State Taxation of Puerto Rican Obligations: An Interest(ing) Question

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STATE TAXATION OF PUERTO RICAN OBLIGATIONS:
AN INTEREST(ING) QUESTION

KENDA K. TOMES*

I. INTRODUCTION

On March 2, 1917, the 64th Congress passed a legislative package creating a civil government for the territory of Puerto Rico. As part of the legislation, Congress included a provision exempting all bonds issued by the Government of Puerto Rico from state and federal taxation. This provision, codified in title 48 of the United States Code, section 745, provides:

All bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia.

Unlike similar federal exemptions for bonds issued by other territories and by the United States, the language of the Puerto Rican statute does not expressly extend to the interest income derived from these exempt obligations. On its face, the language of section 745 exempts the principal of Puerto Rican obligations from such taxation as a property or other intangibles tax, but sets forth no such provision for the interest.

* Juris Doctor - 1992, Chicago-Kent College of Law, and Certified Public Account in Illinois since 1986. I would like to thank Professor Stephen Sepinuck of Gonzaga University School of Law and Professor Jonathan P. Tomes of Chicago-Kent College of Law for their assistance and support. In addition, I would like to thank the 1991-92 Chicago-Kent Law Review editorial board and staff, especially Mary Cameli, the Editor-in-Chief, and Sheryl Cohen, the Managing Editor, as well as Mark Johnson, Editor-in-Chief for the 1992-93 academic year. Special thanks also go to Paul Tomes.

2. Id.
5. A similar provision, 31 U.S.C. § 3124(a), exempts obligations of the United States Government from taxation by the federal government, a state, or a political subdivision of a state. With certain exceptions, the § 3124(a) exemption "applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax." 31 U.S.C. § 3124(a) (1982) (formerly 31 U.S.C. § 742).
As a result, state taxing authorities disagree concerning their ability to tax the interest derived from Puerto Rican obligations. For example, in 1989, Iowa announced that it was considering taxing the interest earned by its taxpayers on Puerto Rican obligations. In addition, other state and territorial taxing authorities and legislatures have enacted laws and regulations which require the taxation of the interest derived from Puerto Rican obligations.

While not all states agree with the actions taken by states like

Iowa,\textsuperscript{11} Iowa's actions are not wholly unjustifiable. First, the federal statute exempting Puerto Rican obligations from taxation is silent as to the tax treatment of the income derived from such obligations. Next, section 745 dates back to 1917, and in draft legislation back to 1916,

\begin{itemize}
  \item 43 ARIZ. REV. STAT. ANN. § 1021(4) (1991), Individuals and corporations must add to their Arizona gross income "the amount of interest income received on obligations of any state, territory or possession located outside the state of Arizona. However, individuals or corporations may deduct the interest derived from the obligations of the United States to arrive at Arizona adjusted gross income. \textit{Id.} § 1022(6). Commercial Clearing House has compiled a list of the securities Arizona includes as obligations of the United States. \textit{Ariz. Tax. Rep. (CCH)} ¶10-425, 1259 (June 1989). This list includes the principal and interest from bonds issued by the Government of Puerto Rico. \ldots \textit{Id.} at n.55.B.2.
  \item 30 DEL. CODE ANN. ch. 11, § 1106(a) (1985). "There shall be added to federal adjusted gross income: (1) a. interest qualifying under section 103 of the United States Internal Revenue Code of 1986 [26 U.S.C. § 103] or any similar statute, other than interest on obligations and securities of this State. \ldots \ldots \textit{Id.} § 1106(a)(1)a. However, Delaware exempts the interest received on obligations if required by federal law. \textit{Id.} § 1106(b)(1). Thus, Delaware exempts the interest derived from Puerto Rican bond obligations because the Attorney General improperly concluded that Puerto Rico was still a dependent possession of the United States and, "therefore, specifically exempt under the statute [48 U.S.C. § 745]. \ldots \ldots \textit{Del. Tax Rep.} ¶ 15-415, 1603-04 (CCH) (March and September 1990), n.50 (discussing Mareno Rios v. United States, 256 F.2d 68 (1st Cir. 1958));
  \item ILL. REV. STAT. ANN. ch. 120 ¶ 2-203(2)(O) (1989) (interest on federal obligations exempt by Illinois Constitution, the United States Constitution, or federal statute Illinois's adjusted income.) \textit{Id.} Illinois Corporate Income Modifications to Federal Taxable Income, ¶11-154, 1399-1400 (CCH) (July 1989). In addition, "[t]he Illinois Department of Revenue has stated in a bulletin that a federal statute (31 U.S.C. § 742) exempts [the] interest [derived from] \ldots \ldots other U.S. obligations from Illinois taxation. Ill. Tax Rep. (CCH) ¶ 11-154 (.12) (July 1989). "Other federal statutes provide exemption from state income taxation with respect to various specifically named types of income. Following is a list \ldots \ldots of exempt income. \ldots \ldots Puerto Rico - Interest derived from bonds issued by Government of Puerto Rico." \textit{Id.} at n.12.II.1;
  \item 6 IND. CODE § 3-1-3.5(a) (Supp. 1990). Modifications to federal Adjusted Gross Income does not include income exempt by federal statute when determining a taxpayer's Indiana taxable income. \textit{Id.} § 3-1-3.5(a). The following obligations and interest derived are exempt from Indiana income taxation: "U.S. Possessions - Puerto Rico, the Virgin Islands, etc. \ldots \ldots " \textit{Ind. Tax Rep. (CCH)} ¶ 16-005(1)(a), 1802-1803 (Dec. 1984).
  \item 23 IOWA CODE ANN. §§ 422.7 and 422.35 (West 1990), Individual's and corporation's Iowa taxable income is calculated making modifications to the federal Adjusted Gross Income. Iowa law provides: (1) "Subtract interest and dividends from federal securities." \textit{Id.} §§ 422.7 and 422.35; (2) "Add interest and dividends from foreign securities and from securities of state and other political subdivisions exempt from federal income tax, under the Internal Revenue Code." \textit{Id.} §§ 422.7 and 422.35. Iowa Admin. Code r. 701(422) was intended to implement § 422.35. "For corporate income tax purposes, the state is prohibited by federal law form taxing \ldots \ldots interest derived from obligations of the United States and its possessions. \ldots \ldots " [W]idely held United States Government obligations [are not taxed by Iowa]." Puerto Rico bonds are included in this list. \textit{Id.} at r. 701(422) (interpreting 23 \textit{IOWA CODE ANN.} § 422.35 (West 1990)).
  \item While Iowa currently does not tax the interest derived from Puerto Rican obligations, Iowa recognizes that it has the authority to tax them and is considering changing its tax laws to include this interest in taxable income. Yacoe, \textit{supra} note 9, at 24.
  \item 57 OHIO REV. CODE ANN. 5747.01 (A)(1)-(3) (Anderson Supp. 1991), Ohio exempts from taxation the principle and interest of obligations of the United States, its territories or its possession. \textit{Id.}
\end{itemize}

Personal Income Computation of Income, List of Federal Government Obligations Exempt From The Ohio Income Tax, ¶ 4195 (CCH) n.25(30) (July 1989), "As of July 25, 1987, the Ohio Department of Taxation has confirmed the following federal obligations to be exempt from the Ohio income tax. \ldots \ldots U.S. Possessions - Obligations of Puerto Rico." \textit{Id.}; New York, \textit{supra} note 8.
before most states had an enforceable income tax, and thus before Congress may have been concerned with an income tax exemption. Finally, states have the power to tax their citizens and federally imposed limitations on that power may be unconstitutional.

Puerto Rico has more than *nine billion* dollars in outstanding obligations in the United States, generating hundreds of millions of dollars annually in interest income payable to investors. Because many states currently do not tax the interest income derived from Puerto Rican obligation, thousands of dollars of tax revenue are not available to state governments. Thus, what may appear as a rather esoteric, academic or arcane issue, is actually very important to the finance industry. Indeed, at least two brokerage houses have established bond funds, which invest solely in Puerto Rican obligations and "Puerto Rico was ranked 12th as an issuer, selling a total of $2.53 billion, according to Securities Data Co./Bond Buyer." The brokerage houses have marketed these funds to

13. U.S. CONST. amend. X; *see also* Nathan v. Louisiana, 49 U.S. 73, 80 (1850) (The Court held that a Louisiana revenue act, which required "each and every money or exchange broker" to pay an annual tax to the State of $250.00, "in lieu of the tax" previously imposed on them, was constitutional. The Court found that the tax was not a tax on the exchange of money in interstate commerce, but rather tax on the business. "The right of a State to tax its own citizens . . . or any particular business or profession, within the State, has not been doubted.").
14. The Puerto Rican obligations outstanding in the United States account for approximately 74% of the total outstanding Puerto Rican bonds.

# TABLE 26*
(FIGURES STATED IN THE BILLIONS.)

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<td>2,553</td>
<td>3,067</td>
<td>3,312</td>
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<td>.230</td>
<td>.357</td>
<td>.396</td>
<td>.428</td>
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<td>Public Enterprises</td>
<td>6,562</td>
<td>6,694</td>
<td>7,232</td>
<td>7,774</td>
<td>8,395</td>
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<tr>
<td>Total</td>
<td>8,837</td>
<td>9,123</td>
<td>10,143</td>
<td>11,237</td>
<td>12,135</td>
</tr>
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</table>

(1) 9/12.135 = 74% of Puerto Rico's total outstanding debt is held in the United States.
** 1989 figures are estimates based on an average increase of 108% calculated for the previous years 1985-1988.
15. Yacoe, *Puerto Rico Debt Seen to Face Crisis If Plan to Tax Bonds Becomes Widespread*, The Bond Buyer, February 23, 1989, at 1. Assuming an average coupon rate of 7%, the annual interest income derived from these nine billion dollars in bonds is approximately $630 million.
16. *Id.* $630,000,000 times even a 2% tax rate times 45 states that have personal or corporate income tax equals at least $56,700,000 in lost tax revenues for the states.


This [Unit Investment] Trust [Bond Fund] was formed for the purpose of providing inter-
the public with the understanding and representation that these funds will be exempt from all federal and most states' taxation.\footnote{Franklin Puerto Rico Tax-Free Income Fund, Prospectus (July 1, 1989); Sears Tax-Exempt Investment Trust, Puerto Rico Municipal Portfolio Series 1, Prospectus (1989).}

Because the potential impact of state taxation of the interest derived from Puerto Rican obligations affects not only Puerto Rico and the states, but also the investor, this Note attempts to determine the proper scope of section 745. First, the Note will examine the history of income taxation in the United States surrounding the enactment of government of Puerto Rico, as well as the current tax treatment of Puerto Rican obligations among the fifty states. Next, the Note will analyze the impact of state taxation of Puerto Rican obligations on Puerto Rico, the states, and the investor. Next, this Note will identify the proper extent of the Puerto Rican bond exemption, by examining the language and legislative history of section 745, the background and legislative history of other analogous United States statutes, and the relevant case law. This section concludes that Congress never intended the section 745 exemption to extend to interest income. Finally, the Note analyzes whether Congress has the constitutional power to prevent states from taxing the obligations or the interest on the obligations of Puerto Rico and concludes that Congress lacks this power.

II. HISTORICAL BACKGROUND AND CURRENT FEDERAL AND STATE INTERPRETATION OF SECTION 745

Article I, section 8 of the Constitution grants Congress the power “to lay and collect taxes . . . to pay the debts and provide for the common Defense and general Welfare of the United States.”\footnote{U.S. Const. art. I, sec. 8, cl. 1.} During the Civil War, Congress imposed various income taxes on the citizens of the United States: the Act of July 1, 1862; the Act of June 30, 1864; the Joint Resolution of July 4, 1864; the Act of March 3, 1865, amending the Act of June 30, 1864; the Act of March 2, 1867; and the Act of July 14, 1870. In 1871, the last of these income tax acts expired and Congress did not attempt to institute another income tax until 1894.\footnote{G.E. Holmes, Federal Income Tax 8 (1925).} This attempt failed, however, because the United States Supreme Court found that the tax, which was a flat tax on the income derived from real property, from...
municipal bonds, and from corporations, was unconstitutional because the Constitution required that Congress tax by apportionment. 21

Finally, Congress amended the Constitution by authorizing a federal income tax without apportionment 22 when 36 of the 48 states ratified the sixteenth amendment in until February 25, 1913. 23 Congress enacted several income taxes between 1913 and 1930, but these taxes were imposed on a very small percentage of the population, the very wealthy, and were not permanent or stable. 25 Consequently, the general public was hardly affected by these taxes. 26 However, on December 1, 1930, the Joint Committee on the Internal Revenue Taxation codified the complete and relatively permanent law of income taxation, which is the basis for today's income tax. 27

In 1917, when Congress enacted the Civil Government of Puerto Rico, following its ratification of the sixteenth amendment, but prior to the Joint Committee's codification of the first permanent income tax law, 28 Congress provided a tax exemption for the bonds issued by Puerto Rico, but failed to provide an express tax exemption for the interest de-

21. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895) (overruled on another point by South Carolina v. Baker, 486 U.S. 505, 524 (1988)). The Court stated, while interpreting U.S. Const. art. I, § 2, cl. 3 that, "Representative and direct taxes shall be apportioned among the several states which may be included within this union according to their respective numbers, which shall be determined by adding to the whole number of free persons . . . ."

22. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

However in 1909, Congress did pass "a special excise tax on corporations with respect to the carrying on or doing of business by such corporations." G.E. HOLMES, supra note 20, at 8. While the Act of August 5, 1909 was not intended to tax the income of these corporations, the tax was measured by the net income of the corporation. Id.

In addition, the Act of August 5, 1909 was held to be constitutional in Flint v. Stone Tracy Co., 220 U.S. 107 (1911).


24. Brushaber v. Union Pacific R.R. Co., 240 U.S. 1, 25 (1916) (The Court held that a tax is not unconstitutional simply because differences exist between the subjects to be taxed. Therefore, the Revenue Act of 1913 is constitutional); the Revenue Act of September 8, 1916, Pub. L. No. 271, § 4, 758 (1916); La Belle Iron Works v. United States, 256 U.S. 377 (1921) (The Supreme Court held the tax imposed by the Acts of March 3, 1917 on excess profits to be constitutional); United States v. Robbins, 269 U.S. 315 (1926) (The Supreme Court held the Act of February 24, 1919, to be constitutional); Unternmyer v. Anderson, 276 U.S. 440, 454 (1928) (The Court upheld the Revenue Act of 1924 as constitutional under the Sixteenth amendment).

25. Congress imposed the early income taxes on a very small percentage of the population, except when the United States was at war. From 1918 to 1932 an average of 5.6 percent of United States citizens were subject to tax. The maximum coverage was 11.4 percent in 1920 and the minimum percentage was 2.5 percent in 1931. Jones, Class Tax To Mass Tax: The Role of Propaganda in the expansion of the Income Tax During World War II, 37 BUFFALO L. REV. 685, 688-689 (1988-89).

26. Id. and J. FREELAND, supra note 12, at 6-7.

27. Id.

28. See supra, notes 19-27 and accompanying text.
PUERTO RICAN OBLIGATIONS

rived therefrom. Thus, a question exists as to the tax status of this interest. The taxability of the interest derived from Puerto Rican obligations is inextricably related to congressional intention when it enacted the organic laws of Puerto Rico and Puerto Rico's current constitutional status as an unincorporated or incorporated territory.

Currently, several states do tax the principal and the interest derived from Puerto Rican obligations, notwithstanding a federal Internal Revenue Service ruling that states that the interest income derived from Puerto Rican obligations is exempt from federal taxation. The federal government and many other states' legislation, which exempt interest earned on Puerto Rican obligations, misinterpret section 745 and the manner in which the Constitution affects congressional authority to enact legislation, dealing with Puerto Rico, such as section 745. The Internal Revenue Service has ruled that interest income from Puerto Rican obligations is exempt from federal taxation. While states are not bound by federal revenue rulings when determining state income tax laws, many states utilize the federal tax structure and rulings as a basis for their own tax structure.

