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Recent Developments in Sovereign Immunity of the Federal Government from State and Local Taxes

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RECENT DEVELOPMENTS IN SOVEREIGN IMMUNITY OF THE FEDERAL GOVERNMENT FROM STATE AND LOCAL TAXES†

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The legal maxim that "states cannot tax the Federal Government," as decreed years ago in *McCulloch v. Maryland*[1] is no longer the panacea for all problems arising from attempts by the states or their political subdivisions to impose taxes on operations of the Federal Government or its instrumentalities. Justice Marshall's 1819 pronouncement in *McCulloch* is, in most instances, the beginning, rather than the end, for the law has followed a devious, and not always clear, route, in its meanderings over the years. As Justice Jackson said in *U. S. v. Allegheny Co., infra,* some 125 years after *McCulloch,* "Looking backward it is easy to see that the line between the taxable and the immune has been drawn by an unsteady hand." The present status of the doctrine of sovereign immunity, having its genesis in *McCulloch* insofar as the area under discussion is concerned, and as it applies to the Federal Government, has aptly been referred to as a "legal myth".[2]

A proper resolution of the problem herein being considered must take into regard not only the rationale of *McCulloch,* which, although antiquated, will be seen to be still applicable in some few instances, but to the *incidence* of the tax (to whom does the taxing authority, by statute or decision, look for the tax in the first instance); whether or not the tax is *discriminatory* (does the tax apply equally to all within the same class); and, to *territorial immunities* (which sovereign, the state or the Federal Government, exercises legislative jurisdiction over the property sought to be taxed, or on which the property sought to be taxed is then located).

In its heyday, the *McCulloch* rationale, wherein the doctrine

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1. 17 U.S. (4 Wheat) 316 (1819). Justice Marshall ruled that Congress, as a means of carrying into effect its sovereign powers, could incorporate a bank and establish its branches within any state. Having done so, the state was constitutionally prohibited from taxing that branch. Moreover, it was decreed that the states have no right to tax any of the constitutional means employed by the Federal Government to execute its constitutional powers.

2. Rakestraw, **The Reciprocal Rule of Governmental Tax Immunity—A Legal Myth,** 3 Okla. L. Rev. 131 (1950)

of sovereign immunity was applied to government "operations", was extended to immunize real property, income of Federal employees, lessees of real and personal government property, and a variety of other Federal interests, from state and local taxation. The doctrine of sovereign immunity received its first setback in 1937 with the decisions in *James v. Dravo Contracting Co.*[3] and *Silas Mason Co. v. Tax Commission,*[4] and has been on the wane ever since. In those cases, although the taxes were upheld, the court discussed an *"economic burden"* test under which a tax might be invalid if the financial burden was upon the Federal Government. In the case of *Alabama v. King and Boozer,*[5] decided in 1941, the Supreme Court apparently rejected such a test in upholding a tax on the sale of lumber to a cost-plus-fixed fee construction contractor who was building an Army Camp, even though the economic burden of the tax ultimately fell upon the Federal Government. In 1944, in *U. S. v. Allegheny Co.,*[6] the Supreme Court devolved what has been referred to by some experts in the field as the "legal incidence" test.[7] In that case, a state tax on the Mesta Machine Co. plant, enhanced in value for tax purposes by reason of government owned machinery in the plant, was held invalid inasmuch as the "legal taxpayer" was the U. S. Actually, the court recognized that the county was attempting to tax Federally owned property in the possession of a government contractor (Mesta Machine Co.) and applied the sovereign immunity doctrine. That test was applied by the court in *Kern-Limerick v. Scurlock,*[8] in holding a gross-receipts (sales) tax on purchases by a Federal contractor invalid where the contract made him a purchasing *agent* for the United States. The court distinguished its earlier decision in *King and Boozer,* by saying in that case the incidence of the tax fell upon an independent contractor, whereas in the instant case, the incidence was upon an agent of the United States. It should be noted, for reasons that are here of no moment, that the Defense Establishment has, since 1955, refrained from specifically designating contractors as agents in contracts written under its auspices. Notwithstanding, in

3. 302 U.S. 134 (1937).
4. 302 U.S. 186 (1937).
5. 314 U.S. 1 (1941).
6. 322 U.S. 174 (1944).
7. Van Cleve, **States' Rights & Fed. Solvency,** 2 Wis. L. Rev. (Mar. 1959).
8. 347 U.S. 110 (1954).

