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Tax Exemption of National Banks - McCulloch Revisited

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From April 1, 1966, to June 30, 1966, appellant, a national bank organized under title 12 of the United States Code,[1] paid a total of $575.66 in sales and use taxes to the Commonwealth of Massachusetts. The tax was authorized by a recently enacted Massachusetts statute[2] and was levied pursuant to an emergency regulation promulgated by the State Tax Commission which denied the bank tax exemption.[3] The Massachusetts Supreme Judicial Court rejected the bank's claim for a refund, holding that national banks are neither impliedly nor statutorily exempt from a state sales and use tax.[4] *Held, reversed*: Because of existing congressional legislation[5] governing the taxation of national banks, states may not levy even a nondiscriminatory sales and use tax upon a national bank. *First Agricultural National Bank v. State Tax Commission*, 392 U.S. 339 (1968).

I. The Rule of Federal Tax Immunity

It is a well established rule that neither the United States nor its agencies and instrumentalities may be taxed without congressional consent.[6] This rule originated in *McCulloch v. Maryland*,[7] where the Supreme Court held that a *discriminatory* tax could not be levied upon a federal instrumentality, because such a tax posed a threat to the sovereignty and unity of the federal government.[8] The Court reasoned that since the "power to tax involves the power to destroy,"[9] it is proper for the federal government to regulate state taxation of instrumentalities which it is empowered to create.[10]

This prohibition on state taxation of federal instrumentalities is clearly unassailable.[11] However, it is equally clear that such a prohibition may be imposed upon the states only when it is determined that an institution claiming immunity is indeed a federal instrumentality.[12] This determination has proven difficult to make. In *Department of Employment v. United States*[13] the Supreme Court commented that "there is no simple test for ascertaining whether an institution is so closely related to governmental ac-

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[1] 12 U.S.C. § 21 (1964).
[2] Mass. Stat., ch. 14, §§ 1, 2 (1966).
[3] 229 N.E.2d 245 (Mass. 1967).
[4] *Id.* at 258.
[5] 12 U.S.C. § 548 (1964). *See* note 41 *infra*.
[6] United States v. Allegheny County, 322 U.S. 174, 177 (1943); Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 449 (1827).
[7] 17 U.S. (4 Wheat.) 316, 431 (1819).
[8] *Id.* at 432. It is significant to note that this case involved a discriminatory tax. The possibility of a non-discriminatory tax was not decided. *See also* note 64 *infra*, and accompanying text.
[9] *Id.* at 431.
[10] *Id.* Although under the tenth amendment, powers not delegated to the federal government are reserved to the states, the states cannot restrict the operations of the federal government when it is acting under constitutional laws and executing powers vested in it by the Constitution. *Id.* at 436. This is because the states delegated such powers to the federal government when they adopted the Constitution.
[11] *See* note 6 *supra*.
[12] First Agricultural Nat'l Bank v. State Tax Comm'n, 229 N.E.2d 245 (Mass. 1967); Liberty Nat'l Bank & Trust Co. v. Buscaglia, 21 N.Y.2d 357, 235 N.E.2d 101, 288 N.Y.S.2d 33 (1967).
[13] 385 U.S. 355 (1966).

tivity as to become a tax immune instrumentality."[14] The Court has indicated, however, that an institution must plainly be an "arm of the federal government"[15] or be so "assimilated by the Government as to become one of its constituent parts"[16] in order to gain immunity.

In determining what constitutes a federal instrumentality, the Supreme Court has consistently examined three factors: (1) the charter under which the institution operates, (2) the services which it performs for the federal government, and (3) the interest or control which the federal government has in the institution.[17] However, examination of these three factors has not always proven conclusive. Many non-banking institutions have been denied tax immunity even though they operated under the authority and supervision of the federal government. In *Railroad Co. v. Peniston*[18] a subdivision of the state of Nebraska attempted to tax the property of Union Pacific Railroad Company. The Supreme Court refused to recognize that the property owned by the company was exempt from state taxation, although the company had been chartered by the federal government, was relied upon to transport mail and other public supplies, and two of its directors could be appointed by the United States government. The Court said that many businesses are employed in the national service and that to prohibit state taxation of a privately owned corporation such as Union Pacific would "greatly embarrass the States in the collection of their necessary revenue without any corresponding advantage to the United States."[19] The Court further noted that while the powers and interests of the federal government must be protected, a privately owned institution is not impliedly immune from state taxation simply because part of its business involves the public interest.

