v. Lewellyn 89 and with its subsequent decision in Denman v. Slayton. 90 The issue before the Court in Flint was the constitutionality of the federal corporate excise tax of 1909. The corporation tax law imposed a tax on the privilege of carrying on or doing business by a corporation measured by the corporation's net income from all sources, including interest from state and municipal bonds. The Court accepted Congress' declaration that the tax was an excise tax. 91 The standard for reviewing such a tax is not the sixteenth amendment but, rather, article 1, section 8, clause 1, of the Constitution, which grants Congress the power to impose "Taxes, Duties, Imposts and Excises." 92 Because this clause contains no limitation except one of uniformity, 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 taxed directly. The Court stated:

It is therefore well settled by the decisions of this court that when the sovereign 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 non-taxable. 93

87. Id. at 230.
88. 220 U.S. 107 (1911).
89. 258 U.S. 384 (1922).
90. 282 U.S. 514 (1931).
92. U.S. Const. art. 1, § 8, cl. 1 provides: "The Congress shall have the Power To lay and collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the Common Defense and general welfare of the United States, but all Duties, Imposts, and Excises shall be uniform throughout the United States."
93. 220 U.S. at 165. This distinction between income and excise taxes was recognized long before the Pollock decisions. See Provident Inst. v. Massachusetts, 73 U.S. (6 Wall.) 611 (1867); Society for Sav. v. Coite, 73 U.S. (6 Wall.) 594 (1867). Similarly, the distinction has been upheld in cases subsequent to Pollock. See Plummer v. Coler, 178 U.S. 115 (1900).
In *Greiner v. Lewellyn*, the Supreme Court summarily rejected the argument that an estate tax based on the net value of the estate, including interest received on municipal bonds of a political subdivision of the Commonwealth of Pennsylvania, was unconstitutional. The estate tax was described as the antithesis of a direct tax. The Court held that the tax due may be calculated without regard to the character of the property transferred.

Less than two months after *Willcuts* was decided, the Supreme Court, in *Denman v. Slayton*, upheld a provision in the Revenue Act of 1921 which disallowed a deduction from gross income for the interest received on a municipal bond where those bonds had been purchased with borrowed funds of which interest payments thereon were deductible. The Court upheld the provision and distinguished *National Life*:

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 [the Act]. . . . The manifest purpose of the exception in paragraph 2, § 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 respondent, "A," with an income of $10,000 arising from non-exempt 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, makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress.

The most recent case to discuss the issue of state immunity from federal taxation is *United States v. Atlas Life Insurance Co.* This case involved a requirement of the Life Insurance Company Income Tax Act of 1959 that insurance companies pro-rate exempt interest

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94. 258 U.S. 384 (1922).
95. Id. at 387.
96. Id.
97. 282 U.S. 514 (1931).
98. Id. at 519-20.
between the company and its policy holders. Respondent argued that the law effectively taxed exempt interest. The Court disagreed, finding that the effect of the law was to equalize the tax burden between taxpayers with exempt and non-exempt securities and taxpayers whose gross income was derived only from taxable sources.\textsuperscript{100} The rule of \textit{Pollock} and \textit{National Life} was not undermined.\textsuperscript{101}

It is clear, therefore, that both by decision and dicta the Supreme Court has upheld the principle that the federal government may not directly tax the interest received from state and local bonds. It follows that the amendments to section 103 of the Internal Revenue Code passed in 1968 and 1969 which limit the tax exemption on industrial development bonds\textsuperscript{102} and arbitrage bonds\textsuperscript{103} are unconstitutional. No case raising this issue has been reported.\textsuperscript{104} Whatever the reasons for the conspicuous absence of discussion on the subject,\textsuperscript{105} it is wrong to infer that the passage of such amend-

\textsuperscript{100} \textit{Id.} at 243-44. The Court noted that, according to a letter submitted by the Department of the Treasury, the enactment did not intend to place a tax on exempt interest, but that an exception had been added to the bill in case of a contrary ruling. \textit{Id.} at 241 n.12.

\textsuperscript{101} For a similar conclusion reached through different reasoning see Comment, Tax-Exempt State and Local Bonds: Form of Intergovernmental Immunity and Form of Intergovernmental Obligation, 21 \textit{De Paul L. Rev.} 757 (1972).

\textsuperscript{102} \textit{I.R.C.} § 103(b).

\textsuperscript{103} \textit{Id.} § 103(c).