Nov. 1959, a U. S. District Court, in the case of *U. S. and Dupont v. Livingston,*[9] found agency to exist under the terms of the contract even though such relationship was not specifically spelled out in the contract. Be that as it may, the "legal incidence" test announced in *Allegheny,* which seemingly stood for the proposition that government owned property was not taxable wherever found, had a short life. In 1953, the Supreme Court, in *Esso Standard Oil Co. v. Evans,*[10] upheld the validity of a state privilege tax on Esso, occasioned by its storage of gasoline owned by the United States, even though it was shown that the United States had contractually obligated itself to reimburse the contractor for any state tax liability incurred. The court distinguished *Allegheny* by saying it was the government *property* taxed in that instance, while here it was the *privilege* of storing government property that was taxed. The court concluded by saying that although the tax in Esso may "burden the United States financially . . . this has been no fatal flaw [since *James v. Dravo Contracting Co., supra*]."

In a series of cases announced on 3 March 1958, the U. S. Supreme Court went even further in decimating the doctrine of sovereign immunity, and for all intents and purposes, repudiated the theory prescribed in *Allegheny. U. S. Borg Warner v. City of Detroit*[11] and *U. S. & Continental Motors v. Township of Muskegan*[12] concerned the application of a 1953 Michigan statute providing that when tax exempt real property is used by a private person in a business conducted for profit, the private person is subject to taxation to the same extent as if he were the owner of the property. Both cases involved government contractors occupying defense plants, one under a lease and the other under a permit which could be terminated at will. The U. S. Supreme Court upheld the imposition of the tax, saying the constitutional immunity of the Federal Government from state taxation was not violated and that the state statute was not discriminatory nor was the statute discriminatorily administered. All of this occurred notwithstanding that, for years, the Federal Government has reimbursed its contractors for the costs of possessory interest taxes. It is interesting to note that defense contractors, at the instigation

9. 179 F. Supp. 9; **Aff'd** per curiam, 364 U.S. 281 (1960).
10. 345 U.S. 495 (1953).
11. 355 U.S. 466 (1958).
12. 355 U.S. 484 (1958).

of the military departments, have again initiated litigation in Michigan for purposes of questioning, *inter alia,* whether or not the statute is discriminatory because property of state-supported educational institutions (of which considerable realty is owned and leased to private interests, including valuable down-town properties in the state capital at Lansing and a high percentage of the vast Willow Run complex on the outskirts of Detroit) and property used by way of concession in or relative to the use of a public airport, park, market, fair ground, or similar property available to the general public, are not subject to taxation under the statutes.

In the third of these 1958 cases, *City of Detroit v. Murray Corp. of America,*[13] the court upheld a tax imposed on Murray, an Air Force subcontractor, on the basis of work in process and inventory, title to which was in the Federal Government on tax day. The court, having earlier that day upheld the possessory interest taxation on government owned real property, found no constitutional impediment to now permitting a possessory interest tax on Government owned personal property. Unlike the real property situation, the Michigan statutes did not specifically authorize such tax, but it was imposed pursuant to the usual personal property tax statute levying the tax on the property. The author Justice for the majority, in commenting on the disparity between the statutes, made a rather startling statement when he said, "It is true that the particular Michigan taxing statutes involved here do not expressly state that the person in possession is taxed 'for the privilege of using or possessing' personal property, but to strike down a tax on the possessor because of such verbal omission would only prove a victory for empty formalism. And empty formalisms are too shadowy a basis for invalidating state tax laws . . . In the circumstances of this case the state could obviate such grounds for invalidity by merely adding a few words to its statutes." Subsequently, the State of Michigan did just that. The confusion was compounded, a week or so later, when the U. S. Supreme Court affirmed, *per curiam,* the fourth in the quartet of March 1958 decisions. This was the case of *American Motors Corp. v. City of Kenosha*[14] which was factually similar to *Murray.* The one noteworthy exception was that the Wisconsin Supreme Court