Many state taxing authorities have issued pronouncements indicating whether or not they tax the interest derived from Puerto Rican, territorial, or United States possession's obligations. (See Table at the end of Part II) For example, five states, Arkansas, Connecticut, Louisiana, Pennsylvania, Tennessee, and the District of Columbia tax the interest derived from Puerto Rican obligations or tax the interest derived from the interest arising from obligations of United States' territories and/or possessions.

30. Supra, note 10.
32. See infra note 314-330 and accompanying text.
34. Several states have no individual state tax. Infra note 40.
35. See Thomson v. Union Pacific R.R. Co. 76 U.S. 579, 591 (1870) (the tenth amendment reserves to the states the power to determine the taxation of its own citizens); Snow v. Dixon, 362 N.E.2d 1052 (Ill. 1977), cert. denied, 434 U.S. 939 (1977) ("the power of the states... to levy and collect taxes is unrestricted where such tax is not otherwise unconstitutional").
36. Several states base their taxable income figure on the individual's federal taxable or adjusted gross income with modifications. CAL. TAX CODE §§ 17071, 17073, 17081, and 17131 (Supp. 1991); 23 IOWA CODE ANN. §§ 422.7 and 422.35 (West 1990). See also supra notes 8, 10, 11, and infra notes 37, 39, 41 and 49.
37. Id.; 12 CONN. GEN. STAT. ANN. § 506 (West Supp. 1990), Connecticut imposes a tax on any one who earns or receives interest on any obligation, unless the taxpayer's adjusted gross income
On the other hand, seven states, Arizona, Delaware, Illinois, Indiana, Iowa, New York, and Ohio specifically exempt the interest derived from Puerto Rican bonds from their state income tax. Seventeen additional states, Alabama, Colorado, Georgia, Kansas, Maine, Maryland, Michigan, Mississippi, Missouri, Nebraska, New Jersey, North Carolina, North Dakota, Oregon, Rhode Island, Utah, and West Virginia, specifically exempt from taxation interest arising from obligations of any territory and/or possession, but do not specify whether the interest derived Puerto Rico obligations is included in their list of territories and possessions.

The remaining twenty-one states either do not have a personal income tax or they do not have a specific provision, which adds back the interest derived from Puerto Rican obligations to the states taxable income, which generally is derived from federal taxable or adjusted gross income. As will be demonstrated by this Note, states that have academic income less than fifty four thousand dollars per year; 47 LA. REV. STAT. ANN. § 287.71 A(2) (West Supp. 1990), "Interest or dividend income on obligations ... issued by ... the United States, its territories or possessions ..." should be added to Louisiana's taxable income.

38. Supra note 11.

39. The following states specifically exempt from taxation interest derived from obligations of a United States territory and/or possession:

40 ALA. CODE § 18-14(2)d. (1990); 39 COLO. REV. STAT. § 22-104(4)(a) (Supp. 1989); 48 GA. CODE ANN. § 7-27(b)(1)(B) (Supp. 1989); 79 KAN. STAT. ANN. art. 32, § 117 (a), (b)(i), and (c)(i) (1989); ME. REV. STAT. ANN. tit. 36, § 5122-2A (1978); 10 MD. TAX-GEN CODE ANN. § 207(c) (Supp. 1990); 205 Mich. Comp. Laws ANN. § 133(b)(4) (1986); 27 MISS. CODE ANN. § 7-15(4)(d) (1972); 143 MO REV. STAT. § 121.3 1, 2(b), and 3(a) (Supp. 1990); 77 NEB. REV. STAT. § 2716(1)(a) (Supp. 1990); 54-8A N. J. STAT. ANN. § 36(b)(3)(A) and (B) (West Supp. 1990); 2D N.C. GEN. STAT. § 105-130.5(a)(4) and (b)(1) (Supp. 1990); 57 N.D. CENT. CODE §§ 38-01.2. 1. a. and 38-01.3 l. a. (Supp. 1991); 316 OR. REV. STAT. § 680(1)(a) (1987); 44 R. I. GEN. LAWS § 30-12(b)(1) and (c)(1) (1989); 59 UTAH CODE ANN. § 10-114(2)(a) (Supp. 1991); 11 W. VA. CODE § 21-12(a) and (c)(1) (Supp. 1991).

40. The following states do not have a personal or corporate income tax.

43 ALASKA STAT. §§ 19.010 (The definition of taxpayer does not include individual or person, unless that person is "acting as a business entity in more than one state."); and 20.012 (1990); FLA. STAT. §§ 220.13(1) and 220.131 (Supp. 1990); Nevada, Nevada Franchise and Income, ¶10-000, 501 (CCH); South Dakota, South Dakota Bank Income Tax, History of Tax, ¶10-002, 1075 (CCH) (January 1988); Texas, Texas Income Tax (None Imposed), 603 (CCH) (March 1988); Washington, Washington Income Tax (None), 701 (CCH) (February 1989); Wyoming, Wyoming Income Tax (None), 701 (CCH) (January 1989).

41. The following states do not specifically discuss the tax status of the interest derived from Puerto Rican obligations or the interest derived from obligations of United States territories or possessions:

cepted the Internal Revenue Service's interpretations of section 745 and are exempting the interest derived from Puerto Rican obligations from taxation are misinterpreting the extent of the section 745 exemption.

**TABLE I**

**STATE TAX TREATMENT OF THE INTEREST DERIVED FROM PUERTO RICAN OBLIGATIONS OR OTHER TERRITORIES AND POSSESSIONS**

| No State Personal Income Tax | Tax the Interest Derived from Puerto Rican Bonds | Exempt the Interest Derived from U.S. Territories' or Possessions' Bonds | Exempt the Interest Derived from Puerto Rican Bonds | No Provision to Add Back Federally Exempted Interest to State Taxable Income
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<td>Alaska</td>
<td>Arkansas</td>
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<td>Florida</td>
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<td>S. Dakota</td>
<td>Penn.</td>
<td>Indiana</td>
<td>Kansas</td>
<td>Kentucky</td>
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<td>Texas</td>
<td>Tenn.</td>
<td>Iowa</td>
<td>Maine</td>
<td>Mass.</td>
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<td>Wash.</td>
<td>and the</td>
<td>New York</td>
<td>Maryland</td>
<td>Minn.</td>
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<td>Wyoming</td>
<td>D.C.</td>
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<td>N. Dakota</td>
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<td>Oregon</td>
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<td>W. Va.</td>
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The Congressional Record of the Senate debates over the Organic Act of Puerto Rico sheds light on the issue of why Congress might have intended to exempt these Puerto Rican bonds from taxation. First, the


42. *See supra* note 41. Many of these states utilize the federal taxable or federal adjustable income to determine the state taxable income. Consequently, if the states do not provide a provision adding the interest income derived from Puerto Rican obligations back into state taxable income, the individual will not be taxed on that income in compliance with Revenue Ruling 70-219.

43. 50 Cong. Rec. 2250 (1917). Senator Vardaman stated, "If the Senator from Ohio will yield to me for a moment, in the consideration of this bill it was thought that this special exemption should be given in order to make this security as attractive as possible."
tax exemption has allowed Puerto Rico to sell the bonds at a lower rate than the current market rate. The investor buys these bonds because the investor receives a tax benefit which more than offsets the cost of investing in these lower yielding obligations.\textsuperscript{44} Thus, Puerto Rico and its municipalities have been able to market their obligations as exempt from state taxation, while state bond issuers have not generally had this privilege.\textsuperscript{45} Second, Congress may have known that by making Puerto Rican obligations and the interest derived therefrom exempt from state and federal taxation, Puerto Rico would owe investors less money in interest and would, therefore, have more money to spend on improving the Puerto Rican island.\textsuperscript{46} The issuer of any tax free bond has an advantage over the issuers of non-tax exempt bonds. The issuer of tax free obligations is able to sell the bonds at a lower interest rate than the issuer of taxable obligations, because investor does not need to make as much income to offset the tax they must pay on taxable investments.\textsuperscript{47} Consequently, the issuer of tax exempt obligations will have more funds to invest toward public purposes, rather than to repay investors the additional interest necessary to make the bonds competitive with other taxable obligations.

As will be detailed in this Note, however, Congress did not intend the interest derived from Puerto Rican obligations to be tax exempt and even if it did section 745 is unconstitutional. Consequently, both the federal and state governments have the statutory and constitutional power to tax and may start taxing the principal and the interest derived from Puerto Rican obligations. To date, however, the federal government and many state governments do not tax this interest and principal.\textsuperscript{48}

Similarly, the federal government, and normally, the issuing state do not tax the interest derived from state bonds.\textsuperscript{49} However, non-issuing

\textsuperscript{44} Id.

\textsuperscript{45} Id. (quoting Senator Harding). "That is a provision that is not granted to any State in the Union."

\textsuperscript{46} "Those people there are undeveloped, and it is for the purpose of enabling them to develop their country to make the securities attractive by extending that exemption. It was thought by the committee that it would probably be better for those people," Senator Vardaman replied to Senator Harding’s concerns. Id.

\textsuperscript{47} Id.; see also Donlan, The 51st State? A Fateful Choice Looms for Puerto Rico, Barron’s, September 3, 1990 at 17 (referring to section 936 and the impact of statehood on Puerto Rican corporations ability to operate without tax consequences).

\textsuperscript{48} See supra notes 33, 38-41 and accompanying text.

\textsuperscript{49} See infra 221-237 and accompanying text.

Thirty-seven of the forty-three states, which have a personal income tax do not tax the interest derived from their own obligations, but do tax the income derived from state obligations other than their own.

\textsuperscript{40} ALA. CODE § 18-14(2)(f) (Supp. 1990); Arizona, supra note 11; Arkansas, supra note 10; California, supra note 41; 39 COLO. REV. STAT. § 22-104 (3)(b) (Supp. 1990); Connecticut, supra note 37 (Connecticut also taxes the interests derived from its own obligations); 30 DEL. CODE ANN.
states do tax the principal and interest earned by holders of other states' obligations.\footnote{50} While many states tax the interest derived from other states' obligations, the federal government does not, in part, to provide state governmental institutions with a tool to borrow money at a lower than market rate interest rate.\footnote{51} “This [federal] interpretation is in accord with the long established congressional intent to prevent taxes which diminish in the slightest degree the market value or the investment

\footnote{50} § 1106(a)(1)(a) (1985); 48 GA. CODE ANN. § 7-27(b)(1)(A); 14 HAW. REV. STAT. ch. 235, § 7(b)(2) (Supp. 1990); 63 IDAHO CODE § 3022(a) (Supp. 1991); Iowa, supra note 11, “Add interest and dividends from foreign securities and from securities of state and other political subdivisions exempt from federal income tax, under the Internal Revenue Code.” Id. §§ 422.7 and 422.35; 79 KAN. STAT. ANN. § 32(a) and (b)(i) (1989); 141 KY. REV. STAT. ANN. § 010(10)(c) (Michie/Bobb-Merrill Supp. 1991); 47 LA. REV. STAT. 287.71 (A)(1) (West Supp. 1990); 62 MASS. GEN. LAWS ANN. § 2(a)(1)(A) (West Supp. 1991); ME. REV. STAT. ANN. tit. 36, § 5122-1A (1978); 10 MD. TAX. GEN. CODE ANN. § 204(b) (Supp. 1989); 206 MICH. COMP. LAWS ANN. § 30(1)(a) (1986); Minnesota, supra note 41; Mississippi, supra § 7(a)(b) and 15(1); Missouri, supra note 59; 15 MONT. CODE ANN. § 30-111(1)(a) (1989); 77 NEB. REV. STAT. § 2716(1)(b) (Supp. 1990); 5 New Hampshire, supra, note 41; 54-8A N.J. REV. STAT. § 36(b)(2)(A) (West Supp. 1990); 12 N.Y. [TAX] LAW § 612(b)(1) (Consol. 1991); 2D N.C. GEN. STAT. §§ 105-130.5(a)(4) (Supp. 1990); 57 N.D. CENT. CODE §§ 38-01. 2. 1. g. and 38-01. 3. e. (Supp. 1989); 57 OHIO REV. CODE ANN. § 5747.01(A)(1) (Supp. 1989); OKLA. STAT. ANN. tit. 68, § 2358 A. 1. (West Supp. 1990); 316 OR. REV. STAT. § 680(2)(a) and 317 OR. REV. STAT. § 309(1) (1987); Pennsylvania, supra note 10; 44 R.I. GEN. LAWS § 30-12(b)(1) (1989), “There shall be added to federal adjusted gross income: (1) Interest income on obligations of any state, or its political subdivisions, other than Rhode Island or its political subdivisions;” South Carolina, supra note 41; Tennessee, supra note 10; 58 VA. CODE ANN. §§ 1-302 A., B. 1., C. 2., 1-322 B. 1. and C. 2. (Supp. 1990); 11 W. VA. CODE § 21-12(b)(1) (Supp. 1991).

Only six states also exempt from taxation the bonds and the interest derived therefrom of other state obligations, as well as their own. ILL. REV. STAT. ch. 120 § 2-203(2)(A); Indiana, supra note 11; 7 N.M. STAT. ANN. § 21-2(B) (1978); 59 UTAH CODE ANN. § 10-114 (Supp. 1991); Vermont, supra note 41; 71 WIS. STAT. ANN. § .05(6)(a) 1. and (b) 1. (1989). Consequently, these states do not discriminate between holders of holders of other state’s property and holders of the taxing state’s property. Intra notes 238-255.

In addition, the District of Columbia is a territory which taxes the interest on obligations it issues and the obligations of other states. See supra note 10. In addition, states have the power to tax and do tax the principal and interest received by its citizens from obligations of the District of Columbia as they tax the interest and principal derived from state obligations other than their own. 77 NEB. REV. STAT. § 2716(1)(b) (Supp. 1990) (Nebraska requires that taxpayers add back interest or dividends received by the owner of obligations of the District of Columbia and other states of the United States to the extent subtracted from federal adjusted gross income when calculating Nebraska's taxable income.)

\footnote{51} Id.

51. Smith v. Davis, 323 U.S. 111 (1944). In Smith, the court held that the state of Georgia could tax the taxpayer’s accounts receivable, which was a result of two contracts for work, labor, and materials furnished to the United States Army. The taxpayer claimed that the tax was unconstitutional because it was a tax on the credit of the United States and upon the federal government’s power to raise funds to operate military and civil organizations. Id. at 112-13. The court rejected this argument because the accounts receivable were non interest bearing and were not obligations used by the United States for credit purposes. However, the court indicated that had the debts of the United States been interest bearing or had the United States issued the obligations for purposes of obtaining credit, the debts or obligations would have been exempt from taxation if the tax interfered with market value or the investment attractiveness of the debt or obligations. Id. at 112.

“The extent of this [taxes] influence depends on the will of a distinct government. To any extent, however inconsiderable, it [the tax] is a burden on the operations of government. It may be
attractiveness of obligations issued by the United States in an effort to secure necessary credit.”

Consequently, while the federal government has the statutory and constitutional authority to tax both Puerto Rican obligation principal and the interest derived therefrom, the federal government would be unlikely to tax such obligations or interest. This seems more apparent when one considers that, if the federal government were to tax the principal and the interest derived from Puerto Rican obligations, it would then have to increase the aid to Puerto Rico to make up for the difference between the taxable and tax exempt interest rates that Puerto Rico would have to pay investors. The states however, have no such disincentive in taxing Puerto Rican obligations and the interest derived therefrom.

