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Problem of Tax Exempt Securites

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THE PROBLEM OF TAX-EXEMPT SECURITIES

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THE DOCTRINE OF TAX EXEMPTION

PRIOR to the adoption of the income tax amendment in 1913, Congress was forbidden to tax municipal securities either directly, or indirectly under the guise of an income tax.[1] The decisions which led up to this conclusion of the courts are among the most important to be found in the reports. Whether they are right or wrong, these decisions follow such an undeviating course that the conclusion which they reach must be accepted as settled law unless it has been overruled by the sixteenth amendment.

They begin with the case of *McCulloch v. Maryland,*[2] decided over a century ago, and continue down through the income tax decisions of 1895 even into our own day. In the *McCulloch Case* it was decided, among other things, that a state may not tax a bank chartered as an instrumentality of the federal government. This decision, which has been reaffirmed in other similar cases, was followed by others in which it was held that the state governments and their municipal subdivisions may not tax the securities of the United States, or the property or revenue of the United States, or the emoluments of federal officers.[3] These decisions and nu-

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[1]"Municipal securities" will be understood to include all securities whether in the form of bonds, certificates of indebtedness, or some other form, issued by the state governments or their municipal subdivisions.

[2](1819) 4 Wheat. (U.S.) 316, 4 L.Ed. 579.

[3]Osborn v. Bank of the United States, (1824) 9 Wheat. (U.S.) 738, 6 L.Ed. 204; Weston v. Charleston, (1829) 2 Pet. (U.S.) 449, 7 L.Ed. 481; People ex rel. Bank of Commerce v. City and County of New York, (1862) 2 Black (U.S.) 620, 17 L.Ed. 451; Van Brocklin v. State of Tennessee, (1886) 117 U.S. 151; 29 L. Ed. 845, 6 S.C.R. 670; Dobbins v. Commissioners of Erie County, (1842) 16 Pet. (U.S.) 435, 10 L.Ed. 1022.

merous dicta simply carry out the general theory that the state governments are totally lacking in the power to control federal instrumentalities, and that the only way in which such control can be prevented is by the complete denial of the state's power to tax or otherwise interfere with such instrumentalities.

"The sovereignty of a state extends," says Marshall, "to everything which exists by its own authority, or is introduced by its permission; but does it extend to those means which are employed by Congress to carry into execution powers conferred on that body by the people of the United States? We think it demonstrable that it does not."[4]

At a later date, when the danger was no longer that the states would destroy the union, but rather that the states themselves would be totally submerged and wiped out of existence by the torrential flow of federal power, the court was compelled to develop the converse of this proposition, namely, that the federal government is without the power to tax the government instrumentalities of the states. It was necessary, indeed, for the court to call attention once more to the separate and independent powers of the states.

"Not only," said the court in a dictum, "can there be no loss of separate and independent autonomy to the states, through their union under the constitution, but it may be not unreasonably said that the preservation of the states, and the maintenance of their governments, are as much within the design and care of the constitution as the preservation of the union and the maintenance of the national government. The constitution, in all its provisions, looks to an indestructible union, composed of indestructible states."[5]

In the case of *The Collector v. Day*[6] it was held that Congress has no power to tax the salary paid by a state to one of its officers. Following this case it was held that the federal government has no power to levy a tax even indirectly upon the property and revenues of a municipal corporation which is acting as an agent of the state and is carrying out public purposes.[7] Finally

[4]McCulloch v. Maryland, (1819) 4 Wheat. (U.S.) 316, 429, 4 L.Ed. 579.

[5]Texas v. White, (1869) 7 Wall. (U.S.) 700, 19 L.Ed. 227. See also the remarks in People ex rel. Bank of Commerce v. City and County of New York, (1862) 2 Black (U.S.) 620, 635, 17 L.Ed. 451, 17 L.Ed. 459; and in Lane County v. Oregon, (1869) 7 Wall. (U.S.) 71, 19 L.Ed. 101.

[6](1870) 11 Wall. (U.S.) 113, 20 L.Ed. 122.

[7]United States v. Railroad Company, (1873) 17 Wall. (U.S.) 322, 21 L.Ed. 597.

in the *Pollock Case*,[8] the famous income tax case of 1895, although the judges disagreed most sharply upon the other points involved, they were unanimous in holding that Congress is without power to levy a tax upon the income derived from municipal bonds. The basis of the latter decision was simply this, that such a levy "is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the constitution."

Because of the obvious fact that the states and municipalities sometimes go into business of a private nature, there has developed one exception to the rule of non-taxability of state instrumentalities. The exception, which is justified on the ground that it prevents the states from seriously impairing the sources of federal revenue, but which at the same time really adds strength and precision to the exemption from federal taxation enjoyed by the states, is illustrated by the South Carolina case involving public liquor dispensaries.[9] The state government, having monopolized in order to control the traffic in intoxicating liquors, objected to paying the federal internal revenue taxes. This objection was overruled by the Supreme Court on the ground that it is only truly governmental instrumentalities which are entitled to the exemption. Otherwise a state might, by monopolizing all lines of private business within the state, exclude the federal taxing power entirely.

