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TAXATION-IMMUNITY OF FEDERAL BONDS TO STATE TAXATION

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TAXATION—IMMUNITY OF FEDERAL BONDS TO STATE TAXATION—A New Jersey statute[1] imposed a tax on domestic stock insurance corporations on the value of intangible property exclusive of tax-exempt property but required an assessment against all intangible property of not less than fifteen per cent of capital and surplus in excess of liabilities. In conformity with this statute, a tax was imposed on the appellant, a domestic stock insurance corporation, of fifteen per cent of the entire net worth, without deduction of the principal amount of tax-exempt United States bonds and accrued interest thereon. The appellant

[1] N.J. Rev. Stat. Cum. Supp. Laws of 1938, 1939, 1940 §54:4-22.

appealed to the United States Supreme Court on the ground that the tax statute was invalid as in conflict with Article I, section 8 of the Federal Constitution, since it interfered with power of Congress to "borrow on the credit of the United States." The appellant also asserted the tax was in conflict with a federal statute,[2] which generally exempts interest-bearing obligations of the United States from state taxation. *Held,* reversed. The Supreme Court found the New Jersey statute invalid as in conflict with the federal statute exempting such securities from state or local taxation; nor could it be sustained as a tax on the corporate franchise. Justice Black dissented. *New Jersey Realty Title Insurance Co. v. Division of Tax Appeals in Department of Taxation and Finance of New Jersey,* 338 U.S. 665, 70 S.Ct. 413 (1950).

Since *McCulloch v. Maryland*[3] it has been recognized that a state cannot tax an instrumentality of the federal government; however, the courts have experienced great difficulty in applying this rule. Federal securities were first considered government instrumentalities in *Weston v. City Council of Charleston,*[4] where the Supreme Court invalidated a state tax on federal securities on the ground that the tax interfered with the power of the federal government to borrow on the credit of the United States. Chief Justice Marshall[5] based this immunity to state taxation solely upon the constitutional supremacy of the federal government,[6] but later courts misapplied this doctrine and developed a reciprocal immunity between the state and federal governments in regard to taxation of their instrumentalities, each sovereign to be free from interference in performance of its governmental functions.[7] Consequently, the courts have looked only to the subject matter on which a tax was laid,[8] and all property taxes on United States obligations, although not discriminatory, have been considered taxes on federal instrumentalities and wholly outside the states' taxing power.[9] On the other hand, state taxes imposed on the privilege of a domestic corporation's franchise have been held valid though the corporation's assets consist wholly or in part of United States obligations,[10] and though the indirect effect is to impair the federal borrowing power. Moreover, state franchise taxes *measured by* income from tax-exempt property, in contradistinction to direct taxes *on* the tax-exempt property, have been repeatedly sustained by the Supreme

[2] 31 U.S.C. (1946) §742.
[3] 4 Wheat. (17 U.S.) 316 (1819).
[4] 2 Pet. (27 U.S.) 449 (1829).
[5] In McCulloch v. Maryland, 4 Wheat. (17 U.S.) 316 (1819).
[6] U.S. CONST., Art. 6.
[7] 47 HARV. L. REV. 321 at 322 (1933).
[8] Powell, "Indirect Encroachment on Federal Authority by Taxing Power of the States," 31 HARV. L. REV. 321 at 322 (1918).
[9] Bank of Commerce v. New York City, 2 Black (67 U.S.) 620 (1862); Bank Tax Case, 2 Wall. (69 U.S.) 200 (1865). See also cases in 1 WILLOUGHBY, CONSTITUTIONAL LAW §89 (1929), and 57 A.L.R. 899 at 900 (1928).
[10] Society for Savings v. Coite, 8 Wall. (73 U.S.) 594 (1868). Pacific Co. v. Johnson, 285 U.S. 480, 52 S.Ct. 424 (1932). See cases discussed in 1 WILLOUGHBY, CONSTITUTIONAL LAW §90 (1929). Also, see generally 57 A.L.R. 899 (1928); 65 A.L.R. 878 (1929); 71 A.L.R. 1237 (1932).