Next, if the states were to exercise their statutory and constitutional rights to tax the interest derived from Puerto Rican obligations, what would be the impact on the taxpayer, on Puerto Rico, and on the states? First, the taxpayer will incur state taxation on all income derived from its holdings in Puerto Rican obligations, as well as possible state intangibles taxes. Because 48 U.S.C. § 745 is unconstitutional, taxpayers may find themselves holding bonds whose interest will be taxable by the state in which the taxpayer lives. Gross income and exclusions are defined by the state and federal revenue and taxing codes. Almost no one is able to avoid the income tax today. The mere fact that an investment was tax exempt at the time the taxpayer invested in it does not preclude the state or federal governments from taxing the income derived from the investment at a later date. “The income tax (with all its changes) may be the price of our civilization.”

Second, the impact on Puerto Rico will be more than slight. If the interest derived from Puerto Rican bonds does not remain exempt from federal and state taxation, Puerto Rico would still be able to raise funds to finance public projects. However, Puerto Rico would need to increase the yield it pays investors between .8 and 3.88 percent in order to com-

carried to an extent which shall arrest them [state bond issues] entirely,” Pollock v. Farmers’ Loan & Trust Co., 157 U.S. 429, 586 (quoting Weston v. City Council, 2 Pet. 449, 468 (1829)).

See also New Jersey Realty Title Ins. Co. v. Division of Tax Appeals in Dept. of Taxation and Finance of N.J., 338 U.S. 665 (1950).

In recent years the Court has recognized that the tax exempt status for federal debt and obligations does not exist as long as the state tax is nondiscriminatory. See supra notes 237-54 and accompanying text.

52. Id.

53. 26 U.S.C. sec. 61 (1986) and various state regulations.

pete with corporate or other taxable municipal bonds, which will increase the cost of each issue. While any of these scenarios place some economic burden on Puerto Rico, the Supreme Court has held that such economic burdens have an indirect and incidental affect. Consequently, absent constitutional actions by Congress, no implied or statutory tax immunity can be afforded a government such as Puerto Rico.

Finally, state taxation of interest derived from Puerto Rican obligations would provide states with additional revenue to repair roads, build needed facilities, pay state employees, as well as provide funds for many other public projects.

As is apparent from this brief discussion, pros and cons exist for providing a tax exemption for the interest derived from Puerto Rican bonds. However, Congress has not expressly provided such an exemption and without express congressional intent to exempt the interest derived from governmental obligations no tax immunity can be implied. Further, the Supreme Court has held that states and federal governments do not need to extend tax-exemptions to claims or to obligations, which the United States does not use or need for credit purposes. As this Note will discuss, Puerto Rico is an incorporated territory for congressional regulatory purposes, which requires Congress to treat Puerto Rico more like a state than an division of the federal government. Consequently, Puerto Rican obligations, as state obligations, are no longer considered for United States credit purposes, and thus, should not be given discriminatory tax exempt status. Barring any possible unfairness to Puerto Rican bond issuers and investors, inherent in a change in the obliga-

55. Puerto Rican obligations, for which the principal and the interest derived are generally exempt from both state and federal income tax, yield about 6.87% and 7.30% for 20 and 30 year obligations, respectively. Puerto Rican Government Public Improvement 30 year obligations yield 7.29% interest, with a coupon rate of 7.30%, and traded Puerto Rican 20 year obligations yield 6.87% interest, with a coupon rate of 7.125%. Barons, April 8, 1991 at 100; and Wall Street Journal, April 8, 1991 at C21.

United States obligations, for which both the principal and the interest derived are also exempt from both state and federal income tax. See 31 U.S.C. § 3124(a). United States Treasury Zero Coupon Strip Bonds yield 7.84% interest for 30 year bonds. Barrons, April 8, 1991 at 139.

However, similar corporate obligations, which are not tax exempt, yield a much higher interest rate. Barron's Best Grade 30 year bonds yield 8.50 - 10.00% and Barron's Intermediate-Grade 30 year bonds yield 9.95%. Id. at 139. Corporate obligations yield from 9.008 - 10.750% with coupon rates ranging from zero to 11.875% for 15-40 year obligations. Wall Street Journal, April 8, 1991 at C21.

57. Id.
60. Id.
61. See infra notes 256 - 313 and accompanying text.
tions tax status, the need for states to exercise their full power of taxation must overrule any rationale used by Congress to dominate such taxing power. Consequently, Congress should not be allowed to sacrifice the states’ ability to raise revenue under the cloak of assistance to another federal possession when in fact Puerto Rico is an incorporated territory for which the entire Constitution applies.

IV. CONGRESSIONAL INTENTION

Congress did not intend to exempt the interest derived from Puerto Rican obligations from either state or federal taxation. First, the language of a statute is controlling, absent contradictory or explanatory legislative history. When Congress grants a tax exemption for the obligations, this exemption refers only to the principal absent Congressional language or legislative history to the contrary. Congress must explain its intentions for the application of the statute in the language of the statute or in the legislative history of the statute. If Congress does not act affirmatively, the Constitution does not imply an income tax exemption for state or federal property. Second, Congress indicated, in the Congressional debates over the enactment of the Puerto Rican civil government act, that the Puerto Rican act was to be modeled after the statute Congress enacted granting a civil government to the Philippine Islands. Congress did not exempt the interest derived from Filipino obligations or indicate that it wanted to change the tax provision of the Filipino act. Therefore, Congress could not have intended to exempt the interest derived from Puerto Rican obligations and courts should not infer such an exemption. Third, Congress exempted the interest derived from United States possessions’ obligations in the Revenue Act of 1916, but did not include the same exemption language in section 745, which Congress enacted one year later. In addition, in similar statutes dealing with obligations issued by other United States territories, such as the Virgin Islands, and Guam, Congress specifically exempted the interest derived from these obligations, but did not amend section 745 to provide the same language for the obligation and the interest derived from Puerto Rico obligations. Finally, courts have found section 745 to be similar to section 3124(a), which exempts United States’ obligations from taxation, but have not inferred that the interest income taxation exemption provided for in section 3124(a) would also apply to section 745.

A. The Language of Section 745

When Congress grants a tax exemption for the obligations, this ex-
puerto rican obligations

emption refers only to the principal absent statutory language or legislative history to the contrary. Should Congress intend that tax exemption to extend to the interest derived from the obligation, then Congress must explain its intentions in the statutory language or the legislative history of the statute. In addition, if Congress does not expressly require, through the statute, the Constitution will not imply an income tax exemption for state or federal property.

Unlike similar federal statutes exempting obligations of the United States or its territories from income taxation of the interest derived therefrom,62 section 745 does not expressly exempt the interest derived from Puerto Rican obligations.63 It merely exempts the obligations themselves from taxation.64 Courts have interpreted similar statutory language to exempt governmental obligations from state property tax. In *American Bank and Trust Co. v. Dallas County*,65 the Texas Tax Commissioner levied a property tax on the American Bank and Trust Company's state and national shares of United States obligations for the years 1979 and 1980.66 The Texas Tax Commissioner computed the tax based on each bank's net assets without deducting the value of United States obligations held by the bank.67 The Texas Court of Civil Appeals upheld the tax.68

On appeal, American Bank, relying on the amended language of section 3701,69 sought a mandamus barring the state from taxing the bank's shares in U.S. obligations.70 In addition, the bank sought declaratory and injunctive relief asserting that the value of their bank's shares should be reduced by the proportionate value of their United States obligations.71

In analyzing the amended language of § 3701, the United States Supreme Court reversed the tax imposed by the tax commissioner. The Court held that the exemption provided in section 3701,72 which exempts

64. Id.
66. Id. at 862.
67. Id. at 859-60.
68. Id.
[All] stocks, bonds, treasury notes, and other obligations of the United States shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. Id. n.1 (1983).
70. Id. at 860.
71. Id.
United States obligations from any form of state taxation, exempted such obligations from a state property tax. First, the court reasoned that the language of the statute provided an exemption from any form of taxation for the United States obligations. The commissioner argued that a tax which only considers the taxpayers holdings in government obligations is an indirect tax on the taxpayer's privilege of doing business in Texas, rather than a direct tax on the taxpayers assets. However, the Supreme Court did not agree. The Court recognized that a tax on a company's holdings in governmental obligations was a tax on that company's assets and the principal of the obligations. The Court stated that a tax which "considers" the obligations in the computation of the tax is a tax on the ownership of an asset, and therefore, a direct tax on the obligations. In addition, the language of the statute bars a tax which "considers" the obligations in the computation of the tax. Consequently, the tax imposed by the commission, which considered the bank's holdings in government obligations in violation of the express language of the statute and therefore, was not an implied exemption.

Second, the Court reasoned that "[a]bsent a clearly expressed legislative intention to the contrary, [the statutory] language must ordinarily be regarded as conclusive." Had the statute or legislative history indicated that Congress did not intend to exempt the obligation (principal) from a state property tax, the Court would not have allowed the bank to deduct its United States obligations from its net assets when calculating its state property tax liability. The Court stated "[i]n these circumstances, the plain language of sec. 3701 is controlling."

73. In 1959, Congress amended section 3701 to specifically include the property tax exemption. "This exemption extends to every form of taxation that would require that either the obligation or the interest thereon, or both, be considered, direct or indirectly, in the computation of the tax ...." The Supreme Court interpreted this to include a property tax exemption and held that the plain language of section 3701, as amended, was not contradicted by its legislative history and was not inconsistent with any federal statute, therefore the property tax exemption was valid. American Bank & Trust Co., 463 U.S. at 862 and 873.

74. Id. at 862.
75. Id. at 863.
76. Id. at 862-64.
77. Id. at 864.
78. Id. at 862 (quoting Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980)).
79. Id. at 873.
Similarly, in *New Jersey Realty Title Ins. Co. v. Division of Tax Appeals in Dep't of Taxation and Finance,* a New Jersey tax commission levied an assessment against the intangible personal property of New Jersey Realty Title Insurance Company. The tax was computed on the realty title company's paid-up capital and surplus without deducting the company's holdings in United States bonds. The Supreme Court held that such a tax is a tax on the principal of the obligations and not a tax on the income of the obligations. The Court reasoned that such a tax is in violation of the express language of section 3701, which exempts the United States obligations from taxation.

While section 745 deals with corporate or individual holdings in Puerto Rican obligations, rather than United States government obligations courts should also find that the language of section 745, which exempts the obligations from state taxation, expressly exempts the principal of Puerto Rican obligations from state taxation.

In addition, the Supreme Court has held that when a statute exempts an obligation's principal from taxation, the Constitution does not imply an automatic exemption for the interest derived therefrom, unless Congress affirmatively indicates such an exemption through the statute's language or legislative history. As discussed earlier, when Congress enacted section 745, similarly to when it enacted other federal statutes, it exempted the principal of the obligation from state taxation. However, unlike the exemptions Congress has provided in other statutes, Congress did not provide an express tax exemption for the interest income derived from Puerto Rican obligations when it enacted section 745. Thus, following the Court's interpretation of the Constitution, courts should not imply a congressional intention to exempt the interest derived from Puerto Rican obligations.

The Court did not always refuse to imply congressional intention to exempt United States property and the income derived therefrom from taxation. In 1927, the Supreme Court held that when the Constitution or Congress provide a tax exemption for the principal of United States obligations, this exemption automatically extends to the interest income

81. *Id.* at 666.
82. A tax on capital and earned surplus is a tax "imposed on the property of the institutions, as contradistinguished from a tax upon their privileges or franchises," which are based on the taxpayer's net income. *Id.* at 673-74.
83. *Id.* at 675-76.
derived from such obligations.\textsuperscript{86} In \textit{Northwestern Mutual Life Insurance Co.}, the Court held that if the principal of United States obligations is exempt from taxation, the interest income derived is automatically exempt from any form of income or franchise tax.\textsuperscript{87} The court reasoned to do otherwise would place a direct burden on the governmental entity's property, which violates the Constitution.\textsuperscript{88}

The Court has never expressly overruled \textit{Northwestern Mutual Life Insurance Co.}. However, the Supreme Court did overrule \textit{Gillespie v. Oklahoma},\textsuperscript{89} the case that \textit{Northwestern Mutual Life Insurance Co.} was based on in \textit{Oklahoma Tax Comm'n v. Texas Co.}\textsuperscript{90} In \textit{Oklahoma Tax Comm'n}, the court held that no implied constitutional immunity exists for the income derived from property leased from the United States as suggested in \textit{Gillespie}.\textsuperscript{91} The Court explained that Congress may have the power to immunize or exempt such income from Oklahoma taxation, but for Congress to create such an immunity or exemption, Congress must take "affirmative action."\textsuperscript{92} In addition, the court found that the law was well settled that such land has been and should be subject to all state and local ad valorem taxes.\textsuperscript{93}

The Court reasoned that despite the possibility that a state tax may reduce the amount the federal government may receive for the sale of property, the reduced price will be too de minimis and remote to adversely impact the government.\textsuperscript{94} The Court reasoned that, contrary to

\textsuperscript{86} "[I]t has been the settled doctrine here that where the principle is absolutely immune, no valid tax can be laid upon income arising therefrom. To tax this would amount practically to laying a burden on the exempted principle." \textit{Northwestern Mutual Life Ins. Co. v. Wisconsin}, 275 U.S. 136, 140 (1927).

\textsuperscript{87} 275 U.S. at 140 (relying on \textit{Gillespie v. Oklahoma}, 257 U.S. 501, 505-56 (1922) ("[W]here the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such source the tax is pro tanto void.").)

\textsuperscript{88} 275 U.S. at 140-41.

\textsuperscript{89} 257 U.S. 501 (1922). In \textit{Gillespie v. Oklahoma}, the court held that the state of Oklahoma could not tax the income earned by the defendant in pursuit of his business, which was located on property the defendant leased from the United States. \textit{Id.} at 505 (relying on Pollock \textit{v. Farmer's Loan & Trust Co.}, 157 U.S. 429 (1895)). The court held that because a tax on the lease principal was "a tax upon the power [of the United States] to make, and could be used to destroy the [United States'] power to make them" a tax on the income derived from such leased property would likewise destroy the United States, and other sovereigns, ability to contract such leases. \textit{Id.} at 505-56 (quoting \textit{Indian Territory Illuminating Oil Co. v. Oklahoma}, 240 U.S. 522, 530 (1916)).

"[A] tax upon the profits of the leases, and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards." \textit{Id.} at 506 (referring to \textit{Weston v. Charleston}, 2 Pet. 449, 468 (1829)).


\textsuperscript{91} \textit{Id.}

\textsuperscript{92} \textit{Id.} at 366.

\textsuperscript{93} \textit{Id.} at 353. Such property is subject to taxes based on the value of the property.

\textsuperscript{94} \textit{Id.} at 354.
the holding in Gillespie, the burden placed on the federal government by such taxes is too remote and indirect to justify an implied tax immunity for the purchasers and subsequent holder of such property.95 The prospective buyer of governmental land or the private individual who uses land to perform services for the United States, will pay the government a fair price for the land based on the prospective profitability of the land, rather than state property tax.96

Similarly, in Graves v. New York ex rel. O'Keefe97 the Court held that the State of New York had the power to tax the salaries of national governmental employees because Congress had not expressly exempted these items from taxation.98 The Court held that “[s]ilence of Congress implies [tax] immunity no more than does the silence of the Constitution. . . . [consequently, if Congress does act,] Congress has disclosed no intention” to exempt what the Constitution does not.99 The Court reasoned no basis exists for the assumption that the economic burden imposed on the federal government would justify any court declaring the employee taxpayer to be clothed with the implied constitutional tax immunity of the government by which she is employed.100

While the burden of a nondiscriminatory tax on the incomes of federal or state government employees will be passed back to the employer, the government, in the form of increased salaries to compensate the employee for the tax, such a burden is “the normal incident of the organiza-

95. Id.

Despite the possibility that the prospect of taxation by the state may reduce the amount the United States might receive from the sale of its property [to a private individual], it is well established that property purchased from the Federal Government becomes a part of the general mass of property in the state and must bear its fair share of the expenses of local government. Id. at 353.

