YALE
LAW JOURNAL

Vol. XXXIV JUNE, 1925 No. 8

FEDERAL TAXATION OF STATE ACTIVITIES AND STATE TAXATION OF FEDERAL ACTIVITIES

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Late in 1924, a United States District Court decided that the income of an employee of a street railway owned and operated by the City of Detroit, Michigan, was not subject to the federal income tax.[1] The decision excited little if any public interest. Probably only a small percentage of the legal fraternity has heard of the decision and a still smaller one has marked it as of any importance. Yet implicit in the problem of that case are questions the final answer to which may well change the whole course of our municipal development and activities, and may even be a vital factor in the discard or the retention of the political philosophy upon which our government was founded and by which until recent years it has largely been guided.

The limited problem of that case was whether a single employee of a municipally owned street railway system should pay a federal income tax. The larger problem of which it is a phase, and upon which a decision must apparently be forced within the next few years, involves the right of the federal government to tax municipal activities generally and indeed those of the states themselves, and to the extent that the right may be declared, the policy of the government in that respect. And if the right of the federal government so to tax be established, it seems that the right of the states to impose taxation to the same extent upon the activities of subordinate divisions of the federal government and even upon those of the federal government itself must follow.

Doubtless the idea that the federal government can tax any state activity or the state any federal activity will come as a shock to the legal mind. Ever since the decision in *McCulloch v. Maryland*[2] it has been laid down as a general rule that each government, and by that

[1] *Frey v. Woodworth* (1924, E. D. Mich.) 2 Fed. (2d) 725.
[2] (1819, U. S.) 4 Wheat. 316.

term was comprehended the political subdivisions of each as well, was free from any burden of taxation attempted to be imposed by the other. The reason given is that the power to tax involves the power to destroy, and hence such freedom is essential to the continuance of two sovereignties side by side. The existing decisions bearing on this question may not be wholly determinative, however, because the growth of publicly controlled enterprises within the last decade has been so marked and promises to continue on such a scale that entirely new factors of policy and of necessity have appeared.

Unquestionably there exists a very real danger if either of these sovereignties[3] possesses *as a matter of right* the general power of taxation of the activities of the other, whether conducted directly by the latter or indirectly through its political subdivisions. It has been declared time and again that if the right to tax at all is conceded, the right to tax out of existence must necessarily follow; that once the power to tax is admitted, there is no limitation upon its exercise.[4] The taxing authority, and that is the legislative body, is the final judge. We need hardly call attention to the many instances in which a legislative body has attempted to accomplish by indirection what it well knew it could not do by direction, to prove the danger. Such instances are far from rare either among the state legislatures or in Congress. One need go no further back in congressional history than the two acts intended to regulate child labor among the backward states, through the exercise in the one case of the interstate commerce power, and in the other of taxation, to illustrate the point we have in mind.[5] Obviously a ready weapon to accomplish this end would always be at hand if Congress and the states each possessed the power to tax any phase of the activities of the other.[6] Nor is it essential that the tax should be laid with an *intent* to destroy to have that result. Where the margin of profit is small or non-existent, as it frequently is with municipal utilities, a small additional burden would be fatal.

Balanced against this danger, however, is the limitation in the field of taxation open to each sovereignty if no burden of taxation, however remote, may be placed upon any activity of its co-sovereignty, and the assertion which is sometimes made that this doctrine of tax exemption results in indefensible inequalities. The direct activities of

[3] It will be understood, of course, that when we refer to two sovereignties we comprehend that of the United States on the one hand and that of each of the states on the other.

[4] *McCulloch v. Maryland, supra* note 2, at p. 432; *Weston v. Charleston* (1829, U. S.) 2 Pet. 449, 468; *Veazie Bank v. Fenno* (1869, U. S.) 8 Wall. 533; *Collector v. Day* (1870, U. S.) 11 Wall. 113, 127; *United States v. B. & O. R. R.* (1872, U. S.) 17 Wall. 322, 327; *McCray v. United States* (1904) 195 U. S. 27, 24 Sup. Ct. 769.

[5] See *Hammer v. Dagenhart* (1918) 247 U. S. 251, 38 Sup. Ct. 529; *Bailey v. Drexel Furn. Co.* (1922) 259 U. S. 20, 42 Sup. Ct. 449.

[6] For a collection of decisions involving statutes in which the revenue from taxation was a secondary consideration and its social consequence the primary one, see (1922) 22 COL. L. REV. 659.

the sovereignties are not alone to be considered, for commonly these public enterprises are conducted through the agency of municipal or quasi-municipal corporations. Their increase has been notable, and there is no indication that this expansion has attained its limit. With the increasing complexity of modern life there is more and more a tendency to take from private hands those businesses stamped with a public interest. The reclamation of farm lands, the farm loan banking system, the activities of the Shipping Board, the industrial development at Muscle Shoals and co-operative farm marketing stand on the federal side of the balance sheet. Against them there is the municipal production and sale of gas and electricity, storage and distribution of water, operation of urban transportation systems and port and terminal facilities, and even in some cases, experiments in the general banking field.[7]

The federal government through its Internal Revenue Bureau has taken the lead in the attack on the scope of the rule of tax exemptibility. The attorney general prevented its complete overthrow by advising that the salaries and wages of state and municipal officials and employees were free from the federal income tax.[8] The Bureau was not so easily balked, however, and its solicitors evolved an exception to the general rule by which it is clearly intended to reach as many incomes derived from municipal activity as possible. As this exception indicates not only the probable line of immediate conflict but perhaps throws light upon that of ultimate cleavage, it is well to understand precisely what it is before a study of the existing decisions is undertaken.

The solicitor declares that the constitutional limitation recognized by the opinion of the Attorney General applies only to salaries and wages earned in the exercise of the governmental functions of a state or its agencies and not to those earned in its proprietary or private activities, and as the test to determine what are governmental and what are proprietary activities, there is taken the distinction which has grown

[7] At the last session there was introduced in the New York state legislature a bill to permit the cities of the state generally either to acquire existing public utilities or to create their own, and within the term are included transportation, heating, lighting, power and water service, telegraphic and telephonic communication, and every other public service for which a franchise or consent to the use of the public streets is requisite. Assembly Bill No. 1030, Introductory No. 976 (Feb. 13, 1925).

[8] (1919) 31 Op. Att'y Gen. 441. Congress, by omitting from the Revenue Act of 1918 the provisions in the earlier act that the salaries or wages of state and municipal officials or employees should be exempt from income tax, suggested by implication that it intended to tax such salaries and wages. The Attorney General of the United States ruled, on the basis of the cases to which we shall later refer, that the operation of the federal taxing power on such income laid a burden on the means and instrumentalities by which the state exercised its powers, that such income was clearly beyond the reach of federal taxation and that Congress could not have intended by the omission of the exemption to tax where it could not constitutionally do so.

up in determining the tort liability of the public bodies to individuals. The distinction is claimed to be based on the rule of *South Carolina v. United States*.[9] We shall presently point out why we believe that this case by no means made any such distinction; but, assuming that it did, there is a fundamental weakness and error in this particular distinction between governmental and proprietary capacities which has been exhaustively considered in a series of articles recently appearing in this Journal.[10] The distinction is wholly illogical, takes no account of modern conditions and of actual facts, and is explicable only by the history of its growth. We shall have occasion to consider how ill-advised this distinction would be if extended to the field of taxation. Nevertheless, it represents the rule which the Bureau of Internal Revenue is now attempting to apply.[11]

Congress itself appears to look with favor upon a distinction between the taxability of certain state or municipal activities and others. In the Revenue Act of 1924, re-enacting substantially the provisions of earlier acts, Congress provides that gross income shall not include "income derived from any *public utility or* the exercise of any *essential governmental function* and accruing to any state, territory or the District of Columbia or any political subdivision of a state or territory***." Subsequent clauses assure the freedom from taxation of any income earned by a utility *in form privately owned but actually accruing to the benefit of a state or municipality*.[12] It is particularly to be noted that the exemption given by Congress is not merely to the "essential governmental functions" of the state or a municipality but

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[9] (1905) 199 U. S. 437, 26 Sup. Ct. 110.

[10] Borchard, *Government Liability in Tort* (1924-5) 34 YALE LAW JOURNAL, 1, 129, 229.