\textsuperscript{104} \textit{But cf.} Kirkpatrick v. United States, 605 F.2d 1160 (10th Cir. 1979). In this case, the court held that bonds issued by a tax-exempt hospital to finance construction were industrial development bonds within the meaning of I.R.C. § 103(b) and, therefore, the interest paid on such bonds was subject to federal income tax. Notably, neither the plaintiff nor the court discussed the issue of the statute’s constitutionality.


Although the present legal basis for the exemption of interest on State and local obligations from the Federal income tax is found only in section 103(a) of the code, there is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local obligations without the consent of the issuing governments. It also is maintained that the exemption is part of a federal system of government under which the Federal Government does not infringe on the powers of the State and local governments. This position has been disputed, and many authorities have indicated that the Federal Government does have a constitu-
ments negates the argument made herein.\textsuperscript{106}

C. Federal Taxation of Other State Activities

It is unclear to what extent the cases involving federal taxation of state activities other than borrowing for a public purpose are relevant to the issue of taxing the state's borrowing power. In the Senate hearings on the Public Salary Act of 1939, Senator Brown quoted David Wood, who he called the "foremost authority on municipal bonds in the United States,"\textsuperscript{107} as saying:

While the courts, both before and since the ratification of the sixteenth amendment, have recognized the limitations which the system of dual sovereignty has imposed upon the taxing powers of the State and of the Federal Government, they have also been aware that these limitations must not be extended too far or they likewise would impair, if not destroy, the very system, the existence of which they were necessary to preserve. Both the State

\textsuperscript{106} See \textit{Waltz v. Tax Comm'n}, 397 U.S. 664 (1970). "It is obviously correct that no one acquires a vested or protected right in violation of the Constitution by long use, even when that span of time covers our entire national existence and indeed predates it." \textit{Id.} at 678.

and the Federal Government must raise revenue, and if the principle of immunity were carried too far, the reciprocal immunities would seriously impair the ability of each sovereign to raise revenue. The courts have, therefore, refused to apply the doctrine to taxes, which are not levied directly upon the exercise of a sovereign power, but which affect it only remotely. This distinction is brought out by two cases like Helvering against Gerhardt and cases involving the taxation of bonds of governmental agencies, or the income derived therefrom. 108

In *Helvering v. Gerhardt*, 109 where a federal income tax on employees of a bi-state agency was sustained, the Court expressly distinguished the situation presented from one where the tax is imposed on a private investor of state bonds. 110 Similarly, in *Commissioner v. Shamberg's Estate*, 111 where it was held that the interest on bonds of the Port Authority of New York was exempt from federal taxation, the court stated that the decision in *Helvering* had no bearing on the issue before them there. 112

It has been argued that the decision in *Graves v. New York ex rel. O'Keefe* 113 rejected this distinction between the taxation of the state's borrowing power and the taxation of other state activities. In this case, the Supreme Court reversed a line of earlier cases 114 and held that salaries of state officials were not immune from federal taxation. 115 In a memorandum prepared by the Justice Department in 1940, 116 it was argued that *Graves*, in specifically overruling its decision in *Collector v. Day*, impliedly overruled its decision in *Pollock*. The memorandum stated that *Graves* laid "the basis for a denial in the future of tax immunity to the income derived from state and municipal bonds." 117 The Supreme Court did state in *Graves* that "[t]he theory, which once won a qualified approval that a tax on the income is legally or economically a tax on its source, is no longer tenable . . ." and intimated that a tax on in-

108. *Id.*
110. *Id.* at 417.
111. 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945).
112. 144 F.2d at 1003.
113. 306 U.S. 466 (1939).
115. 306 U.S. at 487.
117. *Id.* at 3.
come derived from salary is no different than one on "some other form of compensation." 118 Although consistent with the political mood of the times, 119 this is, at best, too expansive a reading of Graves. Properly, this language is dicta as it was unnecessary to decide this point to resolve the question presented. More revealing, however, is the fact that five years later, when the Court of Appeals for the Second Circuit was presented with an opportunity to limit the scope of state immunity from federal taxation in Shamberg, 120 it refused to do so and ignored the dicta from Graves. In addition, the Court in Atlas Life Insurance made no use of Graves in its decision. 121

Notwithstanding this clear distinction between a federal taxation on the state's borrowing power and one on other state activities, some commentators have used those decisions on the latter issue as support for the argument that state immunity from federal taxation largely has been undercut. 122 It is the position of this author,

118. Id.
119. President Franklin Roosevelt sent a message to Congress on January 19, 1939, urging changes in the tax law. In the message Roosevelt stated:

In my message of April 25, 1938, I urged that the time had come when the Congress should exercise its constitutional power to tax income from whatever source derived. I urged that the time had come when private income should not be exempt either from Federal or State income tax simply because such private income is derived as interest from Federal, State, or municipal obligations, or because it is received as compensation for services rendered to the Federal, State, or municipal governments.

