

MAR 6 1959

Dear Tom:

This is with further reference to your letter of February 20 in regard to municipal ownership of manufacturing companies.

The Village of Deming case described by Mr. W.C. Kinard, President of the Relton Corporation, illustrates a clever use of three separate provisions of present law: the income tax exemption of interest on municipal bonds, the income tax exemption of the activities of State and local governments, and the deductibility of lease payments in arriving at taxable income. Each of these provisions is deeply imbedded in our revenue system. Now and then, provisions designed for sound objectives are misused and when the abuse becomes excessive, it becomes necessary to secure remedial legislation. The Deming situation may be a case in point.

On the point of general use of this pattern, I do want to point out that most States prohibit their political subdivisions to incur debt for purposes unrelated to their governing functions.

You will recall that in 1954 the Ways and Means Committee examined at some length the tax-exempt status of bonds issued by local governments to finance the construction of industrial facilities for lease to private firms in programs designed to attract out-of-State Industry. On that occasion the Committee considered terminating the tax-exempt status of these so-called industrial development bonds and denying the deductibility of lease payments for properties constructed with tax-exempt bonds. On other occasions the Committee has scrutinized the tax-exempt status of the proprietary activities of State and local governments unrelated to essential governmental functions. Each of these approaches would help to restrict trafficking in the tax-exemption privilege of governments. The Deming case, as described by Mr. Kinard, is more extreme than some others which have come to our attention in that it uses the vehicle of an artificially high interest rate (9 percent) for the purpose of putting the cloak of tax exemption on payments out of current income on account of the purchase price of an asset. This is a far cry from the kind of essential governmental activity contemplated by Chief Justice Marshall when he formulated the doctrine of intergovernmental tax immunity 140 years ago. A dividing line, however, is not easy to draw partly because delicate Federal-State-local relations are involved and these governments guard their tax immunities jealously.

As for the Deming case itself, I am told that the Revenue Service can do nothing about it under present law. If this sort of thing is to be stopped, the law will have to be changed. We would support appropriate legislation in this area.

I am glad that this matter has been called to your attention and that you are giving it some thought. As requested, I am returning your file on this matter.

Sincerely yours,

Fred C. Scribner, Jr.
Under Secretary of the Treasury

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Enclosure