Notre Dame Law Review

Volume 44 | Issue 2 Article 2

1-1-1969

Taxation of Municipal Bond Interest--Interesting Speculation and One Step Forward

Joseph P. Martori

Harold J. Bliss

TAXATION OF MUNICIPAL BOND INTEREST — "INTERESTING SPECULATION" AND ONE STEP FORWARD

*Joseph P. Martori** and *Harold J. Bliss, Jr.***

I. Introduction

"Municipal bonds" is a generic term encompassing the bonds issued by states, territories, possessions of the United States, municipalities and political subdivisions, and by instrumentalities and agencies of the foregoing.[1] Although the term may be misleading to the extent that states, territories and possessions of the United States can hardly be classified as "municipalities," the scope of the term is not misunderstood in the investment community or among those connected with it. Thus, except where otherwise noted, throughout this article the term "municipal" will be used in this generic sense.

Municipal bonds may be further categorized in accordance with the precise nature of the issuing municipality's obligation to repay its debt. Investment significance attaches to the distinction between "general obligation bonds," for which the full faith, credit and taxing power of the issuer are pledged, and "limited obligation bonds," the debt service of which is dependent upon the revenues from a specific project or the proceeds of special assessments.[2] The quality of these bonds is a function of the economic character of the issuer, "its population, its wealth and income, and the financial competence of its administration."[3]

Indisputably, the most important characteristic of municipal bonds is the exemption afforded the interest thereon from federal taxation. As federal income tax rates have risen, the significance of this feature has increased accordingly. Furthermore, the exemption from federal income taxes is generally coupled with a similar exemption from state taxation in the state where the issuer is located.[4]

Section 103 of the Internal Revenue Code of 1954 (hereinafter referred to as the Code) provides, in pertinent part, as follows:

> (a) General rule.
> Gross income does not include interest on —
> (1) the obligations of a State, a Territory, or a possession of the

* Member, District of Columbia Bar, State Bar of Arizona; B.S., New York University, 1963; LL.B., Notre Dame Law School, 1967; M.B.A., New York University, 1968; associate, *Snell & Wilmer*, Phoenix, Arizona. Mr. Martori was Executive Editor of Volume 42 of the *Lawyer.*

** Member, State Bar of Arizona; A.B., LaSalle College, 1964; LL.B., Notre Dame Law School, 1967; associate, *Evans, Kitchel & Jenckes*, Phoenix, Arizona. Mr. Bliss was Articles Editor of Volume 42 of the *Lawyer.*

1 FUNDAMENTALS OF MUNICIPAL BONDS 1 (G. Calvert ed. 1963).
2 FINANCIAL HANDBOOK 11•26 (4th ed. J. Bogen ed. 1964).
3 *Id.*
4 G. Calvert, *supra* note 1, at 2.

> United States, or any political subdivision of any of the foregoing, or of the District of Columbia . . . .[5]

This statutory exemption, which has been a part of the tax laws since the adoption of the federal income tax in 1913,[6] is believed by some to be bolstered by the constitutional doctrine of "reciprocal" or "intergovernmental" immunity.[7] Justice Van Devanter, speaking for the United States Supreme Court in *Indian Motorcycle Co. v. United States*,[8] expressed that doctrine in these terms:

> It is an established principle of our constitutional system of dual government that the instrumentalities, means and operations whereby the United States exercises its governmental powers are exempt from taxation by the States, and that the instrumentalities, means and operations whereby the States exert the governmental powers belonging to them are equally exempt from taxation by the United States. This principle is implied from the independence of the national and state governments within their respective spheres and from the provisions of the Constitution which look to the maintenance of the dual system.[9]

The very existence of the statutory exemption has virtually precluded any meaningful judicial consideration of the constitutional question.[10] "And while the constitutional doubt remains, it is difficult to get the statute changed."[11]

II. Intergovernmental Immunity as a Constitutional Question

A. Development of the Doctrine

The genesis of the reciprocal immunity doctrine and, consequently, the alleged constitutional prohibition against the federal taxation of the interest on municipal securities is the celebrated opinion of Chief Justice John Marshall in *McCulloch v. Maryland*.[12] There the state of Maryland levied a tax on bank notes of the Second Bank of the United States. In holding such levy invalid on the ground that the Bank was an instrumentality of the federal government, the Court stated:

> We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down, what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy, what there is a right in another to preserve.
>
> . . . .
>
> That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a

5 INT. REV. CODE of 1954, § 103.
6 Act of Oct. 3, 1913, ch. 16, 38 Stat. 168.
7 G. Calvert, *supra* note 1, at 141.
8 283 U.S. 570 (1931).
9 *Id.* at 575.
10 Lowndes, *Current Constitutional Problems in Federal Taxation*, 4 VAND. L. REV. 469, 481 (1951).
11 E. GRISWOLD, FEDERAL TAXATION 125 (1966).
12 17 U.S. (4 Wheat.) 159 (1819).

> plain repugnance in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied.[13]

It is somewhat curious that *McCulloch*, a case dealing with an attempted state infringement of national sovereignty, should give rise to an implied limitation upon the power of the national government vis-à-vis the states. In the course of his opinion, Chief Justice Marshall elaborated the distinction between the power of a state to tax national instrumentalities and that of the federal government to tax state functions.[14] Over a century later, this same distinction was reiterated by Mr. Justice Stone when he wrote:

> He [Chief Justice Marshall] was careful to point out not only that the taxing power of the national government is supreme, by reason of the constitutional grant, but that in laying a federal tax on state instrumentalities the people of the states, acting through their representatives, are laying a tax on their own institutions and consequently are subject to political restraints which can be counted on to prevent abuse. State taxation of national instrumentalities is subject to no such restraint, for the people outside the state have no representatives who participate in the legislation; and in a real sense, as to them, the taxation is without representation. The exercise of the national taxing power is thus subject to a safeguard which does not operate when a state undertakes to tax a national instrumentality.[15]

Nonetheless, *Collector v. Day*,[16] in holding that the salary of a state probate judge was immune from federal income taxation, construed the *McCulloch* decision to warrant an implied restriction upon the federal taxing power. The implied constitutional restriction was found to exist to the extent that a public official was being compensated for the exercise of functions essential to the

---

13 *Id.* at 210.

14 The Chief Justice had little difficulty articulating his position with respect to the taxation of national and state banks. Presumably, for the purpose of his argument, he considered state banks as much instrumentalities of their respective governments as he considered the national bank to be an instrumentality of the federal government. He stated:

> It has also been insisted, that, as the power of taxation in the general and state governments is acknowledged to be concurrent, every argument which would sustain the right of the general government to tax banks chartered by the states, will equally sustain the right of the states to tax banks chartered by the general government. But the two cases are not on the same reason. The people of all the states have created the general government, and have conferred upon it the general power of taxation. The people of all the states, and the states themselves, are represented in congress, and, by their representatives, exercise this power. When they tax the chartered institutions of the states, they tax their constituents; and these taxes must be uniform. But when a state taxes the operations of the government of the United States, it acts upon institutions created, not by their own constituents, but by people over whom they claim no control. It acts upon the measures of a government created by others as well as themselves, for the benefit of others in common with themselves. The difference is that which always exists, and always must exist, between the action of the whole on a part, and the action of a part on the whole — between the laws of a government declared to be supreme, and those of a government which, when in opposition to those laws, is not supreme. *Id.* at 212-13.

15 Helvering v. Gerhardt, 304 U.S. 405, 412 (1938).

16 78 U.S. (11 Wall.) 113 (1870).

maintenance of state governments as they were organized at the time the Constitution was adopted:

> [T]he exemption rests upon necessary implication, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?[17]

More specifically, the Revenue Act of 1894,[18] which attempted to impose an income tax on the interest from municipal bonds, was declared unconstitutional in the landmark Supreme Court decision of *Pollock v. Farmers' Loan & Trust Company*.[19] The Court found no distinction between a tax on the income from such bonds and a tax on the bonds themselves;[20] hence, the tax was held violative of the implied constitutional immunity. *Pollock,* although somewhat attenuated by later decisions, has never been specifically overruled.

Another ground for *Pollock's* invalidation of the Revenue Act of 1894 was that it imposed a direct tax on the income from real estate and personal property without apportionment.[21] It was in response to this latter holding that popular sentiment in many sections of the United States called for a constitutional amendment to eliminate the requirement of apportionment. This resulted in the passage of the sixteenth amendment which, when submitted to Congress, read as follows: "The Congress shall have the 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."

Prior to ratification there was concern that, as proposed, the amendment would be construed as abolishing the intergovernmental immunity rule. Such a fear was voiced by Charles Evans Hughes, then Governor of New York. In a message to his state's legislature, which was in the process of considering ratification or rejection, Governor Hughes stated that:

> [T]he power to tax incomes should not be granted in such terms as to subject to federal taxation the incomes derived from bonds issued by the State itself or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the federal taxing power would be an impairment of the essential rights of the State, which, as its officers, we are bound to defend.[22]

The apprehensions of Governor Hughes and others were assuaged by Senator Borah of Idaho who remarked:

---

17 *Id.* at 127.
18 Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 553-54.
19 157 U.S. 429, *aff'd on rehearing,* 158 U.S. 601 (1895).
20 157 U.S. at 584-86.
21 This, of course, was in violation of the constitutional provision for apportionment of direct taxes. U.S. CONST. art. I, § 2.
22 Reproduced at 45 CONG. REC. 2245 (1910). Curiously, eighteen years later Mr. Hughes filed an amicus curiae brief on behalf of certain insurance companies asserting the validity of an indirect tax on the interest from municipal bonds. National Life Ins. Co. v. United States, 277 U.S. 508 (1928).

> 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.[23]

Further assurances were forthcoming from Senator Root of New York who declared that "[u]nder [the Constitution] we are forbidden to apply the words 'from whatever source derived' in the proposed amendment to any of the instrumentalities of state government."[24] Formal ratification of the sixteenth amendment as proposed occurred on February 25, 1913.