[11] Sol. Op. 152, II-35-1217. Typical of the application of this alleged exception to the general rule are the decisions of the Solicitor that the salaries and wages of officers and employees of a street railway owned and operated by a municipality are subject to the federal income tax; that the income of employees of a municipal water works system, of employees of a port commission and of employees of cafeterias connected with the public schools of the city are subject to the federal income tax, and incidentally that the nature of the function, whether governmental or proprietary, is to be determined by federal and not by state decisions (Sol. Memo. 2232, III-35-1754); and that the transportation charges of a ferry operated by a county under state authority were subject to the federal transportation tax, a contention overruled by the United States Circuit Court of Appeals in *United States v. King County* (1922, C. C. A. 9th) 281 Fed. 686, on the ground that the operation of a ferry was clearly the operation of a public highway and clearly a governmental activity. It is believed that the Solicitor's opinion first referred to is the one before the court in *Frey v. Woodworth, supra* note 1, where the Bureau was overruled, but again on the ground that the operation of a street railway is the operation of one kind of a public highway, and hence the activity is clearly governmental. Neither case can therefore be cited as a decision that the distinction is unsound. See also Treasury decisions cited 38 HARV. L. REV. 797-798, notes 33-49.

[12] Rev. Act, 1924, sec. 213 (b) (7).

also to public operation of public utilities; whereby Congress and the Bureau of Internal Revenue seem not to agree upon policy.[13]

Now the real importance of these doctrines lies not in the effect which they have upon the taxpayers presently concerned, but in the fact that, if successfully urged and logically extended, they make necessary a complete revaluation of our present ideas on the taxation, and eventually upon the feasibility, of municipal activities. If the compensation paid to employees necessary in the conduct of the activity is not exempt, neither, under the existing rule, is the property employed in the activity nor the income from the activity itself, nor indeed the exercise of the power to conduct that activity, and if the United States can reach all these phases of the activity when it is conducted by a municipality, it can reach them when conducted by the state itself, for the exemption rests upon precisely the same grounds; and similarly if the federal government can tax such state activities, clearly the state can tax activities of the same class conducted by the United States or its political subdivisions, since again the exemption of the state and of the federal government is co-relative. Furthermore, under the rule that classification for taxation need be uniform only in the geographical sense, the rates of such taxation apparently need bear no relation to the rates of taxation on similar private businesses, and hence the taxation could be actually destructive.

It may be asked why this result it not desirable—whether the curtailment of municipal, state and federal expansion is not to be desired. This is not a question which we purpose to answer in any detail. The national policy in the past has been to let each sovereignty, state or federal, decide the matter for itself. If it is now desired as a matter of studied policy to curtail that freedom, the problem should be faced frankly, and not attacked under the guise of a revenue question. We are not convinced that it is impracticable, either legally or practically, to establish a line of demarcation which on the one hand will protect the freedom of our dual sovereignties, and on the other safeguard revenue needs. A satisfactory solution will not be found, however, if each new case is considered on its own narrow facts, as has been the tendency. The problem is a broad one and must be studied as a whole. The existing rule is a judicial creation, not an express constitutional provision. Its restatement, therefore, is for the bench to make. A careful examination of the decided cases is warranted, then, both for the light it will throw on the practical aspects of the problem and to determine how far the courts are bound to the present rule.

[13] (1925) For still another distinction see 66 Cong. Rec. 2860-61. Reporting a bill to refund to the city of Philadelphia Civil War taxes levied on a gas works corporate in form but actually owned by the city, it was recommended (and passed) that there be refunded only so much of the tax as related to gas furnished the municipal departments, for street lighting, etc., and not that relating to gas sold to citizens. This is neither the Bureau's test (since the whole gas venture would be proprietary) nor that of the Revenue Act.

THE DECISIONS

The rule that the public activities of the United States and of the states are free from taxation by the co-sovereignty was first laid down by Mr. Chief Justice Marshall in one of his great constitutional decisions, *McCulloch v. Maryland*.[14] The question there presented was whether the state of Maryland had the right to tax the issuance of currency by a branch of the Bank of the United States within its boundaries. Passing first upon the question whether, and deciding that, the United States had the power to incorporate a bank, he held the tax unconstitutional not because of any express provision of the federal constitution, but from necessary implication. It is important to follow the reasoning of the Chief Justice because it is the foundation stone of the whole doctrine of tax exemptibility. Summarized, he argued that the power of taxation was a vital one, concurrently to be exercised both by the states and the federal government. Nevertheless, if that of the states could be exercised upon the powers granted to the United States in the constitution, it would amount to a denial of the federal powers, and accordingly such state taxation is repugnant to the constitution.[15] The scope of the taxation permitted to each sovereignty is to be measured by the extent of that sovereignty and in that way neither under guise of taxation can encroach upon the proper sphere of the other.[16] It is no solution of the problem to say that each should have confidence that the other will not abuse its power if the right of taxation is conceded, for in fact no such confidence existed. If taxation is permissible in slight degree it must be permissible to any extent whatever.[17] To safeguard our constitutional

[14] *Supra* note 2.

[15] *Ibid.* 431: "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 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."

[16] *Ibid.* 429, 430: "If we measure the power of taxation residing in a state, by the extent of sovereignty which the people of a single state possess, and can confer on its government, we have an intelligible standard, applicable to every case to which the power may be applied. We have a principle which leaves to a state the command of all its resources, and which places beyond its reach all those powers which are conferred by the people of the United States on the government of the Union, and all those means which are given for the purpose of carrying those powers into execution. 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."

[17] *Ibid.* 432-3: "If the states may tax one instrument, employed by the government in the execution of its powers, they may tax any and every other instrument. They may tax the mail; they may tax the mint; they may tax patent rights; they

system, therefore, the right of taxation by the one sovereignty upon any power of the other must be wholly denied.

The second case likewise involved an attempt of the state to tax a federal instrumentality. In *Dobbins v. Commissioners*,[18] the question was whether county taxes within the State of Pennsylvania might be assessed upon the captain of a United States revenue cutter for his office. The same principles were applied. The states were restrained by such limitations—and here appears what has been accepted as the general statement of this test—

"as are necessarily implied when the exercise of the right by a State conflicts with the perfect execution of another sovereign power delegated to the United States. That occurs when taxation by a State acts *upon the instruments, emoluments and persons,* which the United States may use and employ *as necessary and proper means to execute their sovereign powers.*"[19]

The commander of the cutter no more than the inanimate property of the United States could be reached by state taxation, because of the burden which it would impose. Otherwise Congress would have to graduate the compensation with reference to its reduction by the tax, and there could be no uniformity, since the tax by the various states would differ. Moreover, it would give the states a revenue out of the revenues of the United States, which was never intended to be possible.

The third of the leading cases is *Collector v. Day*.[20] There for the first time the converse of the question presented in the preceding cases came before the Court, and it was held that the United States was constitutionally prohibited from imposing a tax upon the salary of a state officer, a judge. The reasoning of the decision was identical with that of the earlier decisions, applied this time to assure the freedom of the state sovereignty from interference by the federal government. The Court again declared the independence of the two governments in their respective spheres,[21] and held that it was indispensable, and therefore:

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may tax the papers of the custom house; they may tax judicial process; they may tax all the means employed by the government, to an excess which would defeat all the ends of government. This was not intended by the American people. They did not design to make their government dependent on the states.

Gentlemen say they do not claim the right to extend state taxation to these objects. They limit their pretensions to property. But on what principle is this distinction made?

The distinction between property and other subjects to which the power of taxation is applicable, is merely arbitrary and can never be sustained."

[18] (1842, U. S.) 16 Pet. 435.

[19] *Ibid.* 447.

[20] (1870, U. S.) 11 Wall. 113.

[21] *Ibid.* 124: "The States within the limits of their powers not granted, or, in the language of the 10th Amendment, 'reserved,' are as independent of the General Government as that government within its sphere is independent of the States."

"that *the means and instrumentalities employed for carrying on the operations of their governments, for preserving their existence, and fulfilling the high and responsible duties assigned to them in the Constitution, should be left free and unimpaired;* should not be liable to be crippled, much less defeated by the taxing power of another government, which power acknowledges no limits but the will of the legislative body imposing the tax."