In a similar decision,[20] the Supreme Court upheld a state tax upon a company's production and sale of electricity, even though the company was operating with the permission, and under the supervision, of the federal government. The Court reasoned that a tax exemption was unwarranted because the company was privately owned and engaged in the production of an article of trade solely for profit.[21] In other decisions, the Supreme Court has held that there is no implied immunity from state taxation where a private contractor performs a contract with the federal government,[22] a lessee of tax-exempt Indian lands produces petroleum,[23] or where

[14] *Id.* at 358-59.
[15] *Id.* at 359.
[16] United States v. Muskegon, 355 U.S. 484, 486 (1958).
[17] Department of Employment v. United States, 385 U.S. 355, 359 (1966); United States v. Muskegon, 355 U.S. 484, 486 (1958); Federal Land Bank v. Bismark Lumber Co., 314 U.S. 95, 102 (1941); Clallam County v. United States, 263 U.S. 341, 343 (1923).
[18] 85 U.S. (18 Wall.) 5 (1873).
[19] *Id.* at 33.
[20] Broad River Power Co. v. Query, 288 U.S. 178 (1932).
[21] *Id.* at 180, 181.
[22] United States v. Detroit, 355 U.S. 466 (1958); Curry v. United States, 314 U.S. 14 (1941); Alabama v. King & Boozer, 314 U.S. 1 (1941); James v. Dravo Contracting Co., 302 U.S. 134 (1937). These cases overruled Panhandle Oil Co. v. Mississippi, 277 U.S. 218 (1928), which held that a private contractor dealing with the federal government was immune from state taxation.
[23] Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342 (1949). This case overruled Choctaw, Okla., & Gulf R.R. v. Harrison, 235 U.S. 292 (1914), which granted immunity to a company dealing with Indian lands.

a private corporation fulfills a government contract while using a government-owned plant.[24]

II. Federal Banks—Evolution of the National Bank

McCulloch and *Osborn v. Bank of the United States*[25] represent the first significant attempts to tax a federally created bank. At issue in those cases was the second Bank of the United States, predecessor of the national bank. Organized under a charter granted in 1816,[26] this bank was closely related to the federal government. It is significant that (1) the government owned twenty per cent of its capital stock, (2) the President of the United States had the power to appoint five of its twenty-five directors, (3) the treasurer of the United States was required to deposit all federal monies in the bank, (4) the bank was authorized to transmit federal funds and issue paper currency, and (5) the bank acted as the fiscal agent of the United States by handling United States foreign exchange transactions.[27]

In *McCulloch* the Supreme Court held that the bank was a federal instrumentality and that a tax placed upon the paper currency issued by the bank was unconstitutional.[28] However, in dicta the Court observed that a state was able to levy a tax upon the bank's real estate or upon the interests held in the institution by citizens of the state.[29] In *Osborn* the Court held unconstitutional a $50,000 tax placed upon each office of the Bank of the United States within the taxing state. Although the state contended that the tax was levied on the bank as a corporate entity and not as an agency of the public, the Court declined to make such a distinction. A tax upon the bank's operations, said the Court, would impair the utility of the institution to the federal government.[30] In each case the Court noted that the tax was clearly discriminatory because no such tax was imposed upon state banks. As a result, the Court declared that any tax which affected the operations of the bank could no more be allowed than a tax upon the federal government itself.[31]

These cases clearly established that the Bank of the United States was a federal instrumentality, and therefore entitled to immunity from state taxation. During the years that followed, however, the United States faced grave economic problems which demanded legislative innovations in banking.[32] These innovations were largely concerned with the creation and development of the modern national bank. The history of this latter institution serves to illustrate the differences between it and the Bank of the United States.