It is arguable, then, that in light of the legislative history surrounding the origin and ratification of the sixteenth amendment, the predecessor[25] to section 103(a)(1) of the 1954 Code, enacted in 1913, "constituted an acknowledgment by Congress of the inherent right of the States to this immunity."[26]

Consonant with the above interpretation, in 1928 the Supreme Court affirmed the immunity of interest on municipal bonds from federal taxation in *National Life Insurance Company v. United States*,[27] declaring: "It is settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves . . . . [and] the United States may not tax state or municipal obligations."[28] That case did not involve the direct taxation of interest from municipal securities, but dealt with the method in which a special excise tax measured by the net income of life insurance companies was to be computed. Among the deductions allowed to arrive at net income were (1) interest received from tax-exempt bonds and (2) such amount, if any, required to be added to the income from tax-exempt bonds to equal four percent of the mean required reserve funds.[29] Consequently, a deduction was allowed for tax-exempt interest, and a deduction was allowed for four percent of required reserves, with the proviso that the amount of the former deduction must be subtracted from the latter. The result was that the federal tax on life insurance companies was the same whether the company held tax-exempt securities or not.[30] Thus, life insurance companies derived no tax benefit from holding the tax exempts. Dissenting from the majority's conclusion, Justice Brandeis, joined by Justices Holmes and Stone, considered the question foreclosed by a line of cases that upheld the inclusion of certain tax-exempt items in the computation of net income.[31]

---

23 45 CONG. REC. 1698 (1910).

24 *Id.* at 2540. That is a rather marvelous declaration.

25 Act of Oct. 3, 1913, ch. 16, 38 Stat. 168.

26 *Hearings on Revision of the Federal Income Tax Laws Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess., pt. 1, at 741 (1959) [hereinafter cited as *Hearings*].

27 277 U.S. 508 (1928).

28 *Id.* at 521.

29 Revenue Act of 1921, ch. 136, §§ 213, 245, 42 Stat. 227.

30 This would have been true at least to the extent that the income from such securities did not exceed four percent of the mean of the reserves required to be maintained by law.

31 277 U.S. at 527 (dissenting opinion). Included were: Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120 (1920) (receipts from interstate commerce included in state tax); Shaffer v. Carter, 252 U.S. 37, 57 (1920) (same); United States Glue Co. v.

Indicative of the continued vitality of the doctrine of intergovernmental tax immunity was *Indian Motorcycle Co. v. United States.*[32] That case invalidated a federal tax on the sale of certain items, including motorcycles, imposed upon the manufacturer, producer or importer thereof, where the sale was made to a municipal corporation for use in its police service. The Court's opinion does not indicate whether the tax was required to be absorbed by the manufacturer, producer or importer on whom it was imposed, or whether it could be or was required to be passed on to the purchaser.[33] Previously, in *Panhandle Oil Company v. Mississippi* ex rel. *Knox,*[34] the Court had struck down a state excise tax on the sale of gasoline, collected only from the dealer, as applied to sales made to the United States for use by the Coast Guard and a veterans' hospital. The majority in *Indian Motorcycle* placed its chief reliance on *Panhandle Oil,* and Justice Holmes regarded that case "as controlling in principle and upon that ground acquiesce[d] in this decision."[35] Continuing to oppose any enlargement of whatever immunity might exist, Justice Stone, accompanied by Justice Brandeis, dissented.[36]

B. Decline of the Doctrine

Beginning in 1937, the view of the dissenters on the issue of intergovernmental tax immunity began to command a majority of the Court. The resulting decisions have led to a narrowing of the doctrine with the result that many authorities have concluded that the exemption is not a constitutional mandate.[37] Specifically, the combined effect of *Helvering v. Gerhardt*[38] and *Graves v. New*

Oak Creek, 247 U.S. 321, 326 (1918) (same); William E. Peck & Co. v. Lowe, 247 U.S. 165, 175 (1918) (receipts from exports); Flint v. Stone Tracy Co., 220 U.S. 107, 147-52 (1911) (tax-exempt securities included in measure of corporate franchise tax). Brandeis's view that the treatment of life insurance companies under the Revenue Act of 1921, ch. 136, 42 Stat. 227, did not constitute unconstitutional taxation is disputed in Powell, *The Remnant of Intergovernmental Tax Immunities,* 58 HARV. L. REV. 757, 797 n.100 (1945).

32 283 U.S. 570 (1931).

33 *Id.* at 573.

34 277 U.S. 218 (1928) (Holmes, McReynolds, Stone and Brandeis, JJ., dissenting). Whether *Panhandle Oil* has survived the decisions in *Alabama v. King & Boozer,* 314 U.S. 1 (1941), and *Curry v. United States,* 314 U.S. 14 (1941), is discussed in Powell, *The Waning of Intergovernmental Tax Immunities,* 58 HARV. L. REV. 633, 657-59 (1945).

35 Indian Motorcycle Co. v. United States, 283 U.S. 570, 579 (1931) (acquiescing opinion). Acquiescence would seem to be somewhat less enthusiastic than concurrence.

36 The implied immunity of one government, either national or state, from taxation by the other should not be enlarged. Immunity of one necessarily involves curtailment of the other's sovereign power to tax. The practical effect of enlargement is commonly to relieve individuals from a tax, at the expense of the government imposing it, without substantial benefit to the government for whose theoretical advantage the immunity is invoked.

> This is especially the case where, as here, the sole ground of the immunity is that, although the tax is an excise collected by one government from an individual normally subject to it, the incidence of the tax may conceivably be shifted to the other government. *Id.* at 580 (dissenting opinion).

37 *E.g., Hearings* 682; Gardner, *Tax Immune Bonds,* 8 GEO. WASH. L. REV. 1200 (1940); Gelfand, *Tax Exempt Securities and the Doctrine of Reciprocal Immunity,* 32 TEMP. L.Q. 173 (1959); Ratchford, *Revenue Bonds and Tax Immunity,* 7 NAT'L TAX J. 40 (1954). *Contra, Hearings* 784-89.

38 304 U.S. 405 (1938).

York ex rel. *O'Keefe*[39] has cast doubt upon the viability of *Pollock* and its progeny.

In *Gerhardt* the Court held that salaries of employees of the Port of New York Authority, an instrumentality of the states of New York and New Jersey, were not immune from the taxing power of the federal government. Although Justice Stone's majority opinion was broadly written, the holding of the Court was confined: "[W]e decide only that the present tax neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the state government."[40] It was in this opinion that Justice Stone repeated the difference between the basis for the federal immunity from state taxation and the claimed state immunity from federal taxation which Chief Justice Marshall had explained in *McCulloch*.[41]

The keystone in the edifice of state immunity was *Collector v. Day*,[42] which had invalidated a federal tax as applied to the income of state judges. While not administering the fatal blow to that case, Justice Stone so emaciated the decision that it was easy prey for a quick death one year later.[43]

> The question [*Day*] presented to the Court was not one of interference with a granted power in a field in which the federal government is supreme, but a limitation by implication upon the granted federal power to tax. In recognizing that implication for the first time, the Court was concerned with the continued existence of the states as governmental entities, and their preservation from destruction by the national taxing power. The immunity which it implied was sustained only because it was one deemed necessary to protect the states from destruction by the federal taxation of those governmental functions which they were exercising when the Constitution was adopted and which were essential to their continued existence.[44]

Continuing the view enunciated in his earlier dissenting opinions, Justice Stone further declared: "When enlargement proceeds beyond the necessity of protecting the state, the burden of the immunity is thrown upon the national government with benefit only to a privileged class of taxpayers."[45] The Court reasoned that although the tax deprived the states of the advantage of paying less than the standard rate for services engaged, none of the functions essential to their continued existence as states were curtailed.[46] Although the effect on municipalities in terms of increased operating costs would be more ascertainable if their bond interest were no longer tax-exempt, the authors submit that it is conceptually difficult to distinguish such an effect from the consequences of *Gerhardt* on the states of New Jersey and New York.

---

39 306 U.S. 466 (1939).
40 304 U.S. at 424.
41 *Id.* at 412. *See also id.* at 411 n.1.
42 78 U.S. (11 Wall.) 113 (1870).
43 Graves v. New York *ex rel.* O'Keefe, 306 U.S. 466 (1939).
44 Helvering v. Gerhardt, 304 U.S. 405, 414 (1938).
45 *Id.* at 416.
46 *Id.* at 420. Furthermore, the fact that the economic burden of the taxes might be passed on to the states, thereby increasing to some unknown extent their operating expense, "infringes no constitutional immunity." *Id.* at 422.

Concurring in *Gerhardt,* Justice Black expressed a desire for a re-examination of *Collector v. Day,* adding: "[a] citizen who receives his income from a State, owes the same obligation to the United States as other citizens who draw their salaries from private sources or the United States and pay Federal income taxes."[47] The re-examination came a year later when the Supreme Court decided *Graves v. New York* ex rel. *O'Keefe,*[48] which held that the salary of a federal employee was subject to state income taxation. Justice Stone razed a pillar of the immunity argument of the state when he declared: "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable . . . ."[49] In so holding, the Court specifically overruled *Collector v. Day.*[50]

The demise of *Collector v. Day,* a decision of considerable importance to the holding in *Pollock,* coupled with the disavowal of the theory that a tax on income is the equivalent of a tax on its source and with the significant narrowing of the doctrine of intergovernmental immunity from taxation, suggests that there is little left to support the exemption of interest on constitutional grounds.[51] The breadth of the sixteenth amendment certainly is ample enough to justify the taxation of municipal bond interest.

It could, however, be argued that in *Gerhardt* and *O'Keefe* the burden placed on the government in question by the imposition of the tax was speculative and problematical, and that in the absence of a proven burden the tax was valid. Since taxation of the interest on municipal bonds would clearly require higher yields to investors to compensate for their loss of the exemption feature, thereby establishing a real burden on the borrowing power of the states, the proponents of tax exemption might, with some merit, find continued refuge in the Constitution. But this argument appears to have been put to rest by the Supreme Court's decision in *Alabama v. King & Boozer.*[52] The state of Alabama had imposed a sales tax that it attempted to levy on sales to a contractor of materials purchased for use in performing a cost-plus contract with the federal government. Although the economic burden of the tax was undeniably upon the federal government, the tax was upheld. The added burden to the government was "but a normal incident of the organization within the same territory of two independent taxing sovereignties."[53]

Neither government contractor *qua* contractor nor government lender *qua* lender has been constitutionally granted a specific tax immunity. Although

47 *Id.* at 425 (concurring opinion).
48 306 U.S. 466 (1939).
49 *Id.* at 480.
50 *Id.* at 486.
51 *Cf.* Powell, *supra* note 31, at 795. In *James v. Dravo Contracting Company,* 302 U.S. 134 (1937), the Court sustained a West Virginia tax upon the gross receipts of a contractor derived from building locks and dams for the federal government. Just as contract income is taxable whether the other contracting party is General Motors or New York City, so should interest income be taxable whether the obligor is General Motors or the City of New York.
52 314 U.S. 1 (1941).
53 *Id.* at 9.

addressed to contractors, the Court's statement in *King & Boozer* is equally valid when addressed to lenders:

> The asserted right of the one [Government] to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of those who furnish supplies to the Government and who have been granted no tax immunity.[54]

The above analysis has caused one observer to conclude:

> Thus, even conceding (as one must) that upon the withdrawal of the exemption the interest to be paid by States and local governments would have to be increased to meet the interest costs of other borrowers who are accorded no exemption, this nondiscriminatory burden is "but a normal incident" of the Federal system and constitutes no ground for granting tax exemption to the private citizens who lend money to the States and their subdivisions.[55]

Notwithstanding the probable lack of constitutional justification for the tax immunity afforded municipal bond interest, as long as section 103(a)(1) of the Code remains, the question is academic. It is clearly within the power of Congress to determine matters of inclusion, exclusion and deduction for federal revenue purposes, barring, of course, constitutionally protected items. Hence, the statute's existence has precluded constitutional consideration; yet conversely, as long as there is no definitive resolution of the constitutional question, the statute will probably remain unchanged.[56]

The closest the Supreme Court has come to reviewing the intergovernmental immunity doctrine in recent years is *First Agricultural National Bank v. State Tax Commission*.[57] There the Supreme Judicial Court of Massachusetts had held a national bank subject to the state's sales and use taxes.[58] In addition to real property, federal statutory law prescribes four areas in which the states may tax national banks.[59] There is no reference, either prohibitory or permissive in nature, regarding sales and use taxes, and absent explicit guidance the state

54 *Id.*
55 *Hearings* 683.
56 This does not, of course, include the recent amendment to section 103, Revenue and Expenditure Control Act of 1968 § 107, 82 Stat. 251 (U.S. Cong. News, No. 6, July 1, 1968), excluding industrial development bonds from subsection (a)(1). See note 117 *infra.*
57 392 U.S. 339 (1968).
58 First Agricultural Nat'l Bank v. State Tax Comm'n, 229 N.E.2d 245 (Mass. 1967), *commented on in* 43 Notre Dame Lawyer 446 (1968). A similar result was subsequently achieved in New York. Liberty Nat'l Bank & Trust Co. v. Buscaglia, 21 N.Y.2d 357, 235 N.E.2d 101, 288 N.Y.S.2d 33 (1967), *appeal docketed,* 36 U.S.L.W. 3485 (U.S. June 18, 1968) (No. 1513, 1967 Term; renumbered No. 175, 1968 Term, 37 U.S.L.W. 3024 (U.S. July 2, 1968)), *noted in* 81 Harv. L. Rev. 1576 (1968).
59 Act of June 3, 1864, ch. 106, § 41, 13 Stat. 111, *as amended,* 12 U.S.C. § 548 (1964), which provides, in pertinent part, that:

> The legislature of each State may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several States may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income [subject to certain conditions which the statute then imposes] . . . .

court had ruled that there was no exemption from such taxes.[60] However, Justice Black for the Court chose to follow the view propounded in *Owensboro National Bank v. Owensboro*[61] (and subsequently followed in other cases[62]) that the applicable statute marked the outer limits of state power to tax national banks.[63] Indeed the more recent decisions[64] against implied immunity had virtually necessitated reliance upon the statute. Following the legal incidence test to determine on whom the burden falls, Justice Black concluded that since the tax *must* be passed on to the purchaser under the requirements of the Massachusetts statute,[65] the legal incidence was on the national bank.[66] Consequently, the Court was able to hold that since the legal incidence of the tax was on the national bank and since Congress did not include sales and use taxes among those that the state could assess upon national banks, the federal statute prohibited the application of the Massachusetts tax.[67]

In a dissent joined by Justices Harlan and Stewart, Justice Marshall rejected the view that the statute prescribed the limits of state taxation of national banks, and confronted the question whether national banks are today entitled to the constitutional immunity afforded them in *McCulloch*. As had the Massachusetts court[68] and the New York court,[69] he concluded they were not.[70] Justice Harlan's dissent, aside from seconding that of Justice Marshall, merely incorporated the relevant portions of the Massachusetts court's opinion.[71]

In light of the treatment given the issue of the immune status of national banks under a questionable statute in *First Agricultural Bank*, it appears quite clear that the Supreme Court would not reach the intergovernmental tax immunity question where municipal bond interest is concerned as long as the Code provides an exemption.

III. Scope of the Statutory Exemption

Section 103(a)(1) has not given rise to the plethora of regulations, rulings and cases found under other sections of the Internal Revenue Code. The

60 First Agricultural Nat'l Bank v. State Tax Comm'n, 229 N.E.2d 245, 260 (Mass. 1967); *accord*, Liberty Nat'l Bank & Trust Co. v. Buscaglia, 21 N.Y.2d 357, 235 N.E.2d 101, 288 N.Y.S.2d 33 (1967), *appeal docketed*, 36 U.S.L.W. 3485 (U.S. June 18, 1968) (No. 1513, 1967 Term; renumbered No. 175, 1968 Term, 37 U.S.L.W. 3024 (U.S. July 2, 1968)).

61 173 U.S. 664, 669 (1899).

62 *E.g.*, Des Moines Nat'l Bank v. Fairweather, 263 U.S. 103, 107 (1923); Bank of California v. Richardson, 248 U.S. 476, 483 (1919).

63 First Agricultural Nat'l Bank v. State Tax Comm'n, 392 U.S. 339, 343-46 (1968).

64 Including *Graves v. New York* ex rel. *O'Keefe*, 306 U.S. 466 (1939), where Justice Stone declared: "Silence of Congress implies immunity no more than does the silence of the Constitution." *Id.* at 480.

65 MASS. ANN. LAWS ch. 64H, § 3 (Supp. 1967).

66 392 U.S. at 346-48.

67 *Id.*

68 First Agricultural Nat'l Bank v. State Tax Comm'n, 229 N.E.2d 245 (Mass. 1967).

69 Liberty Nat'l Bank & Trust Co. v. Buscaglia, 21 N.Y.2d 357, 235 N.E.2d 101, 288 N.Y.S.2d 33 (1967), *appeal docketed*, 36 U.S.L.W. 3485 (U.S. June 18, 1968) (No. 1513, 1967 Term; renumbered No. 175, 1968 Term, 37 U.S.L.W. 3024 (U.S. July 2, 1968)).

70 First Agricultural Nat'l Bank v. State Tax Comm'n, 392 U.S. 339, 349-59 (1968) (dissenting opinion).

71 *Id.* at 363 (dissenting opinion).

language of the statute is reasonably self-explanatory, and the Regulation furnishes additional amplification:

> Obligations issued by *or on behalf of* the State, Territory, or possession of the United States, or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State, Territory, or possession of the United States, or a political subdivision thereof. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. The term "political subdivision", for purposes of this section, denotes any division of the State, Territory, or possession of the United States which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State, Territory, or possession of the United States.[72] (Emphasis added.)

The breadth of the term "political subdivision" is evident in *Commissioner v. Shamberg's Estate,*[73] where the United States Court of Appeals for the Second Circuit held that interest on bonds of the Port of New York Authority was not taxable because the issuer was a "political subdivision" within the meaning of the statute.[74] Similarly, the same court held that the Triborough Bridge Authority was, in effect, an instrumentality of the City of New York for tax exemption purposes.[75]

Where municipal securities are issued at a discount, the "original issue" discount is treated as tax-exempt interest, in the case of original purchasers, either upon sale prior to maturity or at maturity.[76] But profits, not including the original issue discount, that are realized upon the sale of municipal securities are fully taxable.[77]

It is noteworthy that the exemption provided by section 103(a)(1) is not limited to interest on obligations that are evidenced by some particular form of instrument. An ordinary agreement of purchase and sale has been held sufficient to fall within the ambit of the statute.[78]

IV. Industrial Development Bonds: The Jig's Up!

> ON DECEMBER 6, THIS MAN SIGNED A BILL INTO LAW THAT COULD LET YOU PUT UP A MULTIMILLION-DOLLAR PLANT IN MASSACHUSETTS WITHOUT PUTTING UP YOUR COM-

72 Treas. Reg. § 1.103-1 (1956).
73 144 F.2d 998 (2d Cir. 1944), *cert. denied,* 323 U.S. 792 (1945).
74 144 F.2d at 1004.
75 Commissioner v. White's Estate, 144 F.2d 1019 (2d Cir. 1944), *cert. denied,* 323 U.S. 792 (1945).
76 I.T. 2629, XI-1 Cum. Bull. 20 (1932).
77 Willcuts v. Bunn, 282 U.S. 216 (1931).
78 Kings County Dev. Co. v. Commissioner, 93 F.2d 33 (9th Cir.), *cert. denied,* 304 U.S. 559 (1937).

PANY'S MONEY. The man is Governor John A. Volpe of Massachusetts. The bill he signed into law — passed with active bi-partisan support by the state legislature — is called the Massachusetts Industrial Development Financing Act. And what it will do is build you the kind of plant you want in Massachusetts, without spending any of your company's money. The program works through the sale of municipal bonds. As a result of this bill, bonds to provide the capital for building and equipment can now be issued by the community where you want to locate. At the lowest possible interest rate. Good deal? Sure, it is! Especially with the sites in Massachusetts. The quality work force. The schools, technicians, executive talent. And plenty more. Look into it. Call us collect at . . . .[79]

A. Background

"Industrial development bonds" are municipal bonds, the proceeds of which are used to finance the acquisition, construction or equipment of industrial facilities for lease to private firms. The bonds may be either general obligations of the issuer or obligations payable solely out of revenues realized upon the lease of the project to private industry. The latter type, falling within the category of "revenue bonds," is the more prevalent.[80] With the recent addition of Massachusetts,[81] approximately forty states have statutes authorizing the issuance of industrial revenue bonds.[82] Although the idea of financing private industrial development through the use of municipal bonds first appeared in Mississippi in 1936,[83] it was not until 1946 that other states joined the "plant pirating"[84] bandwagon.[85] The method of proceeding under industrial development bond statutes and the incidental incentives offered prospective lessees vary from state to state.[86]

In 1954 the Internal Revenue Service issued a ruling declaring the interest on bonds issued by a municipality to finance construction of municipality-owned industrial plants for lease to private enterprise exempt from taxation.[87] It was therein deemed immaterial that the "political subdivision's" repayment obligation was limited to the revenue to be derived from leasing the property erected with the bond proceeds.[88] In 1957 the Service further extended the concept when it ruled that the bonds issued by Alabama's Industrial Development Board, formed pursuant to enabling legislation,[89] were to be considered as issued on behalf of a municipality.[90]

Probably the most significant pronouncement in this area was Revenue

79 This was the text of a full page advertisement appearing in the *New York Times*. Immediately below the large bold print was a picture, approximately 7 x 9 inches, of Governor John Volpe signing the bill into law. N.Y. Times, Jan. 8, 1968, at 65.
80 Nelson, *Tax Considerations of Municipal Industrial Incentive Financing,* 45 TAXES 941, 942 (1967).
81 MASS. ANN. LAWS ch. 40D, § 9 (Supp. 1967).
82 Nelson, *supra* note 80, at 941.
83 *Id.*
84 *Hearings* 734.
85 Nelson, *supra* note 80, at 941.
86 *Id.* at 942.
87 Rev. Rul. 106, 1954-1 CUM. BULL. 28.
88 *Id.*
89 ALA. CODE tit. 37, § 816 (Supp. 1967).
90 Rev. Rul. 187, 1957-1 CUM. BULL. 65.

