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INDIRECT TAXATION OF THE FEDERAL GOVERNMENT: A QUESTIONABLE SOURCE OF REVENUE

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The expenditures of the federal government are greater than one hundred twenty billion dollars annually,[1] and federal property holdings now exceed one-fourth of the nation's land area.[2] Such federal purchases and land holdings are a possible fertile source of tax revenue for some state and local governments. This article will discuss the ramifications of individual states tapping the federal treasury by this means.

FEDERAL IMMUNITY TODAY

After many years of confusion, the issue of federal immunity from state taxation has been clarified by a plethora of recent litigation.[3] In the sales tax area, a nondiscriminatory tax upon a transaction to which a federal government instrumentality is a party is permitted, if the legal incidence of the tax is not upon the federal government[4] or its agents.[5] For example, in 1962, the Supreme Court upheld, per curiam, the imposition of an Illinois "vendor-type" sales tax upon a direct sale to the federal government.[6]

When a contractor for the federal government purchases property out of state, and title passes directly *to him*, the state in which the property is used may impose a nondiscriminatory use tax on such use.[7] Whenever title passes directly to the Government, the contractor may be taxed for his use of such property if the statute taxes use or possession regardless of ownership, as opposed to use incident to owner-

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1 H.R. Doc. No. 15, 88th Cong., 1st Sess. 16 (1963).

2 General Services Administration, Report of the Interdepartmental Committee for the Study of Jurisdiction over Federal Areas within the States (1957).

3 Wolf, State Taxation of Government Contractors (1964); Wolf, State and Local Taxation (Government Contracts Monograph No. 5, 1962).

4 Polar Ice Cream & Creamery Co. v. Andrews, 375 U.S. 361 (1964); United States v. Department of Revenue, 371 U.S. 21 (1962); Alabama v. King & Boozer, 314 U.S. 1 (1941); Colorado Nat'l Bank v. Bedford, 310 U.S. 41 (1940).

5 Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110 (1954); United States v. Boyd, 211 Tenn. 139, 363 S.W.2d 193 (1962), aff'd, 84 Sup. Ct. 1518 (1964).

6 United States v. Department of Revenue, supra note 4.

7 Curry v. United States, 314 U.S. 14 (1941).

ship.[8] If the contractor is an authorized government agent, he is immune from such use taxes.[9]

It is now firmly established that a contractor may be taxed for the possession or use of federal real or personal property, whether under a lease or permit, even though the contractor is executing a federal contract.[10] Prior to assessing such a possessory interest tax, the state legislature must have authorized the imposition.[11]

Any attempt to discriminate against the federal government by providing an exemption from sales, use, or possessory interest taxes for the state, its political subdivisions or its contractors is unlawful.[12] Exemptions for charities, religious organizations, and educational institutions are allowed.[13]

From this capsule summary it is evident that by skillfully designing its tax statutes a state may legally tax purchases by the federal government and by a federal contractor as well as tax the latter's use or possession of federal property. The ramifications of a state indirectly taxing the federal government in this manner are many and varied.

FEDERAL-STATE RELATIONSHIPS

Although there is no specific prohibition in the United States Constitution against state taxation of the instrumentalities, property, and operations of the United States, the courts have generally implied such immunity from the supremacy clause. As early as *McCulloch v. Maryland*[14] the Supreme Court recognized that when a state taxed the operations of the federal government, it acted upon institutions created not merely by its own inhabitants but by others, over whom it could claim no control. The nature of such taxation thus becomes

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[8] United States v. Boyd, supra note 5. See Hallett Constr. Co. v. South Dakota, 119 N.W.2d 117 (S.D. 1963). Compare Chrysler Corp. v. City of New Orleans, 238 La. 123, 114 So. 2d 579 (1959); Avco Mfg. Corp. v. Connelly, 145 Conn. 161, 140 A.2d 479 (1958); General Motors Corp. v. State Comm'n of Revenue & Taxation, 182 Kan. 237. 320 P.2d 807 (1958); Tawes v. Aeriel Prods., Inc., 210 Md. 627, 124 A.2d 805 (1956).

[9] United States v. Livingston, 179 F. Supp. 9 (E.D. S.C. 1959), aff'd, 364 U.S. 281 (1960). Cf. United States v. Boyd, supra note 5.

[10] City of Detroit v. Murray Corp., 355 U.S. 489 (1958); United States v. Township of Muskegon, 355 U.S. 484 (1958); United States v. City of Detroit, 355 U.S. 466 (1958).