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[24] United States v. Muskegon, 355 U.S. 484 (1958).
[25] 22 U.S. (9 Wheat.) 738 (1824).
[26] Act of April 10, 1816, ch. 44, 3 Stat. 266.
[27] P. Studenski & H. Kroos, Financial History of the United States 83-84 (1952).
[28] The Court made this determination after establishing that Congress had the power to create such a bank under the "necessary and proper" clause of the Constitution. 17 U.S. (4 Wheat.) 316, 412 (1819). *See also* note 10 *supra*.
[29] 17 U.S. (4 Wheat.) 316, 436 (1819).
[30] 22 U.S. (9 Wheat.) 738, 862 (1824).
[31] *Id.* at 864; McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 432 (1819).
[32] P. Studenski & H. Kroos, *supra* note 27, at 137.

Development of the National Bank. In an effort to stabilize currency during the Civil War years, Congress passed the National Bank Act of 1863.[33] Under this Act, state banks could receive a charter from the United States upon deposit of federal funds with the Treasury Department.[34] However, because of less stringent banking regulations,[35] and the resulting tendency of banks to prefer state charters, Congress amended the National Bank Act in 1864.[36] This amendment imposed a tax upon the operations of state banks. In the following year Congress increased the tax, thereby making it even more desirable to operate under a federal charter.[37] Since *McCulloch* was assumed to exempt national banks from state taxation except on their real estate or upon the interest held in the bank by citizens of the taxing state,[38] banks were naturally encouraged to convert to national banks. This deprived the states of a valuable source of tax revenue.[39] Therefore, in 1868, Congress provided by statute for state taxation of national banks.[40] This statute, which originally merely echoed the dicta of *McCulloch*, has been revised to enlarge the states' power to tax national banks.[41]

Significant banking innovations in this century have also served to distinguish the national bank from the Bank of the United States.[42] In 1913, Congress passed the Federal Reserve Act,[43] which provided for the establishment of federal reserve banks to issue currency and act as federal depositories.[44] Indeed, since 1935, national banks have issued no currency[45] and have become increasingly similar to state banks.[46] These changes have

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[33] Act of Feb. 25, 1863, ch. 58, 12 Stat. 665.

[34] P. STUDENSKI & H. KROOS, *supra* note 27, at 155.

[35] *Id.* at 154.

[36] Act of June 3, 1864, ch. 106, 13 Stat. 99.

[37] Act of Mar. 3, 1865, ch. 78, 13 Stat. 484. *See* P. STUDENSKI & H KROOS, *supra* note 27, at 155. The constitutionality of this tax upon state banks was upheld in Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533 (1869).

[38] 17 U.S. (4 Wheat.) 316, 436 (1819).

[39] P. STUDENSKI & H. KROOS, *supra* note 27, at 155.

[40] Act of Feb. 10, 1868, ch. 7, 15 Stat. 34.

[41] 12 U.S.C. § 548 (1964) provides:

> The legislature of each State may determine and direct subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several States may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income, provided the following conditions are complied with:
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> 1. (a) The imposition by any State of any one to the above four forms of taxation shall be in lieu of the others . . . .

The statute further provides for the taxing of real property of national banking associations, but requires that such a tax, as well as the above four, be non-discriminatory.

[42] *See* P. STUDENSKI & H. KROOS, *supra* note 27, at 259.

[43] Act of Dec. 23, 1913, ch. 6, § 1, 38 Stat. 251.

[44] 12 U.S.C. § 531 (1964). Federal reserve banks must be distinguished from member banks of the Federal Reserve System. There is one Federal Reserve Bank in each of 8 to 12 districts as provided for by Congress in 12 U.S.C. § 222 (1964). Member banks may be either state banks or national banks. Although national banks are required to become members, state banks are also permitted to join. 12 U.S.C. § 321 (1964).