Ruling 63-20.[91] This ruling set forth the requirements for tax exemption with respect to obligations issued by a nonprofit corporation formed under the general nonprofit corporation law of a state for the purpose of stimulating industrial development within a political subdivision of that state. It is important to note that the "hypothetical" issuer in Revenue Ruling 63-20 was not a corporation formed pursuant to industrial development enabling legislation. The ruling, framed in terms of a transaction that would not result in tax exemption for the interest on the issuer's bonds, went on to list five requirements which, if complied with, would result in the bonds being considered issued " 'on behalf of' the state or a political subdivision thereof for the purposes of section 1.103-1 of the Income Tax Regulations":[92]

> (1) the corporation must engage in activities which are essentially public in nature; (2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness); (3) the corporate income must not inure to any private person; (4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and (5) the corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.[93]

Clearly, Revenue Ruling 63-20 was formalistic in nature; it opened the door to the expansion of industrial development financing irrespective of the existence of state enabling legislation. One commentator, speculating that the Treasury may have been "seeking to hasten the demise of the interest exclusion on industrial revenue obligations," referred to the ruling as "a kind of federal industrial revenue bond legislation."[94] Another, a former Chief Counsel of the Service, spoke of the developing "truckhole" in federal tax law and found that aspect of the ruling which extended the exemption to "interest on the obligations of *private* nonprofit corporations" inconsistent with the Treasury's unwavering opposition to the exemption afforded municipal securities.[95] Shortly after the latter commentator's views appeared in print, the Service embarked on a course to restrict the scope of Revenue Ruling 63-20.[96]

B. Recent Developments

The Treasury has been intermittently seeking to modify or abolish the municipal exemption in one way or another for approximately fifty years.[97]

91 1963-1 CUM. BULL. 24, released on January 11, 1963 as T.I.R. 442.
92 1963-1 CUM. BULL. 24, 25.
93 *Id.*
94 Nelson, *supra* note 80, at 944.
95 Spiegel, *Financing Private Ventures With Tax-Exempt Bonds: A Developing "Truckhole" in the Tax Law,* 17 STAN. L. REV. 224, 228 (1965). For a discussion of the Treasury's attempts to abolish the municipal exemption, see note 97 *infra* and accompanying text.
96 Nelson, *supra* note 80, at 945-47.
97 *Hearings* 702. A history through 1959 of the various attempts to end the immunity is related by Lent, *The Origin and Survival of Tax-Exempt Securities,* 12 NAT'L TAX J.

301, 304-14 (1959). One way in which the Treasury has recently tried to undermine the exemption feature of municipal bonds is by construing section 265 of the Code in a manner which would deny the holders of tax-exempt securities a deduction for interest on their outstanding indebtedness. Were such a position upheld, the benefits to be derived from tax exempts would be negated to the extent that the taxpayer is precluded from deducting interest.

Section 163(a) of the Code permits a deduction for "all interest paid or accrued within the taxable year on indebtedness." To prevent the boon to taxpayers which would result from the allowance of a section 163 deduction where the "indebtedness" was incurred or continued to take advantage of section 103(a)(1), section 265 of the Code provides:

> No deduction shall be allowed for —
>
> . . . .
>
> (2) Interest. — Interest on indebtedness incurred or continued to purchase or carry obligations . . . the interest on which is wholly exempt from the taxes imposed by this subtitle.

Although the legislative history, early rulings (*see* I.T. 1213, I-1 CUM. BULL. 132 (1922)) and cases (*see, e.g.,* R. B. George Mach. Co., 26 B.T.A. 594 (1932); Sioux Falls Metal Culvert Co., 26 B.T.A. 1324 (1932)) confirm the interpretation that section 265(2) applies only when the purpose for which the indebtedness is incurred or continued is to purchase or carry tax-exempt securities, two recent decisions, *Illinois Terminal Railroad Company v. United States,* 375 F.2d 1016 (Ct. Cl. 1967), and *Wisconsin Cheeseman, Incorporated v. United States,* 265 F. Supp. 168 (W.D. Wis. 1967), at first blush appear to extend the denial of the interest deduction far beyond the narrow limits of section 265(2). For a critical discussion of both cases, see McCollom, *Recent Cases Threaten All Interest Deductions for Holders of Tax Exempts,* 27 J. TAXATION 194 (1967).

The Court of Claims, in *Illinois Terminal,* denied the interest deduction with respect to a debt incurred by the railroad to purchase railway assets. The assets for which the indebtedness was incurred were subsequently sold to a municipality for cash and municipal bonds of the purchaser. The taxpayer argued that the bonds were unrelated to the loan but the court, agreeing with the Commissioner, held that the indebtedness was "continued" to "carry" tax-exempt bonds within the purview of section 265(2):

> What plaintiff seeks to do is to receive tax-free income and at the same time deduct the interest expense attributable to obtaining that tax-free income. This is the double benefit prohibited by section 265(2). A business cannot escape taxation of income by the device of purchasing or carrying tax-exempt securities with borrowed money not required to carry on its regular functions. 375 F.2d at 1021.

In *Wisconsin Cheeseman,* the court denied a deduction for the interest paid on short-term loans by a cheese retailer. The seasonal nature of the taxpayer's business required it to borrow substantially in the months preceding its peak sales season. Upon the realization of sales proceeds, the taxpayer liquidated its short-term loans and invested the balance in tax-exempt municipals. This pattern was followed annually. The court concluded that, within the plain meaning of the statute, the taxpayer "incurred" indebtedness to "carry" municipal obligations.

Both *Illinois Terminal* and *Wisconsin Cheeseman* point in the direction of an extended application of section 265(2). Although the Commissioner may be seeking to remove the exemption feature of the bonds regardless of whether there is any connection between the borrowing and the bonds, McCollom, *Recent Cases Threaten All Interest Deductions for Holders of Tax Exempts,* 27 J. TAXATION 194 (1967), the cases to date fall short of upholding this proposition. The opinions in both of the above cited cases speak to "the purpose" for which the indebtedness was incurred. The court in *Wisconsin Cheeseman* said, "this purpose was to make it possible for the plaintiff to carry its municipal securities," 265 F. Supp. at 169; in *Illinois Terminal* it was stated, "[the] issue . . . is whether the . . . loan . . . was continued for the purpose of enabling plaintiff to own," 375 F.2d at 1020, the tax-exempt obligations in question, and held it was continued for such purpose.

There is language in both opinions which justifies a continued inquiry into the purpose of a taxpayer in incurring or continuing indebtedness. For example, *Illinois Terminal* states:

> It is necessary [for the Commissioner] to establish a *sufficiently direct relationship* of the continuance of the debt for the purpose of carrying the tax-exempt bonds.
>
> If the loan was needed to sustain plaintiff's business operation rather than its ownership of tax-exempt securities, the prohibitory features of section 265(2) will not apply. 375 F.2d at 1021. (Emphasis added.)

The opinion of the district court in *Wisconsin Cheeseman* does contain very broad dicta, which, if adopted by the courts at some later date, would extend the scope of section 265(2) to its widest possible limits: "Congress did not wish to grant a deduction for interest payments by a taxpayer who holds securities the interest from which is not taxable." 265 F. Supp. at 171. The Seventh Circuit, however, which affirmed in part and reversed in part the lower court in *Wisconsin Cheeseman,* has apparently chosen to disregard this dicta. It stated that: "In our view, the taxpayer is not *ipso facto* deprived of a deduction for interest on indebtedness while holding tax-exempt securities," Wisconsin Cheeseman, Inc. v. United States, 388

"Proposals for altering the statute or amending the 16th amendment were considered by congressional committees during at least six different sessions from 1918 to 1951."[98]

Apparently the Treasury has recently felt the time ripe for a renewed effort in this direction; the result has been a drying up of the demand for the type of bonds under attack.[99] The chronology of this latest effort, limited to a denial of the exemption concerning industrial development bonds, merits discussion because it evidences the interplay and frequent antagonism arising between the Treasury and Congress in the administration of the revenue laws.

Treasury Information Release 972,[100] dated March 6, 1968, announced that the Treasury was reconsidering its position on the applicability of section 103 of the Code to "so-called industrial development bonds," because "the debtor, in reality, is the private corporation which will use the facility con-

---

F.2d 420, 422 (1968), and went on to endorse the "sufficiently direct relationship" test of *Illinois Terminal. Id.*

Additional support for taxpayers subjected to the Commissioner's reliance on section 265(2) may be garnered from a decision rendered by the Tax Court on April 2, 1968, in *John E. Leslie*, 50 T.C. No. 2, Dec. 28,897. There the court sustained the contention of a taxpayer that no part of its indebtedness was incurred or continued to purchase tax-exempt bonds:

> This case presents us with a new test of the scope of section 265(2) which denies a deduction for interest when indebtedness is incurred or continued to purchase or carry tax-exempt securities. Here we are asked whether a large business that regularly borrows large sums of money in the conduct of its business is to be denied some of its interest deduction because it also holds a relatively small amount of tax-exempt securities.
>
> . . . .
>
> Nor is paragraph (2) [section 265(2)] to be applied merely because the proceeds of an indebtedness are used to purchase or carry tax-exempt securities.
>
> . . . .
>
> In recapitulating these cases, [the cases under section 265(2)] we see that the courts have applied a purpose test in determining whether indebtedness is incurred or continued to purchase or carry tax-exempt securities. The finding of the taxpayer's purpose does not depend solely upon looking into his mind and learning what he was thinking; although his intentions are relevant, purpose may be inferred from his conduct and from the circumstances that confronted him.
>
> . . . .
>
> Thus, there was some relationship between its indebtedness [the taxpayer in the present case] and its holding in tax-exempts — if it had held no tax-exempts, it would have had to borrow less. Nevertheless, we think that the circumstances of this case do not support an inference that indebtedness was incurred to purchase the tax-exempt holdings. *Id.* at 2251-55.

