North Dakota Law Review

Volume 47 | Number 3 Article 8

1970

Licensing - Sales Tax - Right of a State to Levy a Sales Tax on Its Own Subcontractor

William A. Hill

Alabama, by statute[45] and case law,[46] has also developed a broad standard for judicial review of tax assessments. The court is authorized to decide "both as to the legality of the assessment and the amount thereof."[47] The Supreme Court of Alabama in a recent decision, stated that the appellant only must sufficiently show that the assessment was incorrect, to sustain his burden on judicial review.[48]

There remains yet another choice that could be used to change the result of the decision in the instant case. That choice is for the Legislature to take. The Legislature has at least three courses of action that could be taken. First, it could by statute, apply the Alabama approach[49] mentioned above. This choice would alleviate the necessity of reorganizing the administrative procedure of the county boards. Second, the State Administrative Procedure Act[50] could be made applicable to the county boards. This choice would at least give hearings and their procedure courtroom formality. Third, a totally new system could be initiated. This alternative could be in the form of independent tax review boards,[51] now found in many of the states.

In conclusion, it is imperative that action be taken to alleviate the situation created by the instant case. One can only query how an informed Supreme Court could reach a result that has such potential for injustice. However, it matters very little if this defect is remedied by the court or legislature, as long as action is taken. The taxpayers of North Dakota deserve a more equitable system of review of property tax assessments than their Supreme Court has chosen to give them.

STEVEN L. WOOD

LICENSING—SALES TAX—RIGHT OF A STATE TO LEVY A SALES TAX ON ITS OWN SUBCONTRACTOR—The plaintiffs in this case are the executive vice president of the Minnesota Asphalt Pavement Association and a highway construction company. Defendants are the commissioner of highways, commissioner of taxation, and the state audi-

45. ALA. CODE tit. 51, § 140 (1958).
46. Monroe Bond and Mortgage Co. v. State, 254 Ala. 278, 48 So.2d 431 (1950).
47. ALA. CODE tit. 51, § 140 (1958).
48. State v. City Wholesale Grocery Co., 283 Ala. 426, 218 So.2d 140 (1969).
49. *See* discussion *supra*.
50. N.D. CENT. CODE § 28-32-01 (1960).
51. Independent Tax Review Boards typically consist of 3 to 5 members, with diverse political affiliations, who have a required degree of expertise in Taxation Law, and are given quasi-judicial powers to hear tax appeals. *See, e.g.*, Kansas K.S.A. 74-2433 (1969), and New Jersey N.J.S.A. 54:2-3 (1960).

tor. The plaintiffs charge that MINNESOTA STATUTE, subdivision 4 of section 297A-25 is unconstitutional as a violation of the Minnesota constitutional section providing for a trunk highway fund.[1] According to this section the trunk funds are to be employed only for the creation, construction, improvement or maintenance of a state highway system.[2] Attack on subdivision 4 is twofold: first the plaintiffs assert that it is unconstitutional as applied to state purchases. Going further the plaintiffs say that subdivision 4 is not severable within itself and since it is agreed to be unconstitutional as to state purchases then it must also be unconstitutional as to those purchases made by individual contractors who sell their finished product to the state. Secondly, assuming that the provision is found to be severable and consequently unconstitutional as to state purchases it nevertheless remains violative of the trunk fund provisions. Of necessity contractors would include anticipated materials sales tax as an item of expense in preparing bids for state jobs. Upon accepting the bids state trunk funds would be committed to the project and thus the state would indirectly absorb the sales tax.

In response the defendants denied that merely by contracting for highway projects does the state assume any sales tax. They assert that the tax is upon the *contractors'* purchases—not upon those of the state.

Considerations before the court were: (1) Is subdivision 4 a severable provision? (2) Is subdivision 4 unconstitutional as to state purchases? (3) Is an application of subdivision 4 to contractors only, nevertheless a misappropriation of trunk funds?