[45] P. STUDENSKI & H. KROOS, *supra* note 27, at 259.

[46] Examples of functions conferred upon national banks by Congress are (a) branch banking, 12 U.S.C. § 36(c) (1964); (b) fiduciary powers, 12 U.S.C. § 92(a) (1964); (c) rate of interest on loans, 12 U.S.C. § 85 (1964); (d) capitalization, 12 U.S.C. § 51 (1964); (e) interest on time and savings deposits, 12 U.S.C. § 371 (1964). *See* First Agricultural Nat'l Bank v. State Tax Comm'n 392 U.S. 339, 357 (1968).

clearly diminished the importance of national banks as fiscal agents of the federal government.[47]

III. First Agricultural National Bank v. State Tax Commission

In *First Agricultural* the Court declined to re-examine the role of the modern national bank in order to decide the constitutional question of whether the bank "is so closely related to governmental activity as to become a tax immune instrumentality."[48] Instead, the Court declared itself bound by the great body of precedent concerned with the immunity of national banks[49] and the legislative history and construction of 12 U.S.C. section 548,[50] the statute governing taxation of national banks.

The Court noted that before the enactment of section 548 the tax status of national banks was greatly debated, and that section 548 is a compromise, permitting the taxation prescribed by *McCulloch* as well as in four additional areas.[51] Dismissing a contrary contention by the Tax Commission, the Court held that section 548 prescribes the *only* means for state taxation of national banks.[52] Indeed, there is strong authority for such a conclusion. In *Bank of California v. Richardson*[53] the Court held that section 548 was intended to "comprehensively control the subject with which it dealt," and "furnish the exclusive rule" for state taxation of national banks.[54] In *Des Moines National Bank v. Fairweather*[55] the Court again held that section 548 was designed to prevent any form of state taxation not specifically enumerated in the statute.[56]

By reference to the legislative history of section 548, the Court precluded the argument that national bank immunity is a result of "legislative oversight." Importance was attached to the fact that in 1923, section 548 was amended[57] to correct a Supreme Court decision which had attempted to broaden the definition of taxable national bank property. The Court also noted that a bill which specifically would have permitted sales and use taxes to be levied upon national banks was defeated by Congress in 1950.[58] Thus, the Court concluded that if a change is to be made in the tax status of national banks, it must come from Congress.[59]

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[47] P. Studenski & H. Kroos, *supra* note 27, at 259.

[48] 392 U.S. at 341. This was the test applied in Department of Employment v. United States, 385 U.S. 355, 358 (1966).

[49] First Nat'l Bank v. Hartford, 273 U.S. 548 (1927); Des Moines Nat'l Bank v. Fairweather, 263 U.S. 103 (1923); Owensboro Nat'l Bank v. Owensboro, 173 U.S. 664 (1899). The Court also relied upon dicta supporting national bank immunity. Department of Employment v. United States, 385 U.S. 355, 360 (1966).

[50] *See* note 41 *supra*.

[51] 392 U.S. at 342-43.

[52] *Id.* at 343.

[53] 248 U.S. 476 (1919).

[54] *Id.* at 483.

[55] 263 U.S. 103 (1923).

[56] *Id.* at 107. *See* Owensboro Nat'l Bank v. Owensboro, 173 U.S. 664, 669 (1899).

[57] Act of Mar. 4, 1923, ch. 267, 42 Stat. 1499.

[58] *See Hearings on S. 2547 Before the Subcomm. on Federal Reserve Matters of the Senate Comm. on Banking and Currency*, 81st Cong., 1st Sess. 9 (1950).