The fourth case is *United States v. Baltimore & Ohio Railroad Co.*[22] There, pursuant to a statute of the Maryland legislature, the city of Baltimore was authorized to issue its bonds, the proceeds of which were to be paid over to the railroad company, in return for which that company issued a mortgage upon its properties to the city. The federal government, under one of the Civil War revenue acts, attempted to tax the interest upon the mortgage which was payable to the city. The Court held the attempt unconstitutional, and declared again that:

"The right of the States to administer their own affairs through their legislative, executive and judicial departments, in their own manner through their own agencies, is conceded... This carries with it an exemption of those agencies and instruments from the taxing power of the Federal Government," and held expressly that *"A municipal corporation like the City of Baltimore, is a representative not only of the State, but is a portion of its governmental power. It is one of its creatures, made for a specific purpose, to exercise within a limited sphere the powers of the State."*[23]

But, argued counsel for the government, admitting all this, the act exempts the city *"in the exercise only of functions strictly belonging to them in their ordinary governmental and municipal capacity." This exemption was express. It is the identical exemption now urged by the Bureau of Internal Revenue.* The court passed upon this contention. *It disapproved it.* It was purely a matter in the discretion of the state or of the city to determine whether a given act furthering the city's commercial prosperity was wise or not and whether the end to be attained was one which the city properly might undertake by that means. The United States had no standing to effect a decision in such a matter. It was purely a local concern.[24]

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[22] (1872, U. S.) 17 Wall. 322.

[23] *Ibid.* 327, 329.

[24] *Ibid.* 330: "The Legislature and the authorities of the City of Baltimore decided that the investment of $5,000,000 *in aid of the construction of a railroad, which should bring to that city the unbounded harvests of the West, would be a measure for the benefit of the inhabitants of Baltimore and of the municipality.* This vast business was a prize for which the States north of Maryland were contending. Should it endeavor by the expenditure of this money or this credit to bring this vast business into its own State, and make its commercial metropolis great and prosperous, or should it refuse to incur hazard, allow other States to absorb this commerce and Baltimore to fall into an inferior position? *This was a question for the decision of the city under the authority of the State. It was a question to be decided solely with reference to public and municipal interests.*

The determinative importance of this declaration of the Supreme Court in relation to the attack on the rule is obvious. It makes the state, or the agency to which it has delegated the duty, the one to determine whether a given undertaking is properly public in its nature, *a determination which after all is the concern of the locality and not of a separate sovereignty removed, if not opposed, in interest, and certainly not in a position to appreciate the factors which determine the need or folly of the step.*

We must call attention to one other decision because it squarely overrules the deduction which had been drawn from the language of Mr. Chief Justice Marshall in the *McCulloch* case,[25] that the property rights of a governmental agency are subject to taxation where all the other aspects of the agency and the activity are not.[26] In *Clallam County v. United States,*[27] it appeared that a county in the state of Washington had attempted to levy its state and county tax upon land and other physical property of the United States Spruce Production Corporation, an agency created by the United States government and incorporated under the laws of the state of Washington to aid in the conduct of the war by producing lumber for aircraft purposes. Validity of the taxes was urged on the ground that "taxation of the property of the agent is not taxation of the means." But, said the court,[28]

"....it may be, and, in our opinion, clearly is, when, as here, not only the agent was created, but all the agent's property was acquired and used, for the sole purpose of producing a weapon for the war. This is not like the case of a corporation having its own purposes as well as those of the United States, and interested in profit on its own account."

Treating these as the leading cases, they seem to hold clearly that *any and all of the instrumentalities and agencies, animate and inanimate, tangible and intangible, which either sovereignty may select or use for the execution of its powers are to be free from any interference*

The city had authority to expend its money in opening squares, in widening streets, in deepening rivers, in building common roads or railways. The State could do these things by the direct Act of its Legislature, or it could empower the city to do them. It could act directly or through the agency of others. *It is not a question to be here discussed, whether the action proposed would in the end result to the benefit of the city.* It might be wise, or it might prove otherwise..... The city had the power given it by the Legislature to decide the question. It was within the scope of its municipal powers."

[25] *Supra* note 2.

[26] *Ibid.* at p. 435: "This opinion does not deprive the states of any resources which they originally possessed. It does not extend to a tax paid by the real property of the bank, in common with the other real property within the state, nor to a tax imposed on the interest which the citizens of Maryland may hold in this institution, in common with other property of the same description throughout the state."

[27] (1923) 263 U. S. 341, 44 Sup. Ct. 121.

[28] At p. 344, 44 Sup. Ct. 122.

through taxation by the opposing sovereignty. As we read these cases there is no suggestion of *any* limitation upon the exercise of these sovereign powers under guise of taxation by the other. *Policy* may dictate the grant of *permission* for such taxation but there is never an inherent *right* to it.

How does this statement of the rule compare with its application in other cases?

As we might expect, the property owned outright by the one government may not be taxed by the other.[29] So, too, the property owned by an agency of the sovereign and essential to the accomplishment of its delegated functions is wholly free from such taxation, even though in form the agency is a private corporation and the tax attempted to be applied is that levied upon other private corporations.[30] The bonds issued by the one sovereignty or by its political subdivisions cannot be taxed directly or indirectly by the other, either in the form of a tax on the bonds as such[31] or upon a capital amount in any part made up thereof,[32] or upon the income therefrom.[33] In the same way the agencies selected by the one sovereignty to execute its powers or perform its functions are wholly free from taxation except to the extent permitted by that sovereign, *even though they are privately owned or controlled and their operations inure to private profit.*[34]

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[29] *Van Brocklin v. Tennessee* (1886) 117 U. S. 151, 6 Sup. Ct. 670.

[30] *Clallam County v. United States, supra* note 26; *King County v. U. S. Shipping Board E. F. C.* (1922, C. C. A. 9th) 282 Fed. 950; *U. S. Spruce Prod. Corp. v. Lincoln County* (1922, D. C. Or.) 285 Fed. 388; *United States v. Coghlan* (1919, D. C. Md.) 261 Fed. 425. In the *King County* case, decided by the Circuit Court of Appeals for the Ninth Circuit, and the *Coghlan* case, there were involved attempts of Washington and Maryland counties to levy taxes, in the one case on shipyard property, and in the other upon land, owned by the Shipping Board Emergency Fleet Corporation. The Fleet Corporation had, of course, been denied governmental immunity from suit but this was held to have nothing to do with the right to freedom from taxation, and it was declared that the property was clearly free from taxation. The *Spruce Corporation* case involved the situation as the *Clallam County* decision. The *Clallam County* decision specifically approves the other three. See also *Matter of De la Vergne Machine Co.* (1925, 3d Dept.) 207 N. Y. Supp. 680.

[31] *Weston v. Charleston* (1829, U. S.) 2 Pet. 449.

[32] *Bank of Commerce v. New York City* (1862, U. S.) 2 Black, 620; *Bank Tax Case* (1864, U. S.) 2 Wall. 200; *Banks v. The Mayor* (1868, U. S.) 7 Wall. 16; *First National Bank v. Kentucky* (1869, U. S.) 9 Wall. 353; *Owensboro Bank v. Owensboro* (1898) 173 U. S. 664, 19 Sup. Ct. 537; *F. & M. Savings Bank v. Minnesota* (1914) 232 U. S. 516, 34 Sup. Ct. 354; *Farmers' & B. L. Ins. Co. v. Anderson* (1925, Kan.) 232 Pac. 592.

[33] *Pollock v. Farmers' Loan & Trust Co.* (1895) 157 U. S. 429, 15 Sup. Ct. 673.

[34] *Osborn v. Bank* (1824, U. S.) 9 Wheat. 738; *California v. Cent. Pac. R. R.* (1888) 127 U. S. 1, 8 Sup. Ct. 1073; *Owensboro Bank v. Owensboro, supra* note 32; *Smith v. Kansas City T. & R. Co.* (1921) 255 U. S. 180, 41 Sup. Ct. 243.

The *Osborn* case repeated the situation in the *McCulloch* case (*supra* note 2) in aggravated form, but a new ground of attack apparently was that the bank was a private corporation whose principal object was individual trade and profit. The

Enterprises conducted by the government or its subdivisions directly are free from any interference by such taxation, even though the tax rests upon the private citizen benefiting by the activity and not upon the public body.[35] When the one government exercises its own right of taxation, that right is free from any control by the other sovereign.[36] The rule has even been extended to relieve from taxation bonds tendered by an individual to secure a license from a municipality.[37]

So much for the cases in which a tax has been forbidden. How do the cases in which such taxation was permitted fit in the rule as we have stated it? The cases in which acts of taxation have been upheld fall into four classes.