Deliberating upon these issues the Minnesota Supreme Court in 1969 found the whole of subdivision 4 unconstitutional. The defendants obtained a rehearing in December of 1970. Withdrawing its prior decision the court held that the application of the statute was severable and valid as to purchases by contractors but unconstitutional as to separate state purchases. *Hoene v. Jamieson,* 182 N.W.2d 834 (Minn. 1970).

The court in finding the provision to be severable noted that only in subdivision 4 is there any mention of contractor exemption and that its inclusion therein is surplusage to the true intent of § 297A-25 when considered in toto.[3] MINNESOTA STATUTE § 297A-25, subdivision 1 (h) states in part that:

> The gross receipts from the sale of and the storage, use, or consumption of all materials, including chemicals, fuels, petroleum products, lubricants, packaging materials, feeds,

1. MINN. CONST. art. 16 § 7 (Supp. 1956).
2. MINN. CONST. art. 16 §2 (Supp. 1956).
3. Hoene v. Jamieson, 182 N.W.2d 834 at 837.

> seeds, fertilizers, electricity, gas and steam, used or consumed in agriculture or industrial production of personal property intended to be sold ultimately at retail, whether or not the item so used becomes an ingredient or constituent part of the property produced . . . shall be exempt from the Minnesota sales tax.[4]

Subdivision 1 (j) of the same section further exempts:

> The gross receipts from all sales of tangible personal property to, and all storage, use or consumption of such property by, the United States and its agencies and instrumentalities or the state of Minnesota and its agencies, instrumentalities and political subdivisions.[5]

These two provisions would have been all encompassing except for the exclusionary provisions of subdivision 4 of the same section:

> Nothing herein shall exempt the gross receipts from sales of road building materials intended for use in state trunk highway or interstate highway construction, whether purchased by the state or its contractors.[6]

Special attention should at this time be given to the wording of the above clause. It implies that regardless of whether the purchase is made by the state or an independent contractor the sale is subject to a state sales tax. This section insofar as it includes state purchases is in conflict with subdivision 1 (j) which specifically exempts all state purchases from any sales tax. The resolution of this conflict is the problem in the instant case.

Recalling subdivision 1 (j) the reader will note that it specifically exempts the state of Minnesota and its instrumentalities from any incidence of sales tax. This provision would be neutralized with respect to state highway projects if subdivision 4 were literally read as a complete exemption of materials used by the state itself. The motivation behind the enactment of subdivision 4 was not to extinguish state exemption, but rather to take advantage of the federal government involvement in highway projects.[7] The reason, in other words, was to retain *federally* purchased materials as a taxable item. All other U. S. government purchases are previously exempt by the provisions of 1 (j). Such exemption was not however, previously afforded to contractors and in view of the rationale for subdivision 4's enactment there is no reason to exonerate them from the tax. The court in the instant case summarily found the tax unconstitu-

4. MINN. STAT. ANN. § 297A-25, subdiv. 1(h) (1965 amend.).
5. MINN. STAT. ANN. § 297A-25, subdiv. 1(j) (1965 amend.).
6. MINN. STAT. ANN. § 297A-25, subdiv. 4 (1965 amend.).
7. 182 N.W.2d at 838.

tional as to state purchases simply saying that a contrary result would be violative of the trunk fund provisions.[8]

With respect to subdivision 4's continued applicability as to highway contractors the Minnesota Supreme Court follows a long line of precedent in its reasoning.[9] However, the cases relied upon involve for the most part, not the question of taxing a *state* employed contractor, but rather, the imposition of such tax upon a *federally* employed contractor. The court's holding regarding subdivision 4's invalidity as applied to direct state purchases and the question of severability are beyond the scope of this comment which will be limited to a consideration of the provision's validity as applied to independent contractor purchases.