The unanimous decision of the judges in the income tax case that the federal government may not tax the income of municipal bonds brought to completion the development of a principle which had been in the making since the days of Marshall. The principle is, in brief, that the states may not tax federal instrumentalities as such, and that the federal government may not tax the proper governmental instrumentalities of the states and their municipalities. The principle is nowhere stated in the constitution in so many words, but in the words of Marshall the first part of it "so entirely pervades the constitution, is so intermixed with the materials which compose it, so interwoven with its web, so

[8]Pollock v. Farmers' Loan and Trust Co., (1895) 157 U.S. 429, 39 L.Ed. 759, 15 S.C.R. 673.

[9]South Carolina v. United States, (1905) 199 U.S. 437, 50 L.Ed. 261. 26 S.C.R. 110. But it is true, as has been pointed out, that there will be some practical difficulty in continuing to uphold both the rule in this case and that in The Collector v. Day. Corwin, Constitutional tax exemption, suppl. 13 Nat. Mun. Rev. 67, note.

blended with its texture, as to be incapable of being separated from it, without rending it into shreds,"[10] whereas the second part of it has been developed by the judges since the Civil War as a necessary corollary of the first. The whole rule has, in fact, become an established maxim of American constitutional law.

The Income Tax Decisions of 1895

The principle which we have just been discussing has never given rise to any important controversy until very recent years. The public at large have thought little of it, and no political party has demanded its modification. It has been accepted almost universally and without serious question that the state and federal governments should not tax each other. Entirely different was the reception accorded to the income tax decision of 1895 as to the taxation of incomes generally.

During the Civil War and for some years thereafter the government levied an income tax and derived a considerable revenue therefrom. No one questioned the power of the government to levy such a tax, but a number of years after the war question was raised whether an income tax is not a direct tax which, under the constitution, must be apportioned among the states according to population.[11] The constitution provides that "representatives and direct taxes shall be apportioned among the several states . . . according to their respective numbers" as determined by the census; that "no capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken;" and that "all duties, imposts, and excises shall be uniform throughout the United States."[12] Since the income tax at that time was being levied uniformly, the litigant hoped to prove the act invalid by demonstrating that it was a direct tax which should have been apportioned. The Supreme Court refused to take this view. It held that there were only two types of direct taxes, namely capitation taxes and taxes on real estate. An income tax was held to be an excise or duty which it was proper to levy uniformly throughout the United States.

After the country had gone some years without an income tax, Congress in 1894 again passed an act for the imposition of such a tax, and again by the rule of uniformity. This act was im-

[10]McCulloch v. Maryland, (1819) 4 Wheat. (U.S.) 316, 424, 4 L.Ed. 579.

[11]Springer v. United States, (1881) 102 U.S. 586, 26 L.Ed. 253.

[12]Constitution, art. I, sec. 2, par. 3; sec. 9, par. 4; and sec. 8, par. 1.

mediately attacked by most able counsel on behalf of a loan and trust company.[13] The chief contention of the plaintiff was that the tax upon the income from real and personal property was a direct tax just as much as if the tax had been laid upon the real estate or personal property directly. While it was agreed among the judges that a tax upon salaries and business profits would be an indirect tax, subject to the rule of uniformity, it was finally held upon the second hearing of the case, five judges concurring against four dissenting, that a tax upon income from property is a direct tax which must be apportioned according to population. This decision, which was a reversal of the earlier ruling of the court, invalidated certain essential portions of the income tax law and made the whole act inoperative. One consequence of this reversal of position was the arousing of a great deal of adverse criticism of the court throughout the country.

It should be noted here that the court did not declare that Congress had no power whatever to levy an income tax. On the contrary the possession of this power by Congress was asserted. What the court did say was that a tax upon the income from property, if levied at all, must be apportioned among the states according to population. The court, in other words, traced the income to its source, and held that if a tax upon the source would constitute a direct tax, so also would a tax upon the income from that source.

Practically speaking, however, the decision of 1895 made a federal income tax unworkable. In the first place a tax upon the income, "gains or profits from business, privileges, or employments," would have to be levied uniformly, while a tax upon the income derived from property would have to be apportioned according to population. In the second place, to have apportioned the latter tax among the states would have been to reduce it to an absurdity and to have made its administration almost impossible. To apportion a tax Congress must first decide how much revenue it desires from the tax. Suppose that it decides to raise $500,000,000 in a population of approximately 100,000,000 people. This would amount to five dollars per capita. New York state, with ten million inhabitants, would pay $50,000,000. Minnesota, with two and a third million, would pay about $11,500,000, and so on through the states. Because of differences in total

[13]Pollock v. Farmers' Loan and Trust Co., (1895) 157 U.S. 429, 39 L.Ed. 759, 15 S.C.R. 673, 158 U.S. 601, 39 L.Ed. 1103, 15 S.C.R. 912.

income and in the distribution of incomes according to size, there would have to be a different income tax rate schedule for each one of the forty-eight states. The rate would be relatively high in Minnesota and very low in New York. Under a uniform income tax the people of New York state paid income and profits taxes in 1921-22 of over $525,000,000. The people of Minnesota paid a little over $30,000,000, or about one seventeenth as much. Under an apportioned tax New Yorkers would have paid only four times as much total as the citizens of Minnesota instead of seventeen times as much. The result of such a law, aside from its gross inequalities, would probably be to make residence in New York more than ever attractive to the wealthy people of the country.