The recent cases indicate that the Commissioner is apparently bent upon extending section 265(2) to a point far beyond that which is justified by the legislative history of the statute and the prevailing case law. If construed to require an inquiry into the taxpayer's purpose in incurring or continuing indebtedness, the statute is admittedly difficult to administer. However, difficulty of administration is no excuse for acting in derogation of congressional intent. Hence, the burden now rests on Congress to amend the statute to alleviate the hardships besetting the Treasury.

Rule-making by judicial interpretation has its limits; such rules tend to be confined to the exigencies of the particular case. Frequently the effect is to confuse rather than to clarify.

98 *Hearings* 741.

99 N.Y. Times, Feb. 26, 1968, at 53, col. 6.

100 7 CCH 1968 STAND. FED. TAX REP. ¶ 6648.

structed with the proceeds of the bond issue."[101] The release stated that proposed regulations, the effect of which would be to exclude from the scope of section 103(a)(1) bonds sold after the regulations went into effect, were to be issued on or before March 15, 1968. Accordingly, the Service proposed to publish a revenue ruling revoking Revenue Rulings 54-106[102] and 57-187[103] and appropriately modifying Revenue Ruling 63-20.[104] Furthermore, the Service announced that it would cease issuing ruling letters with respect to industrial development bonds.[105] At least two corporations "rushed to beat the deadline" established in the above release.[106] An attempt by the Senate to pressure the Treasury into retracting its proposed action was narrowly defeated.[107] Shortly thereafter, the Senate Finance Committee attached a rider to the Tax Adjustment Bill of 1968[108] that would have continued the exemption for interest on industrial development bonds until Congress provided otherwise.

A proposed regulation, pursuant to the Treasury's announcement in Treasury Information Release 972, was to be the subject of hearings scheduled to begin on May 20, 1968.[109] It is quite conceivable that the inclusion of the

---

101 *Id.*
102 See notes 87-88 *supra* and accompanying text.
103 See note 90 *supra* and accompanying text.
104 See notes 91-93 *supra* and accompanying text.
105 T.I.R. 972, 7 CCH 1968 STAND. FED. TAX REP. ¶ 6648.
106 Wall Street Journal, March 12, 1968, at 23, col. 1.
107 *Id.* at 21, cols. 1-3.
108 H.R. 15414, 90th Cong., 2d Sess. (1968).
109 Proposed Treas. Reg. § 1.103-7, 33 Fed. Reg. 4950 (1968). The proposed regulation in pertinent part reads as follows:

> (a) *Treatment of industrial development bonds.* An industrial development bond (as defined in paragraph (b) of this section) shall not be considered to be an obligation of a State, a territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia within the meaning of section 103(a)(1) and § 1.103-1 (hereinafter referred to as a "governmental unit").
>
> (b) *Definition of industrial development bonds.* (1) The term "industrial development bond" means any indebtedness issued by a governmental unit if under the terms of such indebtedness or any underlying lease, deferred payment sale, loan or similar arrangement—
>
> (i) One or more identifiable persons other than a governmental unit have the use of, or the right to use, all or a major portion of the proceeds, or property acquired with the proceeds, of such indebtedness,
>
> (ii) Such person is required to provide all or a major portion of the funds necessary to pay the principal and interest on such indebtedness, and
>
> (iii) The payment of the principal and interest on such indebtedness is secured in whole or in major part—
>
> (a) By a security interest (as defined in subparagraph (2) of this paragraph) in such property, or
>
> (b) By an interest in (or to be derived from) payments to be made with respect to such property or to such loan.
>
> Such indebtedness, although issued by a governmental unit, is in reality the indebtedness of a person other than a governmental unit since under the terms of the indebtedness or any underlying lease, deferred payment sale, loan or similar arrangement the governmental unit serves as a conduit for disbursing funds provided by such person, and the liability for providing the funds to pay the principal and interest on the indebtedness is that of such person. Similarly, the status of such indebtedness of a person other than a governmental unit is not changed by the agreement of a governmental unit to guarantee the indebtedness of such person.
>
> (2) For purposes of subparagraph (1) of this paragraph, the term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an indebtedness.

provisions of subsection (c)(2) of the proposed regulation[110] was an attempt by the Treasury to quiet or lessen the Senate opposition to this regulation.

The early response to the proposed regulation appeared to sound its death knell. On March 26th the Senate voted to require the Treasury to continue indefinitely the exemption of interest on industrial development bonds.[111] It was suggested that this action may have been taken because of Congress's decision to move on its own.[112] Then two days later, the Senate, after heavy

---

(3) For purposes of subparagraph (1)(i) of this paragraph, use of property by a person other than a governmental unit exists only if, under the lease, deferred payment sale, loan, or similar arrangement, a major portion of any direct economic benefit to be derived from property (other than property described in subdivision (ii) of this subparagraph) may inure to such a person. Thus, a person other than a governmental unit will not be considered, for purposes of subparagraph (1)(i) of this paragraph, to have the use of, or the right to use, property if —

(i) Such property is owned by a governmental unit and such person is operating or managing the property on behalf of a governmental unit and does not have rights with respect to such property such that a major portion of any direct economic benefit to be derived from such property may inure to a person other than a governmental unit, or

(ii) Such property is functionally related to a facility owned by a governmental unit that is or will be operated or managed by or on behalf of the governmental unit, and such property is operated as an integral part of the entire facility.

(4) Examples [13 examples illustrating the provisions of this section are given]

(c) *Applicability.* (1) Except as otherwise provided in subparagraph (2) of this paragraph, the provisions of this section are applicable to any indebtedness initially sold (within the meaning of subparagraph (3) of this paragraph) after March 15, 1968.

(2) The provisions of this section are not applicable to any indebtedness initially sold (within the meaning of subparagraph (3) of this paragraph) at any time prior to September 15, 1968, if, on or before March 15, 1968 —

(i) The issuance of such indebtedness was approved by the governing body of the governmental unit issuing such indebtedness or by the voters of such governmental unit;

(ii) In connection with the issuance of such indebtedness or with the use of the proceeds to be derived from the sale of such indebtedness or property to be acquired with such proceeds, the governmental unit issuing such indebtedness has made a significant financial commitment;

(iii) Any person other than a governmental unit who will use (within the meaning of paragraph (b)(3) of this section) the proceeds to be derived from the sale of such indebtedness or the property to be acquired with such proceeds has expended, or has entered into a binding contract to expend, for purposes which are related to the use of such proceeds or such property, an amount equal to or in excess of 20 percent of such proceeds; or

(iv) In the case of an indebtedness issued in conjunction with a project where financial assistance will be provided by a Federal or State agency concerned with economic development, such agency has approved the project or an application for financial assistance is pending.

(3) For purposes of this paragraph, an indebtedness will be considered "initially sold" on the date on which a buyer or underwriter enters into a binding contract with the issuer for the purchase of such indebtedness at a fixed price. An agreement between a buyer or underwriter and an issuer will be considered to be a binding contract for the sale of an indebtedness although the obligations of one or both parties to such agreement are subject to one or more conditions which are beyond the control of such party or parties. Thus, for example, if a sale of bonds to be issued by a county at a fixed price must first be approved by the voters of the county, such agreement will be considered a binding contract, if it is otherwise unconditional, and the bonds will be considered initially sold on the date on which the agreement is executed.

110 Quoted in note 109 *supra.*

111 114 Cong. Rec. S3339 (daily ed. March 26, 1968); Wall Street Journal, March 27, 1968, at 21, col. 1.

112 Wall Street Journal, March 27, 1968, at 21, col. 1.

pressure was brought by organizations opposing the continued growth of tax-exempt industrial development bonds,[113] reversed its position of March 26th and voted to revoke the exemption, effective January 1, 1969.[114] As a result of the Senate's reversal, when the Revenue and Expenditure Control Act of 1968[115] was enacted the exemption for industrial development bonds had met its Waterloo.[116] Section 107 of that act provides for the exclusion of industrial development bonds from the coverage of section 103(a)(1) of the Code.[117] For the

---

113 Wall Street Journal, March 29, 1968, at 16, cols. 1-2. It is interesting to note that one of these pressure groups was the National Association of Counties which, "in communications to Senators, declared that continued growth of tax-free industrial bond issues 'poses a disastrous threat to the entire state and local government bond market.'" *Id.* The association's demand bolstered the argument of the Treasury that the flooding of the market with industrial bond issues, designed to aid private business, tended "to increase interest rates local government must pay on issues financing strictly public projects." *Id.*

114 114 CONG. REC. S3562 (daily ed. March 28, 1968); Wall Street Journal, March 29, 1968, at 16, cols. 1-2.

115 82 Stat. 251 (U.S. CONG. NEWS, No. 6, July 1, 1968).

116 That the demise was not universally welcomed is shown by the report that Chairman Mills of the House Ways and Means Committee introduced a bill, hardly before the ink in the President's signature to the Revenue and Expenditure Control Act of 1968 was dry, that would virtually nullify the effect of the industrial development bonds aspect of the legislation. Wall Street Journal, July 10, 1968, at 4, cols. 3-4.

117 Revenue and Expenditure Control Act of 1968 § 107, 82 Stat. 251 (U.S. CONG. NEWS, No. 6, July 1, 1968) provides in its entirety:

SEC. 107. INDUSTRIAL DEVELOPMENT BONDS.

(a) Amendment of Section 103.—Section 103 (relating to interest on certain governmental obligations) is amended by relettering subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) Industrial Development Bonds.—

"(1) Subsection (a) (1) not to apply.—Except as otherwise provided in this subsection, any industrial development bond shall be treated as an obligation not described in subsection (a) (1).

"(2) Industrial development bond.—For purposes of this subsection, the term 'industrial development bond' means any obligation —

"(A) which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (within the meaning of paragraph (3)), and

"(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—

"(i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

"(ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

"(3) Exempt person.—For purposes of paragraph (2) (A), the term 'exempt person' means—

"(A) a governmental unit, or

"(B) an organization described in section 501(c) (3) and exempt from tax under section 501(a) (but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business, determined by applying section 513(a) to such organization).

"(4) Certain exempt activities.—Paragraph (1) shall not apply to any obligation which is issued as part of an issue substantially all of the proceeds of which are to be used to provide—

"(A) residential real property for family units,

"(B) sports facilities,

"(C) convention or trade show facilities,

"(D) airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing,

"(E) sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy, gas, or water, or

"(F) air or water pollution control facilities.

"(5) Industrial parks.—Paragraph (1) shall not apply to any obligation issued as part of an issue substantially all of the proceeds of which are to be used for the acquisition or development of land as the site for an industrial park. For purposes of the preceding sentence, the term 'development of land' includes the provision of water, sewage, drainage, or similar facilities, or of transportation, power, or communication facilities, which are incidental to use of the site as an industrial park, but, except with respect to such facilities, does not include the provision of structures or buildings.