The first class are those in which there was express permission by one sovereign to the other to levy the tax in question. Obviously, if a sovereign may prohibit all taxation, it may grant the right to another power to whatever extent it desires, and that has been done, particularly with respect to national banks, in regard to real property and to private interest in the governmental agency.[38]

As to the second class, those in which the government levying the

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Chief Justice held that it was not created for these ends but to serve a legitimate public need and purpose, that the transaction of private business was the source of compensation for its services to the government, and that "if the trade of the bank be essential to its character as a machine for the fiscal operations of the government, that trade must be as exempt from state control as an actual conveyance of the public money." (At p. 867.)

The recent *Kansas City Title Company* case illustrates the limit to which the rule may be carried. Taxation of the Federal Land Banks and all their instrumentalities, including the mortgages and bonds to be issued, was expressly forbidden except on the realty which they owned and the property right in their stock. The act was attacked both on the ground that congress had no power to create the banks and that the tax exemption was invalid. The court concluded that *since the banks were to be depositaries of public moneys and purchasers of bonds,* that clearly brought them within the creative power of Congress, even though they might have many other purposes not within such power if considered separately; that there was no power to tax the property or franchises of such banks except to the extent permitted by Congress; that "if the state can tax these bonds, they may destroy the means provided for obtaining the necessary funds for the future operation of the banks"; that the court had nothing to do with the policy of the legislation; and accordingly that the legislation in all respects was valid.

[35] *United States v. King County supra* note 11.

[36] *Lane County v. Oregon* (1868, U. S.) 7 Wall. 71, where the United States made paper currency legal tender while the State of Oregon demanded payment of state taxes in gold or silver, it was decided that the state law controlled since Congress had no right whatever to interfere with such an essential sovereign attribute of the state as the right to collect its taxes as it would.

[37] *Ambrosini v. United States* (1902) 187 U. S. 1, 23 Sup. Ct. 1.

[38] *Bank Tax Cases* (1865, U. S.) 3 Wall. 573; *First National Bank v. Kentucky* (1869, U. S.) 9 Wall. 353; *Lionberger v. Rowse* (1869, U. S.) 9 Wall. 468; *Mercantile Bank v. New York* (1887) 121 U. S. 138, 7 Sup. Ct. 826; *Owensboro National Bank v. Owensboro, supra* note 32; *Smith v. Kansas City T. & T. Co.* (1921) 255 U. S. 180, 41 Sup. Ct. 243.

tax had plenary power over the subject matter, irrespective of taxation, it is very obvious that where the power of Congress to legislate upon a subject is paramount and Congress could, by direct action, prohibit the states from acting in that field, the fact that it accomplished the same result by indirection, presents no bar. In such a case, no burden of taxation rests upon the state in the performance of its functions, for the activity in which it was engaged was not its own function but that of the United States.[39]

In the third class are those cases in which the tax did not rest upon a public agent at all although the taxpayer asserted that status. Although there are few of these cases they are of importance because they indicate a sound line of demarcation between the taxation and the exemption of agencies engaged in the accomplishment of public purposes. In two of the cases, the right of the states to levy taxes upon the real property of transcontinental railroads either chartered or aided by the federal government was upheld, and the language of the court may suggest that the railroads were federal agencies of the same status as the national banks, but that nevertheless, they were taxable *of right* to the extent that the tax laid no oppressive burden upon the execution of the sovereign powers.[40] So far as those cases imply a distinction between the taxation of the operations of public agencies and of the property which they employ, they are clearly overruled by the recent decisions holding exempt from taxation the property of the Spruce Production Corporation and the Emergency Fleet Corporation to which we have already called attention.[41] The decisions are, however, obviously sound because the objects of the railroads

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[39] *Veazie Bank v. Fenno* (1869, U. S.) 8 Wall. 533. The United States had levied a tax upon state bank notes used for circulation. The Supreme Court of the United States held the act valid. The constitutional power to provide for currency is vested in Congress and Congress was entitled to restrain or regulate the circulation of other currency in any way it desired.

[40] *Thomson v. Pacific R. R.* (1869, U. S.) 9 Wall. 579; *Railroad Co. v. Peniston* (1873, U. S.) 18 Wall. 5. In the *Thomson* case the court reiterated the ordinary rule that Congress might in its discretion exempt the agencies employed in the furtherance of any of its powers from any state taxation, "which would really prevent or impede the performance of them," but said, "We think there is a clear distinction between the means employed by the government and the property of agents employed by the government. Taxation of the agency is taxation of the means; taxation of the property of the agent is not always, or generally, taxation of the means." In fact, the decision of the court seems to rest upon a presumed *intent* of Congress to permit taxation. For, says the court, "it will be safe to conclude, in general, in reference to persons and state corporations employed in government service, *that when Congress has not interposed to protect their property from state taxation,* such taxation is not obnoxious to that objection."

The *Peniston* case went further because there four of the eight judges held that the states had a *right* to tax such railroad property. They place their decision upon the remote effect of such a tax, and upon the deplorable result if such were not the rule, due to the withdrawal of so much property from federal taxation.

[41] *Supra* note 28.

were not in fact primarily to fulfill the sovereign purposes of the United States, but were to earn profit for the individual stockholders. The gain to the Federal government was purely incidental and the railroads were not in any true sense agencies of the Federal government.[42]

In the last class is a case standing by itself, *South Carolina v. United States*.[43] It was there held in substance that where a state invaded a field (1) *therefore wholly reserved to private enterprise* (2) *upon which the federal government consistently had levied a tax, which tax was continuing,* and (3) *where the element of profit to the state was a substantial one, the tax was valid.* The state could not claim immunity, because it was not engaged in performing a function which, at the time the federal constitution was adopted, would have been attributable to its sovereign nature. The court is very materially influenced by the fact that the operation was a source of substantial profit to the state and might well tempt South Carolina and its sister states to enter the liquor and many other fields of private business under the guise of the exercise of police power, with the resultant loss to the federal government of material sources of revenue. Nevertheless, as its test the court takes the distinction between activities historically "of a strictly governmental character" as contrasted with those "of an ordinary private business." The test which the Bureau of Internal Revenue contends was laid down by this case, that of the distinction between governmental and proprietary activities in the tort field, was in fact cited as an analogy only, and the court always returns to the idea that "whenever a

[42] In support of this principle, see *Veazie Bank v. Fenno, supra* note 39, at pp. 547-8: "It cannot be admitted that franchises granted by a state are necessarily exempt from taxation for franchises are property, often very valuable and productive property, *and when not conferred for the purpose of giving effect to some reserved power of a state,* seem to be as properly objects of taxation as any other property." Compare *Weir v. Jaybird Mining Co.* (1924, Okla.) 232 Pac. 425. The correct principle to be applied to such cases is indicated in the decision on the federal corporation tax, *Flint v. Stone Tracy Co.,* (1910) 220 U. S. 107, 31 Sup. Ct. 342. To the objection, based largely on the national bank and the railroad cases, that the act taxed "franchises which are the creation of the state in its sovereign right and authority" the court answered that while the original incorporation was an exercise of the state's power, the purpose of the incorporation and the exercise of the charter powers had no public aspect at all. It was these which were taxed and not the act of incorporation. The bank cases were distinguished because there the primary purpose of the corporation was said to be the effectuation of sovereign federal powers rather than the creation of a private business entity. That the principle of the *Flint* case is consistent with the general rule, and does not support a distinction between state and federal corporations as such, is supported by the declarations of the courts that if there could be such a thing as a Federal corporation for purely private purposes, that corporation would be taxable by the states. *Osborn v. The Bank, supra* note 34, at pp. 859-862. The explanation is, of course, that the federal government possesses no general power to create corporations and can charter them only to further the exercise of the sovereign powers which it possesses.