96. Id. at 354.

97. 306 U.S. 466 (1939).

98. Id. at 486.

99. Id. at 480.

It is true that the silence of Congress, when it has authority to speak may sometimes give rise to an implication as to Congressional purpose. The nature and extent of that implication depend upon the nature of the Congressional power and the effect of its exercise. (Referring in footnote 1 to the dormant commerce clause, Congress does not regulate commerce. Therefore, until it does, States have the authority to regulate commerce). But there is little scope for the application of that doctrine to the tax immunity of governmental instrumentalities. The constitutional immunity of either government from taxation by the other, where Congress is silent, has its source in an implied restriction upon the powers of the taxing government [not the taxed government]. So far as the implication rests upon the purpose to avoid interference with the functions of the taxed government or the imposition upon it of the economic burden of the tax, it is plain that there is no basis for implying a purpose of Congress to exempt the federal government or its agencies from tax burdens which are unsubstantial or which courts are unable to discern. Id. at 479-80.

100. Id. at 486. “That assumption . . . is contrary to the reasoning and to the conclusions reached in the Gerhardt case” and in several other cases. “In their light the assumption can no longer be made.” Id. (citations omitted).
tation within the same territory of two governments, each possessing the taxing power."\textsuperscript{101} In addition, the effect on the employer is indirect and incidental. Therefore, the Court reasoned that it could not rightly imply a tax immunity to the government employer or the employee when the Constitution has expressly granted the power of taxation to the federal government and has reserved that the power of taxation to the states.\textsuperscript{102}

For many years the Supreme Court has limited the reach of the intergovernmental tax immunity doctrine, but until recently had not applied these limitations to federal and state obligations.\textsuperscript{103} In 1988, the Supreme Court held that no implied tax immunity exists for holders of state obligations,\textsuperscript{104} thus overruling its holding in \textit{Pollock v. Farmers' Loan & Trust Co.}\textsuperscript{105} In \textit{Pollock v. Farmers' Loan & Trust Co.}, the Court held that a tax levied on the income derived from municipal real estate and bonds interfered with the municipalities' ability to sell bonds and make contracts, and therefore, was an indirect tax on the municipality.\textsuperscript{106} Such a tax interfered with the municipality’s intergovernmental tax immunity, and consequently, was unconstitutional.\textsuperscript{107}

As previously stated, the Supreme Court overruled \textit{Pollock} in 1988 in \textit{South Carolina v. Baker}.\textsuperscript{108} The Court in \textit{Baker} stated that it saw no constitutional reason for treating persons who receive interest on governmental bonds differently than persons who receive income from other types of contracts with the government, and no tenable rationale

\textsuperscript{101}. \textit{Id.} at 487.
\textsuperscript{102}. \textit{Id.} "The immunity is not one to be implied from the Constitution, because if allowed it would impose to an inadmissible extent a restriction on the taxing power which the Constitution has reserved to the state governments." \textit{Id.}
\textsuperscript{103}. \textit{South Carolina v. Baker}, 485 U.S. 505 (1988). "The rationale underlying . . . the general immunity for governmental contract income has been thoroughly repudiated by modern intergovernmental immunity caselaw." \textit{Id.} at 520. "Likewise, the owners of state bonds have no constitutional entitlement not to pay taxes on the income they earn from [governmental] bonds." \textit{Id.} at 524-25.
\textsuperscript{104}. \textit{Id.} at 1367 ("[w]e thus confirm that subsequent caselaw has overruled the holding in \textit{Pollock} that state bond interest is immune from a nondiscriminatory federal tax.")
\textsuperscript{105}. 157 U.S. 429 (1885). The Court stated that a tax on the income of United States property is a tax on the property itself, and is therefore a direct tax. \textit{Id.} at 580-81 (relying on its holding in \textit{Weston v. City Council}, 2 Pet. 449, 465-69 (1829)). Referring to \textit{Weston}, the Court stated "a tax on the income of United States securities was a tax on the securities themselves, and [such a tax is] equally inadmissible." \textit{Id.} The Court held that under the constitution the federal and state governments could not levy direct tax without apportionment. \textit{Id.}
\textsuperscript{106}. \textit{Id.} at 585-86.
\textsuperscript{107}. \textit{Id.}

In addition, following the passage of the sixteenth amendment in 1913, the Constitution no longer requires that Congress ensure apportionment before they enact a federal income tax. \textit{See supra} notes 22-25.
for distinguishing the costs imposed on States by a tax on state bond
interest from the costs imposed by a tax on the income from any other
state contract.\textsuperscript{109}

The Court reasoned that “under [the] current intergovernmental tax im-
munity doctrine” state governments can not tax the United States di-
rectly, but have the constitutional authority to tax any private individual
or association with whom the federal government does business, even
though some of the financial burden will fall on the United States.\textsuperscript{110} A
state tax on private individuals is an indirect tax and does not violate the
Constitution. Only a direct tax on the federal government would inter-
fere with the federal governments intergovernmental tax immunity. The
Court stated that a direct tax is one that falls on the United States it-
sely.\textsuperscript{111} Similarly, with certain exceptions “[t]he rule with respect to state
tax immunity is essentially the same.”\textsuperscript{112}

Consequently, while Northwestern Mutual Life Insurance Co. has
not been directly overruled, the basis for the Court’s reasoning that the
Constitution provides an implied immunity from taxation for govern-
mental obligations and the interest derived therefrom, without Congress-
sional action, has been repeatedly overruled and is no longer accepted.\textsuperscript{113}
Thus, the Court should not imply an exemption from taxation for the
interest derived from any obligation unless Congress expressly grants the
interest such an exemption, even if Congress has granted such an exemp-
tion to the principal of the obligation.

The language of section 745 provides for the exemption of Puerto
Rican obligations from all forms of taxation. Courts should interpret
this, absent legislative history to the contrary, to exempt only the prin-
cipal of Puerto Rican obligations from taxation. In contrast, Congress did
not provide section 745 or section 745’s legislative history with language
which would exclude the interest derived from the Puerto Rican obliga-
tions from any form of taxation. Because the Supreme Court has re-
jected its early constitutional reasoning that United States and state
obligations are impliedly exempt from taxation, without affirmative ac-
tion by Congress, courts cannot imply a congressional intention to ex-
empt such interest.

\textsuperscript{109} Baker, 485 U.S. at 524-25.
\textsuperscript{110} Id. at 523.
\textsuperscript{111} Id.
\textsuperscript{112} Id. A federal tax which discriminates for holders of federal property or contracts over
holders of state property or contracts may be allowed. However, a parallel state tax could not be
imposed on holders of federal property or contracts, unless a similar tax was imposed on holders of
similar state property or contracts. Id. at 526.
\textsuperscript{113} Oklahoma Tax Comm’n v. Texas Co., 336 U.S. 342, 365 (1949); Graves v. New York ex rel
B. Legislative History of Puerto Rican and Filipino Statutes

The legislative hearings held by Congress before enacting the Organic Government of Puerto Rico do not contradict the language of section 745,114 which further indicates that Congress did not intend to extend the exemption provided in section 745 to the interest derived from Puerto Rican obligations. On January 20, 1916, Congressman Jones115 presented Congress with a bill,116 which detailed the rules for the proposed government of Puerto Rico. Section 3 of the bill granted Puerto Rico the power to issue "bonds and other obligations."117 Section 3 also exempted such obligations118 from state and federal taxation.119 On March 3, 1917, Congress adopted the bill120 and codified section 3 in title 48.121

While Congress did not indicate whether this exemption was to be limited to intangible taxes on the principal or whether it also extended to the interest income derived from the obligations, Congress indicated that section 3 of the Jones Act was to be similar to the like provision in the act

115. Congressman Jones was from Virginia. Id.
116. The bill was approved by the Insular Affairs Committee before Congressman Jones presented it to the entire Congress. Id.
117. [A]nd when necessary to anticipate taxes and revenues, bonds and other obligations may be issued by Porto [sic] Rico or any municipal government therein as may be provided by law, and to protect the public credit: Provided, however, That no public indebtedness of Porto [sic] Rico or of any municipality thereof shall be authorized or allowed in excess of 7 per cent of the aggregate tax valuation of its property, and all bonds issued by the government of Porto [sic] Rico or by its authority shall be exempt from taxation by the Government of the United States, or by the government of Porto [sic] Rico or of any political or municipal subdivision thereof, or by any State, or by any county, municipality, or other municipal subdivision or any State or Territory of the United States, or by the District of Columbia. Id. at 8424 (emphasis added).
118. H.R. 9533, 64th Cong., 2d Sess., 50 CONG. REC. 2250 (1917). Congress intended the exemption of Puerto Rican obligations to include a property tax exemption on the principal of the obligations. The Court has held that statutes indicating that the obligation is tax exempt include the tax associated with an intangible property tax. See American Bank and Trust Co. v. Dallas County, 463 U.S. 855, 862 (1983) and New Jersey Realty Title Ins. Co. v. New Jersey, 336 U.S. 665 (1950).
119. The debates and committee hearings occupy over 1000 pages of congressional record, however, the discussion of the meaning and significance of the bond exemption provision is approximately two paragraphs.

Mr. Harding. "I wish to ask the Senator from Colorado [Mr. Shafroth] a question in relation to this section. Is it the intention of the sponsors of the bill to exempt all the subdivision and municipal bonds from Federal and State taxation?"

Mr. Shafroth. "I think that is the provision of the law."

Mr. Harding. "That is a provision that is not granted to any State in the Union."

Mr. Shafroth. "It may be, but it is the same provision that we have extended to the Philippine Islands." 50 CONG. REC. 2250 (1917).
120. Balzac v. Puerto Rico, 258 U.S. 298, 305 (1922), the adopted bill has been commonly referred to as the Jones Act and the Jones Act "provide[d] a civil government for Porto [sic] Rico." Id.
creating the government for the Philippine islands, enacted in 1902. When Congress granted the Philippine Islands their civil government, it also authorized the government of the Philippine Islands with an avenue to incur indebtedness, borrow money, and to issue and sell registered or coupon bonds. In addition, Congress provided that such bonds will be "payable . . . together with the interest . . . and said bonds shall be exempt from the payment of all taxes or duties of the government of the said Islands, or . . . of the Government of the United States."  

However, when the Filipino bill was first presented to the entire Congress it provided that Philippine obligations would be exempt from not only federal taxes, but also state taxes. During the Congressional debates, one Congressman questioned whether Congress had the power to exempt bonds issued by the Philippines from state taxation. Although Congress never specifically answered this question in the many pages of Congressional debates, Congress either intentionally or inadvertently dropped from the language of the actual statute the provision exempting these obligations from state taxation.

As indicated from the language of the Filipino act, Congress intended to exempt the Filipino bonds from federal intangible property tax-

122. H.R. 9533, 64th Cong., 2d Sess., 50 CONG. REC. 2249 (1917). During the Senate debates concerning section 3 of the Puerto Rican Civil Government bill Senator Shafroth, the initiator of the house bill before the Senate, stated "We have here exactly the same that was allowed in the Philippine bill." Id.

The United States created the Filipino territorial government following the Spanish Indian War. S. 2295, 57th Cong., 1st Sess., 35 CONG. REC. 6082 (1902).


124. Id. at 708 (emphasis added).

125. Mr. Bacon. "I should like to ask the Senator from Massachusetts whether the committee has considered the question of the right of Congress to exempt from taxation in the States bonds issued by the government of the Philippine Islands?"

Mr. Lodge. "The committee have [sic] considered that question, that point having been raised, and the committee were of opinion that, as we have made similar exemptions in cases of bonds in Territories, we were at liberty to do so in this case."

Mr. Bacon. "The Senator will note, Mr. President, that the question of precedent would not control that matter, unless it be a precedent set by the Supreme Court. . . ."

Mr. Lodge then acknowledged that the Mr. Bacon's concern would be addressed at a later date. However, the Congress did not discussed this issue further. S. 2295, 57th Cong., 1st Sess., 35 CONG. REC. 6082 (1902).

126. Id. at 123-6092.

127. The legislative history indicates that the Congressional committee intended to exempt at least the obligations issued by the Filipino government from state taxation.

[B]onds shall be exempt from the payment of all taxes or duties of the government of the Philippine Islands or any local authority therein, or of the Government of the United States, as well as from taxation in any form by or under State . . . in the United States or the Philippine Islands.

Id. at 6082 (emphasis added). But Congress did not include the last line of the above quote in the actual statute. Philippine Islands Temporary Civil Government Act of July 1, 1902, Pub. L. No. 235, 57th Cong., 1st Sess. sec. 72, 708 (1902).
However, Congress indicated that it did not intend to exempt the interest derived from these obligations from either federal or state taxation.129 First, the language of the Filipino act Congress specifically said that the interest, along with the principal, should be paid to the investors, but failed to mention interest when exempting the bond from taxation.130 Second, when Congress enacted the government for the Philippine Islands, Congress understood that taxation of interest income was possible. While only one state and one territory had an income tax when Congress enacted the government for the Philippine Islands,131 several federal income taxes had been in effect since the mid 1800's.132 Finally, Congress did not purport to exempt the interest derived from Filipino obligations from state taxation.133

When Congress enacted both the Filipino and Puerto Rican bond provisions, it was well aware of the possibility that federal and state governmental bodies would consider taxing not only the principal of a governmental obligation, but also the interest income derived therefrom.134 Because Congress did not exempt the interest income derived from Filipino obligations from state or federal taxation and Congress indicated that the Filipino act was the model for the Jones Act, Congress could not have intended to extend the federal or state tax exemption of section 745 to the interest derived from the Puerto Rican obligations.

Had Congress intended to exempt the interest derived from Puerto Rican obligations from state and federal taxation, Congress should have indicated in the Jones Act's legislative history or in the statutory language of section 745 an intention to modify the tax exemption provision of the Filipino Act, which Congress expressly relied on. At best, Congress did not affirmatively manifest an intent to make such a modification.

128. See supra notes 123-127 and accompanying text.
130. Id.
132. Hawaii imposed an income tax as long ago as 1901, while it was still a territory.” Hawaii Income Tax, Compilation, 875, (CCH) ¶ 10-002 (Sept. 1987).
133. Supra note 19 and 22 and accompanying text.
134. See infra notes 135-71.
C. Congress Knew How to Create an Income Tax Exempt Provision

Not only does the language of section 745 and the legislative history surrounding section 745 indicate that Congress did not intend to exempt the interest income derived from Puerto Rican obligations from taxation, but Congress enacted a revenue statute excluding other interest from taxation prior to enactment of section 745.135 When Congress enacted section 745, in 1917, few states had a personal income tax.136 This may lead one to believe that Congress was unaware of the language required to cause the interest derived from Puerto Rican obligations to be tax exempt or believed that the taxation of interest income was not possible. However, the states had ratified the sixteenth amendment137 and a valid federal income tax was in effect,138 conditions which would hardly have escaped Congress' notice. Obviously, Congress was well aware of its authority and the language required to exempt the interest derived from governmental obligations. First, the federal revenue act in effect at the time Congress enacted section 745 expressly exempted the interest derived from obligations of possessions. Second, the Revenue Act of 1916, while providing an exemption for the interest derived from United States obligations, did not provide the same exemption for territories that were not possessions. Finally, in 1949 and 1950, Congress specifically exempted the interest income derived from the obligations of other territories, such as the Virgin Islands and Guam.