The Sixteenth Amendment

In the popular discussions which followed upon the decision in the income tax case, almost the entire emphasis was placed upon the rule of apportionment for direct taxes. The other phase of the decision, relative to the taxation of the income of municipal bonds, was then relatively unimportant and seems to have been generally ignored. The Democratic party became the chief exponent of an income tax. Its platforms and its speakers dwelt upon the need of such a tax as a means of making the wealthy pay their proportionate share of the national taxation, but at first little progress was made.

In 1907 a business panic was followed by depression. With the diminution of business, the tariff revenues declined. When President Taft took office in 1909 the treasury faced a deficit of approximately one hundred million dollars. The president therefore called Congress in special session in March to revise the tariff and to provide revenue to cover the deficit. In his first address he recommended the imposition of an inheritance tax as a source of additional revenue.[14] Democratic and insurgent Republican members of Congress were not content with these measures. They proceeded to add to the tariff bill an amendment to provide for a uniform income tax. It was their expectation that the measure would be attacked as unconstitutional, but with the changed membership of the supreme court they hoped for a reversal of the decision of 1895.

Under these circumstances the president delivered a special message to Congress.[15] For immediate revenue purposes he now

[14]44 Cong. Rec., March 4, 1909, p. 3.

urged the imposition of an excise tax on corporations. As to the income tax he said:

"Although I have not considered a constitutional amendment as necessary to the exercise of certain phases of this power, a mature consideration has satisfied me that an amendment is the only proper course for its establishment to its full extent. I therefore recommend to the Congress that both houses, by a two-thirds vote, shall propose an amendment to the constitution conferring the power to levy an income tax upon the national government without apportionment among the states in proportion to population."

He urged Congress not to reënact the income tax law previously declared unconstitutional.

"For the Congress to assume that the court will reverse itself, and to enact legislation on such an assumption, will not strengthen popular confidence in the stability of judicial construction of the constitution."

Previous to President Taft's special message, Senator Brown of Nebraska had offered a resolution for a constitutional amendment to the effect that "The Congress shall have power to lay and collect taxes on incomes and inheritances." Upon being informed in debate that Congress already had both of the powers in question, and that it was only the rule of apportionment which stood in the way of federal income taxation, he offered, a few days later, a second resolution which read "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population."[16] Not long afterwards there emerged from the Senate committee on finance, of which Senator Aldrich of Rhode Island was chairman, a resolution for a constitutional amendment, reading:[17]

"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."

In this form the amendment passed both houses and was submitted to the states. The action of Congress upon it was indeed a curious proceeding.[18] Here was a proposed constitutional amendment, destined as it proved to be the first one adopted in over forty years. The chief proponents of the measure were

[15] 44 Cong. Rec., June 16, 1909, p. 3344.
[16] 44 Cong. Rec., pp. 1548, 1568, 3377.
[17] 44 Cong. Rec., p. 3900.
[18] 44 Cong. Rec., pp. 1568-70, 4067-68, 4105-21, 4364, 4390-4441, 4493, 4495, 4629, Appendix pp. 70-71, 75-79, 103-114, 117-128, 131-132.

men who had never espoused the cause of income taxation. The resolution was discussed on only one day in the Senate and one in the House. There was no critical analysis of the wording of the amendment, no attempt made to explain its meaning in detail. One member said:

"The resolution is simple in construction and covers but one subject and one purpose. It is formulated in clear and unambiguous terms, leaving no possibility for doubtful construction."

Another averred that it was "very defectively drawn," but neglected to point out the defects. One thing only is clear, and that is that the members who discussed it expected it to overrule the decision of 1895 as to the apportionment of income taxes among the states. There was no word of discussion of the problem of tax exempt securities, or of the taxation of incomes derived from state and municipal salaries. The printed debates discover no intention whatever upon the part of the members of Congress to enlarge the power of taxation already possessed by the federal government, or of bringing the income from municipal securities under federal income taxation. Since the evidence of the debates upon this point is entirely negative, however, it is, of course, not correct to say upon the basis of this evidence alone that Congress had no intention of the sort.

No sooner had the proposed amendment been submitted to the states than questions began to be raised as to its meaning. Governor Hughes' message to the New York legislature early in 1910 raised serious doubts as to what effect the amendment would have if adopted.[19] He said:

"The comprehensive words 'from whatever source derived,' if taken in their natural sense, would include not only incomes from real and personal property, but also incomes derived from state and municipal securities."

Several other governors expressed similar misgivings.[20] It would be far more to the purpose to have the opinions of the members of the state legislatures which adopted the amendment, but such evidence is now impossible to obtain.

Senator Borah found early opportunity to address the Senate in reply to Governor Hughes.[21] He came to the conclusion that

[19]Message of Jan. 5, 1910; Evans v. Gore, (1920) 253 U.S. 245, 261, 64 L.Ed. 887, 40 S.C.R. 550; quoted in Corwin, Constitutional Tax Exemption, suppl. 13 Nat. Mun. Rev. 60.

[20]Corwin, Constitutional Tax Exemption, suppl. 13 Nat. Mun. Rev. 60.

[21]45 Cong. Rec., Feb. 10, 1910, pp. 1694-99. See also remarks of Senator Brown, pp. 2245-47.

the proposed amendment added nothing to the taxing power of Congress, which was "complete, unfettered, plenary before;" that it dealt, and purported to deal, only with the manner of exercising the power; and that

"to construe the proposed amendment so as to enable us to tax the instrumentalities of the state would do violence to the rules laid down by the supreme court for a hundred years, wrench the whole constitution from its harmonious proportions and destroy the object and purpose for which the whole instrument was framed."