[11] Ford Motor Co. v. Korzen, 196 N.E.2d 656 (Ill. 1964); Continental Motors Corp. v. Township of Muskegon, 365 Mich. 191, 112 N.W.2d 429 (1961); Martin Co. v. State Tax Comm'n, 225 Md. 404, 171 A.2d 479 (1961); General Dynamics Corp. v. County of Los Angeles, 51 Cal. 2d 59, 330 P.2d 794 (1958).

[12] United States v. Department of Revenue, supra note 4; Phillips Chem. Co. v. Dumas Independent School Dist., 361 U.S. 376 (1960). See Comptroller v. Pittsburgh-Des Moines Steel Co., 231 Md. 132, 189 A.2d 107 (1963); Knapp-Stiles, Inc. v. Department of Revenue, 370 Mich. 629, 122 N.W.2d 642 (1963).

[13] United States v. Department of Revenue, supra note 4.

[14] 17 U.S. (4 Wheat.) 316 (1819).

an action by a part against the whole under a policy in which the whole is unrepresented.

A. *Reasons Supporting the Removal of Federal Immunity*

The financial plight of the states has become increasingly acute; one cannot deny that federal immunity has intensified the problem. Given this financial situation, those who advocate increased state taxation of the federal government generally employ the following arguments. First, they contend that when state and local governments are involved, the federal government should pay its way. Second, they argue that every state should share in the added financial burden imposed on a single state when defense contractors perform government contracts in the furtherance of national defense. Finally, they suggest that local communities should be permitted to recover for losses in tax revenues caused when federal ownership of property reduces the tax base while still requiring the expenditure of local funds to provide essential services.[15]

B. *Arguments for the Maintenance of Federal Immunity*

Let us consider in detail the answers to these propositions that are most frequently advanced by the federal government. First, it is argued that an examination of federal expenditures which aid state and local governments indicates that the federal government does pay its way. In fiscal 1964 federal financial assistance to state and local governments totaled approximately ten and a half billion dollars.[16] This figure does not include substantial expenditures which contribute to state and local coffers in the form of state and local taxes paid directly or indirectly as a result of other federal expenditures, including a forty-seven billion dollar defense budget.[17] Since over 10% of the federal budget goes to aiding state and local governments, there is a basis for the federal government's argument. One weakness in this position is, however, that the states being thus aided may very well not be the states being hurt by federal immunity.

Second, let us consider whether those states which do not benefit by having defense contractors located within their borders should contribute to the payment of added sums resulting from local taxation of sales to the federal government. It is argued on the federal side that there is little to support such payments by the other states, since only the taxing state is benefited, although indirectly, by the presence of those defense contractors. The attempts by governors and other state

[15] Groves, Tax Immunities on Federal Property, 1959 Wis. L. Rev. 167 (1959); Pierce, Tax Immunity Should Not Mean Tax Inequity, 1959 Wis. L. Rev. 173 (1959).

[16] H.R. Doc. No. 15, supra note 1, at 408.

[17] Federal Publications, The Government Contractor, ¶ 474 (1963).

officials to increase both the number of defense contractors located in the state and the amount of contract awards to those contractors is pointed to as an indication of the benefits which the states derive from such activities.[18] If defense contractors are such a burden to a state, it would be difficult to explain this intense desire on the part of state officials to increase the burden.

Third, some writers have similarly indicated that the argument that federal ownership is mostly a burden to local governments, which should be shared, is inconsistent with the strong pressure brought to bear by local interests either for the location of large military facilities in their community or against the termination of industrial type work being performed at nearby government facilities.[19] Others have pointed out that unless payments by the federal government are limited to situations of demonstrable hardship, payments to rural communities situated near some self-contained government installations may result in an undeserved windfall to those local communities while the entire nation is footing the bill. For example, a possessory interest tax imposed upon an Atomic Energy Commission contractor at Oak Ridge, Tennessee, for his possession of two billion dollars worth of federal government property probably would eliminate the need of the local jurisdiction for any other tax revenues. A state which was unsuccessful in its attempts to secure the location of a new government installation within its borders would likely feel much less than joyful if it had to present this bonanza to the successful state in the form of payments from its citizens' federal tax money. Such payments would appear to provide the favored states with additional favors at the expense of the less favored.

EFFECT OF STATE TAXATION OF THE FEDERAL GOVERNMENT

The Government, being required by regulation to get the most for the taxpayer's money, must let a contract for supplies to that responsible bidder or offeror submitting the lowest responsive bid or proposal. A contractor must adjust his prices to include all state taxes he is forced to pay because the contract clauses require that applicable taxes be included in the prices quoted. This factor becomes particularly important when that contractor is involved in the close competition which exists in both advertised as well as negotiated procurements. A spread of only one or two per cent between the lowest and next lowest bid in multi-million dollar defense procurements is

[18] The Evening Star (Wash. D.C.), Jan. 1, 1962, p. B-3; The Evening Bulletin (Phila.), Sept. 11, 1963, p. 57.