First, in the Revenue Act of 1916,139 Congress exempted the interest derived from United States possessions' obligations, from state and federal taxation.140 The Revenue Act of 1916, stated that the interest income of the following shall be exempt from taxation: "obligations of a State or any political subdivision thereof or upon the obligations of the United States or its possessions."141 This statute makes clear that Congress was aware of its authority, its ability, and the possible need to exempt government obligations from federal and state taxation. The Revenue Act of 1916 indicates that Congress knew how to exempt munici-

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137. U.S. CONST. amend XIV.
See supra note 22, 23 and accompanying text for other valid income taxes prior to the 1900s.
140. Id.
141. Id.
principal obligations and the interest derived therefrom from taxation, but choose not to for Puerto Rican obligations.

Second, while in the Revenue Act of 1916 Congress provided an income taxation exemption for the interest derived from United States possessions, Congress did not make the same exemption for territories, which were not possessions. Courts and writers often use the terms possession and territory interchangeably, but traditionally the two terms are not the same. For example, some scholars would not consider Puerto Rico to be a possession, but rather a territory.

The Supreme Court defined a territory under the Constitution and the laws of the United States, to be an inchoate state:

a portion of the country not included within the limits of any state, and not yet admitted as a state into the Union, but organized under the laws of Congress, with a separate Legislature, under territorial governor and other officers appointed by the President and Senate of the United States.

Further, "a territory is a distinct political society and, therefore, sovereign in its action, except as limited by the Organic act[, which states that a territory's actions are] subject to approval or disapproval by a high authority." The constitution allows states and incorporated territories to regulate their own concerns and Congress to direct the internal affairs of an unincorporated territory.

However, a possession is a portion of the United States which enjoys no organized sovereign system of government. In re Lane, the

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142. Holmes, supra note 136, at 257.

OBLIGATIONS OF THE POSSESSIONS OF THE UNITED STATES.

Interest paid on the obligations of possessions of the United is exempt. Interest on the obligations of the territories, or political subdivisions thereof, can be considered as exempt only on the ground that the territories are possessions of the United States, since the law does not expressly include territories in the exemption provision.

Id.


144. A possession is not a territory, under the generally accepted definition. See supra notes 143-63 and accompanying text.


147. Territory v. Lee, 2 Mont. 124, 133-34 (1874).

"The aim of the ... Organic Act was to give Puerto Rico full power of local self-determination, with an autonomy similar to that of the states and incorporated territories. The effect was to confer upon the territory many of the attributes of quasi sovereignty possessed by the states—as, for example, immunity from suit without their consent." Puerto Rico v. Shell Co., 302 U.S. 253, 262 (1937) (footnotes omitted).

148. Lee, 2 Mont. at 133.

149. In re Lane, 135 U.S. 443 (1890).
court reasoned that, in 1890, Oklahoma was not a territory because "[i]t had no established or organized system of government for the control of the people within its limits, as the territories of the United States have."151 Similarly, courts have defined the word "possession" as "[t]he thing possessed, that which anyone occupies, owns or controls."152 In *Connell v. Vermilya-Brown Co.*,153 the court held that an American defense base, leased to the United States on the Bermuda Islands by Great Britain, would be a possession of the United States as long as the land was within the sovereign jurisdiction of the United States.154

When Congress enacted the Revenue Act of 1916, Puerto Rico was a territory rather than a possession. For example, in 1909, in *New York ex rel. Kopel v. Bingham*,155 the accused sued for a writ of habeas corpus, complaining that the Puerto Rican governor's demand for his return to Puerto Rico was "insufficient in law" and that the New York authorities should not detain him.156 However, the Supreme Court did not agree. First, section 5278 of the Revised Statute provided that when an executive authority of any state or territory demands the return of a fugitive, who has fled the jurisdiction of the demanding state or territory, the executive of the state or territory to which the fugitive has fled shall arrest and secure the fugitive and to return the fugitive to the custody of the demanding state or territory.157 Second, the court reasoned that the organic act of Puerto Rico158 provided that the statutory laws of the United States were applicable and had the same effect in Puerto Rico as in the United States.159 Third, the Court found that the organic act of Puerto Rico provided that the governor of Puerto Rico "shall . . . have all the powers of governors of the territories of the United States."160

The Court finally reasoned that the organic act of Puerto Rico gave

150. *Id.*
151. *Id.* at 447-48.
154. *Id.* at 861.
155. 211 U.S. 468 (1909).
156. *Id.* at 472.
157. *Id.* at 472-73 (discussing section 5278 of the Revised Statutes; U.S. Comp. Stat. 1901, p. 3597.)
158. *Id.* (referring to 31 Stat. 80, ch. 191 (1900) commonly called the Foraker Act).
159. *Id.* (citing 31 Stat. 80, ch. 191 sec. 14 (1900) ("except [those involving] the internal revenue laws, which, in view of the provisions of section three, sh[ould] not have force and effect in Puerto [sic] Rico").
160. *Id.* at 474 (citing 31 Stat. 80, ch. 191, sec. 17 (1900)).
Puerto Rico the kind of organization required by *Ex Parte Morgan*\(^\text{161}\) to qualify Puerto Rico as a territory and not simply a possession.\(^\text{162}\) Consequently, the Court held that Puerto Rico was a territory under the constitution and the laws of the United States, and therefore the Puerto Rican governor had every right to demand the return of fugitives who have fled from Puerto Rico to other states or territories of the United States.\(^\text{163}\) Since the early 1900's Puerto Rico has been considered a territory, not a possession. Consequently, when Congress enacted the Revenue Act of 1916 it did not provide a tax exemption for the interest derived from Puerto Rican obligations.

Finally, in 1949 and 1950,\(^\text{164}\) Congress specifically exempted the interest income derived from the obligations of other territories, such as the Virgin Islands and Guam.\(^\text{165}\) While these statutes are similar to section 745, they are not identical. When Congress enacted these other territorial statutes, Congress explicitly exempted both the principal and the interest income derived from these territorial obligations by expressly stating an exemption for both.

Congress enacted the federal statute, section 1574, which dealt with Virgin Island obligations, in 1949.\(^\text{166}\) Section 1574 conspicuously states that

> [a]ll such bonds issued by the government of the Virgin Islands or by its authority shall be exempt as to principal and interest from taxation by the Government of the United States, or the government of the Virgin Islands, or by any state [of the United States], Territory, or possession or by any political subdivision of any state, Territory, or possession or by the District of Columbia.\(^\text{167}\)

In addition, one year later, Congress enacted the "Organic Act of Guam" to provide a civil government for Guam.\(^\text{168}\) Congress included a provision,\(^\text{169}\) which allowed Guam to issue bonds, as it had done for other territories.\(^\text{170}\) In section 1423(a), Congress also specifically stated

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161. 20 F. 298, 305 (W.D. Ark. 1883).
163. "It may be justly asserted that Porto [sic] Rico is a completely organized territory, although not a territory incorporated into the United States, and that there is no reason why Porto [sic] Rico should not be held to be such a territory as is comprised in § 5278."
166. Id.
167. Id. (emphasis added).
170. Id.
that the interest arising out of Guam's obligation would be tax exempt.\textsuperscript{171}

Not only did Congress not expressly provide the same tax exemption in section 745 that it later provided in section 1574 or section 1423(a), but Congress has had the opportunity to amend section 745, and has chosen not to.\textsuperscript{172} Congress' failure to amend section 745 to specifically exempt the interest derived from Puerto Rican obligations supports the proposition that Congress never intended such interest to be tax-exempt.

Little, if any, justification exists to demonstrate that Congress was not aware of the language required to provide an exemption for the interest derived from Puerto Rican obligations when it enacted section 745. First, when Congress enacted section 745 it had previously provided such an exemption for United States possessions in the Revenue Act of 1916. Second, not only did Congress not provide an exemption for the interest derived from Puerto Rican obligations in section 745, it also did not do so in the Revenue Act of 1916 because Puerto Rico was not a possession. One could hardly believe that Congress understood what language was needed to make an exemption in 1916, forgot in 1917, and reacquired the understanding in 1949. Finally, Congress has had the opportunity to amend section 745, but has chosen not to. Congress's failure to amend section 745 to specifically exempt the interest on Puerto Rican obligations supports the proposition that Congress never intended such interest to be tax-exempt.

\textbf{D. Section 745 and Its Relationship to Section 3124(a)}

Courts which have interpreted section 745 have not determined that Congress intended the interest derived from Puerto Rican obligations to be exempt from taxation. While these courts have identified similarities between section 745 and section 3124, which exempts United States obligations and the interest derived therefrom from state taxation, they have not found the interest income taxation exemption of section 3124(a) to be mandated by section 745. These courts noted that Congress did not indicate an express intent to exempt such interest from state taxation.

Both section 3124(a) and section 745 detail the tax status of government obligations. However, section 745 involves Puerto Rican obliga-

\textsuperscript{171} All bonds issued by the government of Guam or by its authority shall be exempt, as to principle and interest, from taxation by the Government of the United States or by the government of Guam, or by any State or Territory or any political subdivision thereof, or by the District of Columbia.

\textit{Id.}

\textsuperscript{172} 48 U.S.C. § 745 was amended in 1950 (64 Stat. 458 (1950)) and 1960 (75 Stat. 245 (1960)).
tions and 31 U.S.C. § 3124(a) provides a tax exemption for United States obligations and the interest derived therefrom. Unlike section 745, section 3124(a), expressly exempts from state and federal taxation the interest income derived from the obligations it covers. The section 3124(a) exemption "applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax."173 However, section 3124(a)(1) allows states to tax the interest derived from United States obligations if the state tax is a nondiscriminatory franchise tax.174 Similarly, courts have held that section 745, like section 3124(a)(1), allows states to tax the interest derived from Puerto Rican obligations, if the tax is a nondiscriminatory franchise tax. However, these same courts have not expanded the similarities of sections 745 and 3124(a) to imply an exemption for the interest derived from Puerto Rican obligations from other state or federal income taxes.

The Supreme Court of Minnesota, upon noticing the similarity between section 745 and section 3124(a), concluded that the interest derived from the Puerto Rican obligations was not exempt from their state's nondiscriminatory franchise tax,175 but did not extend the tax exemption provided in section 3124(a) to the interest derived from Puerto Rican obligations.176 In *Rochester Bank & Trust Company v. Commissioner of Revenue*,177 the Minnesota Commissioner of Revenue obtained a writ of *certiorari* to review a decision of the Minnesota Tax Court.178 The state tax court had held that interest income received by the Rochester Bank and Trust Company on its Puerto Rican bonds did not have to be included in the bank's taxable net income for purposes of computing the bank's excise tax.179

The Supreme Court of Minnesota disagreed, thereby finding that the interest earned on the bank's Puerto Rican obligation holdings was sub-

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174. *Id.* § 3124(a)(1).
175. *Rochester Bank & Trust Co. v. Comm'r of Revenue*, 305 N.W.2d 776 (Minn. 1981). The Minnesota Supreme Court held that section 745 did not exempt the interest derived from Puerto Rican obligations from the state's non-discriminatory franchise tax, just as section 3124(a) does not exempt the interest derived from United States obligations from states' non-discriminatory franchise.
176. A franchise tax is a tax on corporations for doing business in a state, county, or city. The tax is not an income tax, but is based on the corporation's entire net income. *Id.*
177. In addition, a non-discriminatory tax is one that states may impose on holders of federal obligations or property if the state also impose an equivalent tax on holders of state obligations or property. The tax is non-discriminatory if the tax is not places no greater "burden on holders of federal property than on holders or similar state property." *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983).
178. *Id.* at 777.
179. *Id.*
ject to the Minnesota's nondiscriminatory franchise and excise tax.180 It analogized section 745 to section 3124(a)(1),181 which provides an exception to the general rule that all United States obligations are exempt from state taxation.182 Section 3124(a)(1) allows states to tax the interest derived from United States obligations if the tax is a "nondiscriminatory franchise tax" that is imposed on a corporation doing business in the state.183 The Supreme Court of Minnesota extended section 3124(a)'s exception to the exemption provision to Puerto Rican obligations and section 745 by implication,184 arguing that public policy required the courts to interpret the two statutes to include the same exceptions to their exemptions.185

Similarly, the New York State Tax Commission relying on Rochester Bank & Trust Company v. Commissioner of Revenue found section 745 to be similar to section 3124(a)(1). In Federal Insurance Company v. New York,186 Federal Insurance Company filed for a refund of a New York franchise tax it paid on its Puerto Rican Bond holdings.187 The commission held that interest derived from Puerto Rican bonds had to be included in the taxpayer's entire net income, for the purposes of determining a non-discriminatory franchise tax.188 The commission reasoned that all interest derived from state or local bonds was includable, and that the interest derived from Puerto Rican obligations was no exception.189 Consequently, the commission refused to issue a refund and required the company to include the $1,624,943 interest earned from its Puerto Rican obligations in its taxable income for the purpose of arriving at the company's New York state entire net income.190

While both courts have recognized the similarities in section 745 and 3124(a), neither court expanded the similarities between section 3124(a) and section 745 to include an income tax exemption for the inter-

180. Id.
182. Id.
185. Id.
187. Id. at 16883.
188. Id.
190. Id.
est derived from Puerto Rican obligations as is provided for the interest derived from United States obligations in section 3124(a). While the Supreme Court of Minnesota reasoned that uniformity is required for the tax treatment of United States governmental obligations as well as United States "possessions, agencies or instrumentalities," the court noted that Congress had not expressed any intent to extend the exemptions of the exception provided in section 3124(a)(1) to section 745.

The Minnesota Supreme Court noted that Congress did not manifest an express intent "that the exemption should extend beyond a prohibition against direct taxation." The court supported its decision to extend the exception of section 3124(a)(1) to section 745 based on public policy and its finding that while Congress had not expressed an intent to include "in the bank's tax[able] net income of interest earned on Puerto Rican bonds in the computation of its excise tax, . . . neither is there clear indication that Congress intended to exclude it."

The Minnesota Supreme Court's reasoning is interesting. However, as has been discussed above, the Supreme Court of the United States has held that the Constitution places no prohibition against a governmental body implying a right to tax governmental obligations where Congress has not expressly limited that right. As logically follows, the same governmental body is not required to imply an exemption absent express congressional action. Consequently, congressional failure to provide an express interest income tax exemption would be enough for states to tax the interest derived from Puerto Rican obligations, but not enough for Congress to require them to exempt the same interest from taxation.

E. Summary

The evidence is persuasive that Congress did not intend the interest derived from the Puerto Rican obligations to be tax-exempt. First, the

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192. Rochester Bank & Trust Co. 305 N.W. 2d at 779.
193. Id.
194. Id. "We do not discern in indicia of Congressional intent, or consideration of public policy, any basis to support distinctive treatment between obligations of the United States government and those of its possessions, agencies or instrumentalities."
language of section 745 does not expressly exempt the interest derived from Puerto Rican obligations and absent legislative or statutory language specifically exempting such interest, courts cannot infer a constitutional tax exemption for such income. Second, the legislative history indicates that Congress did not intend to provide a state tax exemption for the interest income derived from Puerto Rican obligations. Third, Congress expressly exempted the interest derived from the obligations issued by United States possessions in the Revenue Act of 1916, but did not include the same exemption of the interest in section 745, which Congress enacted one year later. In addition, in similar statutes dealing with obligations issued by other United States territories, such as the Virgin Islands and Guam, Congress expressly exempted the interest derived from these obligations, but has not amended section 745 to provide the same exemption for the obligations issued by Puerto Rico. Finally, courts have extended some of the provisions of section 3124(a) to section 745, but have found that Congress did not express an intent to extend all the provisions of section 3124(a) to section 745. With these issues in mind, at the time Congress enacted section 745, it had enough experience exempting interest income from state and federal taxation that had Congress intended to make such an exemption for the interest derived from Puerto Rican obligations it would have done so.