But the most cogent reply to Governor Hughes was contained in a letter written by Mr. Root to Mr. F. M. Davenport of the New York state legislature.[22] It was his conclusion that the amendment would not "in any degree whatever . . . enlarge the taxing power of the national government" or "have any effect except to relieve the exercise of that taxing power from the requirement that the tax shall be apportioned among the several states. The effect of the amendment will be, in my view, the same as if it said, 'The United States may levy a tax on incomes without apportioning the tax, and this shall be applicable whatever the source of the income subjected to the tax,' leaving the question 'What incomes are subject to national taxation?' to be determined by the same principles and rules which are now applicable to the determination of that question." No one arose in either house to dispute this view, although Mr. Borah spoke at length in the Senate, and the letter written by Mr. Root was spread at large upon the Record. When we couple this fact with the negative testimony of the debates at the time of the proposal of the amendment, we have not complete proof of the intention of Congress in proposing the amendment, but at least very good grounds for a controlling presumption.

Views of the Broad Constructionists

In the interpretation of the sixteenth amendment there are two outstanding difficulties. One is that the amendment takes the form of a substantive grant of power to Congress. The second is embodied in the words "from whatever source derived." The amendment seems, in other words, to grant to Congress a power not previously possessed, to tax incomes, and to tax them from whatever source they may be derived. This plausible view is rendered the more natural when we recall that the income tax

[22] 45 Cong. Rec., March 1, 1910, pp. 2539-40.

case of 1895 raised both the question of apportionment of the tax and the question of the power of Congress to tax the income from municipal bonds. It may be reasoned, therefore, that the amendment was designed to surmount at one stride both the supposed obstacles to income taxation discussed in that case.

The latter view is ably presented in an article by Professor Henry Rottschaefer in the MINNESOTA LAW REVIEW.[23] The bases upon which his argument rests are as follows: *First.* Prior to 1913 there was a double defect in the federal power to levy income taxes. On the one hand Congress had no power to tax the income of municipal bonds, and on the other hand it was required to follow the rule of apportionment instead of the rule of uniformity in taxing the income derived from property. *Second.* Unlike other federal amendments, the income tax provision takes the form of a grant of power to Congress. *Third.* Literally construed the amendment grants Congress the power to levy taxes upon incomes from whatever source derived, and to levy them without apportionment among the states according to population. It serves thus to overcome both of the previous defects in the power of Congress to tax incomes. *Fourth.* Where the literal meaning is so obvious, and where the language serves so well to remedy a preëxisting evil, it is unnecessary and improper to study other evidences as to the motives and intent of the framers of the amendment. *Fifth.* In any case the intent of the members of Congress is of little moment, since it was the state legislatures which actually adopted the amendment. The conclusion reached is that the amendment may properly be construed to authorize federal taxation of the income of municipal bonds.

In his two articles on the subject, Professor E. S. Corwin pursues a somewhat different course of reasoning, but comes to substantially the same conclusion.[24]

"Approached without preconceptions," he says, "the sixteenth amendment clearly gives the power to tax incomes from municipal and state bonds, as well as the salaries of state officials, by a general income tax."

The amendment must be taken as meaning what it literally says, or seems to say. "On correct theory" Congress "has always had the power to tax incomes from state and municipal securities by a general income tax." This power was effectually taken

[23]8 MINNESOTA LAW REVIEW 112-126.

[24]Tax-exempt Securities, 33 New Republic, 243-45; Constitutional Tax Exemption, suppl. 13 Nat. Mun. Rev. 49-67.

away by the decision in the *Pollock Case,* but "the sixteenth amendment restores that power by striking down the judicial theory whereby such incomes came to be exempted. Congress may tax incomes from whatever source derived. The words of the amendment are perfectly explicit and the sense of them could not be made clearer by a dozen constitutional amendments." But it is impossible here to show with what a wealth of information and dialectic power this author proceeds to demonstrate his views.

In a dissenting opinion in the case of *Evans v. Gore,*[25] Justice Holmes has suggested but has not fully expounded an interpretation which comes to the same conclusion. He also looks upon the amendment as a grant of power to Congress to tax incomes "from whatever source derived." It is true, he says, that the amendment goes on to provide for the levy of such taxes "without apportionment among the several states, and without regard to any census or enumeration," and this, he says, "shows the particular difficulty that led to it. But the only cause of that difficulty was an attempt to trace income to its source, and it seems to me that the amendment was intended to put an end to the cause and not merely to obviate a single result. I do not see how judges can claim an abatement of their income tax on the ground that an item in their gross income is salary, when the power is given expressly to tax incomes from whatever source derived." While the case here under discussion involves the taxation of the salary of a federal judge, the reasoning is broad enough to cover the case of municipal bond interest. What Justice Holmes asserts is that the amendment rules out and makes inadmissible all discussion of the source from which income is derived. No one, he thinks, may now be heard to claim exemption from income taxes on the ground that his income is derived from this or that supposedly exempt source.