13. 355 U.S. 489 (1958).
14. 356 U.S. 21 (1958).

found the contract ineffective for purposes of vesting title in the Federal Government, at least for tax purposes, whereas in the *Murray* case, the court assumed that the United States had full title to the property. There can be little more than speculation as to the basis on which the Court affirmed the *American Motors case.* Subsequently, the California Supreme Court, in two cases tried and decided together, *General Dynamics Corp. and Aerojet General Corp. v. County of Los Angeles,*[15] veered from the path recently followed by the U. S. Supreme Court in refusing to interpret the provisions of its statutes in the same way that similar provisions were interpreted in *Murray.* The California Court said in pertinent part, ". . . we cannot sustain a property tax here on the ground that the legislature could constitutionally provide for the levy of a tax of equal amount under a different scheme." More recently, in *The Martin Company v. State Tax Commission,*[16] the Maryland Court of Appeals held that Maryland tax laws did not provide for taxation of Martin's right to use and possess personal property of the United States. The court said, "Our holding, we believe, is in accord with that of the Supreme Court of California with regard to similar tax statutes of that state involved in the *General Dynamics case* . . . The statutory history and previous construction of [our laws], are important factors in leading us to the view that the holding of the California Supreme Court is more persuasive than the construction of the Michigan tax laws involved in the *Murray Corporation* case and its companion cases as to our statutes."

Today, the United States conducts much of its business through a vast number of private parties. The trend in the U. S. Supreme Court has been to reject immunizing these private parties from non-discriminatory state taxes, as a matter of constitutional law, even though the United States bears the economic brunt of the tax, indirectly in some instances, by inclusion in price, and more directly in many instances, by reimbursement to the contractor as an item of cost.

The U. S. Supreme Court has not been reluctant to point out the alternative to the foregoing, for in *U. S. v. Detroit,* reiterated in *Detroit v. Murray, supra,* it said, "Of course this is not to say that Congress, acting within the proper scope of its power, cannot confer immunity by statute where it does not

15. 330 P.2d 794 (1958).
16. 171 A.2d 479 (1961).

exist constitutionally. Wise and flexible adjustment of intergovernmental tax immunity calls for political and economic consideration of the greatest difficulty and delicacy. Such complex problems are ones which Congress is best qualified to resolve." Congress has legislated rather extensively in this area. Most widely known among the immunizing statutes is the *Soldiers and Sailors Civil Relief Act* which protects active duty military personnel from income, personal property, automobile license fees, and certain other type of taxes imposed by a state in which they are not domiciled.[17] Originally a cloak of immunity was thrown around contractors for the *Atomic Energy Commission*.[18] Although upheld by the U. S. Supreme Court in *Carson v. Roane-Anderson Co.*,[19] the immunity was subsequently modified by the Congress in authorizing payments by the Atomic Energy Commission to the "state and local governments in lieu of property taxes."[20] Family housing projects built by private corporations, under the Capehart program, have been exempt from state and local taxes, and limits had been set on the amount of such taxes which could have been imposed with respect to similar projects operated by private parties under the Wherry Program[21] (the acquisition by the Air Force of the title to most, if not all, Wherry projects, has rendered the latter provision one of academic interest at this time). Conversely, Congress had subjected Reconstruction Finance Corporation real property to state and local taxation.[22] The abolition of the Reconstruction Finance Corporation and subsequent transfer of its property to other governmental agencies had the effect of removing the property from state and local tax rolls. The havoc which such action worked upon state and local fiscal plans was recognized by the Congress when payments in lieu of taxes for such transferred real property were authorized.[23] Also, in the "Hayden-Cartwright Act" and the "Buck Act" amendment thereto, Congress has permitted the imposition of state and local sales, use, income and gasoline taxes in Federal areas[24] although preserving the immunity of the United States, its instrumentalities, and authorized purchases there-