VI. SECTION 745 IS UNCONSTITUTIONAL

While the Supreme Court has never expressly held that Puerto Rico is an incorporated territory, the events that have taken place since 1917 demonstrate that Puerto Rico has been incorporated into the United States. Thus, Congress no longer has the power, under the constitutional territorial clause, to interfere with the states’ power to tax the principal and the interest derived from Puerto Rican obligations. The territorial clause grants Congress the power to enact any

198. The Court has never answered the question of whether the bill of rights applies to Puerto Rican citizens because Puerto Rico is incorporated or because its citizens are citizens of the United States. Examining Bd. of Engineers, Architects and Surveyors v. Flores De Otero, 426 U.S. 572, 599-600 (1976); Torres v. Commonwealth of Puerto Rico, 442 U.S. 465, 468-470 (1979).
199. In Rodriguez v. Popular Democratic Party, the Court referred to Puerto Rico as “like a state.” 457 U.S. 1, 7 (1982).
200. U.S CONST. art. IV, § 3, cl. 2.
201. Nathan v. Louisiana, 49 U.S. 73, 82 (1850); Snow v. Dixon, 362 N.E.2d 1052, 1062 (Ill. 1977), cert. denied, 434 U.S. 939 (1977). The Supreme Court concluded in Dorr: that the power to govern territories, implied in the right to acquire territories, and given to Congress in the Constitution in article [IV], § 3, to whatever other limitations it may be subject, the extent of which must be decided as questions arise, does not require . . . [Congress] to enact for ceded territories, not made part of the United States by Congressional action, a system of laws which shall include the right of trial by jury, and that the Constitu-
necessary law regarding territories.\textsuperscript{202} However, the United States Supreme Court has interpreted this power to apply without limitations to unincorporated territories,\textsuperscript{203} and with limitations to incorporated territories.\textsuperscript{204} The Supreme Court has held that incorporated territories are very similar to states because the entire Constitution is applicable to them, and therefore, Congress is constrained by the entire Constitution when enacting laws regarding incorporated territories.\textsuperscript{205} This Note will demonstrate that Congress may not constitutionally prevent the states from taxing other states' obligations\textsuperscript{206} and, similarly, Congress may not prevent the states from taxing Puerto Rican obligations because Puerto Rico has been incorporated, thus, is more like a state\textsuperscript{207} than simply a division of the federal government.

Section 745 violates the Constitution. First, federal and state governments have the power, under the Constitution, to tax the interest derived from state obligations. Second, states have the power, under the Constitution, to tax the interest derived from other states obligations. Third, under certain circumstances states have the power, under the Constitution, to tax federal obligations and the interest derived therefrom. Finally, Puerto Rico has been incorporated, and therefore, should be treated more like a state government than a portion of the federal government. This incorporation qualifies Puerto Rico for state-like treatment and the full protection of the Constitution. Section 745, which at-
tempts to limit the application of the Constitution to Puerto Rico and discriminates in favor of Puerto Rican obligations, is unconstitutional. Thus, states may tax Puerto Rican obligations and the interest derived therefrom.

A. The Federal Governments Has the Power to Tax the Interest Derived from State Obligations

In 1895, the United States Supreme Court held, in Pollock v. Farmers' Loan & Trust,\(^{208}\) that the federal government cannot tax the interest derived from municipal securities. The Court reasoned that the tax forced the state or local government to borrow on the credit of the United States and was consequently at odds with the constitutional scheme.\(^{209}\) The Court reasoned that a tax on income derived from state or local government stocks or obligations was a tax on the contract,\(^{210}\) thereby interfering with the state or local government's power to borrow money. The Court held that such a tax violated the state and local government's constitutional right of intergovernmental immunity.\(^{211}\)

However, the holding in Pollock has been slowly eroded,\(^{212}\) and was finally overturned in 1988.\(^{213}\) In South Carolina v. Baker, the Supreme Court criticized the Pollock holding, by ruling that all interest derived from bonds was taxable whether the bonds were issued by the federal government, a state, a municipality, an individual or a private corporation.\(^{214}\) Further, the Court held that Congress may choose to tax unregistered state obligations and the interest derived therefrom and yet to exempt from federal taxation registered state obligations and the interest derived.\(^{215}\) The Court reasoned that "[t]he theory . . . that a tax on income is legally or economically a tax on its source, is no longer

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208. 157 U.S. 429 (1895).
209. Id.; see also Weston v. City Council, 2 Pet. 449, 468 (1829) (The court held that “taxation on the interest” derived from municipal securities would operate on “the power to borrow before it is exercised.” This would have an influence on the contract and would be “a tax on the power [of the states and their instrumentalities] to borrow money, . . . and consequently [would be] repugnant to the constitution.”)
210. Pollock, 157 U.S. at 585; Weston, 2 Pet at 469.
211. Pollock, 157 U.S. at 585; Weston, 2 Pet at 469.
212. Graves v. New York ex rel. O'Keefe, 306 U.S. 466, 486 (1939) (state taxation of salaries of government employees is valid under the Constitution); Helvering v. Gerhardt, 304 U.S. 405 (1938); James v. Dravo Contracting Co., 302 U.S. 134, 160 (1937) (While a tax on a government contract may increase the governments cost the increased cost will not invalidate the tax.).
214. Id. at 525-27.
215. Id. (federal taxation of the interest derived from unregistered state obligations is constitutional even when Congress exempts registered state obligations and the interest derived therefrom from taxation).
While, the burden of a nondiscriminatory tax on the income of governmental employees or investors who own government property may be passed back to the government through increased salary rates or higher interest rates, this burden is a normal incident of doing business in the same territory in which two governments each possess the power of taxation.\textsuperscript{217} The Constitution presupposes this effect,\textsuperscript{218} "owners of state bonds have no constitutional entitlement not to pay [federal] taxes on income they earn from state bonds, and States have no constitutional entitlement to issue bonds paying lower interest rates than other issuers."\textsuperscript{219} Consequently, the rationale that the taxation of income derived from governmental property is a direct tax on the governmental body is no longer valid. Rather, after \textit{Baker}, the Constitution allows the federal government to tax state obligations, as long as all states are affected equally.\textsuperscript{220}

\textbf{B. States Have the Power to Tax Other States Obligations}

Further, not only can the federal government tax state obligations, but the Supreme Court has held that the Constitution does not prohibit states from taxing the bond issues of other states because to do so would interfere with the taxing power possessed by each state.\textsuperscript{221} The Constitution grants the states the power to tax the income of its citizens through the Tenth Amendment\textsuperscript{222} and this power is an essential element of the sovereignty of each state.\textsuperscript{223}

\begin{itemize}
\item \textsuperscript{216} Id. at 523 (citing Graves v. New York ex rel. O'Keefe, 306 U.S. 466, 480 (1939)).
\item \textsuperscript{217} Graves, 306 U.S. at 487.
\item \textsuperscript{218} Id.
\item \textsuperscript{219} Baker, 485 U.S. at 524-25.
\item \textsuperscript{220} Id.
\item \textsuperscript{221} In Bonaparte v. Tax Court, 104 U.S. 592 (1881), the Court answered the question whether the registered public debt of one State was exempt from taxation by the debtor State, or could be taxed there and whether the income and debt was taxable by another State when owned by a resident of the latter State. The court held "[w]e know of no provision of the Constitution of the United States which prohibits such taxation. . . . [In addition the court] conceded that no obligation of the contract of the debtor State is impaired." \textit{Id.} at 524.
\item \textsuperscript{222} "The power of the State legislature to levy and collect taxes is unrestricted where such tax is not otherwise unconstitutional." Snow v. Dixon, 362 N.E.2d 1052, 1062 (Ill.), \textit{cert. denied}, 434 U.S. 939 (1977).
\item \textsuperscript{223} Nevada v. Hall, 440 U.S. 410, 422 (1979) ("[t]he Full Faith and Credit Clause does not require a State to apply another State's laws in violation of its own legitimate public policy."). Consequently, each state may tax the principal and interest income derived from another state's obligations, if held by its citizens, even if the other state exempts its bond principal and the interest derived therefrom from its own taxation. \textit{Id.} at 421-22.
\item \textsuperscript{224} In \textit{Bonaparte v. Tax Court}, 104 U.S. 592, 594 (1881). "The debtor State is in no respect [the property holder's] sovereign, neither has it any of the attributes of sovereignty as to the debt it owes, except such as belong to it as a debtor." \textit{Id.} at 595.
\end{itemize}
The Tenth Amendment, which grants the states powers that are not specifically enumerated, is still valid. In *Garcia v. San Antonio Metro. Transit Authority*, the Court overruled *National League of Cities v. Usery* by holding that states are not entitled under the tenth amendment to exclusively regulate traditionally state functions. However, the court indicated that unenumerated "limits on the Federal Government's power to interfere with state functions" undoubtedly exist. For example, in *Rodriguez v. Popular Democratic Party*, the Court held that Puerto Rico, like the states, was entitled to regulate its own election system and process, as long as such regulations do not restrict Puerto Rican citizens' access to the electoral process or discriminate among voters or political parties, as guaranteed by the Constitution. Similarly, the Supreme Court has held that the states' power to tax its citizens exists under the Constitution.

The tenth amendment of the Constitution grants the states the power to tax the income of its citizens and little if any federal power under the Constitution can impair this exercise of state sovereignty.

No one questions that the power to tax all property, business, and persons, within their respective limits, is original in the States and has never been surrendered. [However,] it cannot be so used, indeed, as to defeat or hinder the operations of the National government; but 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.

While the Constitution’s tenth amendment does not allow states to ignore express congressional regulation of interstate commerce, federal property, state taxation of federal and state obligations, property,

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224. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X.
225. Even after *Garcia*, "[a]lthough the tenth amendment is moribund, it is by no means dead." *Constitutional Law*, 97 Harv. L. Rev. 70, 200 (1982); see *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 547 (1985) (While the federal government can regulate most traditional state functions, limits on the federal power may exist); *Snow v. Dixon*, 362 N.E.2d 1052, 1062 (Ill.), cert. denied, 434 U.S. 939 (1977) (In this relatively recent decision, the court held that the state power of taxation has been left to the states through the tenth amendment.)
226. 469 U.S. at 547.
229. 457 U.S. at 11.
231. "The power of the State legislature to levy and collect taxes is unrestricted where such tax is not otherwise unconstitutional." *Snow*, 362 N.E.2d at 1062.
tracts, or other traditionally state functions, the Constitution does not authorize Congress the power to place these regulations in a discriminatory manner. Consequently, Congress does not have the power to give Puerto Rico, which has been incorporated, any state, or any other incorporated territory a more favorable bond issue provision than it grants any of the other fifty states of the United States. Similarly, holders of Puerto Rican obligations should be subject to the same taxes as holders of other state obligations.

C. States Have the Power to Tax the Interest Derived from Federal Obligations

Even, if Puerto Rico has not been incorporated and is still a portion of the federal government, states may still have the authority to tax the principal and the interest derived from Puerto Rican bonds. While the Supreme Court has held that the federal government has the power to tax state obligations and the interest derived therefrom, and that states have the power to tax the interest derived from the obligations of other states, the Supreme Court has also held that under certain circumstances states have the power, under the Constitution, to tax federal obligations and the interest derived therefrom.

Under the constitutional rule of governmental tax immunity established in McCulloch v. Maryland, Congress codified this constitutional rule in section 3124(a) of the United States Code. Over the years, the Supreme Court has expanded its holding in

236. During congressional hearings Senator Harding noted "[t]hat [exempting bonds from federal and state tax] is a provision that is not granted to any state in the Union," and consequently may be discriminatory. H.R. 9533, 64th Cong., 2d Sess., 5 CONG. REC. 4810 (1917).
237. This note will demonstrate that Puerto Rico which is more like a state government than the federal government. See Part V, section C.
241. 4 Wheat. 316 (1819).
McCulloch to bar not only direct taxes on the federal government, but also indirect taxes. Under these holdings the Court stated that any tax on the income derived from federal or state property, obligations, and contracts was exempt from state taxation, even if the property, obligation, or contract was held by a private individual or association.244

However, later cases have overruled these expansive holdings, thereby, modifying the Court's interpretation of McCulloch.245 Today, the Supreme Court has recognized that absent congressional statutory action to exempt United States obligations from taxation by all states, states may tax the obligations and the interest derived from these federal obligations.246 In Memphis Bank & Trust Co. v. Garner,247 which involved a state tax on income derived from federal obligations, the Court acknowledged that the constitution and section 3124(a)(1), under the correct circumstances, allowed states to impose a tax on the interest derived from federal obligations.248 The Supreme Court ruled that state taxation of the interest derived from federal bonds was not barred by the Constitution as long as the tax did "not discriminate against holders of federal property or those with whom the Federal Government deals."249

244. "The reasons for exempting all the property and income of a state, or of a municipal corporation, which is a political division of the state from federal taxation, equally require the exemption of all the property and income of the national government from state taxation." Pollock v. Farmers' Loan Trust, 157 U.S. 429, 585 (1885), overruled by South Carolina v. Baker, 485 U.S. 505 (1988) (a federal tax on of income derived from municipal property was unconstitutional because the tax on the income was the same as a tax on the property); "It cannot be denied (and denial is not attempted) that bonds of the United States are beyond the taxing power of the states," Northwestern Mut. Life Ins. Co. v. Wisconsin, 275 U.S. 136, 140 (1927) (the Constitution implies an exemption for the interest derived from federal obligations).

245. South Carolina v. Baker, 485 U.S. at 520-22 (discussing Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939); Memphis Bank & Trust v. Garner, 459 U.S. 392, 397 (1983); Helvering v. Gerhardt, 304 U.S. 405 (1938) (The court upheld a state sales tax imposed on a government contractor even though the financial burden of the tax was passed on to the Federal government); James v. Dravo Contracting Co., 302 U.S. 134 (1937) (The fact that a tax on a government contract would increase the cost to the Government is not a legitimate reason to invalidate the tax). See also Thomson v. Union Pacific R.R., 76 U.S. 579, 587-88, (1869) (State governments have the authority, under the Constitution and absent Congressional legislation, to tax the property of private corporations doing business under federal contract.)


247. Id.

248. Id. at 397 (referring to 31 U.S.C. § 3124(a), which the Court holds is a restatement of the constitutional rule imposed by McCulloch v. Maryland, 4 Wheat 316 (1819). The Court recognized that if the state tax qualified under the exception provided by § 3124(a)(1), the states were free to tax the interest derived from the federal obligations); section 3124(a)(1) provides that the exemption extends to every form of taxation, "except nondiscriminatory franchise or . . . other nonproperty tax[es] [in lieu thereof] imposed on . . . corporation[s], and [except] estate [taxes] or inheritance tax[es]." 31 U.S.C. § 3124(a)(1) (1976).

However, under the Constitution "[a] state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." Consequently, states have the authority, under the Constitution and section 3124(a)(1) to place a nondiscriminatory tax on federal obligations and the interest derived, but seldom follow through with such taxes.

Under section 745, Congress has not taken the steps required to exempt Puerto Rican obligations and the interest derived therefrom from state taxation. As discussed earlier, Congress has failed to express an intent to exempt the interest derived from state taxation. However, if Puerto Rico is determined to only be a portion of the federal government and not an incorporated territory, and Congress amends section 745 to expressly exempt the interest derived from Puerto Rican obligations from state taxation, any state, which taxes not only the obligations and the interest derived from federal obligations, but also taxes the principal and the interest derived from their own state obligations, may tax the interest derived from Puerto Rican obligations.