The writer has found only one other line of argument put forward to justify federal taxation of the income of municipal bonds. During the debates upon the War Revenue Act in the Senate in 1917-18 Senator Knox argued that the war power was broad enough to authorize the tax.[26] He argued from some language found in the case of *The Collector v. Day* that the exemption of state instrumentalities from federal taxation was founded upon the principle of self-preservation. When the life of the nation was in danger, when lives and wealth were being

[25](1920) 253 U.S. 245, 264-67, 64 L.Ed. 887, 40 S.C.R. 550.
[26]56 Cong. Rec., Sept. 30, 1918, pp. 10933-41.

conscripted to protect the entire people, he thought the doctrine of self-preservation required that the federal government should have the power to tax the incomes of all the people. Since this line of argument has nothing to do with the sixteenth amendment it will be unnecessary to refer to it again.

The Official View

Giving all due consideration to the eminent authorities who assert the present power of Congress to tax the income of municipal bonds, it must be said that the weight of opinion is against them. Congress itself has from the first seemed to assume that its power does not extend so far.[27] Even during the war when, if ever, the national government stood in dire need of a copious revenue, and when one revenue act was actually drawn to subject such income to taxation, so great was the doubt upon this point that this provision was finally omitted.[28] The misgivings as to the possession of this power have been expressed both in debate and in committee reports, and more recently by the proposal, which passed one house of Congress in 1923 and is now again before that body, of a resolution for a constitutional amendment to authorize the taxation in question.[29] President Harding also held the view that a new amendment is needed, and President Coolidge holds the same position.[30] It is unnecessary, perhaps, to call attention to the attitude of the treasury department.[31] This practical construction of the constitution may not be ignored.[32] It began with the first Congress and the first administration which took office after the adoption of the amend-

[27]38 Stat. at L., p. 168 (1913); 39 Stat. at L., pp. 758-59 (1916); 40 Stat. at L., pp. 329-30 (1917); ibid. pp. 1065-66 (1918); 42 Stat. at L., p. 238 (1921). In the acts of 1918 and 1921, no express provision is made for exempting the salaries of state and municipal officers and employees, but it has been ruled that the exemption still exists on constitutional grounds.

[28]House Report No. 767, 65th Cong., 2nd Sess., p. 9; Senate Report No. 617, 65th Cong., 3rd Sess., p. 6; 56 Cong. Rec., pp. 10933-41, 10628-33, 11181-87; 40 Stat. at L., p. 1065-66.

[29]House Report No. 969, 67th Cong., 2nd Sess.; H. J. Res. 314, 67th Cong., 2nd Sess. The proposed amendment is given in note 48, infra.

[30]Message, President Harding, Dec. 6, 1921; 62 Cong. Rec., p. 39; ibid., Dec. 8, 1922, 64 Cong. Rec., p. 215; message of President Coolidge, Dec. 6, 1923, 65 Cong. Rec., p. 98.

[31]See the N. Y. Times, especially under dates of Jan. 9 and 12, 1924.

[32]"Contemporaneous or practical construction of an ambiguous provision of a constitution by the legislative or executive departments of the government is always important, and is frequently of controlling influence in determining its meaning." 12 C.J. 712, (Const. Law §65) and cases there cited.

ment and has continued without change down to the present time.

Because Congress, doubting its own power, has failed to enact a law to make municipal bond interest taxable as income, it has been impossible for the Supreme Court to pass directly upon the question. We are not, however, without clues as to the probable attitude of the judges. In a number of decisions, where it has been called upon to interpret and to apply the income tax amendment, the Supreme Court has asserted in dicta that it was not the intention of the amendment to enlarge the scope of the federal taxing power, or to extend that power to subjects formerly exempt from taxation, but that its purpose was merely to change the law as to the apportionment of income taxes. In the leading case upon the amendment Chief Justice White said:

"It is clear on the face of its text that it does not purport to confer power to levy income taxes in a generic sense,—an authority already possessed and never questioned,—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived."[33]

In another decision handed down at the same term of court the Chief Justice said that:

"by the previous ruling [quoted above] it was settled that the provisions of the sixteenth amendment conferred no new power of taxation, but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged, and being placed in the category of direct taxation subject to apportionment by a consideration of the sources from which the income was derived."[34]

There are similar dicta in other cases, particularly in that of *Evans v. Gore*,[35] which involved the power of Congress to tax the income derived by a federal judge from his official salary. This case involved a question not unlike that which is discussed in this paper. The decision, which the writer does not attempt to justify, simply was that the income tax amendment does not change or overrule that provision in article 3, section 1, of the

[33]Brushaber v. Union Pacific Railroad Co., (1916) 240 U.S. 1, 36 S.C.R. 236, 60 L.Ed. 493.

[34]Stanton v. Baltic Mining Co., (1916) 240 U.S. 103, 36 S.C.R. 278, 60 L.Ed. 546.

[35](1920) 253 U.S. 245, 64 L.Ed. 887, 40 S.C.R. 550. See also Peck and Co. v. Lowe, (1918) 247 U.S. 165, 62 L.Ed. 1049, 38 S.C.R. 432; Eisner v. Macomber, (1920) 252 U.S. 189, 64 L.Ed. 521, 40 S.C.R. 189.

constitution, which provides that the compensation of federal judges "shall not be diminished during their continuance in office." The court refused to tolerate a diminution even in the form of an income tax. In this decision the history of the sixteenth amendment was carefully reviewed in the light of the information then available in order to ascertain its purpose. The conclusion was stated as follows:

"Thus the genesis and words of the 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."