"(6) Exemption for certain small issues.—

"(A) In general.—Paragraph (1) shall not apply to any obligation issued as part of an issue the aggregate authorized face amount of which is $1,000,000 or less and substantially all of the proceeds of which are to be used (i) for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or (ii) to redeem part or all of a prior issue which was issued for purposes described in clause (i) or this clause.

"(B) Certain prior issues taken into account.—If—

"(i) the proceeds of two or more issues of obligations (whether or not the issuer of each such issue is the same) are or will be used primarily with respect to facilities located in the same incorporated municipality or located in the same county (but not in any incorporated municipality).

"(ii) the principal user of such facilities is or will be the same person or two or more related persons, and

"(iii) but for this subparagraph, subparagraph (A) would apply to each such issue,

then, for purposes of subparagraph (A), in determining the aggregate face amount of any later issue there shall be taken into account the face amount of obligations issued under all prior such issues and outstanding at the time of such later issue (not including as outstanding any obligation which is to be redeemed from the proceeds of the later issue).

"(C) Related persons.—For purposes of this paragraph and paragraph (7), a person is a related person to another person if—

"(i) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), or

"(ii) such persons are members of the same controlled group of corporations (as defined in section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears therein).

"(7) Exception.—Paragraphs (4), (5), and (6) shall not apply with respect to any obligation for any period during which it is held by a person who is a substantial user of the facilities or a related person."

(b) Effective Date.—

(1) In General.—Except as provided by paragraph (2), the amendment made by subsection (a) shall apply to taxable years ending after April 30, 1968, but only with respect to obligations issued after such date.

(2) Transitional provisions.—Section 103(c) (1) of the Internal Revenue Code of 1954, as amended by subsection (a), shall not apply with respect to any obligation issued before January 1, 1969, if before May 1, 1968—

(A) the issuance of the obligation (or the project in connection with which the proceeds of the obligations are to be used) was authorized or approved by the governing body of the governmental unit issuing the obligation or by the voters of such governmental unit;

(B) in connection with the issuance of such obligation or with the use of the proceeds to be derived from the sale of such obligation or the property to be acquired or improved with such proceeds, a governmental unit has made a significant financial commitment;

(C) any person (other than a governmental unit) who will use the proceeds to be derived from the sale of such obligation or the property to be acquired or improved with such proceeds has expended (or has entered into a binding contract to expend) for purposes which are related to the use of such proceeds or property, an amount equal to or in excess of 20 percent of such proceeds; or

(D) in the case of an obligation issued in conjunction with a project where financial assistance will be provided by a governmental agency concerned with economic development, such agency has approved the project or an application for financial assistance is pending. [Footnote omitted.]

present at least,[118] the bell has apparently tolled for industrial development bonds.

V. The Merits of Excluding Industrial Development Bonds from Section 103(a)(1)

The tremendous growth of industrial development financing "has long been attacked by some municipal bond dealers."[119] The total dollar value of industrial development issues floated in 1958 was approximately twenty-six million.[120] In late February, 1968, when it became apparent that the Treasury was seeking to move in the direction of ending the exempt status of such bonds, more than five hundred million dollars of these bonds were "overhanging the market."[121]

Remedial action rectifying the inequities which result from the applicability of section 103(a)(1) of the Code to industrial development bonds was long overdue. The ostensibly meritorious arguments for maintaining the existing exemption from taxation afforded municipal bond interest have no application to industrial development bonds. It is contended by those who champion the exclusion of municipal bond interest from taxation that the exemption is an instrument of federalism, *i.e.*, that it promotes our system of dual sovereignties.[122] Additionally, the exemption is said to assist the states in providing *public facilities and services*.[123] However, neither contention is valid when applied to industrial development bonds. The effect of such bonds has been to divide the states by promoting industrial migration. This, in turn, has resulted in a waste of resources and in other unsettling economic consequences. Furthermore, under the guise of a governmental activity, *private industry* has profited at the expense of the American people.

The application of the exemption to industrial development bonds has been called "a perversion of the basic purpose of the tax law."[124] These bonds are in reality commercial bonds; the issuing municipality has simply "sold its income tax exemption privilege to a private corporation."[125]

> The official statements describing new issues of industrial development bonds appear similar, if not identical, to preliminary prospectuses covering taxable corporate bonds registered with the Securities and Exchange Commission.
>
> In fact, the industrial development bond statements frequently reveal little about the towns selling the bonds and much about corporations that will lease the facilities. Critics of industrial aid bonds have cited this practice as convincing evidence that the underwriters really do not consider the bonds as tax-exempt municipal securities.[126]

118 See note 116 *supra*.
119 N.Y. Times, Jan. 21, 1968, § F, at 1, col. 8.
120 *Hearings* 731. For a state-by-state summary of the total amount of industrial aid financing for the years 1956-1966, see 114 CONG. REC. E2177-78 (daily ed. March 22, 1968).
121 N.Y. Times, Feb. 26, 1968, at 58, col. 6.
122 *Hearings* 738, 740, 769.
123 *Id.* at 790-91.
124 *Id.* at 732.
125 *Id.*
126 N.Y. Times, Jan. 21, 1968, § F, at 12, col. 3.

The abuse of the tax system in this area is analogous to the experience in the late 1950's and early 1960's involving gifts to charitable organizations and the inequitable tax benefits accruing to certain charitable donors:

> [A] lesson learned is that reliance on tax benefits presents seemingly unavoidable temptations toward promotion. . . . The greater the tax benefits, the greater becomes the pressure for active promotion.
>
> . . . .
>
> Advertising the tax-savings also called the attention of the Internal Revenue Service to the fact that they were in the middle of the whole picture. The I.R.S. had granted the tax relief, and the adverse reaction reflected as unfavorably on that agency as it did on the charitable institutions.[127]

As it did then, the Internal Revenue Service, and even the Congress, has responded to the demand for relief.

There is little doubt about the constitutionality of section 107 of the Revenue and Expenditure Control Act of 1968. If the doctrine of intergovernmental tax immunity is at all viable, it certainly has no application to industrial development bonds. To contend that subsidization of private industry in this fashion is a function that was essential to the maintenance of state governments as they were organized at the time the Constitution was adopted[128] would be utter foolishness. Furthermore, it is submitted that the rule-making authority of the Treasury[129] alone would have been sufficient to exclude industrial development bonds from section 103(a)(1); had the Treasury done so, the need for the recent congressional exclusion would have been obviated.

VI. Effects of Exempting Municipal Bond Interest from Taxation

A. Investors

Municipal securities have always sold at lower yields than taxable bonds of similar quality and maturity. This yield differential is a function of several factors:

> The differential would widen if progression in the Federal income tax steepened, or if the level of rates increased, of if the volume of State-local issues shrank; it would narrow if progression lessened, if the level of rates decreased, or the volume of State-local issues grew.[130]

The value of the tax exemption of municipal bonds to a given individual is dependent upon his taxable income. An investor in the higher tax brackets will obtain greater advantages from the purchase of tax-exempt bonds than will one with a more modest income. This proposition is illustrated by the Table

127 R. DESMOND, HIGHER EDUCATION & TAX MOTIVATED GIVING: THE FEDERAL TAX HISTORY OF LIFE INCOME AND ANNUITY GIFTS 56 (1967).
128 See Helvering v. Gerhardt, 304 U.S. 405 (1938).
129 INT. REV. CODE of 1954 § 7805.
130 *Hearings* 708.

entitled "Tax-Exempt Bonds and Their Equivalents," set out in Appendix A. A municipal bond yielding 4.5 percent is the equivalent of a 5.77 percent taxable yield for a couple with a taxable income of $10,000 who file a joint return. Yet the same bond would be worth a taxable yield of 11.25 percent to a couple with a joint taxable income of $100,000. A couple with a total taxable income of $35,000 and investment income of $3,000 from investments yielding 4.5 percent would fare 70 percent better by investing in municipal bonds of the same yield.[131]

Bond yields of 4.5 percent are not uncommon today. The Dow-Jones municipal yield index, which measures the yields of twenty representative state and city issues in the twenty-year maturity range, has fluctuated from a low of 4.25 percent to a thirty-four-year high of 4.65 percent in 1968.[132] The monthly average of the Dow-Jones municipal yield index from 1965 to the present is depicted in Appendix B.

B. Issuing Governments

New issues of tax-exempt municipals have increased nearly 100 percent in the past ten years.[133] The total dollar value of these bonds outstanding in 1968 exceeds 100 billion dollars.[134]

"It is impossible to quantify the economic effects of the exemption of municipal bond interest."[135] The exemption feature undoubtedly manifests itself in the form of reduced borrowing costs to the issuer. However, the extent of the interest savings is not simply a matter of multiplying the yield differential by the total value of municipal bonds outstanding, because such computation erroneously presumes that the only distinction between municipals and comparable industrials is the tax-exempt status of the former. Furthermore, "[d]epending upon the quality of the bonds used for the comparatives, the spread or differential in yield will vary."[136]

> One of the chief attributes of bond issues is their lack of homogeneity. It is difficult enough to compare two issues in the same category, but the comparison of an industrial and a municipal, for example, is likely to become farfetched indeed. Bond issues differ in degree of risk, marketability, maturity, reputation of the issuer for fair dealing, and size, to name only five major characteristics.[137]

It is believed safe to estimate that on the basis of the total municipals outstanding to date and a yield differential ranging between 1 and 2.5 percent, the reduction in municipal borrowing costs exceeds one billion dollars per annum.

131 Wall Street Journal, April 15, 1968, at 7.
132 *Id.* at 19, col. 2.
133 See Appendix C, "Annual Municipal Bond Sales: 1951-1968," *infra.*
134 *Id.*
135 *Hearings* 724.
136 *Id.* at 686.
137 *Id.* at 777.

C. Federal Government

To the extent of the reduction in borrowing costs, the exemption of municipal bond interest from federal income taxation represents an indirect federal subsidy to the states and their political subdivisions. The size of the subsidy is governed by the capital needs of the issuing municipalities, and, for this reason, it has been termed "a sort of unconditional Federal subsidy."[138]

The cost of tax exemption to the Government far exceeds the reduction in borrowing costs to municipalities. The reason for this "leakage" is that "the bond buyer purchases the tax exemption at bargain prices."[139] That the tax benefits acquired by a municipal bond buyer manifestly overshadow the yield he sacrifices by foregoing comparable industrial bonds is evident from the Table set forth in Appendix A. "Were it not for the progression in our individual surtax rates, this disturbing effect of the tax exemption would probably not exist."[140]

More detrimental to the federal tax structure than the loss of revenue attributable to the exemption feature is its apparent irreconcilability with our ostensible adherence to the theory of progressive income taxation. This loophole, a "shocking violation" of the basic principle that "equal incomes should bear equal tax liabilities," undermines "taxpayer morale in a system which depends largely on self-assessment."[141]

VII. Conclusion

This article has sought to view the current status of municipal securities, with some emphasis upon industrial development bonds. A few additional comments may be appropriate in summation.

