The Municipal Bond Tax Exemption & the Original, 1913 Federal Tax Code

One hundred years after America's first tax code was enacted, municipal bonds remain the cornerstone of financing our nation's most critical infrastructure and investments – the roads, bridges, airports, affordable housing, public utilities, and access to universities, healthcare facilities, and much more that Americans depend upon every day. Its roots date to the original federal tax code, and to the founding of the nation.

For most of our history, the US did not have an income tax. An attempt in 1894 to institute a federal income tax to compensate for the loss of tariff duties was ruled unconstitutional by the Supreme Court.

On July 12, 1909, the resolution proposing the Sixteenth Amendment was passed by the Congress and submitted to the state legislatures. The amendment allowed Congress to levy an income tax without apportioning it among the states or basing it on the census.

In 1910, New York Governor Charles Evans Hughes, shortly before becoming a Supreme Court Justice, spoke out against the income tax amendment. Hughes supported the idea of a federal income tax, but the future Supreme Court Justice believed the words "from whatever source derived" in the proposed amendment implied that the federal government would have the power to tax state and municipal bonds. Governor Hughes believed this would excessively centralize governmental power.

To address this question, the first federal tax code was enacted on October 3, 1913 -- eight months after the Sixteenth Amendment was ratified -- including a federal tax exemption for municipal bonds under the doctrine of reciprocal immunity. The doctrine is that state and local governments should not tax the federal government, and the federal government should not tax state and local governments. The tax exemption remains today: **"That in computing net income . . . there shall be excluded the interest upon obligations of a State or any political subdivision thereof."**

The 1913 Tax Code was just 27 pages in length, short and simple. The Code included eleven personal deductions and exclusions in addition to the municipal bond exemption, including:

- Exemption for life insurance death benefits;
- Deductions for trade or business expenses;
- Deductions for interest payments;
- Deductions for federal, state and local taxes;
- Deductions for casualty losses;
- Deduction for losses from bad debts;
- Deduction for depreciation related to property used in a business;
- Deduction for dividend income that had been taxed at the corporate level;
- Deduction for income on which tax had already been withheld;
- Exclusion for the compensation of the President, Supreme Court and other federal judges, and compensation of all officers and employees of States or political subdivisions;
- Personal exemption.

The first legal service publication of all relevant rules, regulations, opinions and judicial decisions related to the 1913 Code was 400 pages. Today, that volume has grown to 73,954 pages! See graphic at www.cch.com/TaxLawPileUp.pdf. For more information, visit www.munibondsforamerica.org.