The Case for Strict Construction

In construing the words of the amendment, the most important question is whether they are to be construed as a grant of power. To the author it would seem that they do not constitute a grant of power in a substantive sense, but only in an adjective sense. Congress has always had the substance, namely the power to tax incomes. This power was conferred by the original constitution, article 1, section 8.

"The Congress shall have power: 1. 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."

This provision is still in effect. It has been supported by numerous judicial decisions and by the most far-reaching judicial dicta as to the extent of the taxing power.[36] The power to tax incomes is traceable to this source, and not to the sixteenth amendment. The two must be read together, the one as conferring the power, and the other as determining the manner in which the power may be exercised. But the substantive power to tax incomes, as well as the power to tax other subjects, has for many years by an unbroken line of decisions, been held to be subject to the limitation that the federal government may not tax the instrumentalities of the states. A tax upon the income derived from government bonds has been held, with unimpeachable logic, to be equivalent to a tax upon the government directly.[37]

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[36]License Tax Cases, (1867) 5 Wall. (U.S.) 462, 18 L.Ed. 497; Veazie Bank v. Fenno, (1870) 8 Wall. (U.S.) 533, 540, 19 L.Ed. 482; Knowlton v. Moore, (1900) 178 U.S. 41, 44 L.Ed. 969, 20 S.C.R. 747.

[37]Weston v. Charleston, (1829) 2 Pet. (U.S.) 449, 7 L.Ed. 481. "The right to tax the contract to any extent, when made, must operate upon the power to borrow, before it is exercised, and have a sensible

What the income tax amendment does, and does very effectively, as all agree who have studied the question, is to abolish the requirement created by the decision in the *Pollock Case* of apportioning the tax upon income derived from property among the states according to population. The gist of the amendment is this: "The Congress shall have power to lay and collect taxes on incomes . . . without apportionment among the several states, and without regard to any census or enumeration." The form of the amendment clearly indicates that this is the essence of the whole proposition.

But the question still remains, Does not the amendment do more than this? This brings us to the second difficulty, namely the meaning of the elliptical clause, "from whatever source derived," which is inserted parenthetically in the middle of the sentence. It should be noted that the sentence is entirely complete without it. Indeed, as originally drafted the amendment contained no such phraseology. The words in question were inserted, as explained by one who had reason to know, to make assurance doubly sure that all legal income taxes might be levied by the rule of uniformity.[38] After the *Pollock Case* decision the law seemed to require that taxes upon the income from salaries, business profits, and other income not arising from property, should be levied uniformly, whereas taxes upon the income from property would have to be levied according to the rule of apportionment. To the writer it would seem that the words in question might well have been omitted, that they are a mere work of supererogation. Or, if it was deemed necessary to put them in, it might have been better to have said, "from whatever *legally taxable* source derived," for this, according to Mr. Root, was the intention. In other words, the term "whatever" has reference only to those sources of income which were formerly taxable by the federal government.

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influence on the contract. The extent of this influence depends on the will of a distinct government; to any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely." p. 468. See also People ex rel. Bank of Commerce v. City and County of New York, (1862) 2 Black (U.S.) 620, 17 L.Ed. 451; Farmers and Mechanics Savings Bank v. State of Minnesota, (1914) 232 U.S. 516, 58 L.Ed. 706, 34 S.C.R. 354. In the arguments for abolishing tax exemption it is admitted that state and local governments will have to pay a higher rate of interest if the exemption is abolished.

[38]See Senator Root's letter in 45 Cong. Rec., March 1, 1910, pp. 2539-40.

It is our purpose, however, not to show how the amendment might have been more clearly drafted, but to try find its meaning as it is. Do the four words, "from whatever source derived," empower Congress to tax the income of municipal bonds? The exemption of federal instrumentalities from state taxation, and of state instrumentalities from federal taxation, is a rule which lies at the very foundation of our federal system. Perhaps we should have had an equally good system of government if the judges had never insisted upon this complete separation between the two authorities, but the fact is that our law has developed in this way. The importance of this separation has been stressed by the Supreme Court time and again, from Marshall's day to the present. Are we to suppose that the Congress, without discussion of the question, by the clumsy use of four words in the middle of an amendment designed apparently for a different purpose, intended to introduce a change of so tremendous significance?

By the ordinary principles of legal draftsmanship a change so important would seem to require at least a separate sentence, and some separate consideration. It could hardly be effected by mere inadvertence. New and fundamental powers are not usually conferred by a single phrase found in two provisions having a different purpose. A single simple sentence usually accomplishes only one object. It is interesting in this connection to note that those who assert that this one-sentence amendment accomplishes two objects, usually construe it as if it were two sentences, or two practically coördinate clauses, reading substantially as follows: "The Congress shall have power to lay and collect taxes on incomes from whatever source derived. Such taxes may be laid without apportionment among the several states, and without regard to any census or enumeration." They omit even to note the parenthetical position of the words "from whatever source derived," which in the amendment are entirely set off by commas.