[43] *Supra* note 9.

state engages in a business which is of a private nature that business is not withdrawn from the taxing power of the nation."[44]

It is beyond dispute that this decision is entirely out of line with all the other cases which we have examined and the dissent of three justices, led by Mr. Justice White, is a strong one and far more consistent not only with the precedents theretofore established but with the many cases since decided and which we have reviewed above, and with reason.[45] The best that can be said of this case is that it stands on its

[44] For many years prior to the decision of this case the United States had collected a license tax from dealers in intoxicating liquors. The State of South Carolina by statute took over the sale of liquor, establishing dispensaries which were managed by its own agents and prohibiting sale by all others. Protest was made against the collection of the federal tax upon these agents of the state, which, in the exercise of its sovereign power, conducted the liquor business. "The exemption of the state's property and its function from Federal taxation is implied from the dual character of our Federal system and the necessity of preserving the state in all its efficiency. In order to determine to what extent that implication will go *we must turn to the condition of things at the time the Constitution was framed. What, in the light of that condition, did the framers at the convention intend should be exempt?* Certain is it that modern notions as to the extent to which the functions of a state may be carried had then no hold." Then after a review of some of the cases which we have examined, the court says: "These decisions, while not controlling the question before us, indicate that the thought has been that the exemption of state agencies and instrumentalities from national taxation is limited to those which are of a strictly governmental character, *and does not extend to those which are used by the state in the carrying on of an ordinary private business.*"

[45] Justice White said that while "the ruling made is, from an economic point of view, a just one," the principle "strips the states of their lawful authority" and "also endows the states with a like power to divest the government of the United States of its lawful attributes." Reviewing the authorities, he decided that the majority opinion was squarely contrary to the existing decisions on the principle "that the state under its police authority" had the right absolutely to prohibit the sale of liquor or to subject it to such regulations as it deemed proper, and accordingly that the tax was one on the exercise of a sovereign power. He answered the other reasons advanced by the majority. First, as to the plea that the state derived revenue from the activity, he said of the argument, "if pushed to its logical conclusion, the far-reaching result of the proposition that wherever revenue is derived from an act by one government, therefore the other may burden the agent or instrumentality of the other," is that the states could tax national banks, post office, the mails, the government transport and many other federal activities. Nor did he consider the plea of necessity a sound one. While, if carried to a fantastic extreme as in the illustrations of the majority, the states *might* destroy the constitutional system under the exemption claimed, he pointed out that the alternative was to destroy the constitutional system by the opposite course, permitting each sovereignty to control the other through taxation, and that it was more important to avoid the immediate danger than the future and improbable one. On the argument that the problem was analogous to that of liability of public agencies for torts in their proprietary capacity, he urged that the analogy was unsound, but showed that in any case that distinction had not been approved by the United States Supreme Court, citing *Barnes v. District of Columbia* (1875) 91 U. S. 540; *Workman v. New York* (1900) 179 U. S. 552, 21 Sup. Ct. 212. Lastly, he refused to accept the doctrine that a constitutional

own peculiar facts and certainly it has never been followed in the sense that a similar limitation of the rule has been applied in the tax field. On the contrary it would seem that a later decision on the South Carolina legislation implies a retrogression even in the particular circumstances.[46]

With a fairly complete review not only of the cases upholding freedom of public activities from taxation but also of those in which taxation was permitted, what can be said of the rule as it is now established and of the probable or possible future limitations? The rule may be summarized substantially as follows:

1. It has been consistently held from the first decisions that the federal and state government respectively are mutually, equally and wholly exempt from taxation by the other which rests any burden whatsoever on the exercise of their respective sovereign functions. This protection covers their municipal and political subdivisions and even in some instances agencies privately owned and operated, and extends to property, real and personal, tangible or intangible, owned or used in their own hands or created by them in furtherance of their purposes (bonds and similar intangible items), to their employees, to their operations and to every aspect of their activities.

2. Permission is frequently given to the co-sovereignty, however, for limited taxation, which is usually permitted to rest only on the physical property of a private agent and upon the private property interests involved; and even in those cases it is limited to equality with the taxation imposed upon similar bodies or property interests of the taxing jurisdiction.

3. Where one sovereign has a paramount power in some field it may be exercised through taxation as well as by any other means.

4. A private agency existing by virtue of the exercise of the sovereign power but not primarily created for or engaged in the performance of public duties may be taxed, because such taxation is not of the sovereign or its functions or instrumentalities at all. There seems, however, always to be a question of fact in such case whether the creation and functions of the agency are primarily public or not.

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limitation could not be applied unless it appeared that the framers of the constitution could have envisaged the particular situation when that instrument was adopted. If this argument were sound it would prevent, of course, any regulation of modern instrumentalities not known a century and a half ago.

[46] *Murray v. Wilson Distilling Co.* (1909) 213 U. S. 151, 29 Sup. Ct. 458. South Carolina repealed its act for the sale of liquor and appointed a commission to wind up the business. In an action against the commission, the defense was interposed that the state was the real party in interest and this defense was upheld. Since the *Emergency Fleet Corporation* decision (*supra* note 28) seems to establish that the tax exemption exists even where freedom from suit does not, the limitation of this case on the *South Carolina* decision is evident. The *South Carolina* case was explained by saying that it dealt with the power of a state to destroy the *pre-existing* right of taxation by the United States, whereas this decision only enforced an exemption from suit existing under the federal constitution *when the dispensary act was passed.* At p. 173, 29 Sup. Ct. 465.

5. One case standing by itself and with a strong dissent has upheld taxation by the federal government of a state activity which clearly was the exercise of a sovereign power and duty, but in a field theretofore reserved strictly to private enterprise, and where there appeared to be a substantial element of profit as a motive for the activity. That case was later explained by saying that the federal taxation antedated the exercise of the state's power of regulation.

It seems, therefore, that the rule may be summarized by saying that every exercise of the sovereign power for its proper and normal ends in whatever form and through whatever agency, is wholly free from any burden of taxation levied by the co-sovereignty upon any instrumentality or form of the activity.

But in seeking a guide for the future application of the rule, there is left at issue the question—what are such proper and normal ends? We can say definitely, of course, that those activities which have been specifically approved in the cases already decided are such. Is there, however, no broader and more general guide? We think there is.

Identically the same problem has been presented in determining whether the exercise or the grant of the sovereign powers of eminent domain and taxation in a given case were proper. These powers are attributes of the sovereign only, and their exercise by the sovereign itself or their grant to others is justified only if the purpose to be accomplished thereby is a public one. We suppose that few acts of public authority are more carefully and consistently scrutinized by the courts than those which fall within these fields. The money of the public generally must not be taken to be applied for the benefit of private citizens; the property of one individual cannot, without his consent, be devoted to the private use of another. Private enterprise to accomplish private ends must find its own funds and acquire its own property and may not tap the sovereign power for these results.

To be within the field in which these powers may legally be exercised, the end to be attained must be one *normally the concern of the sovereign; that is to say, one affecting the public as a body of citizens and hence properly to be attained through the exercise of the sovereign powers. These are never permitted to be used to further private ends.*[47]

[47] *Olcott v. Supervisors* (1872, U. S.) 16 Wall. 678; *C. B. & Q. R. R. v. Otoe Co.* (1872, U. S.) 16 Wall. 667; *Mt. Vernon W. C. D. Co. v. Alabama I. P. Co.* (1915) 240 U. S. 30, 36 Sup. Ct. 234; *Rindge v. Los Angeles Co.* (1922) 262 U. S. 700, 43 Sup. Ct. 689; *Milheim v. Moffat Tunnel Imp. Dist.* (1922) 262 U. S. 710, 43 Sup. Ct. 694. As the rule is succinctly stated in the *Olcott* case, "That the state might itself make such an improvement (construct a railroad) and impose taxes to defray the cost, or exercise its right of eminent domain, therefore, was beyond question. Yet, confessedly it could neither take property nor tax for such a purpose *unless the use for which the property was taken or the tax collected was a public one.*" *Olcott v. Supervisors, supra,* at p. 691.

Private advantage may, of course, result from the act of the sovereign and may indeed be the primary object of the individual or body to whom the grant is made. But from the public point of view this private advantage and object must always

In other words, the test is identical with that which we have deduced for determining when the one sovereign is free from taxation by the other. This being so, the decisions on the use of eminent domain and the tax power, having covered a wider range of subjects and problems, will be helpful in indicating what activities undertaken by the authority of the one sovereign will be held free from taxation by the other.