At first glance it is obvious that any sales tax imposed upon a contractor engaged in state projects will eventually be passed on to the state itself. But as the instant case points out, the tax must be considered simply an item of overhead—"a cost of doing business."[10] This is not a radical approach. Property taxes and a myriad of other overhead expenses are always assumed by the contractor when involved in job bidding.[11] Sales taxes are just as susceptible of assimilation into overhead as are the other expenses.[12] Tax liability has traditionally been considered one of the burdens a citizen must assume in return for the protection of the state.[13] Contractors, then, must bear their part of this burden. To this end it has been recognized that in regards to agents of the federal government the states may validly tax.[14] In fact the reciprocal rights of the state and federal governments to tax certain agents of each other has been recognized under certain conditions. The United States Supreme Court in setting a limitation on this right said that the tax in its mutual effect ". . . must receive a practical construction which permits both [governments] to function with the minimum of interference . . ."[15] with each other.

Ordinarily any tax imposed directly upon the federal government is invalid.[16] "Direct" in this connotation has been held to mean: a tax levied upon governmental property or officers;[17] or a tax levied upon a contract of the government.[18] These criteria, originally established on questions of a state's power to tax federal agencies,

8. *Id.* at 839-40.
9. *See,* Annot., 114 A.L.R. 318 (1938).
10. 182 N.W.2d at 839.
11. *Id.*
12. James v. Dravo Contracting Co., 302 U.S. 134, 159 (1937).
13. Welch v. Henery, 305 U.S. 134, 146 (1938).
14. James v. Dravo Contracting Co., 302 U.S. 134, 154 (1937).
15. Metcalf & Eddy v. Mitchell, 269 U.S. 514, 523-24 (1926).
16. McCullouch v. Maryland, 4 Wheat. 316, 326-27 (1819).
17. Dobbins v. Erie County, 16 Pet. 435, 449-50 (1842).
18. Osborn v. United States Bank, 9 Wheat. 738, 859-71 (1824).

have been extended to determinations of the state's power to tax *state* agencies. Recognition of this transposition is evidenced by the applicable tax statutes of the states. Representative of these are MINNESOTA STATUTE, § 297A-25, subdivision 1 (j)[19] and NORTH DAKOTA CENTURY CODE provision 57-39.2-04 subdiv. (6) which states:

> There are specifically exempted (from sales tax) the gross receipts from all sales . . . to the United States or any state thereof, including the state of North Dakota, or any of the subdivisions, departments, agencies or institutions thereof.[20]

The applicability of a tax to a contractor depends upon two things, first, the relationship of the taxable subject to the governing entity and secondly, the effect of this tax upon the governing body. The question then, is whether a contractor employed by a *state* may constitutionally be made subject to the state sales tax. In answering this question the Minnesota Supreme Court in the instant case used the "direct" test and said that determination of the tax validity depends upon the extent of the economic impact wrought upon the state.[21]

The whole subject of tax impact upon the government is difficult to resolve. With respect to the direct effect theory one approach has been to determine relationship of the tax subject to the government.[22] Another way of expressing the same idea is to put the question into terms of "independent" vs. "dependent" functions. There is no question as to the dependency of U.S. ship yards, Postal department or Atomic Energy Commission upon the federal government. Likewise, state fish and game departments etc. are dependents of the state government. Clearly these institutions do not operate in and of themselves and any tax upon them would be violative of the respective statutory exemptions.

Beyond these easily distinguishable relationships lies a very broad class of business entities whose relationship is not so easily discernible. Independent contractors involved in governmental construction projects are among these.

For a brief idea of how courts have resolved this relationship question consider the following two examples. Contractors involved in army camp construction in Alabama sought to avoid the Alabama use tax by claiming exemption under the Alabama statute similar to the NORTH DAKOTA CENTURY CODE provision.[23] The United States Supreme Court in this case said that the contractors were not agents

19. MINN. STAT. ANN. § 297A-25, subdiv. 1(j) (1965 amend.).
20. N.D. CENT. CODE § 57-39.2-04, subdiv. 6 (Supp. 1969).
21. 182 N.W.2d at 837.
22. James v. Dravo Conracting Co., 302 U.S. 134, 154 (1937).
23. Curry v. United States, 314 U.S. 14, 16-17 (1941); CODE OF ALA. Title 51, § 789 (1940); CODE OF ALA. Title 51 § 786 (34) (1959).