Another objection to the broad interpretation is that, once accepted, it may be extended almost indefinitely. It can be made to apply not only to income from municipal securities, but to all income from salaries and wages paid by state and local governments to their officers and employees. It can be made to apply to pensions, to bonuses, and to all other forms of payment by state and local governments to individuals. It need hardly stop there. The principle of taxation at the source may be applied,

the federal government ordering the states and municipalities to withhold a portion of the salaries and wages, and possibly even of contractual interest payments, and to pay these sums directly to the federal government. Indeed it might be suggested that if the intention of Congress in proposing the amendment and of the states in adopting it is to be ignored, and if we are not to seek in history the meaning of the provision, the very "incomes" or revenues of the state and municipal governments as such might, under a broad interpretation, become directly taxable by the federal government. The sixteenth amendment does not specify "personal incomes" as being alone taxable, and there have been cases where a federal tax has impinged with substantial directness upon municipal revenues.[39]

The power to tax is still the power to destroy. If Congress has the power to tax the income from municipal bonds and the salaries of state and municipal employees, it might, by classifying incomes into "earned" and "unearned," by raising some rates and lowering others, by the addition of surtaxes, and by other devices, put direct burdens upon the operations of state and local governments. The argument that this will not be done in fact is one which the court refused to consider in the case of *McCulloch v. Maryland* as well as in subsequent cases.[40] It is the existence of the power which is obnoxious to the constitution, and not a particular method of exercising the power.

There are still other objections to a broad construction of the amendment. If taken broadly and literally, it would seem to authorize the impairment of the obligation of contracts. All municipal bonds sold after the income tax decisions of 1895 certainly could have been taken by the purchasers on the faith that the income therefrom was exempt from federal taxation. The state and municipal governments had the legal right to certify that tax-exemption was one of the privileges attaching to their securities. The taxation of bonds under such circumstances, it has been held, operates directly upon the contract.[41] The buyer of a tax exempt bond pays something for the exemption privilege in the form of lessened interest, or interest foregone. Surely Congress and the state legislatures did not connive at the

[39]United States v. Railroad Co., (1873) 17 Wall. (U.S.) 322, 21 L.Ed. 597.

[40]People ex rel. Bank of Commerce v. City and County of New York, (1862) 2 Black (U.S.) 620, 629-35, 17 L.Ed. 451, 17 L.Ed. 459.

[41]Weston v. Charleston, (1829) 2 Pet. (U.S.) 449, 7 L.Ed. 481; and other cases cited in note 36, supra.

passing of an amendment to the constitution to impair existing contractual obligations! This, it has been held in a similar situation, would be "so inconsistent with the honor and dignity of the United States that such an intent should not be presumed without the clearest legislative language requiring it."[42] But there are no words in the amendment which in any way recognize such contractual rights or guarantee against the taxation of the interest-income of such previous buyers in good faith. The presumption must be that the taxation of such income was not intended. It is interesting to note in this connection how careful the framers of the proposed new amendment have been to protect the contractual rights of those who buy municipal bonds before the amendment takes effect.[43]

Another consideration is perhaps not unworthy of mention. What the amendment authorizes Congress to do is to lay and collect "taxes" on incomes in a certain manner. What are taxes? Is it too far-fetched to suggest that if the federal government should attempt to levy a charge directly upon the state and municipal governments as such, it would not be a tax at all, but a forced contribution of wholly arbitrary character? Is it not proper to construe the decisions upon this point from *McCulloch v. Maryland* down to date as holding in effect that such levies do not come under the designation of taxes?[44] This does not seem to have been said in so many words, yet this is the result, for in all the cases the courts assert the complete and "plenary" power of "taxation" of both the state and federal governments, but at the same time deny the power to levy the contributions in question. If this be so as a direct levy, it is almost as true of a charge upon incomes derived from either the state or federal government, for such a charge would react directly upon the paying authority.

There is, finally, a very real objection to the position of the broad constructionists in their refusal to consider the intent of

[42]Farmers and Mechanics Savings Bank v. State of Minnesota, (1914) 232 U.S. 516, 58 L.Ed. 706, 34 S.C.R. 354.

[43]See note 48 for the proposed amendment. Of course the federal government itself is not forbidden by express language of the constitution to impair the obligation of contracts, but at the same time it is not to be presumed that an act of Congress or even a constitutional amendment is intended to bring about an impairment. If possible a construction should be given to the language used which will avoid such a result.

[44]The definitions of taxation do not include the idea of one government "taxing" another. Taxes impinge upon natural persons and private corporations, upon property and business, upon privileges or franchises and income, but not upon governments as such.

the framers of the amendment, and of those who adopted it, as having any bearing upon the question. They take the view that the meaning of the amendment is so entirely clear upon the face of it that it is improper to resort to the evidences as to intent. When all three branches of the federal government seem to be united in holding a narrow view of the powers conferred by the amendment, it is a little difficult to understand how it can be said that the opposite construction is so clearly the right one that it could not be made clearer. In fact there is actual doubt as to the meaning of the words, although the official view is that of narrow construction.

But it is suggested that we should approach the question without preconceptions. It may be true that a man from Mars, or an average uninformed citizen, knowing nothing about the constitutional history of the country, or about the other provisions of the constitution, upon being handed a slip of paper containing only the sixteenth amendment, would probably say that it constituted a grant of power to Congress to tax incomes, and that the words "from whatever source derived" would seem to authorize the taxation of all sorts of incomes, including an income from municipal bonds. Likewise it has been the experience of the writer with beginning classes in American government that they always assert, and with almost perfect assurance, that the fifth amendment prohibits the states from dispensing with the grand jury in criminal cases, that the term "ex post facto law" in article I, section 9, means any law passed with reference to an act previously committed, and that the two-thirds vote required by article V for the submission of constitutional amendments means two-thirds of all the members of each house.