The construction of highways—using that term in its ordinary sense of a route to accommodate public vehicular and pedestrian traffic—is one of these purposes so imprinted with the sovereign—or, as it is called in this field, the public nature, as to justify the exercise of the powers of eminent domain and taxation.[47a] So is the construction of bridges and ferries used to convey these highways across water[48] and the improvements of channels for the purpose of navigation—highways upon water instead of on land.[49] So is the construction of railroads—those instrumentalities of communication and transportation which are "highways" in the broad legal sense even though they are normally privately owned and their operations result in private profit.[50] Nor does the fact that the construction is of a siding limited in its use to one individual always change the purpose to a private one, since the public has an appreciable interest even in such a limited phase of commerce.[51] Of course, street as well as steam railways are within the rule.[52] By a logical and sound extension of the reasoning in these cases, all projects which tend to further commercial growth are within the rule, since they foster the prosperity and well being of the public generally, though the most immediate and direct result may be a private profit.[53]

But the public welfare is not bound up with the interchange of commodities alone. That is only a narrow phase. The production

be subordinate and purely incidental to the public one, and this being so, its existence does not in the slightest degree affect the right to employ the sovereign powers.

[47a] *C. B. & Q. R. R. Co. v. Otoe Co.* and *Rindge v. Los Angeles Co. supra* note 47.

[48] *Luxton v. No. River Bridge Co.* (1894) 153 U. S. 525, 14 Sup. Ct. 891; *United States v. King County, supra* note 11.

[49] *Huse v. Glover* (1896) 119 U. S. 543, 7 Sup. Ct. 313; *U. S. v. Chandler-Dunbar U. P. Co.* (1913) 229 U. S. 53, 33 Sup. Ct. 667; *Re Rouge River* (1920, E. D. Mich.) 266 Fed. 105, 113, and cases cited.

[50] *C. B. & Q. R. R. v. Otoe Co. supra* note 47; *Olcott v. Supervisors, supra* note 47; *Pine Grove v. Talcott* (1873, U. S.) 19 Wall. 666; *Cherokee Nation v. So. Kan. River Co.* (1889) 135 U. S. 641, 10 Sup. Ct. 965; *Wisconsin Co. v. Jacobson* (1900) 179 U. S. 287, 21 Sup. Ct. 115.

[51] *Hairston v. D. & W. Ry.* (1908) 208 U. S. 598, 28 Sup. Ct. 331; *Union Lime Co. v. Chic. N. W. Ry.* (1914) 233 U. S. 211, 221, 34 Sup. Ct. 522.

[52] *Hendersonville L. & P. Co. v. Blue Ridge etc. Ry.* (1916) 243 U. S. 563, 37 Sup. Ct. 440.

[53] *Mobile v. Kimball* (1880) 102 U. S. 691; *Huse v. Glover, supra* note 49; *Cook v. Port of Portland* (1891) 20 Or. 580, 27 Pac. 263; all holding that harbor improvements were undertaken as proper public functions.

of commodities is of equal importance, and so, too, are the facilities for enjoying prosperity when it is attained. Accordingly, it is no surprise to find that the sovereign power may be extended to aid in drainage[54] and irrigation[55] projects and the creation of a water system for general public use,[56] all of which bear the obvious impress of public interest. But the rule goes even further and permits the extension of such aid to corporations formed to manufacture and distribute electric power to the public, not merely for light and general domestic use but for industrial use as well.[57] So too, the establishment of public parks or of forest reservations or of scenic drives and similar works which furnish healthy recreation to the public, justify the use of sovereign power.[58]

There are many other activities to further which the use of these powers of eminent domain and of taxation are justified but which it is unnecessary to review in detail here.[59]

The variety and nature of the subjects in which the exercise of these powers have been permitted suggest the real scope and basis of the rule. The state may properly bring its sovereign powers into play to accomplish whatever conduces to the health, the prosperity, the morals or the general welfare of the public. The exercise of these powers is by no means limited to matters of necessity; but those of convenience and even pleasure and recreation are within them. Nor need the result be a benefit to every individual in the body politic. It is permissible and frequently necessary to parcel out advantages piecemeal; and it is sufficient if there is a gain to an appreciable section of the public, always as citizens, however, and not as individuals.

In short, the state is the guardian of the public welfare, and whatever furthers that welfare is properly and normally its concern, and for the accomplishment of those objects it may exert its sovereign powers.

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[54] *Orr v. Allen* (1917, S. D. Ohio) 245 Fed. 486 (containing an excellent and exhaustive review of the principles and authorities), affd. (1918) 248 U. S. 35, 39 Sup. Ct. 23; *Matter of Tuthill* (1900) 163 N. Y. 133, 57 N. E. 303.

[55] *Fallbrook Irrigation Dist. v. Bradley* (1896) 164 U. S. 112, 17 Sup. Ct. 56; *East Oregon Land Co. v. Willow River Co.* (1913, C. C. A. 9th) 204 Fed. 516.

[56] *Pocantico Water Works Co. v. Bird* (1891) 130 N. Y. 249, 258, 29 N. E. 246, 248.

[57] *Mt. Vernon W. C. D. Co. v. Alabama I. P. Co. supra* note 47; *Washington W. P. Co. v. Waters* (1910, N. D. Idaho) 186 Fed. 572; and *cf. U. S. v. Chandler-Dunbar Co.* and the *Rouge River* cases, *supra* note 49, and the *Hendersonville* case, *supra* note 52.

[58] *Shoemaker v. United States* (1893) 147 U. S. 282, 13 Sup. Ct. 361; *People v. Adirondacks Ry.* (1899) 160 N. Y. 225, 248, 54 N. E. 689, 696, affd. (1900) 176 U. S. 335, 20 Sup. Ct. 460; *Rindge v. Los Angeles Co. supra* note 47.

[59] See notes of cases appearing in 33 L. Ed. 740, 40 L. Ed. 188. In addition to the uses named above, cases are there cited supporting the employment of the sovereign power for canal, telephone, levee and cemetery purposes and many additional illustrations of the use of the power in the instances already enumerated are given.

But this use of the sovereign power to accomplish a sovereign function is the very test by which the courts have determined the right of one government to freedom from taxation by the other. The reason for the rules seems identical. Development in the one field may be expected to follow the growth which already has taken place in the other. So far as we can predict from analogy, therefore, the two governments can each expect their ventures in transportation, terminal and harbor service, improvement of the land, manufacture of gas and electricity, the furnishing of water, the maintenance of facilities for recreation and health, and every other activity which benefits the public as such, to be free from taxation by the other.

THE FUNDAMENTAL QUESTION

Up to this point we have discussed the question of tax exemption solely on the basis of existing decisions and a logical development therefrom. Precedents have been known to be faulty, however, and growth in the law illogical. Argument from analogy is always weak. Fundamentally, we believe this rule of tax exemption and the reasons which have been given for it to be sound; but with the intricacies of modern constitutional law we are not so sure that the basis of the rule, its implications and its relations to other problems are thoroughly understood. At an earlier point we have said that there seems to have been no re-examination of the rule in the light of modern conditions, and that in default of such re-examination it bade fair to go astray. We think that such a re-examination is not arduous, that even with the confusion due to the rapid growth of constitutional law in the last half century the underlying principles are so well established that they need only to be stated to be accepted, and that with such recognition their application will not be difficult.

It must be evident that this question of state and federal tax exemption is not primarily a revenue problem at all but fundamentally an economic and political problem. It is twofold in nature. It raises first the question whether and to what extent the federal government and the states may extend their activities into the field of business operation, either as regulatory measures or for any other purpose. Secondly, it involves the issue of state and federal relationship, the conflict of the conceded powers of one with the conceded powers of the other, the right of either by indirection to control the discretion of the other when it could not accomplish that result directly. Fortunately the answers to these questions seem well established.

The first principle which we may regard as settled is that each sovereign not only has the right, but is charged affirmatively with the duty, of furthering the welfare of the public by proper action, regulatory or otherwise, in those fields affected with a public interest.[59a] And those fields broaden with the growth of our economic life. We hold no

[59a] See *supra* notes 47-59.

brief for a socialistic trend of government, but it can hardly be argued seriously that in this generation any government can confine its activities within the limits which were proper 135 years ago. The whole tendency of judicial, and particularly of federal, decision has been to broaden the right of regulation; and this growth has been based on a very real necessity as the added complexity of business has added to the danger of abuse. Not a decade passes without the extension of the doctrine of the police power, without a new and important limitation upon the due process clause, upholding the rights of the state or the nation to interfere with business as a part of their regulatory power and free from the charge of trespass upon property rights in the constitutional sense.