A fair and effective progressive income tax and a huge perpetual reserve of tax-exempt bonds could not exist side by side.

The tax immunities heretofore accorded to private income derived from Government securities or Government employment are not inexorable requirements of the Constitution, but are the result of judicial decision. I repeat that it is not unreasonable to hope that judicial decision would permit the elimination of these immunities.


120. 144 F.2d 998, 1003 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). See notes 111 & 112 supra and accompanying text.

More recently, however, in the Senate debates on the Danforth Amendment making the
however, that the case law in this area will not support taxing mortgage subsidy bonds, as the Bill attempts to do.

In *Helvering v. Gerhardt*, the Court held that activities not “essential to the preservation of state governments” could be taxed even though collected from the state treasury. The opinion explicitly states that the borrowing power is essential to the preservation of state government. *Helvering* effectively was reaffirmed in *New York v. United States*, where the Court held that the sale by a state of mineral water was subject to the federal taxing power. In both *Helvering* and *New York* the Court refused to find such state-run, profit-making activities beyond the competence of the federal taxing power.

In contradistinction, the mortgage loan program which the Bill restricts is not a profit-making enterprise. The proceeds acquired by state and local debt issued under these programs are used most commonly to subsidize housing for low and low-middle income

"Wildfall Profit Tax" applicable to oil from state owned lands, Senator Russell Long, Chairman of the Senate Committee on Finance, and others argued that such a tax would imply that the federal government could tax the interest on municipal bonds and therefore would be unconstitutional. See 125 CONG. REC. S18461-66 (daily ed. Dec. 13, 1979); id. at S18651-55 (daily ed. Dec. 15, 1979). Senator Long reviewed New York v. United States and declared it provided three criteria for Congress to tax a state, viz.: “One, income from State-owned lands is immune from Federal taxation. Two, discrimination against a State will not be permitted; that is unconstitutional. Three, the Federal tax cannot interfere with the sovereign functions of the State government being taxed.” Id. at S18655. See also id. at S18661 (remarks of Sen. Tower) & 126 id. at S585 (daily ed. Jan. 30, 1980) (remarks of Sens. Wallop & Armstrong) (objecting to attempt by Rep. Ullman to append the Bill to the Windfall Profits Tax bill in the conference committee). However, Senator Long and his colleagues are no doubt mindful that New York v. United States, 326 U.S. 572 (1946) (sale of state owned mineral water), Allen v. Regents of the Univ. System, 304 U.S. 439 (1938) (admission charge for athletic events), and United States v. California, 297 U.S. 175 (1936) (state run railroad) may be read to support the proposition that business activities of a state are not beyond the reach of the federal taxing or commerce regulatory power even if the revenues derived are utilized to effect a public purpose. A distinction should be made, however, that mortgage revenue bonds directly effect a public purpose. Consistency on the constitutional argument would lead one to assume that the followers of Senator Long’s position would oppose the Bill.

123. 304 U.S. 404 (1938).
124. Id. at 419.
125. Id. at 417.
127. However, see the vigorous dissents of Justices Douglas and Black, id. at 590, 593-98 (Douglas & Black, JJ., dissenting), and the interpretation of this case by Senator Long, note 122 supra. See also South Carolina v. United States, 199 U.S 437 (1905).
128. See pt. II supra.
families.\textsuperscript{129} Therefore, neither New York nor Gerhardt stand as precedent for taxing the bonds at issue herein.\textsuperscript{130}

The case of National League of Cities v. Usery\textsuperscript{131} also supports this position. There, amendments to the Fair Labor Standards Act which included state and local fire and police officials within its scope were challenged as a violation of the tenth amendment. This amendment states that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."\textsuperscript{132} The Court held that the amendments as applied to the states were an unconstitutional infringement on state sovereignty. Those activities which are "integral government functions" may not be regulated by the Congress.\textsuperscript{133}

\textbf{V. Conclusion}

While it is clear that not every activity in which a state engages would fall within National League's prohibition, it is beyond doubt that the borrowing power is an integral government function ex-

\textsuperscript{129}Id.