The majority of the states, however, do not tax the principal or interest derived from obligations issued by their own state, but do tax the principal and the interest derived from other states' obligations. Consequently, a tax imposed by these states on the principal or interest derived from any federal obligations, including Puerto Rican obligations, would create a greater burden on holders of federal obligations than on holders of similar state obligations. Therefore, such a tax would be dis-

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Baker, 485 U.S. at 521 (discussing Alabama v. King & Boozer, 314 U.S. 1, 62 (1941) (So long as the state tax on the contractor was nondiscriminatory and is for the costs of the materials to the government, the tax is "but a normal incident of the organization within the same territory of two independent taxing sovereignties." The governments asserted right to be free from taxation by the another government does not spell immunity from paying the added cost, attributable to the taxation of those who furnish supplies to the government and who have been granted no tax immunity.))

251. In Graves v. New York ex rel O'Keefe, 306 U.S. 466 (1939), the Court held that while tax exemption could not be implied by the Constitution, Congress had the authority to exempt federal obligations from state taxation, but only if Congress acted affirmatively. Id. at 480.

Currently, Congress does not exempt the interest derived from United States obligations from a nondiscriminatory state franchise tax. 31 U.S.C. sec. 3124(a)(1) (1982). In addition, courts have similarly interpreted Section 745 to not exempt the interest derived from Puerto Rican obligations from such nondiscriminatory state income tax or franchise tax. Rochester Bank & Trust Co. v. Comm'r of Revenue, 305 N.W. 2d 776, 779 (1981); Federal Ins. Co. v. New York, No. TSB-H-82(24)C (File No. 33253), slip op. (State Tax Comm'n November 15, 1982) (per curiam) (released 1983).

252. See supra note 49. The Court in Bonaparte, recognized that "The only agreement [the states had made] as to taxation was that the debt should not be taxed by the State which created it." Bonaparte v. Tax Court, 104 U.S. 592, 594 (1881).
criminatory tax, which would be in violation of the Constitution and section 3124 of the United States Code. 253

On the other hand, states which tax the principal and the interest derived from their own obligations, would have the power and the right, under the Constitution, to tax the principal or interest derived from Puerto Rican obligations because the tax would not discriminate against federal property holders. 254

However, as will be discussed in section D of this part of the Note, the Constitution does not consider Puerto Rico to be more like the federal government than a state government. Rather the Constitution considers Puerto Rico to be incorporated into the Union. 255 Congress cannot interfere with a state's autonomy to decide whether or not to tax obligations of other states and likewise Congress cannot interfere with a state's freedom to tax the principal or the interest derived from Puerto Rican bonds held by its citizens.

D. Puerto Rico Is Incorporated

Congress may not constitutionally prevent the states from taxing another states obligations or the interest derived therefrom. 256 Similarly Congress may not prevent the states from taxing Puerto Rican obligations because Puerto Rico has been incorporated, and therefore, is more like a state 257 than simply a division of the federal government.

Prior to the enactment of the Organic Act of Puerto Rico on March 2, 1917 and prior to the Supreme Court's decisions in the "Insular Cases," of the early 1900s, the Court held that unincorporated territories and possessions were entitled to the protection of the entire Constitu-

253. Memphis Bank & Trust Co., 459 U.S. at 397-99 (1983). “Our decisions have treated § 742, [codified at 31 U.S.C. § 3124(a) (1982)] as principally a restatement of the constitutional rule,” which exempts federal obligations from discriminatory taxation, but does not exempt such obligations or the interest derived from discriminatory taxation.

254. Id. at 397.

255. Mora v. Torres, 113 F. Supp. 309 (D.P.R. 1953), aff’d 206 F.2d 377 (1st Cir. 1953) (Congress is subject to other provisions of the Constitution when regulating Puerto Rico, such as the 5th amendment). Compare Rodriguez v. Popular Democratic Party, 457 U.S. 1, 7-8 (1982) (Puerto Rico, like a state, has the authority under the Constitution to fill vacancies that occur in legislative and other elective positions).

256. Bonaparte, 104 U.S. at 594; Thomson, 76 U.S. at 591 (1869). Compare South Carolina v. Baker, 485 U.S. 505, 526-27 (1988). The Baker Court determined that a congressional imposed tax on unregistered state obligations did not interfere with states sovereignty because the tax was not discriminatory. “[A] nondiscriminatory federal tax [or exemption] on the interest earned on state bonds does not violate the intergovernmental tax immunity doctrine.” Rather an exemption or tax for some state obligations over other states obligations would be discriminatory. Id.

257. Rodriguez v. Popular Democratic Party, 457 U.S. 1, 7-8 (1982) (Puerto Rico, like a state, has the authority under the Constitution to fill vacancies that occur in legislative and other elective positions).
tion. However, by the early 1900s, the Supreme Court had changed its position. The “Insular Cases” established that the Constitution, other than the territorial clause, does not automatically apply to unincorporated territories or possessions. The Court held that Congress must incorporate the territory or possession before Congress is limited by all other provisions of the Constitution in its regulation of and legislation for the United States property. Today, courts have predominately utilized the “Insular Cases” to determine the application of the Constitution to territories and possession.

At the time the “Insular Cases” were decided the United States had recently conquered and acquired Puerto Rico. Years later, when Con...
gress enacted section 745, Puerto Rico was still an unincorporated territory of the United States. In 1922, in *Balzac v. People of Porto Rico*, the Supreme Court held that the defendant was not entitled to a jury for either a civil or a criminal trial. The Court held that the Sixth and Seventh Amendments did not apply to citizens of Puerto Rico because Puerto Rico was an unincorporated territory. Congress did not expressly incorporate Puerto Rico, therefore, the court reasoned that incorporation should not be “assumed without express declaration, or an implication so strong as to exclude any other view.”

However, in a similar case, *Rassmussen*, the Supreme Court indicated that if the unincorporated territory was incorporated into the United States the entire Constitution would become applicable to it and the defendant would be entitled to the protection of the sixth and seventh amendments, even without congressional grant.

To determine whether section 745 is unconstitutional because Congress incorporated Puerto Rico and, therefore, is limited by the entire Constitution in its capacity to regulate or legislate for Puerto Rico this Note will examine two issues: first, whether Congress incorporated Puerto Rico; and second, if Congress did incorporate Puerto Rico whether a statute such as 48 U.S.C. § 745 is unconstitutional and outside the congressional power because section 745 is in violation of states’ constitu-

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266. In *Balzac*, 258 U.S. 298 (1922), the Court found that Congress had not incorporated Puerto Rico when it enacted The Organic Act of Puerto Rico of March 2, 1917. *Id.* at 306-13 (1922). Similarly, the Court in *Downes* considers Puerto Rico to be “a territory appurtenant and belonging to the United States, but not a part of the United States within the revenue clauses of the United States Constitution.” *Downes v. Bidwell*, 182 U.S. 244, 287 (1901).

267. 258 U.S. at 298.

268. The courts have ruled that federal statutes and provisions that discuss possession of the United States are applicable at a jury trial in criminal and civil cases against citizens of territories of the United States. “But it is just as clearly settled that they do not apply to [a] territory belonging to the United States which has not been incorporated into the Union.” *Id.* at 304-5.

269. *Id.* at 306. The court further reasoned that because Congress provided a separate Bill of Rights in the Jones Act for Puerto Rico, which did not include the rights of the sixth and seventh amendments, that Congress could not have intended to incorporate Puerto Rico. However, the Court did acknowledge that absent any other countervailing evidence, a law of Congress or a provision in a treaty acquiring territory, declaring an intention to confer political and civil rights on the inhabitants of the new land as American citizens, may be properly interpreted to mean an incorporation of [the territory] into the Union, as in the case of Louisiana and Alaska. *Id.* at 309 (referring to *Rassmussen v. United States*, 197 U.S. 516, 520-21 (1905)).

270. *Rassmussen v. United States*, 197 U.S. 516, 520-21 (1905) (Because Alaska was an incorporated territory of the United States the court held that the criminal defendant was entitled to a jury trial that comported with requirements of the 6th and 7th amendments.) Unlike *Balzac* the defendant in *Rassmussen* was entitled to a jury trial that comported with the requirements of the 6th amendment, because Alaska had been incorporated into the United States. *See also* Balzac, 258 U.S. at 309 (referring to *Rassmussen* and *Dorr*, 195 U.S. 138, 148 (1904) (the Court acknowledged that express incorporation is not necessary when the territory and the citizens living there do not have the cultural differences with that of the citizens of the United States.))
tional right to tax its citizens, granted under the tenth amendment and state's sovereignty power.

1. Did Congress Incorporate Puerto Rico

To determine whether Congress incorporated Puerto Rico this Note will explore three areas: (1) whether Congress made Puerto Rico an independent commonwealth by the compact between the United States and Puerto Rico, in 1950; (2) whether Puerto Rico fits the definition of an incorporated or unincorporated territory, and (3) whether the Supreme Court has held that Puerto Rico is like a state.

a. The Compact of 1950

On July 3, 1950, Congress enacted a compact with Puerto Rico, which one may argue incorporated Puerto Rico into the United States under Public Law number 600. Since the 1950's, courts have held that Puerto Rico is no longer a dependent territory or possession of the United States, but rather an incorporated territory and commonwealth. The "Insular Cases" mandate that when a territory, such as Puerto Rico, is incorporated the entire Constitution, not only the territorial clause, is applied to that territory. Further, courts have held that once a territory is incorporated and no longer a dependant possession, Congress cannot ignore the other provisions of the Constitution when legislating for the territory.

In Mora v. Torres, the district court held and the First Circuit affirmed that the fifth amendment no longer applied to Puerto Rico "on the basis that Puerto Rico [was] a possession, dependency or territory subject to the plenary power of Congress. . . . " Rather the fifth

271. "Fully recognizing the principle of government by consent, section 731(b) to 731(E) or (e) of this title are now adopted in the nature of a compact so that the people of Puerto Rico may organize a government pursuant to a constitution of their own adoption." 48 U.S.C. § 731(b) (1950) (emphasis added).
274. Rodriguez v. Popular Democratic Party, 457 U.S. 1, 7-8 (1982); Examining Bd. of Engineers, Architects and Surveyors v. Flores de Otero, 426 U.S. 572, 599-600 (1976); Torres, 442 U.S. at 468-470 (While the Court acknowledged that the Insular cases are still applicable in determining the application of the Constitution to incorporated or unincorporated territories the Court failed to determine whether Puerto Rico was incorporated or not); Hooven & Allison Co., 324 U.S. 652, 674, 682-84 (1945); Dorr v. United States, 195 U.S. 138, 145 (1904); Downes v. Bidwell, 182 U.S. 244, 287-344 (1900) (White J., concurring); Mora, 113 F. Supp. at 309 (the district court found and the appellate court affirmed that Puerto Rico has been incorporated).
275. Downes, 182 U.S. at 287; Balzac, 258 U.S. at 306-313; Mora, 113 F. Supp. at 309 (the district court found and the appellate court affirmed that Puerto Rico has been incorporated).
277. Id.
amendment applied to Puerto Rico through the compact granted by Congress. The Court reasoned that the Puerto Rican government is no longer an agency of the United States, nor does the United States exercise its power over Puerto Rico through the delegation of the Federal Government, but rather that Puerto Rico has been incorporated by compact with the United States.

Similarly, Alaska was acquired by treaty established by the action of Congress. In *Rasmussen v. United States*, the Court held that congressional action combined with the reiterated decisions of this Court indicated that Alaska had been incorporated into the United States. The Court found that the doctrine settled as to unincorporated territory in the "Insular Cases" is inapposite and lends no support to the contention that Congress in legislating for Alaska had the authority to violate the express commands of the 6th amendment. The Court reasoned that even though the treaty did not expressly incorporate Alaska or specifically grant Alaskan citizens the protection of the sixth amendment, because Alaska was incorporated, the Constitution automatically inferred this right on the citizens of Alaska.

Where [the] territory is part of the United States the inhabitants thereof were entitled to the guaranties of the 5th, 6th, and 7th Amendments, and that the act or acts of Congress purporting to extend the Constitution were considered as declaratory merely of a result which existed independently by the inherent operation of the Constitution. The Court reasoned that once a territory is incorporated into the United States, Congress is bound by the entire Constitution, not simply by the territorial clause.

Because Congress created a compact with Puerto Rico, and the Supreme Court treats such action as implying a territory's incorporation into the United States, the entire Constitution now applies to Puerto Rico. Thus, the mere fact that Congress, through the language of the

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278. Congress has relinquished its plenary power to make all needful rules and regulations for Puerto Rico, by granting the people of Puerto Rico a compact. *Id.*

279. Under the compact Puerto Rico has been incorporated into the United States. Now Puerto Rico enjoys the total right of self government, which is incompatible with the previous status of Puerto Rico as a possession, dependency or unincorporated territory. *Id.* at 313-14.

280. 197 U.S. 516, 525 (1905).

281. *Id.* at 520-21.

282. *Id.* at 527.

283. *Id.* at 526.

284. *Id.* at 525. In *Hooven & Allison Co. v. Evatt*, 324 U.S. 671 (1945), the Court held that "Congress is not subject to the same constitutional limitations," when legislating for areas that are not united with the United States by incorporation, as Congress is limited when "legislating for the United States," or its states. *Id.* at 674. In addition, the court held that the incorporated territories are entitled to government under all provisions of the Constitution, rather than only by grant of Congress under article IV, section 3, clause 2 of the Constitution. *Id.* at 682 (Reed, J. dissenting).
compact and section 745,285 attempted to preclude states from exercising their taxing power under the tenth amendment, is not in and of itself enough to say that Puerto Rico is not incorporated or that Congress is not limited by the entire Constitution.

b. The Definition of an Incorporated Territory

Second, to determine whether Puerto Rico is a territory which has been incorporated into the United States, the Note will discuss the definition of an incorporated territory. An incorporated territory is one that the federal government intends to joined into the Union as a state.286 In addition, an incorporated territory is one which Congress has created a compact with.287 On the other hand, an unincorporated territory of the United States belongs to the United States, but is not constitutionally united with it.288

First, an incorporated territory is one that the federal government intends to joined into the Union as a state. Congress and the President have made it clear that they would admit Puerto Rico into the union should the citizens of Puerto Rico request statehood.289 In an interview done in early 1990, the Bush administration indicated that it was behind efforts to bring Puerto Rico in as a state.290 While not every congressional leader agrees that Puerto Rico should be a state, a vast majority are in favor of statehood for Puerto Rico and believe that Puerto Ricans should be given the choice as whether to join the Union as a state or not.291 Consequently, Puerto Rico meets the first requirement to be in-

286. Granville-Smith, 349 U.S. 1, 8, n.12. Congress has indicated that statehood is the destiny of all "incorporated territories" or possessions.
288. Hooven & Allison Co v. Evatt, 324 U.S. 671, 674 (1945); U.S. CONST. art. IV, § 3, cl. 2.

The referendum will allow Puerto Rican citizens to chose between "enhanced" Commonwealth status, statehood or independence. Ronald Walker, spokes person for resident commissioner Jaime Fuster, said that the referendum has broad bipartisan support including endorsement of President Bush and Speaker of the House Tom Foley. Greenway, [Puerto Rico] States News Service, September 20, 1990.

291. In a thirty-seven to one vote, Marlenee, Congressman from Montana, "was the only member on the House Interior Committee this week to oppose holding a referendum in the Caribbean Commonwealth to see if the majority of its citizens favor statehood.” Montana would lose one of its representatives if Puerto Rico, which has a population of 3.6 million, more than four times that of Montana, became a state. Greenway, States News Service, September 20, 1990.

The other Montana Congressman, Pat Williams, also stated that he reservations about Puerto
cluded among the incorporated territories of the United States.