or instrumentalities of the federal government and thus remained liable as if the contract had been with a private party.[24] Although the government may ultimately have been the recipient of the finished camps, under a cost-plus contract such result is not determinative of taxability. A more straight forward expression of contractor immunity is found in *Boeing Company v. Omdahl.*[25] This case involved a suit by a federally employed contractor against the state of North Dakota. In argument the plaintiff company contended that at the time of its purchases it was an agent of the United States government. As a consequence, the federal government was in fact the purchaser and thereby the federal exemption from the sales tax shifts to the contracting company.[26] The North Dakota Supreme Court, after examining the contractual provisions, found that the contractor was the actual purchaser. Proof of this result arose from the evidence of the contractor's inability to pledge government credit and its great discretion in financing and purchasing.[27] Basing its holding upon the above findings the court said that:

> Even though title vests immediately in the United States, that is not conclusive of ownership for tax purposes when it appears that the taxpayer retains the essential indicia of ownership.[28]

Where the materials are ordered by the contractor, paid for by him and the government incurs a reimbursement obligation only upon delivery, inspection and acceptance there is no tax immune relationship.[29]

Although there may be an insufficient relationship between the government and its contractor to establish contractor immunity, the effect of the tax may be of such a nature as to be burdensome to the government. This is another criteria for the determination of tax "directness." With respect to tax effect the North Dakota Supreme Court has announced the test to be one of "legal incidence."[30] Who is legally obligated to pay for the goods? If the contractor defaults does the ultimate liability rest with the government sponsor? If so then the tax is invalid as a burden upon the government. Variants of this test have been employed by other state jurisdictions but in a different context.[31]

Apparently the fact that the sales tax is ultimately passed on

---

24. Curry v. United States, 314 U.S. 14, 17-18 (1941).
25. Boeing Co. v. Omdahl, 169 N.W.2d 696 (N.D. 1969).
26. *Id.* at 701.
27. *Id.* at 705-06.
28. *Id.* at 707.
29. Alabama v. King & Boozer, 314 U.S. 1, 10-13 (1941).
30. Boeing Company v. Omdahl, 169 N.W.2d 696, 702 (N.D. 1969).
31. Utah Concrete Products Corp. v. State Tax Comm'n, 101 Utah 518, 125 P.2d 408 (1942); J. W. Meadors & Co. v. State, 89 Ga. App. 583, 80 S.E.2d 86 (1954).

to the taxing state is not enough to distinguish these cases from situations wherein the tax is passed on to the federal government. Directness of the tax effect remains the paramount issue in both.

State courts have sought to answer the question by a determination of who is the consumer and who is the user.[32] Once it is shown that the contractor is the consumer then he is liable for the tax regardless of the finished product's ultimate destiny. North Dakota arrived at this result in a case in which the contractor was engaged in construction work for the state and its tax exempt agencies.[33] The plaintiff in that case, relying upon subdivision 6 of § 57-39.2-04 of the NORTH DAKOTA CENTURY CODE contended that he was merely a retailer and that the tax-immune state agency was the consumer.[34] The court said that all component parts of an end product are subject to a sales tax.

The various court interpretations of sales tax immunity statutes are in general agreement. While the theories may use different words, the underlying basis for determining tax immunity of state employed contractors remains virtually the same throughout all jurisdictions. State adoption of the early U.S. Supreme Court guidelines of tax immunity has resulted in some rather clear rules. Employment by the state is not enough in itself to render the contractor immune. There must either be a close relationship between the contractor and the state or, a significant effect wrought upon the state by the contractor's tax liability. It seems clear that the Minnesota Supreme Court was correct in applying the sales tax to state-employed contractors. The validity of this decision is even more apparent in light of similar holdings in both state and federal courts.

WILLIAM A. HILL

32. J. W. Medors & Co. v. State, 89 Ga. App. 583, 80 S.E.2d 86, 88 (1954).
33. Northern Improvement Company v. Engen, 68 N.W.2d 463 (N.D. 1954).
34. *Id.* at 466.