A. Intergovernmental Immunities

It was stated early in this article that there appears to be little left to support the exemption of interest (section 103(a)(1) of the Code) on constitutional grounds. It is, however, recognized that neither *Pollock v. Farmers' Loan & Trust*

---

138 *Id.* at 715.

139 *Id.* at 687. The bond buyer purchases his bonds at "bargain prices" in the sense that the bonds are priced below the value of the tax exemption.

> The cost to the bond buyer is assumed to be three-fourths of 1 percentage point in yield, yet the tax benefits which he acquires may be far in excess of that loss of income to him. For example, a bondholder in a 47-percent bracket who invests in a municipal bond with a 3½-percent yield obtains the equivalent of a 6.6-percent yield from a taxable bond. And as the taxpayer goes into the higher tax brackets, the excess benefits from the tax exemption feature multiply rapidly. In an 81-percent surtax bracket the bondholder obtains a yield equivalent to 18.4 percent on a taxable bond. Similar benefits are obtainable by corporate investors in tax-exempt bonds; a corporation, taxable at the flat 52-percent rate, obtains the effect of a 7.3-percent yield through the purchase of a municipal bond with a 3½-percent yield. *Id.* at 687-88. [Of course, since these Hearings were held in 1959, the figures would have to be adjusted to reflect current rates of taxation. However, the point remains clear.]

140 *Id.* at 688.

141 *Id.* at 684.

Company[142] nor *National Life Insurance Company v. United States*[143] has been specifically repudiated. Therefore, either opinion could serve as precedent for a subsequent Supreme Court decision holding that the repeal of section 103(a)-(1) requires a constitutional amendment. But on balance it is believed that the more recent Court decisions pertaining to reciprocal tax immunities militate against such future action by the Supreme Court. However,

> [U]ntil the statutory immunity of interest from state and municipal bonds, which prevents a judicial determination of any constitutional immunity, is repealed, the constitutional immunity seems destined to remain a subject for interesting speculation.[144]

B. Industrial Development Bonds

Stimulated by the recent activity of the Treasury, Congress has abolished the exemption as far as industrial development bonds are concerned. However, the new legislation specifically limits the revocation of the tax exemption privilege to interest on bond issues of more than one million dollars.[145] This concession to communities seeking to attract small industry, although possibly warranted on other grounds, is, it is submitted, recidivistic. The fact that an industrial development bond issue is small in size is of no consequence with respect to the rationale for abolishing the exemption. Furthermore, the concession could conceivably subject the proposed amendment to constitutional attack on the grounds that it discriminates against larger industry in contravention of the fifth and fourteenth amendments.

C. Repeal of Section 103(a)(1)

The authors feel that the current statutory exemption in section 103(a)(1) is inconsistent with a strict application of the theory of progressive income taxation. Solicitor General Erwin Griswold has stated: "The federal income tax cannot be fair and adequate in the application of its progressive rates until this hole is in some way filled."[146]

Moreover, the repeal of the exemption would not wreak catastrophic effects upon state and local governments. To the extent that municipal bond yields increased as a result of the loss of their tax-exempt status, those tax-exempt institutions (pension trusts, charitable organizations, etc.) that derive no benefit from the exemption feature and, consequently, have no incentive to forego the higher yields of comparable industrials would be attracted to the municipal securities industry.

---

142 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895).
143 277 U.S. 508 (1928).
144 Lowndes, *Current Constitutional Problems in Federal Taxation*, 4 VAND. L. REV. 469, 481 (1951) (footnote omitted).
145 Revenue Expenditure and Control Act of 1968 § 107 (a)(6)(A), 82 Stat. 251 (U.S. CONG. NEWS, No. 6, July 1, 1968), set out in note 117 *supra*.
146 E. GRISWOLD, FEDERAL TAXATION 125 (1966).

Finally, the federal government could directly subsidize, if need arose, state and local borrowing and, in so doing, avoid the "leakage" resulting from the presently existing indirect subsidy. Numerous proposals and plans have been submitted in this regard.[147]

The abolition of the exemption privilege as applied to industrial development bonds is a step in the right direction — it may be a prelude of things to come.

147 *Hearings* 690-98, 713-14.

APPENDIX A

Tax-Exempt Bonds and Their Equivalents*

(Based on Effective 1968 Individual Tax Rates—Regular Tax Rates Plus 7.5% Tax Surcharge)

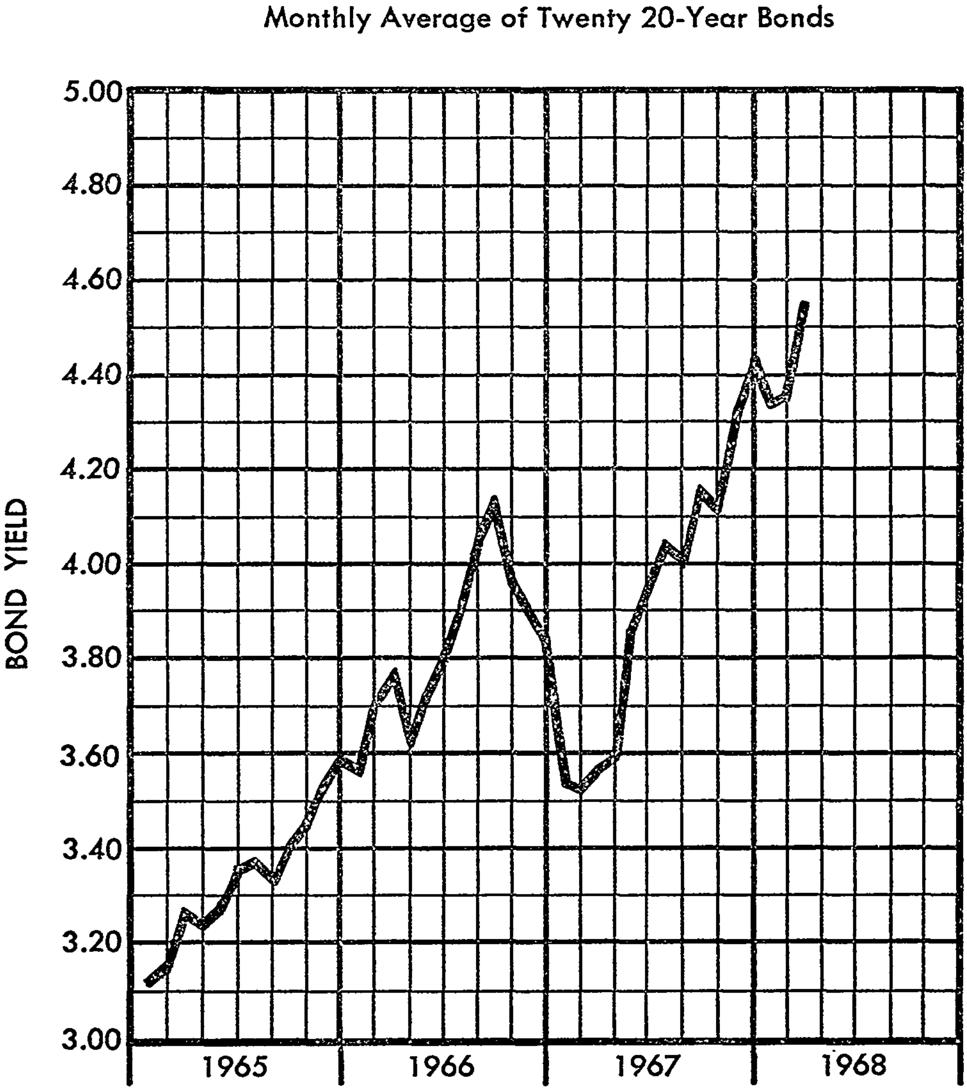
Taxable Income (Joint Return)		Taxable Income (Separate Return)		Effective Tax	Bond Yield																	
Over	Not Over	Over	Not Over	Rate	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70
$ 8,000	$ 12,000	$ 4,000	$ 6,000	23.7%	2.62	2.75	2.88	3.01	3.15	3.28	3.41	3.54	3.67	3.80	3.93	4.06	4.19	4.33	4.46	4.59	4.72	4.85
12,000	16,000	6,000	8,000	26.9%	2.74	2.87	3.01	3.15	3.28	3.42	3.56	3.69	3.83	3.97	4.10	4.24	4.38	4.51	4.65	4.79	4.92	5.06
16,000	20,000	8,000	10,000	30.1%	2.86	3.00	3.15	3.29	3.43	3.58	3.72	3.86	4.01	4.15	4.29	4.43	4.58	4.72	4.86	5.01	5.15	5.29
20,000	24,000	10,000	12,000	34.4%	3.05	3.20	3.35	3.51	3.66	3.81	3.96	4.12	4.27	4.42	4.57	4.73	4.88	5.03	5.18	5.34	5.49	5.64
24,000	28,000	12,000	14,000	38.7%	3.26	3.43	3.59	3.75	3.92	4.08	4.24	4.40	4.57	4.73	4.89	5.06	5.22	5.38	5.55	5.71	5.87	6.04
28,000	32,000	14,000	16,000	41.9%	3.44	3.61	3.79	3.96	4.13	4.30	4.48	4.65	4.82	4.99	5.16	5.34	5.51	5.68	5.85	6.02	6.20	6.37
32,000	36,000	16,000	18,000	45.2%	3.65	3.83	4.01	4.20	4.38	4.56	4.74	4.93	5.11	5.29	5.47	5.66	5.84	6.02	6.20	6.39	6.57	6.75
36,000	40,000	18,000	20,000	48.4%	3.88	4.07	4.26	4.46	4.65	4.84	5.04	5.23	5.43	5.62	5.81	6.01	6.20	6.40	6.59	6.78	6.98	7.17
40,000	44,000	20,000	22,000	51.6%	4.13	4.34	4.55	4.75	4.96	5.17	5.37	5.58	5.79	5.99	6.20	6.40	6.61	6.82	7.02	7.23	7.44	7.64
44,000	52,000	22,000	26,000	53.8%	4.33	4.55	4.76	4.98	5.19	5.41	5.63	5.84	6.06	6.28	6.49	6.71	6.93	7.14	7.36	7.58	7.79	8.01
52,000	64,000	26,000	32,000	57.0%	4.65	4.88	5.12	5.35	5.58	5.81	6.05	6.28	6.51	6.74	6.98	7.21	7.44	7.67	7.91	8.14	8.37	8.60
64,000	76,000	32,000	38,000	59.1%	4.89	5.13	5.38	5.62	5.87	6.11	6.36	6 60	6.85	7.09	7.33	7.58	7.82	8.07	8.31	8.56	8.80	9.05
76,000	88,000	38,000	44,000	62.4%	5.32	5.59	5.85	6.12	6.38	6.65	6.91	7.18	7.45	7.71	7.98	8.24	8.51	8.78	9.04	9.31	9.57	9.84
88,000	100,000	44,000	50,000	64.5%	5.63	5.92	6.20	6.48	6.76	7.04	7.32	7.61	7.89	8.17	8.45	8.73	9.01	9.30	9.58	9.86	10.14	10.42
100,000	120,000	50,000	60,000	66.7%	6.01	6.31	6.61	6.91	7.21	7.51	7.81	8.11	8.41	8.71	9.01	9.31	9.61	9.91	10.21	10.51	10.81	11.11
120,000	140,000	60,000	70,000	68.8%	6.41	6.73	7.05	7.37	7.69	8.01	8.33	8.65	8.97	9.29	9.62	9.94	10.26	10.58	10.90	11.22	11.54	11.86
140,000	160,000	70,000	80,000	71.0%	6.90	7.24	7.59	7.93	8.28	8.62	8.97	9.31	9.66	10.00	10.34	10.69	11.03	11.38	11.72	12.07	12.41	12.76
160,000	180,000	80,000	90,000	73.1%	7.43	7.81	8.18	8.55	8.92	9.29	9.67	10.04	10.41	10.78	11.15	11.52	11.90	12.27	12.64	13.01	13.38	13.75
180,000	200,000	90,000	100,000	74.2%	7.75	8.14	8.53	8.91	9.30	9.69	10.08	10.47	10.85	11.24	11.63	12.02	12.40	12.79	13.18	13.57	13.95	14.34
200,000	....	100,000	....	75.3%	8.10	8.50	8.91	9.31	9.72	10.12	10.53	10.93	11.34	11.74	12.15	12.55	12.96	13.36	13.77	14.17	14.57	14.98