Second, Congress created a compact with Puerto Rico in 1950.292 The term "commonwealth" was presented to the people of Puerto Rico to describe the meaning of the compact:293

[In contemporary English [commonwealth] means a politically organized community . . . in which political power resides ultimately in the people, hence a free state, but one which at the same time [is] linked to a broader political system in a federal or other type of association and therefore does not have an independent and separate existence.294

The word "commonwealth" clearly defines the relationship created under the terms of the "compact" between the people of Puerto Rico and the United States.295 Puerto Rico's status with the United States is "that of a state[,] which is free of superior authority in the management of its own local affairs[,] but which is linked to the United States of America and hence is a part of its political system in a manner compatible with its federal structure."296 The constitution allows states of the Union, as it does incorporated territories, to regulate their own concerns, but Congress must direct the internal affairs of a unincorporated territory.297

Puerto Rico fits the definition of an incorporated territory because Congress and the President intend to join Puerto Rico into the Union as a state and Puerto Rico carries commonwealth status.

c. Puerto Rico Is Like a State

Third, the Supreme Court has held that Puerto Rico is like a State. In Rodriguez v. Popular Democratic Party,298 the Court found that the Puerto Rican legislature, like any state legislature, could vest in one political party the power to fill an interim vacancy in the Puerto Rico Legislature.299 The Court reasoned that Puerto Rico, like a state, "is an autonomous political entity, 'sovereign over matters not ruled by the Constitution.'"300 Consequently, the Court found that "[t]he methods by which the people of Puerto Rico and their representatives have chosen

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293. Mora, 113 F. Supp. at 315-16.
294. Id. at 316 (quoting statements by Governor Luis Munoz Marin in Resolution No. 22, Constitutional Convention of Puerto Rico, 426-458) (emphasis added).
295. Id.
296. Id. (emphasis added).
299. Id. at 4.
to structure the Commonwealth’s electoral system are entitled to sub-
stantial deference,” just as similar laws chosen by state legislatures are
granted great deference. In addition, the Court acknowledged that
Puerto Rico’s Supreme Court’s interpretation of the statute must be ac-
corded great weight, as statutory interpretations made by state Supreme
Courts. The Court further reasoned that “absent some clear consti-
tutional limitation Puerto Rico [like a state] is free to structure its poli-
tical system to meet its “special concerns and political circumstances.”

While each citizen's right to vote is protected by the Constitution, no
provision under the Constitution “expressly mandates the procedures
that a state or the Commonwealth of Puerto Rico must follow in filling
vacancies in its own legislature.” No provision exists under “the
United States Constitution or any of its amendments which either ex-
pressly or impliedly dictates the method a State must use to select its
Governor.” Puerto Rico, like a state, is afforded constitutional rights
and deference to regulate its own commonwealth.

Similarly, in Calero-Toledo v. Pearson Yacht Leasing Co., the
Supreme Court has held that Puerto Rico was entitled to the complete
protection of the Constitution and that Congress is limited by the Consti-
tution when enacting laws for Puerto Rico. The Court stated that Puerto
Rico had similar needs as that of a state.

In Calero-Toledo v. Pearson Yacht Leasing Co., the Supreme
Court has held that the entire Constitution applied to Puerto Rico and
that Congress was limited by the Constitution when enacting laws for
Puerto Rico. In Calero-Toledo v. Pearson Yacht Leasing Co., the appellee
argued that he was unconstitutionally denied due process of the law, in-

301. Id. at 8-12 (Puerto Rico like other states has the authority to fill legislative vacancies in a
method that “plainly serves the legitimate purpose of ensuring that vacancies are filled promptly,
without the necessity of the expense and inconvenience of a special election” as long as the method
employed “does not fall disproportionately on any discrete group of voters, candidates, or political
parties.”) Id. at 12.
302. Id. at 13. “Moreover, we should accord weight to the Puerto Rico Supreme Court’s assess-
ment of the justification and need for particular provisions to fill vacancies caused by the death,
resignation, or removal of a member of the legislature.” Id. at 8.
303. Id. at 13-14 (quoting Garcia v. Barcelo, 671 F.2d 1, 7 (9th Cir. 1982).
304. Id. at 7-8.
305. Id. at 9 (quoting Fortson v. Morris, 385 U.S. 231, 243 (1966) (The Court relies on Justice
Black's statements concerning the states power under the Constitution to regulate its own election as
support for its holding that Puerto Rico, which is like a state, also has the power under the Constitu-
tion to regulate its elections.)
306. 416 U.S. 663, 671 (1974). See also Examining Bd. of Engineers, Architects, and Surveyors
307. Calero-Toledo, 416 U.S. at 671; Examining Bd. of Engineers, Architects, and Surveyors,
426 U.S. 572. See infra notes 308-13 and accompanying text.
Flores De Otero, 426 U.S. 572 (1976).
so far as the Puerto Rican statutes authorized the appellants, the Superintendent of Police and the Chief of the Office of Transportation of the Commonwealth of Puerto Rico, to seize the appellee's yacht without notice or hearing and thereby, unconstitutionally deprived the appellee of its property without just compensation.\textsuperscript{309} The Puerto Rican three-judge district court heard the case and agreed. Puerto Rican officials appealed to the Supreme Court.\textsuperscript{310}

The United States Supreme Court, in affirming the district court's decision, granted direct appeal based on 28 U.S.C. § 2281, which allows any party to appeal "an order granting or denying . . . an . . . injunction in any civil action . . . [which is] required by any Act of Congress to be heard and determined by a district court of three judges."\textsuperscript{311} The Court reasoned that Puerto Rican legislation, like that of state legislation,\textsuperscript{312} is subject to review by the federal courts created by Article III of the Constitution. Further, the Court reasoned that because Puerto Rico's needs are similar to those a state, Puerto Rican statutes, like state statutes, may need to be reviewed by the Supreme Court when constitutional questions arise.\textsuperscript{313}

While section 745 does not require or prohibit Puerto Rico or its citizens from any action or from enjoying the benefits of the Constitution, the idea that Congress has unlimited power to enact such laws may. In addition, section 745 definitely interferes with the fifty states right to tax its citizens. The argument that section 745 is good for Puerto Rico does not override its unconstitutional nature. With the benefits of incorporated territory status come obligations and duties to the rest of the country.

Congress has incorporated Puerto Rico. First, Congress created a compact between Puerto Rico and the United States, which fully incorporates Puerto Rico into the United States. Congress has labeled Puerto Rico an independent commonwealth free to manage its local affairs. Second, Congress and the Presidential administration of the United States intend to give Puerto Rico the chance to join the Union. Finally, the Supreme Court has held that Puerto Rico is like a state, consequently, it is entitled to and subject to the protection of the entire Constitution.

\textsuperscript{309} Caldero-Toledo, 416 U.S. at 665-68.
\textsuperscript{310} Id. at 669.
\textsuperscript{311} Id. 669 and 670, n.7.
\textsuperscript{312} Id. (emphasis added).
\textsuperscript{313} Id; U.S. CONST. art III.
2. Is Congress Limited by the Tenth Amendment When Enacting Legislation for Incorporate Territories

Because Congress has incorporated Puerto Rico we must determine whether a statute such as 48 U.S.C. § 745 is unconstitutional and outside the congressional power because section 745 is in violation of states' constitutional right to tax its citizens, granted under the tenth amendment and states' sovereignty power. The Court has never directly address the issue of whether the tenth amendment and states' right of sovereignty are provisions which Congress is to be limited by when enacting legislation for incorporated territories. However, the "Insular Cases" indicated that Congress is limited by all provisions of the Constitution when enacting laws for incorporated territories. In addition, the Court indicated it did not restrict Congress when enacting legislation for unincorporated territory, although it did require Congress to consider the entire Constitution when enacting legislation for incorporated territory, so as to facilitate a smooth transition for these unincorporated territories from their old form of government to the United States' form.

The Court believed immediate adaptations of the entire Constitution to unincorporated territories may be too painful and create bitter divisions among the citizens of the unincorporated territory and the citizens of the United States. In Dorr, the court reasoned that Congress needed the power to establish laws for unincorporated territories without regard to other provisions of the Constitution in order to facilitate the transition from a Spanish government to the government recognized in the United States. In other words, Congress should not be hampered by other provisions of the Constitution when establishing laws for an unincorporated territory if the laws are unknown and unsuited for the territory's and its peoples' needs. However, once Congress has incor-

315. Id., 195 U.S. at 148.
316. Id.
317. Id. at 148-49.
318. Id. (Citizens of unincorporated territories are not entitled to jury trials and Congress is not required to provide jury trials to unincorporated territories.)
porated the territory, the territory and its citizens are entitled to and must accept the Constitution as its guidance for government.319

When Congress enacted the Jones Act, it did not incorporate Puerto Rico, but rather keep Puerto Rico as an unincorporated territory to allow it time to adjust to the new ways and laws of the United States. Likewise, when Congress enacted section 745, it did so to assist Puerto Rico in obtaining the necessary loans required to develop and join the rest of the United States in economic strength.320 However, Puerto Rico has had 73 years to develop, to grow, and to adjust to the culture and legal system of the United States so that it might join and compete with the rest of the United States. In addition, while Puerto Rico is not attached to North America, the transportational difficulties of the early 1900s no longer exist. People from both Puerto Rico and the United States are able to freely immigrate back and forth, as United States citizens do from one state to the other. Thus, none of the barriers preventing incorporation that were present in 1917 exist today. As discussed above, while Congress did not expressly state that Puerto Rico was incorporated, when it granted Puerto Rico and its citizens commonwealth status in 1950, Congress has apparently incorporated Puerto Rico.321 Consequently, it is time for Puerto Rico to embrace the United States Constitution.

Congress has attempted to grant Puerto Rican obligations special tax treatment under the compact of 1950 and section 745,322 but these statutes ignore selected sections of the Constitution. In Dorr, the court indicated that once a territory was incorporated all provisions of the constitution would apply, thus, Congress can no longer ignore the constitutional mandates of the tenth amendment and states sovereignty when enacting legislation for Puerto Rico. Instead, Congress must consider these provisions when creating legislation for Puerto Rico, as Congress would if enacting legislation that would involve one of the fifty states.323

319. Id.
320. Supra note 46. See also Balzac v. Puerto Rico, 258 U.S. 298, 309-310 (1921) (the Jones Act, of 1917, and the treaty acquiring Alaska, referred to in Rasmussen v. United States, 197 U.S. 516 (1905), are different because, unlike the Philippines or the Puerto Rican island, Alaska was an enormous territory, sparsely settled, offering opportunity for immigration and settlement by American citizens. Alaska was also attached to the North American continent and within easy reach of the United States. In addition, incorporation involved none of the difficulties presented in incorporation of Puerto Rico or the Philippines, as referred to in Dorr.)
322. Id; and 48 U.S.C. § 745 (1917).
323. Dorr v. United States, 195 U.S. 138, 141 (1904); See also Arkansas, supra note 10, where the Arkansas taxing commission recognizes that Puerto Rican obligations and the interest derived therefrom are no longer entitled to the tax exemption status potentially provided by Section 745
Similarly, Congress cannot require states to exempt the principal and the interest derived from selected states' or incorporated territories' obligations, thereby exempting state obligations from taxation in a discriminatory manner. Such an exemption would be tantamount to a discriminatory exemption for holders of one state's obligations and the interest derived therefrom over another. Congress obtained its power to rule and regulate Puerto Rico and other unincorporated territories from the territorial clause of the United States Constitution. However, once a territory is incorporated into the United States, Congress is not only obligated to enact rules and regulations for that territory, but must also respect the limits of other provisions of the Constitution. Section 745 is unconstitutional because it interferes with states' power of taxation under the tenth amendment.

The Court has indicated that Congress cannot enact regulations for incorporated territories that violate any other provision of the Constitution. In addition, the Court has held that the Constitution does not prohibit a state from taxing the principal or interest derived from the obligations of other state obligations. "In our dual system of government[s], the position of the state as sovereign over matters not ruled by the Constitution requires a deference to state legislative action beyond that required for the laws of a[n] [unincorporated] territory." Consequently, section 745, which provides a discriminatory exemption for holders of Puerto Rican obligations over holders of other state obligations interferes with the states' power to regulate its citizens under the tenth amendment.

In summary, Puerto Rico is no longer a simply a temporary and because Puerto Rico is now a commonwealth and an incorporated territory. "The District of Columbia is a U.S. possession, thus its obligations are exempt, but not those of Puerto Rico, because the latter is an independent commonwealth."

324. South Carolina v. Baker, 485 U.S. 505, 526-27 (1988); Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1982); Nathan v. Louisiana, 49 U.S. 82 (1850) (state taxation of federal obligations or contracts and the interest derived, therefrom is valid under the constitution, unless the state does not tax similar state or local income derived from a similar state obligation or contract. This type of tax would be discriminatory and in violation with the constitution. 31 U.S.C. § 3124(a).)

325. U.S. CONST. art. IV, § 3, cl. 2.


330. Rodriguez v. Popular Democratic Party, 457 U.S. 1, 7-8 (1982) (the Supreme Court stated "Puerto Rico, like a state, is an autonomous political entity, 'sovereign over matters not ruled by the Constitution.'")
dependent territory\textsuperscript{331} of the United States', rather Puerto Rico has been a territory of the United States for over 73 years.\textsuperscript{332} Puerto Rico no longer needs protection from drastic changes and major cultural conversions from a Spanish form of government to a American form. Congress has incorporated Puerto Rico, and therefore, can no longer use the territorial clause to dictate to states legislation that violates another provision of the Constitution. Incorporated territories are entitled and must embrace the full Constitution.

While, incorporated territories should be given the respect of states, they should not be protected by Congress as unincorporated territories are. In addition, states are sovereign within their respective territories; it follows that they may impose what taxes they think proper upon persons or things within their dominion.\textsuperscript{333} While the tenth amendment does not totally protect states from regulation of traditionally state activities, the Constitution does protect states from discriminatory regulations by the federal government. As discussed, states have the power to tax the interest derived from other state obligations as well as federal obligations.\textsuperscript{334} Similarly, congressional application of the territorial clause of the Constitution to Puerto Rico no longer need interfere with states' rights under the tenth amendment. Section 745, which attempts to exempt Puerto Rican bonds from state taxation creates a discriminatory regulation by Congress and therefore, should be held unconstitutional.

\textbf{VII. CONCLUSION}

Puerto Rican obligations and the interest derived can be subject to both state and federal taxation. First, Congress did not intend to extend the obligation tax exemption provided for in 48 U.S.C. § 745 to the interest derived from the Puerto Rican bonds. Second, the Congress has incorporated Puerto Rico, thus, the Constitution and the courts have turned away from treating Puerto Rico as a dependant territory. Consequently, the need for Congress to utilize the constitutionally granted power of art. IV, § 3, cl. 2 is diminished. 48 U.S.C. § 745 which attempts

\textsuperscript{331} Mora v. Torres, 113 F. Supp. 309 (1953), aff'd 206 F.2d 377 (1st Cir. 1953).


\textsuperscript{333} Ohio Life. Ins. & Trust Co. v. Debolt, 57 U.S. 428 (1853).

to exempt Puerto Rican bonds from state taxation should be held unconstitution al and any attempt to extend the statute to include the interest derived therefrom should be struck down. This statute violates the states' Tenth Amendment power to determine what should be included in the states' taxable income because it discriminates in favor of a state-like territory over other states of the United States.

Thus, both the history and the language of 48 U.S.C. § 745, coupled with the states' power to determine whether to tax various items, leads one to the conclusion that the states may tax the interest on Puerto Rican bonds. In addition, barring the limited unfairness to Puerto Rican bond issuers and investors, the need for states to exercise their full power of taxation must overrule any rationale used by Congress to authorize exempting these obligations' principal or the interest derived therefrom, from taxation. Consequently, the interest derived from the Puerto Rican obligations should not be tax exempt.