The second principle is that whether a given field is charged with a public interest is a question of fact in every given case, to be determined largely by local conditions.[60] The creation of an expensive tunnel for the use of a private railroad could not often be a proper public task, and yet circumstances may justify it.[61]

The third principle is that once the public interest is established, how the sovereign shall act to protect or further it is a matter wholly in its own discretion. It may accomplish the result by regulation—by statute administered in the normal way, or by a special supervisory commission— or it may find and determine that the function will not be properly performed without its own intervention. What form this intervention shall take it alone may decide—through the advance of funds, the extension of the aid of its sovereign power, actual operation by itself. And whatever mode it chooses, it may select the agency by which it will act—its own officers, municipalities, special commissions of a public nature, private corporations or individuals.[61a]

The fourth principle is that each sovereign is wholly free within its sphere from any dominion by the other, that neither can accomplish by indirection what it could not do directly. Our federal system rests upon this principle and we know of no real deviation from it. It is the basis of all the decisions that the police power of the states does not justify state legislation directed at interstate commerce, and also of this same long line of decisions which we have reviewed, holding the federal tax power insufficient to affect the reserved powers of the states.[61b]

Certainly all these principles should be taken into consideration and no tax upheld which conflicts with any one of them. Giving due consideration to the principles there still remains a broad range of taxation,

[60] *Hairston v. Danville & W. Ry. supra* note 51; *Rindge v. Los Angeles Co. supra* note 47; *Milheim v. Moffat Tunnel Imp. Dist. supra* note 47; *Orr v. Allen, supra* note 54.

[61] *Milheim v. Moffat Tunnel Imp. Dist. supra* note 47.

[61a] *United States v. B. & O. R. R. Co. supra* note 22; see also authorities cited *supra* notes 14-37.

[61b] *Supra* notes 14-37.

open to each sovereign, even in the public field. To begin with, a vital and fundamental distinction is possible in *the nature of the agent selected by the sovereign to perform its sovereign function.* The agent may be public or private in nature. When it acts through a public agent, that agent—officer, commission or political subdivision—is the sovereign itself so far as its relations to the co-sovereign are concerned, and it is entitled to every exemption that attaches to the sovereign itself.[61c]

Yet taxation of these private agencies could not be wholly unrestrained. It must not rest upon them *as a class,* i. e., as private agencies performing public duties. When the sovereign function is peformed through an individual or a private corporation—national or state banks, railroads, gas, water and electric companies, corporations operating toll highways or bridges and all others in the field of public utilities—the exemption ought to apply *so far as the sovereign function itself is involved.* The federal government has no right to prevent or impede the furnishing of gas to a city by discriminatory taxation against a private corporation. Such taxation would, we think, clearly rest a burden on the sovereign function of state which authorized the act and that is precisely the principle of the national bank cases. The taxes attempted in the *McCulloch* and the *Osborn* cases on the Bank of the United States were intended primarily, and indeed openly, not as revenue measures but to prevent its functioning as the federal agent. A tax which in fact rests on the public function, whether because it is discriminatory or because it is generally so oppressive as to prevent proper performance of the public service, ought to be held illegal and there should be no unusual difficulty in deciding when the tax falls in the forbidden class, for the courts are constantly passing on similar questions.[62]

But when the tax levied on the corporation is common to all corporations and businesses, whether it is on the franchise, the operations, the property, the income or the salaries of the employees, it then seems to rest no particular burden on the sovereign function as such. There has never been any doubt as to this in relation to private corporations created by the states, and we think that the length to which the courts have gone in exempting national banks from taxation has an historical explanation in the hostility of the states in the early days to this form of federal enterprise, leading to an extreme in protective measures. Certainly as to all these private corporations performing public ser-

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[61c] See cases cited *supra* notes 14-37.

[62] For example, both the problem and the principle seem to be the very ones presented by and applied in the cases where it is claimed that a state tax rests a burden on interstate commerce and the court prohibits or permits the particular tax according as it does or does not in fact constitute such a burden. See Thomas Reed Powell, *State Income Taxes and the Commerce Clause* (1922) 31 YALE LAW JOURNAL, 799.

vices, state and federal alike, there seems no reason why in their private aspect they should not be taxable as others are.

The second distinction which seems feasible and sound lies *in the nature of the act which the sovereign undertakes.* But here it is necessary to walk warily, for in form this is precisely the principle which the critics of the rule of exemption advance. Their error is in their application of the rule, and before suggesting what appears to be the correct one, we ought to dispose of those which are unsound.

All the recent attacks upon the rule rely upon the *South Carolina* case.[63] As we shall presently show, that decision seems not to stand for the proposition for which it is usually cited, but its true rule is equally dangerous. The court was concerned over the tendency toward public ownership of public utilities, and the prospect of public embarkation in the sale or the importation of any and all commodities. It argued that such action would be improper because it would not have been permissible at the time the federal constitution was adopted and hence could not be within the purview of that instrument at any subsequent time. Applied literally, the decision would deny the sovereign character to every function not recognized as public in the eighteenth century. Such a decision, giving no recognition to changing economic and social conditions, seems explicable only if the court approached the problem solely as a problem of taxation. Certainly it would not have applied the same rigorous limitation to other aspects of public action, for it approved the earlier decision upholding the police power of South Carolina to control the sale of liquor.[64] Accordingly it must hold that action by the state or nation which would be stamped with the sovereign nature in every other aspect is of a different nature for purposes of taxation. The decision seems illogical, inconsistent with later decisions on the same question, and perhaps expressly limited by *Murray v. Wilson Distilling Company.*[65] If the sovereign is ever free from taxation by the co-sovereign, surely it must be free as to all sovereign functions, and necessarily, what is a sovereign function in other aspects of the problem must retain its nature as to taxation, else the protection of the rule would be lost.

More recent attempts to limit the application of the rule[66] rest in form upon the *South Carolina* decision; but the test which they attempt to apply is that between the governmental and proprietary capacities of municipalities in the tort field, a principle for which the *South*

[63] *Supra* note 9.

[64] *Ibid.* 454, 26 Sup. Ct. 113.

[65] *Supra* note 46.

[66] Compare the Treasury Department's opinion, *supra* note 11. See also address by W. S. Chamberlain before the Section of Public Utility Law of the American Bar Association, July 7th, 1924; argument by Prof. Edwin S. Corwin of Princeton reprinted in the Congressional Record for February 9th, 1924, pages 2233-2238; and the unfavorable comment on the *Frey* decision, *supra* note 1, in (1925) 38 HARV. L. REV. 793 and (1925) 25 COL. L. REV. 653.

Carolina case by no means stands. The court there called attention to the tort rule only as an analogy, and the distinction which it applied is the much broader one just noticed.

Aside from all this, the governmental-proprietary distinction is wholly unsound. Its essential weakness even in the tort field to which it has heretofore been reserved, has been so ably and exhaustively treated by Professor Borchard in his article[67] that we need not discuss it in detail. The doctrine as it has developed would be even more incongruous in determining the proper sphere of governmental action. Whatever the philosophical difference between the governmental and proprietary capacities of public bodies, the distinction actually drawn is certainly not sound. It makes no recognition of the growing necessity for public control of activities affecting the body of citizens, and its application has been warped by the desire to accord justice to individuals suffering from public torts of whatever nature. If the question were presented *de novo,* it would be hard to establish a distinction between the limited safeguarding of public health by the maintenance of hospitals or a Health Department, which in this field are declared to be governmental functions,[68] and other acts certainly as directly connected with and essential to the preservation of health such as the maintenance of sewers and drains,[69] or of public parks,[70] or of a healthful supply of water for public use.[71] It is equally difficult to see why the use of water for protection from fire is governmental while the use of the same water through the same conduits under the same control for other purposes is considered private.[72] To illustrate the inconsistency even more strikingly, there is no function more distinctively governmental in every aspect, historical and actual, than the construction and maintenance of highways. Yet in the

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[67] Borchard, *op. cit. supra* note 10. The origin of the distinction between the governmental and proprietary capacities of municipal corporations in the field of tort liability is a wholly illogical one, as Professor Borchard has abundantly shown. Finding its source in the old doctrine of the personal immunity of an absolute sovereign from suit, the principle should never have been transplanted in republican soil. Conflicting with this principle that the sovereign, i. e., the states and their agents and depositaries of power, the municipalities, could not be sued and hence in effect were not liable for their wrongs, was the growing humanitarian tendency of the law to lift the burden of a public wrong from the one individual against whom it was committed and distribute it over the whole body of citizens who, through their selected agent, had committed it. This result was accomplished by inventing a distinction between the governmental acts of municipalities, i. e., those they are said to undertake as representatives of the sovereign power and their proprietary acts, those said to be undertaken by them by virtue of their corporate personification of a given locality.

