
Tax Reform and the Forgotten Context of the Municipal Tax Exemption

By Ernesto A. Lanza / Feb 27, 2017

The municipal bond community views with concern the potential for federal tax reform, with a well-founded fear that tax reform may create an opening for the elimination of the federal tax exemption for municipal bonds. While many members of Congress have expressed support for continuing the municipal tax exemption, the general view is that any expansive reform of the tax code will involve laying all options on the table, and the dynamics of the legislative process will leave the exemption at risk.

The debate over the municipal tax exemption focuses, by and large, on the cost to the federal treasury of foregone tax revenues, the relative economic efficiency of the federal subsidy entailed by tax exemption as compared to direct federal subsidy payments, the distribution of the tax benefit among investors, the central role of states and localities in building and maintaining our nation's core infrastructure, and general notions of federalism. What receives scant attention, however, is the relationship between the origins of the federal income tax and the municipal tax exemption, and the related balance between the municipal tax exemption and the exemption from state tax for many federal debt securities. While, in an economic sense, there is a cost associated with the municipal tax exemption, such cost can be viewed as an agreed-upon "overhead cost" for maintaining an important component of our federal form of government.

As state and local governments, other municipal market participants and policymakers weigh the role of the municipal tax exemption in a revised federal tax code, they should be mindful that the federal government achieved an understanding with the states on enduring federalist principles of comity and reciprocity through the course of ratifying the 16th Amendment to the US Constitution¹ to lay the foundation for the modern federal income tax system.

Municipal Tax Exemption, the 16th Amendment and the Federal Income Tax

The US Supreme Court's decision in *South Carolina v. Baker*² marked the end of the Court's recognition of a Constitutional basis for the municipal tax exemption, overturning its pre-16th Amendment decision in *Pollock v. Farmers' Loan & Trust Co.*³ *Pollock's* expansive view of the intergovernmental immunity doctrine - that a tax on municipal securities interest "is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution"⁴ - was based on an earlier Supreme Court decision invalidating a city tax on federal debt securities.⁵ The *South Carolina* opinion observed that this expansive view of the intergovernmental immunity doctrine had been "thoroughly repudiated" by the late 1930s, and that *Pollock* had not yet been overturned prior to 1988 due to "the historical fact that Congress has always exempted state bond interest from taxation by statute, beginning with the very first federal income tax statute."⁶

The incorporation of the municipal tax exemption as one of the original, and enduring, features of the modern federal income tax was no accident of history. Rather, it was one of the core planks of the bargain struck between the states and the federal government as the state legislatures voted to ratify the 16th Amendment. In explicitly granting authority to Congress to impose a tax on income from whatever source derived, the 16th Amendment eliminated any requirement for the apportionment of direct taxes (such as a tax on municipal securities interest, pursuant to the *Pollock* opinion) among the states based on population.⁷ While the belief that there was an inherent Constitutional immunity against taxation of interest on municipal securities still had adherents during the ratification process, there were many in state government and in Congress who felt that the 16th Amendment could serve as a basis for imposing such a tax.

For example, during the Congressional debate on the original 1913 income tax legislation, Congressman Charles Bartlett of Georgia observed, in connection with the ratification of the 16th Amendment two months earlier:

It is a fact that in my State and in a number of other States, when this amendment was up before the legislature for adoption, many people opposed the adoption of the amendment because there was nothing specifically said in the amendment that excepted State, municipal, and other subdivisions of State bonds from taxation under the proposed amendment: but the friends of the amendment felt justified in assuring them that except in great stress, except in time of war, Congress would never think it wise to tax the bonds of the State or the subdivisions thereof.⁸

Thus, a promise to maintain a legislative exemption from taxation for municipal securities served as a critical inducement to the states to ratify a Constitutional amendment that would eliminate state-based apportionment for taxation of investment earnings and permit direct taxation of interest on municipal securities. In fact, the 16th Amendment might never have been ratified without the bargain struck over the municipal tax exemption. True to this promise, the original federal income tax statute included the municipal tax exemption, as one of a very small number of deductions in that landmark tax legislation, and this exemption has existed continuously ever since. That the municipal tax exemption has been revised, restated and made partially conditional through various tax reform efforts over the years - and is now scored as simply another line-item "tax expenditure" like the large number of other exemptions, deductions, credits and preferences that have since been added - should not obscure the fact that the municipal tax exemption continues to stand as one of the original pillars of the federal tax code.

The Municipal-Treasury Trade-Off

The repudiation of the expansive view of the intergovernmental immunity doctrine cuts both ways, so that the more restricted modern intergovernmental immunity doctrine also no longer forbids, as a Constitutional matter, state taxation of income derived from securities issued by the federal government and its instrumentalities. Instead, such exemption currently is based on a series of statutory provisions exempting US Treasury securities and the securities of many other federal instrumentalities (collectively, "Treasury/federal tax-exempted securities") from most forms of state and local taxation, including income tax.⁹ In effect, just as the federal government can be viewed as "subsidizing" state and local governments through the municipal tax exemption, so to the federal government can be viewed, with equal justification, as imposing on state and local governments an obligation to subsidize the federal government through the state tax exemption of Treasury/federal tax-exempted securities.

In abiding by the bargain struck by the federal and state governments in connection with the adoption of the 16th Amendment and the enactment of the federal income tax, maintenance of the mutual exemption for municipal securities and Treasury/federal tax-exempted securities would clearly serve to undergird this bargain. Were the bargain to be broken by eliminating the municipal tax exemption in the course of tax reform, it could be argued that the statutory exemptions for Treasury/federal tax-exempted securities also should be eliminated - both to reciprocate the change to the treatment for municipal securities and to partially offset the negative economic repercussions of eliminating the tax exemption by permitting state and local governments to tax earnings on Treasury/federal tax-exempted securities. The elimination of the municipal tax exemption without regard to the likely collateral economic and market dislocations would strongly suggest that Congress should also discount any economic or market dislocations that might be caused by similarly eliminating the state tax exemption for Treasury/federal tax-exempted securities.

In truth, the better approach - from the vantage points of economics, federalism and our current critical need to revitalize America's infrastructure - would be to maintain the current tax-free status of both municipal securities and Treasury/federal tax-exempted securities.

While the ultimate treatment of municipal securities under the federal tax code is a matter for policymakers to decide, that decision should be based on factors important to the American people and their principles rather than merely as one input to be eliminated in a general rebalancing of the federal tax burden. To do otherwise would be to breach the bargain struck by the federal and state governments that characterizes our federalist system of governance.

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¹ "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." US Constitution, Amendment XVI.

² 485 U.S. 505 (1988).

³ 157 U.S. 429 (1895).

⁴ 157 U.S. at 586.

⁵ *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829).

⁶ 485 U.S. at 523, referring to Act of Oct. 3, 1913, ch. 16, 38 Stat. 114.

⁷ US Constitution, Article I, Section 2, Clause 3.

⁸ 63 Cong. Rec. 507 (1913) (statement of Representative Charles Bartlett).

⁹ See, e.g., 31 U.S.C. 3124. Securities of certain federal instrumentalities or government-sponsored enterprises do not enjoy state tax exempt treatment and are not Treasury/federal tax-exempted securities.