Taxable Income (Joint Return) Over	Not Over	Taxable Income (Separate Return) Over	Not Over	Effective Tax Rate	Bond Yield 3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20	5.30	5.40	5.50
$ 8,000	$ 12,000	$ 4,000	$ 6,000	23.7%	4.98	5.11	5.24	5.37	5.50	5.64	5.77	5.90	6.03	6.16	6.29	6.42	6.55	6.68	6.82	6.95	7.08	7.21
12,000	16,000	6,000	8,000	26.9%	5.20	5.34	5.47	5.61	5.75	5.88	6.02	6.16	6.29	6.43	6.57	6.70	6.84	6.98	7.11	7.25	7.39	7.52
16,000	20,000	8,000	10,000	30.1%	5.44	5.58	5.72	5.87	6.01	6.15	6.29	6.44	6.58	6.72	6.87	7.01	7.15	7.30	7.44	7.58	7.73	7.87
20,000	24,000	10,000	12,000	34.4%	5.79	5.95	6.10	6.25	6.40	6.55	6.71	6.86	7.01	7.16	7.32	7.47	7.62	7.77	7.93	8.08	8.23	8.38
24,000	28,000	12,000	14,000	38.7%	6.20	6.36	6.53	6.69	6.85	7.01	7.18	7.34	7.50	7.67	7.83	7.99	8.16	8.32	8.48	8.65	8.81	8.97
28,000	32,000	14,000	16,000	41.9%	6.54	6.71	6.88	7.06	7.23	7.40	7.57	7.75	7.92	8.09	8.26	8.43	8.61	8.78	8.95	9.12	9.29	9.47
32,000	36,000	16,000	18,000	45.2%	6.93	7.12	7.30	7.48	7.66	7.85	8.03	8.21	8.39	8.58	8.76	8.94	9.12	9.31	9.49	9.67	9.85	10.04
36,000	40,000	18,000	20,000	48.4%	7.36	7.56	7.75	7.95	8.14	8.33	8.53	8.72	8.91	9.11	9.30	9.50	9.69	9.88	10.08	10.27	10.47	10.66
40,000	44,000	20,000	22,000	51.6%	7.85	8.06	8.26	8.47	8.68	8.88	9.09	9.30	9.50	9.71	9.92	10.12	10.33	10.54	10.74	10.95	11.16	11.36
44,000	52,000	22,000	26,000	53.8%	8.23	8.44	8.66	8.87	9.09	9.31	9.52	9.74	9.96	10.17	10.39	10.61	10.82	11.04	11.26	11.47	11.69	11.90
52,000	64,000	26,000	32,000	57.0%	8.84	9.07	9.30	9.53	9.77	10.00	10.23	10.47	10.70	10.93	11.16	11.40	11.63	11.86	12.09	12.33	12.56	12.79
64,000	76,000	32,000	38,000	59.1%	9.29	9.54	9.78	10.02	10.27	10.51	10.76	11.00	11.25	11.49	11.74	11.98	12.22	12.47	12.71	12.96	13.20	13.45
76,000	88,000	38,000	44,000	62.4%	10.11	10.37	10.64	10.90	11.17	11.44	11.70	11.97	12.23	12.50	12.77	13.03	13.30	13.56	13.83	14.10	14.36	14.63
88,000	100,000	44,000	50,000	64.5%	10.70	10.99	11.27	11.55	11.83	12.11	12.39	12.68	12.96	13.24	13.52	13.80	14.08	14.37	14.65	14.93	15.21	15.49
100,000	120,000	50,000	60,000	66.7%	11.41	11.71	12.01	12.31	12.61	12.91	13.21	13.51	13.81	14.11	14.41	14.71	15.02	15.32	15.62	15.92	16.22	16.52
120,000	140,000	60,000	70,000	68.8%	12.18	12.50	12.82	13.14	13.46	13.78	14.10	14.42	14.74	15.06	15.38	15.71	16.03	16.35	16.67	16.99	17.31	17.63
140,000	160,000	70,000	80,000	71.0%	13.10	13.45	13.79	14.14	14.48	14.83	15.17	15.52	15.86	16.21	16.55	16.90	17.24	17.59	17.93	18.28	18.62	18.97
160,000	180,000	80,000	90,000	73.1%	14.13	14.50	14.87	15.24	15.61	15.99	16.36	16.73	17.10	17.47	17.84	18.22	18.59	18.96	19.33	19.70	20.07	20.45
180,000	200,000	90,000	100,000	74.2%	14.73	15.12	15.50	15.89	16.28	16.67	17.05	17.44	17.83	18.22	18.60	18.99	19.38	19.77	20.16	20.54	20.93	21.32
200,000	....	100,000	....	75.3%	15.38	15.79	16.19	16.60	17.00	17.41	17.81	18.22	18.62	19.03	19.43	19.84	20.24	20.65	21.05	21.46	21.86	22.27

* Reproduced by permission from STANDARD FEDERAL TAX REPORTS, published by and copyright 1968, Commerce Clearing House, Inc., Chicago, Illinois.

APPENDIX B

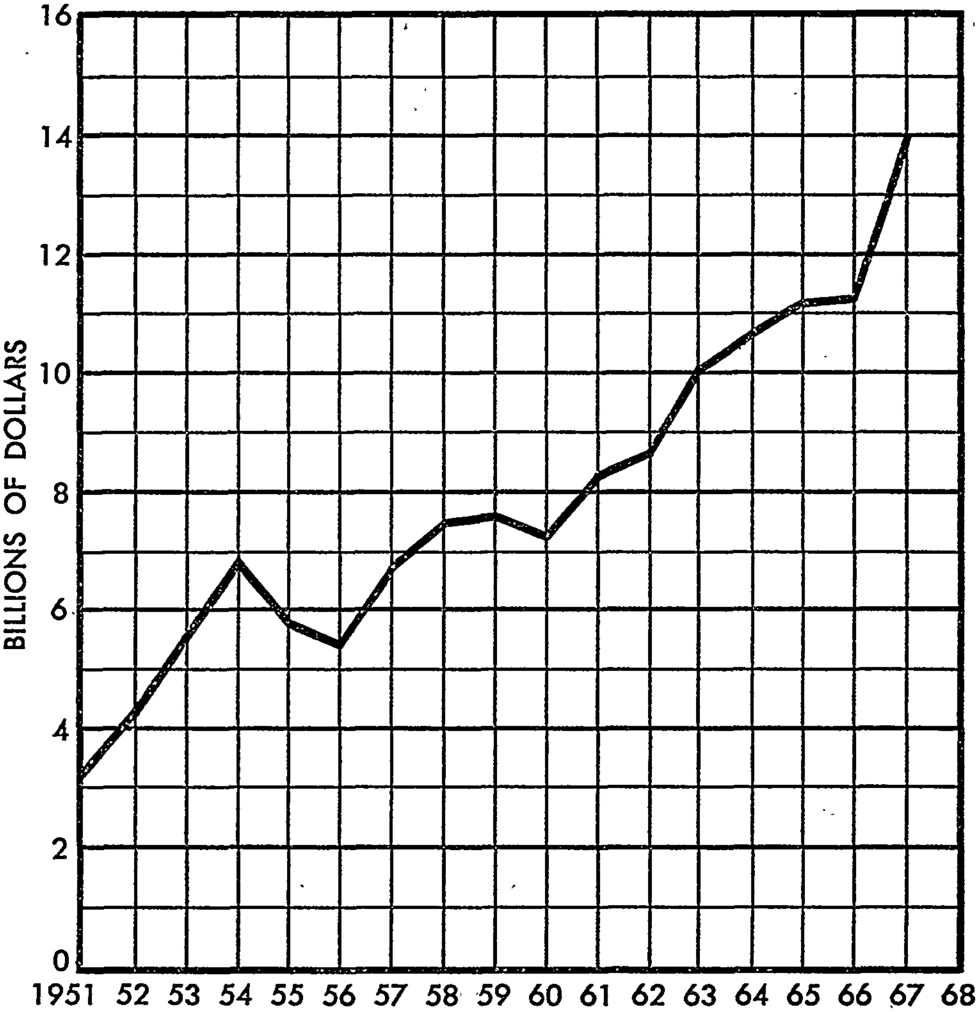
MUNICIPAL BOND YIELDS*



* Wall Street Journal, April 15, 1968, at 19, col. 3.

APPENDIX C

Annual Municipal Bond Sales: 1951-1968*
($ billions)



* *Hearings* 743 (for 1951-1958); Wall Street Journal, April 15, 1968, at 7, col. 2 (for 1958-1968).