Court.[11] This seems in direct conflict with the general rule that federal bonds and the interest thereon are immune from state taxation,[12] but is consistent with the formalistic concept that a state may tax all appropriate subject matter within its territorial jurisdiction, regardless of the incidental effect on the federal government.[13] Indeed, save for a short period in the late 1920's,[14] emphasis has never been placed on the economic burden sustained by the federal government.[15] In the instant decision, since there was no pretense of its being a franchise tax,[16] the Supreme Court should have experienced no difficulty in finding a tax on net worth unconstitutional simply as a direct tax on tax-exempt property. However, it is difficult to tell the exact basis for the court's decision. The court invalidates the tax due to its "practical operation and effect" as a tax imposed on federal bonds contrary to an Act of Congress.[17] The more recent decisions of the Supreme Court have equated "practical operation and effect" with the formal operation of the tax.[18] If this is the court's meaning here, it is merely finding a tax invalid which in form is a direct property tax. However, the court may have intended "effect" to mean the economic effect on the federal government's borrowing power. Some support for this conclusion is found in the court's statement that it is immaterial whether this is a franchise tax measured by net worth or a property tax measured by net worth. It is more probable that the court is not

[11] Such a tax was first sustained in Home Insurance Co. v. New York, 134 U.S. 594, 10 S.Ct. 593 (1890).

[12] In the same cases that sustain such a tax, the court, contradictorily, reiterates that a state cannot do indirectly what it cannot do directly. See Home Insurance Co. v. New York, supra note 11, and Educational Films v. Ward, 282 U.S. 379, 51 S.Ct. 170 (1931).

[13] Plummer v. Coler, 178 U.S. 115, 20 S.Ct. 829 (1900) sustained a state inheritance tax on a bequest of a life-interest in government bonds. Cleveland Trust Co. v. Lander, 184 U.S. 111, 22 S.Ct. 394 (1902) sustained a state tax on corporate shares, imposed on the individual stockholder, where the corporation's capital was exclusively invested in United States bonds.

[14] A state franchise tax, measured by net income, derived in part from federal securities, was found unconstitutional in Macallen Corp. v. Massachusetts, 279 U.S. 620, 49 S.Ct. 432 (1929) since it was specifically intended to reach the securities. This case was overruled by Educational Films Corp. v. Ward, supra note 12, which professed to distinguish it, and the "intent rule" was rejected in Pacific Co. v. Johnson, supra note 10.

[15] Powell, "Waning of Intergovernmental Tax Immunities," 58 HARV. L. REV. 633 (1945).

[16] The tax had been invalidated by the former New Jersey Supreme Court, Garden View Homes v. Board of Adjustment, 137 N.J.L. 44, 60 A. (2d) 265 (1948), as an ad valorem tax on personal property and so in conflict with the federal statute, 31 U.S.C. (1946) §742. The new New Jersey Supreme Court held the tax valid as on net worth and not as a franchise tax in N.J. Realty Title Ins. Co. v. Division of Tax Appeals, 1 N.J. 496, 64 A. (2d) 341 (1949). The New Jersey legislature and taxing officials considered this a tax on personal property: See the court's notes 1, 2, 3, and 9.

[17] Congress may provide immunity for instrumentalities which might otherwise be taxable where they are "necessary and proper" for carrying out governmental functions. Pittman v. Home Owners' Loan Corp., 308 U.S. 21, 60 S.Ct. 15 (1939).

[18] The formal operation of a tax, as found by the Supreme Court, is to be distinguished from the label applied by the state legislature in enacting the tax statute. Justice Black's dissent correctly indicates that the Supreme Court has always refused to limit its determination of the validity of a state tax to "the descriptive language which may have been applied to it."

employing an economic test but is indicating that net worth is not a proper measure of a franchise tax, as it would be considered a property tax on the federal bonds.[19] Future decisions may better clarify the court's position in this area of intergovernmental tax immunities.

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[19] Basic economic reasons could be found to underlie this formal distinction: Thomas Reed Powell shows that net worth should not be a proper measure for a franchise tax in "Intergovernmental Tax Immunities," 8 GEO. WASH. L. REV. 1213 at 1214 (1940), since taxes measured by capital inclusive of federal bonds make floating a federal bond issue more difficult. He finds that franchise taxes measured by either gross or net income derived from federal securities have a less adverse effect on the federal borrowing power.