[19] Van Cleve, States' Rights and Federal Solvency, 1959 Wis. L. Rev. 190 (1959); The Evening Bulletin (Phila.), Aug. 22, 1964, p. 1, col. 5.

now the rule rather than the exception. Contractors who must pay taxes on their materials and end products sold to the Government or on government-owned machinery and property in their possession or use under government contracts are not in as strong a competitive position as contractors in states which do not impose such taxes. Placing a contractor in this disadvantageous competitive position may make his state less attractive as a site for industrial expansion and contribute to the loss of business by firms located in the state. A favorable tax climate is a significant consideration in deciding into which state a large corporation will expand or in which of its plants in the different states it will perform its contracts.

The effect of an adverse tax climate upon government contractors has been clearly demonstrated in Illinois. Illinois was involved in extensive litigation in both the federal and state courts over the right of a state to tax direct sales to the federal government. In October, 1962, the United States Supreme Court affirmed the right of Illinois to impose a vendor type sales tax upon direct sales to the federal government while simultaneously exempting sales to charities, religious and educational institutions but not sales to state and local governments.[20] Within six months of the decision, the Illinois legislature amended its statutes to provide an exemption for sales to the federal government. The legislature justified its enactment by specifically stating in the statute that:

> . . . [T]he imposing of the retailers' occupation tax on the proceeds from sales to the Federal Government is driving business out of Illinois by encouraging purchasing Federal Government agencies to make their purchases of tangible personal property outside Illinois.[21]

A sales or use tax imposed upon the purchase of construction materials by construction contractors of the federal government becomes an important factor in deciding where to build costly federal facilities, such as a service academy, a new research plant, or a nuclear reactor. A four or five per cent sales or use tax payable in one state on the materials incorporated in such a structure would mean that the Government would get less for its money in such a state than in a state where no such tax was levied. Thus, if there are two or more possible sites, and all other factors are substantially equal, the additional four or five per cent cost of placing an installation in a state where such a tax is imposed upon materials incorporated in the project may well be the deciding factor against locating in that state.[22]

[20] United States v. Department of Revenue, supra note 4.

[21] S.B. 444, Ill. Laws 1963, March 21, 1963.

[22] In comparison, it is interesting to note that in Colorado, which has one of the

In selecting a site for a new government facility which is to be contractor operated, the Government must consider whether reimbursement to the contractor will be required because of state possessory interest taxes. Otherwise, it would mean that each year the Government would get less for its money in a state imposing such taxes, as compared to a state where no such tax had to be paid.

If the federal government is to be subjected to state taxation indirectly by vendor type sales taxes and possessory interest taxes, it is clear that the added cost of close to a billion dollars yearly will have to come from additional federal tax revenues. The federal government may take the position that the way to raise the federal funds to pay for these added tax burdens is to remove those intergovernmental tax immunities which benefit state and local governments at the expense of the federal treasury. One solution which has been suggested is the removal of the income tax exemption for the interest from bonds and securities issued by those municipalities which prefer to impose possessory interest type taxes upon the holders of government property.[23] A second remedy may be to remove the exemption from Federal Manufacturers and Retailers Excise Taxes currently provided where the product is sold to a state government.[24] Of course, an obvious additional answer would be to reduce federal grants to those states indirectly taxing the federal government.

DEVICES AVAILABLE TO FEDERAL AGENCIES

The federal government is now showing considerable sophistication in avoiding the payment of state and local taxes.[25] Several avenues are presently available to the federal government to reduce the state and local tax burden.

The title passing provisions of the progress payments[26] and government property clauses[27] authorized for use in defense contracts by procurement regulations can and do reduce sales and use tax exposure. These two title vesting clauses provide for passage of title directly to the Government from the vendor without title ever vesting in the contractor. If title never vests in the contractor on his purchases covered by the contract, neither a state sales tax imposed upon a

most favorable sales and use tax climates for government contractors, the dollar amount of defense contract awards to contractors located within that state has increased 176 per cent over the past five years.

[23] Van Cleve, supra note 19.

[24] Int. Rev. Code of 1954, § 4055.

[25] Wolf, Reducing State and Local Tax Costs to Compete More Effectively for Government Contracts, 1962 Mil. L. Rev. 35 (1962).

[26] ASPR, 32 C.F.R., app. E, §§ 510.1, 510.2 (1961); Wolf, State Taxation of Government Contractors, supra note 3, at 297.

[27] ASPR, 32 C.F.R. § 13.503 (1960).

transfer of title of tangible personal property for a consideration nor a state use tax imposed upon use incident to ownership can be applied to such purchases by the contractor.