[68] Borchard, *op. cit. supra* note 10, at p. 246.

[69] *Ibid.* 235.

[70] *Ibid.* 239.

[71] *Ibid.* 252, *et seq.*

[72] *Ibid.* 253-254.

field of tort liability the courts, with unusual unanimity, declare these activities to be proprietary in their nature.[73] The absurdity of extending the rule to a field beyond its present bounds is the more apparent when it is found that the different courts cannot agree upon the character in which a municipality undertakes these functions,[74] and that within its present limits the doctrine has been repudiated by the United States Supreme Court, where the present questions must finally seek their solution.[75] Certainly when the question has been directly presented whether these same actions were proper sovereign ones—i. e. when the exercise of the powers of eminent domain or taxation have been involved—the courts have consistently answered that they were.

Yet there remains an entirely proper distinction based on the nature of the act undertaken—the true distinction between governmental (or public) and private acts as contrasted with the illogical distinction in the tort field. An act is not a sovereign one merely because it is performed by a public body any more than another function loses its public nature when undertaken by a private agency. What stamps a function as sovereign is its relation to the public at large. It must affect a part of the public, *qua* public, and must be reasonably essential to their welfare. The creation and maintenance of a water supply might usually be such, yet if the system were erected for the purpose of distributing the water to the people of another state, clearly the function would not be public. A federal project for the manufacture of aeroplanes is a sovereign one when it is undertaken in the stress of war to fill a vital deficiency, and might well be such in peace times if it were in fact essential to the development of aviation, but if the government entered the field in competition with private interests competent to fill all actual requirements, is it not clear that its action no longer would be stamped with the sovereign nature because no longer supported by a public need?[76]

So what in its inception was a proper public act might in part become a private one by the extreme to which it was developed; for example, by overproduction of a service furnished to the public and the disposition of the excess in a manner stamping the activity in part with a private nature. In this connection, it is to be noted, however, that the United States Supreme Court has held that a surplusage of produc-

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[73] *Ibid.* 229.

[74] In addition to Professor Borchard's article, see (1925) 38 HARV. L. REV. 793, 796, notes 21-25.

[75] *Barnes v. Dist. of Columbia* (1876) 91 U. S. 540; *Workman v. New York* (1900) 179 U. S. 552, 574, 21 Sup. Ct. 212, 220.

[76] The determination whether a given act was public or private as a matter of fact might present a difficult question of fact but it is an issue which is constantly determined by the courts. It is, for example, the very question which confronted the court in all the cases to which we have referred dealing with exercise of the power of eminent domain and of taxation.

tion over and above that required to satisfy the public need, does not in and of itself destroy the public nature of the activity.[77]

The element of gain might be another important factor. Every public activity is entitled to be self supporting and indeed profitable, if it can be made so. The charge for the service is but a special form of taxation. But the profits might be so large, and the apparent public need so small, as to justify a finding that the activity was undertaken not for the public end at all but purely for revenue purposes. Certainly entry by a public body upon an activity purely or primarily for gain has not yet received the stamp of approval as performance of a sovereign function.

This second test would make no distinction between the state and its political subdivisions—another point of difference with the tort rule. Certainly the state has no more the attributes of sovereignty in a truly private enterprise than has any other body, while a municipality is no less entitled to the freedom accorded sovereigns than is the state itself when the function performed is a sovereign one. To hold otherwise would be to deny the state the right to select or create subordinate agencies to perform its duties.

These two grounds of exception to the general rule of tax exemption, founded in the nature of the agent and the nature of the act, are consistent with the fundamental constitutional principles upon which the exception rests. They may not be the only ones. We have said that what is needed is a re-examination of the entire question, and as a beginning we have endeavored to give the rule as it is pictured by the existing precedents, the reasons underlying it, its extension so far as that can be forecast, and such limitations upon it as occur to us, protecting the revenue needs of the two sovereigns without infringement on their freedom. The question is too large a one to be covered exhaustively within the limits of such an article as this. Its importance warrants further extended study.[78]

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[77] *United States v. Chandler-Dunbar W. P. Co. supra* note 49; *Hendersonville L. & P. Co. v. Blue Ridge I. R. Co. supra* note 52; *Re Rouge River, supra* note 49.

[78] A collateral question of equal interest and practical difficulty is that of taxation within the state upon its own political sub-divisions. These commonly have been free from taxation but the wisdom or possibility of continuing this course with recent developments is now the subject of debate. For example, where political subdivisions for a special purpose are created, overlapping in the territorial sense existing municipalities and acquiring valuable property, ought that property to contribute to the municipal income? A thorough study of this problem has been commenced in connection with the Port of New York Authority, the territorial limits of which embrace over 180 municipalities and the program of which may eventually involve the acquisition or creation of property of great value. The study is in the hands of a commission consisting of seven representatives from the states of New York and New Jersey of such standing and ability as to insure confidence in any decision which they may reach. Their report doubtless will be a valuable contribution to the literature of taxation.

It is our hope that an understanding of the rule will remove much of the hostility to it which has been expressed. That hostility seems to be based either upon an attempt to extend the field of revenue for one sovereign or the other, or upon opposition to the principle of municipal ownership and operation of public utilities which the rule undoubtedly tends to foster.

There need be no great concern about limitations of the subjects of taxation. Purposes recognized as public or likely so to be recognized are not of sufficient importance to constitute a real limitation upon the field open to the co-sovereign, and there is no indication that the ingenuity of the tax authorities is approaching its limit. Any concern about this phase of the problem must be based upon possibilities which are so remote as to warrant no real consideration. There is no likelihood that the Supreme Court will approve such a socialistic interference with business as to shut off the excise taxes of the federal government.

Neither does it seem that the question of municipal ownership or control of public utilities is as closely bound up with this question of tax exemption as is generally assumed. Unless one accepts outright the principle that the federal government should dominate the states, this matter of tax exemption has no place in the discussion of that debatable and much debated issue. Municipal ownership is a local issue. Whether it should be undertaken is a question the answer to which may properly vary with local conditions. Even if its wisdom in a given case is highly debatable, who should decide it except the locality immediately involved? The operation is not necessarily removed from taxation by the co-sovereignty, unless it is a proper public purpose, and we think that we have shown that mere municipal operation by itself does not establish this. But even though taxation is prevented in some instances by the presence of the public interest, is not this a low price to pay for the mutual independence of states and nation?

It is not amiss to emphasize the fact that the final answer to this problem is a judicial one. The legislative branch, indeed, may take the initiative, either in determining upon a particular activity, or on attempting to levy tax claimed to be objectionable, but it is the court which will finally decide the propriety of the action. All the principles which we have enunciated are judicial ones. None are expressly included in our constitution. Whether an activity is properly a public one has time and again been declared to be purely a judicial question,[79] and the rule of tax exemption which we have studied had its very inception, not in a clause of the constitution, but in the implications of that doctrine as spelled out by the United States Supreme Court. Any modification of the rule which may seem proper lies wholly

[79] *Fallbrook Irrigation District v. Bradley, supra* note 55; *Hairston v. D. & W. Ry. supra* note 51; *Rindge v. Los Angeles Co. supra* note 47; *Milheim v. Moffat Tunnel Imp. Dist. supra* note 47; *Re Rouge River, supra* note 49.

within the jurisdiction of the court which created the rule, and the only burden resting on its critics is to persuade the court of its error either in its entirety or in particular application.

We cannot escape the conclusion that the issue in this question whether the federal government may tax state activities or the states tax national activities, is the very one upon which the matter was first decided—that with all the increasing complexity of the question, and all the changing aspects of its application, the one issue that really matters is the continued assurance that the states and the federal government shall each remain free in their respective spheres to exercise as they see fit the powers that belong to them, and that there shall be preserved our federal system, the free association of sovereign states, subordinated to a superior will only in the limited degree contemplated by the grants of power in the Federal Constitution. We are still an indissoluble union of indestructible states.