[59] First Agricultural Nat'l Bank v. State Tax Comm'n, 392 U.S. 339, 346 (1968). Having reached this conclusion, the Court turned to another contention raised by the Tax Commission, *viz.*, that the incidence of the tax did not fall upon the bank and that, as a result, the tax was permissible

Three Justices[60] joined in dissenting from the decision, believing that the constitutional question should have been decided. Speaking for the dissenters, Mr. Justice Marshall observed that "the refusal to decide the issue gives further life to a largely outmoded doctrine."[61] The dissent also noted[62] that "virtually all of the later cases in which national banks have been held to be federal instrumentalities" have been based upon *McCulloch, Osborn,* and *Owensboro National Bank v. Owensboro.*[63] Justice Marshall indicated that these cases should be read simply for the principle that the Constitution prohibits a state from taxing discriminatorily a federally established instrumentality.[64]

Citing *Tradesmen's National Bank v. Oklahoma Tax Commission,*[65] the dissent interpreted section 548 as a measure designed only to prevent *discriminatory* taxation, and not as an exhaustive provision of permissible taxes. It was felt that such an interpretation would allow Congress an opportunity to "re-evaluate the situation."[66] Justice Marshall noted that the burden should be placed upon the party seeking to prove, rather than upon the party seeking to disprove, that a tax exempt status exists.[67]

IV. Conclusion

First Agricultural National Bank v. State Tax Commission seems difficult to reconcile with cases involving non-banking institutions. Indeed, while non-banking institutions claiming tax immunity have been subjected to a careful examination of their nature and relation to the federal government,[68] national banks have largely escaped such scrutiny.[69] The Court in *First Agricultural* appeared not to follow its own trend toward restricting the "scope of immunity of private persons seeking to clothe themselves with governmental character."[70] In light of prior decisions,[71] and the legislative history of section 548, the Court's interpretation of the scope of this statute seems to be correct. However, the question of statutory construction should be reached only after it has been accurately determined that national banks are federal instrumentalities.[72] The view of

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even in the absence of congressional authorization. Referring to the language of the statute, the Court concluded that the incidence of the tax did fall upon the bank and thus could not be allowed. In so holding, the Court noted that "we are not bound by the state court's characterization of the tax." *Id.* at 347.

[60] Mr. Justice Marshall, with whom Mr. Justice Harlan and Mr. Justice Stewart joined. Mr. Justice Fortas took no part in the consideration or decision of the case.

[61] 392 U.S. at 349.

[62] *Id.* at 350.

[63] 173 U.S. 664 (1899).

[64] 392 U.S. at 351.

[65] 309 U.S. 560, 567 (1940).

[66] 392 U.S. at 363.

[67] *Id.*

[68] Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342, 352 (1948). *See* cases cited notes 22, 23 *supra.*

[69] Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342, 352 (1948).

[70] *Id.*

[71] *See* text accompanying notes 54, 56 *supra. But see* Michigan Nat'l Bank v. Michigan, 365 U.S. 467 (1960).

[72] Liberty Nat'l Bank & Trust Co. v. Buscaglia, 21 N.Y.2d 357, 235 N.E.2d 101, 288 N.Y.S.2d 33 (1967).

the dissenting opinion and that of cases overruled by the Court's decision[73] leave some doubt as to whether such an accurate determination was made in *First Agricultural.*

Perhaps the Court's decision may be justified by virtue of the fact that national banks do perform some significant services for the federal government.[74] The question, however, is not whether such responsibilities are entrusted to national banks, but whether greater responsibilities are entrusted to them than to other banks. It is the avowed policy of the Court not to pass upon constitutional questions if there is some other ground upon which the case may be decided.[75] The Court may have had this policy in mind in holding section 548 to be controlling. However, if national banks are not federal instrumentalities, Congress is without authority to accord them preferential treatment.[76] While the *McCulloch* decision protected national banks from discrimination, the effect of the *First Agricultural* decision may be to discriminate against state banks.

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[73] *Id.*

[74] National banks are required to become members of the Federal Reserve System, which subjects them to careful federal regulation. *See* 12 U.S.C. § 222 (1964). *But see* notes 44, 46 *supra.*

[75] Siler v. Louisville & N.R.R., 213 U.S. 175, 193 (1909).

[76] United States v. Detroit, 355 U.S. 466 (1958).