\textsuperscript{130}United States v. California, 297 U.S. 175 (1936), is not apposite. In that case, the Court held that a state-run railroad was not beyond the scope of the federal commerce clause. Although National League of Cities v. Usery, 426 U.S. 833 (1976), distinguishes the situation in California from federal regulation of local fire and police departments, National League's reasoning undermines the holding in California. See 426 U.S. at 850-51.

\textsuperscript{131}426 U.S. 833 (1976).

\textsuperscript{132}U.S. Const. amend. X.


The Department of Labor, in accordance with the Court's decision, has promulgated regulations for administration determinations of what constitutes a "traditional governmental activity" exempt from the Fair Labor Standards Act. See 44 Fed. Reg. 75,628-30 (1979) (to be codified in 29 C.F.R. § 775). The Department has added to the Court's determination that a railroad is not a traditional function the following functions: off-track betting corporations; local mass transit systems; generation and distribution of electric power; provision of residential and commercial telephone and telegraphic communication; production and sale of organic fertilizer as a by-product of sewage processing; production, cultivation, growing or harvesting of agricultural commodities for sale to consumers; and, repair and maintenance of boats and marine engines for the general public. Id. at 75,630. The Department has found the operations of libraries and museums to be traditional. Id.

In Amersbach v. City of Cleveland, 598 F.2d 1033 (6th Cir. 1979), city airport employees were found to serve an integral government function and therefore beyond the scope of the Fair Labor Standards Act. The court noted that there are four elements common to integral government functions. Those are: 1) the function benefits the community as a whole and is "available to the public at little or no direct costs"; 2) the function is undertaken "for the purpose of public service rather than for pecuniary gain;" 3) the function is principally provided by government; and 4) government is "particularly suited" to perform the function. Id. at 1037.
empt from federal regulation.\textsuperscript{134} In addition, the purpose for which proceeds from the mortgage subsidy bonds are put serves such a function. States are empowered to provide for the general health and welfare of their citizens.\textsuperscript{135} The state, in providing certain housing, depending on the economic climate at the time, is performing a public purpose\textsuperscript{136} and exercising no less an integral government function than it does in providing police or fire protection. Where the state, through its representatives, chooses to subsidize an activity for the protection and enhancement of its citizens, the federal government should not,\textsuperscript{137} and may not, interfere with that deci-

\textsuperscript{134} See note 125 supra and accompanying text.

\textsuperscript{135} Such power may be granted by a "general welfare" clause in the state constitution or by specific authorization. \textit{Compare}, e.g., \textsuperscript{\textit{Colo. Const. pream.}; \textit{Ill. Const. pream.}; \textit{Me. Const. pream.}; \textit{Mass. Const. pream.}; \textit{Ohio Const. pream.}; \textit{Okla. Const. pream.}; \textit{S.D. Const. pream.}; \textit{Wis. Const. pream.} (general welfare) with \textit{N.Y. Const. art. VII, §§ 8(1) & (2), 14, 18, 19; art. VIII, §§ 1, 2; art. XVIII (specific authorization)}.


\textsuperscript{137} Recent legislation considered by Congress shows more concern for the implications of \textit{National League} than does the Bill. For example, in the legislative history accompanying the Bankruptcy Reform Act of 1978 it is stated 'that certain changes in the municipal bankruptcy law are based on the decision, \textit{viz.}:

\textit{The Court enunciated a stronger policy of Federalism and States' rights than had been stated since the first Municipal Bankruptcy Act was held unconstitutional in 1936. In deference to developing ideas of Federalism, this bill takes greater care to insure that there is no interference in the political or governmental functions of a municipality that is proceeding under Chapter 9, or of the State in its power to control its municipalities.}'}

The Bill does interfere with such state and local government choice and is, therefore, unconstitutional.

As was noted above, a case considering a constitutional challenge to the arbitrage or industrial development bond regulations has not been found. However, given the current disposition of the Court in light of National League, the time may be ripe for a test, the result of which, hopefully, will be to end the perennial attempts to unconstitutionally interfere with the states.

Postscript

On March 26, 1980, the Bill passed the House by a vote of 238 to 178. 126 Cong. Rec. H2237 (daily ed. Mar. 26, 1980). It is expected that the Bill will be rewritten in conference.