Some sales and use tax payments can be eliminated by designating the place and method of delivery of supplies to take advantage of interstate commerce exemptions. The choice of a government or commercial bill of lading further strengthens the Government's hand in this regard.

By clearly designating a contractor an agent of the federal government, the government departments may be able to clothe their contractors with the same federal immunity from state taxation which the Government possesses. The United States Supreme Court in the *Kern-Limerick* case[28] held that a contractor who was designated an agent of the federal government was entitled to federal immunity from state taxation. By a similar appointment in a contract, the federal procurement officials may well be able to establish this immunity.

In *Paul v. United States*,[29] involving minimum milk price laws, the Supreme Court recognized the ability of federal agencies to issue a regulation covering the manner in which supplies would be procured and thereby make ineffective state laws concerning such procurements. Under the theory upon which that case was decided, it would be possible for government agencies to provide in their procurement regulations that supplies should be procured without the payment of state and local taxes imposed upon sales to the Government. Assuming this interpretation of the *Paul* case is followed, the application of state sales and use taxes to such sales to the federal government may be precluded.

Another approach available to the federal government in certain situations was established in the *Halliburton Oil Well* case.[30] Louisiana attempted to impose its use tax upon use within the state of property purchased outside the state regardless of whether it was use incident to ownership. The Court held that a complementary use tax was unlawful because it discriminated against interstate commerce. The tax in question was imposed upon the use of material purchased outside the state when a sales tax would not have been applicable if the material had been purchased within the state. In most states if title passes to the federal government from the vendor, a sales tax does not apply. Accordingly, any attempt to apply a complementary use tax only upon the use of material purchased outside the state with title passing directly to the Government from the vendor would be

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28 Kern-Limerick, Inc. v. Scurlock, supra note 5; United States v. Boyd, supra note 5.

29 Paul v. United States, 371 U.S. 245 (1963).

30 Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64 (1963).

discriminatory against interstate commerce. There are at least five states that may possibly follow this practice.[31]

RATIONALE FOR THIS TYPE OF FEDERAL ACTIVITY

One may question the justification for the federal government's attempts to reduce the impact of state and local taxes by resorting to some of the aforementioned devices. Arguably, it is only by such action that the federal government will obtain the same fair tax treatment which it affords to the states under the federal tax statutes. On sales to a state or local government, Federal Manufacturers and Retailers Excise Taxes do not have to be paid, even though those taxes are also of the vendor type.[32] Supplies for further manufacture are also exempt from these federal taxes even where the final product is exempt because sold to a state.[33] The language used by the Supreme Court in the *Phillips Chem. Co.* case is frequently paraphrased to state that it does not seem too much to ask that the state treat those who deal with the federal government as well as the federal government treats those with whom the states deal.[34]

In addition, taxes currently being imposed by most states on the sale of construction materials and equipment to construction contractors may add nearly a billion dollars to the cost of the Federal-aid highway construction program.[35] With up to 90% of the cost of this highway construction program being paid by the federal government, the action of those states taxing such a gift may be described as looking the proverbial gift horse in the mouth.

Further, the past practice of some states intentionally discriminating against the federal government by imposing sales and use taxes upon sales to the federal government and its contractors while at the same time exempting sales to the state and political subdivisions and their contractors, does not appear to represent a situation in which the complaining party has so acted as to justify intervention by a court of equity.

Of course, it is possible that elected representatives of the majority of states that are not being subsidized by indirect taxation of the federal government may find it distasteful for their citizens to pay

[31] These are Alabama, North Dakota, South Carolina, Tennessee, and Washington. For a compilation of the applicable statutory provisions, see Wolf, State Taxation of Government Contractors, supra note 3, at 307-423 (Appendix).

[32] Int. Rev. Code of 1954, §§ 4055, 4221(a)(4).

[33] Int. Rev. Code of 1954, § 4221(a)(1).

[34] See Phillips Chem. Co. v. Dumas Independent School Dist., supra note 12, where the Court said, at 385:

> . . . [I]t does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself.

[35] Federal Publications, The Government Contractor, ¶ 281 (1961).

federal taxes to subsidize a small number of other states imposing such indirect taxes on their federal government.

In conclusion, it is clear that there are two sides to the question of whether states should indulge in the luxury of indirectly taxing the federal government. While such taxation may be accomplished legally, experience indicates that by so doing, a state may imperil its attractiveness to business. It is also apparent that the federal government possesses some rather lethal weapons in its arsenal with which to oppose any determined tax assault by state and local governments. The contractor appears as the unfortunate beneficiary of this dilemma, since he must comply with the orders of the federal government although it is he who bears the burden of the state tax.