It is, of course, entirely improper to pick out a single provision of a constitution and to construe it by itself without reference to other parts of the document. It is equally unjustifiable to take the bare words and to construe them with an uncompromising literality. To do so is to make language not the servant but the master of the will. It ceases to be the tool and becomes the workman. When the letter is the law, the people become the victims of the unskilled draftsman and the careless copyist. We do not put mere grammarians and lexicographers upon the bench any more than we submit questions of constitutional construction to the uninformed. Constitutional questions are submitted to courts consisting of judges who are supposed to know something of law and history, not excluding the history of the con-

stitution. The more learned they are, the more previous knowledge they have, the greater is our confidence in them. Indeed, in the long run under our system of government, it is the judges who are the ministers of the constitution, "not of the letter, but of the spirit: for the letter killeth, but the spirit giveth life." They are supposed to know the intent of the framers and the spirit of the document as a whole, and to apply this knowledge in interpreting the meaning of the words.

There is, then, a doubt as to the meaning, not perhaps of this amendment taken by itself without regard to other provisions, but of this provision when read, as it should be, in connection with the rest of the constitution, and as to the interpretation to be placed upon the instrument as a whole including this amendment. The instrument must be construed as a whole, and it must be given a practical construction which will give due weight to all its parts.

Little is gained by the citation of rules of constitutional construction. It would be impossible to harmonize all the different dicta of the court upon this point. We know that in practice the judges do study the history of the constitution, the reasons for its adoption, the debates at the time of its adoption, and even the opinions of contemporaries as to its meaning and purpose. Not only is this done in practice, but the judges assert that it is proper to follow this course.[45] Perhaps a leading digest of the law is not far wrong when it summarizes the rules upon this point as follows:

"The fundamental purpose in construing a constitutional provision is to ascertain and give effect to the intent of the framers and of the people who adopted it. The court, therefore, should constantly keep in mind the object sought to be accomplished by its adoption, and the evils, if any, sought to be prevented or remedied."[46]

This rule, if it be sound, probably applies as much to amendments as to the original document, and is particularly applicable where there is doubt as to the meaning of one provision when construed in conjunction with another. The opportunity has not yet arisen for the court to pass directly upon the question dis-

[45]"If, from the imperfection of human language, there should be serious doubts respecting the extent of any given power, it is a well settled rule, that the objects for which it was given, especially when those objects are expressed in the instrument itself, should have great influence in the construction." Marshall, C. J. in Gibbons v. Ogden, (1824) 9 Wheat. (U.S.) 1, 6 L. Ed. 23. See also Evans v. Gore, (1920) 253 U.S. 245, 65 L.Ed. 887, 40 S.C.R. 550.

[46]12 C.J. 700 (Const. Law §43). See also the cases there cited.

cussed in this paper, but other questions touching upon the sixteenth amendment have arisen. In deciding these questions the judges have resorted, and that very properly, to the history of the amendment, to the necessities which gave it birth, and to the records which exist as to the purpose of the framers and of those who adopted it. Let it not be thought that they have read merely the printed page in this connection, nor that they are required to restrict themselves to that sort of evidence. The judges who have rendered the decisions thus far upon this amendment are men who lived through the period of agitation for it and of its adoption. Not improperly, perhaps, they have called upon their own knowledge of what took place, and of the reasons why it took place. No doubt they have agreed with Mr. Root that the question of tax-exempt securities was not a serious evil at the time the amendment was proposed, and that it was not intended to change the law upon that point. Perhaps they have been mistaken as to the facts. That may very well be, but the evidence adduced, up to the present time to prove that Congress and the state legislatures intended to make the income from municipal bonds taxable by the federal government is very meagre.[47]

From what has been said it must follow that we cannot speak with absolute assurance and finality upon the question at issue. At the same time the official or strict construction of the sixteenth amendment appears to be the sound one. It is preferable to the other view because it considers the constitution as a whole, it is not misled by the mere form of the amendment into a disregard of its substance, it conforms to the generally held opinion as to the intention of those who framed the provision, it does not open the door to such obnoxious results as the impairment of the obligation of contracts, and it preserves the fundamental rule of our constitutional jurisprudence that the federal government may not tax the governmental instrumentalities of the states. This view is, therefore, adequately supported by reason. It is, also, buttressed by the weight of opinion and by a long continued practical construction. To change the accepted interpretation[48]

[47]The best collections of evidences on this point will be found in Evans v. Gore, (1920) 253 U.S. 245, 64 L.Ed. 887, 40 S.C.R. 550; and in Corwin, Constitutional Tax Exemption, suppl. 13 Nat. Mun. Rev. 59-62.

[48]Such an amendment was submitted to the last Congress. It passed the lower house with the requisite two-thirds majority and was recommended for passage in the Senate, but the latter body was unable to reach a vote upon it. The same amendment is now again

at this late date would seem to require a new constitutional amendment dealing expressly with the subject.

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before Congress but has failed by a small margin to pass the House of Representatives. It reads as follows:

"Section 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any state, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other states.

"Section 2. Each state shall have power to lay and collect taxes on income derived by its residents from securities issued, after the ratification of this article, by or under the authority of the United States; but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of such state." H. J. Res. 314, 67th Cong., 4th Sess., 1923; H. J. Res. 1 and 136, 68th Cong., 1st Sess., 1923.