17. 50 U.S.C. § § 501, 574.
18. Sec. 9(b) Atomic Energy Act of 1946, 60 Stat. 765.
19. 342 U.S. 232 (1952).
20. 42 U.S.C. § 2208.
21. Sec. 511, Housing Act of 1956, 42 U.S.C. § 1594, note.
22. 15 U.S.C. § 607.
23. 40 U.S.C. § 521.
24. 4 U.S.C. § 104-110.

from, from all save the latter.[25] A bill has been introduced in the present session of Congress which would extend the provisions of the "Buck Act" to personal property located within a Federal enclave.[26]

Except for mere mention here, inasmuch as the subject is a rather exhaustive one within itself, immunity from taxation extends to areas over which the Federal Government exercises exclusive legislative jurisdiction. That concept, embodied in the doctrine of territorial immunity, has recently, although most assuredly not for the first time,[27] been applied by a Texas District Court in *General Dynamics Corp. v. The Board of Equalization of the City and Independent School District of Fort Worth, et al.*[28] Therein, it was held that U. S. owned property in the possession of a contractor and a contractor owned property, located within a Federal enclave, was beyond the purview of local taxing authorities. On 26 July 1961 the Texas Supreme Court dismissed the writ of error noting that no reversible error was shown in the opinion below.

While the courts frequently spoke of discrimination, little was done, until recently, to define what was and what was not, such discrimination as would vitiate a tax. In the case of *Phillips Chemical Co. v. Dumas Independent School District,*[29] decided 23 February 1960, the U. S. Supreme Court struck down the school district assessment against *Phillips* for the years 1949 through 1954. The object of the tax was industrial property leased by *Phillips,* from the Army, for purely commercial purposes. The tax was assessed under a 1950 Texas law which provided for a tax, measured by the full value of the property, on one who uses or occupies Federal property for profit. In comparing the taxes on other exempt property in Texas with the tax on a lessee of the Federal Government, it was ascertained that lessees of other tax exempt property, such as that owned by the state, were taxed only if the lease was for three years or more, and the assessment was based only on the value of the leasehold. In an attempt to bring itself within the permissible classification features of previous decisions, in other words, justify the discrimination, the state

25. 4 U.S.C. § 107.
26. H.R. 5362 (87th Cong., 1st Sess.).
27. Report of the Interdepartmental Committee for the Study of Jurisdiction Over Federal areas within the states, Part II, a text of the Law of Legislative Jurisdiction, June 1957, Chapter VII, contains discussion and listing of cases.
28. District Ct. of Tarrant Co., Tex., 67th Jud. Dist., No. 9983-C.
29. 361 U.S. 376 (1960).

argued that: (1) the state can collect in rent what it loses in taxes, (2) the state may legitimately foster its own interests, and, (3) the greater magnitude of Federal leasing has a greater impact on the local economy. The court rejected the argument *in toto*. The court concluded that the discrimination was apparent, saying further, "where the taxation of the private use of the Government's property is concerned the Government's interests must be weighed in the balance. Accordingly, it 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."

In February 1961, in *U. S. Olin Mathieson Chemical Corp. v. Dept. of Revenue of the State of Illinois, et al*,[30] a three judge U. S. District Court enjoined the state from levying and/or collecting its retailer's occupation (sales) tax from those contractors doing business with the United States inasmuch as the tax did not reciprocate the exemption granted to retailers doing business with the state and its political subdivisions. The court did not question, in fact it recognized, that the state legislature has the power to grant an exemption according to its views of public policy, subject only to the limitation that the exemption and the classification upon which it is based be reasonable and not arbitrary. However, the court said, "In our view . . . a retailer who deals with the Federal Government falls within the same class as a retailer who deals with the State of Illinois. If an exemption is made from the general classification of retailers who sell tangible personal property on the legally justifiable basis of dealing with the State of Illinois, it is because such retailer deals with a governmental entity. By exempting a retailer who deals with the State of Illinois and its political subdivisions, the legislature has subdivided retailers who transact business with governmental entities into two divisions—those who deal with the State of Illinois and its subdivisions and those who deal with the United States. To be valid, such an exemption must fall alike on all similarly situated and must include retailers who deal with the Federal Government." The state has petitioned the U. S. Supreme Court for review, but in view of the decision in *Phillips,* it seems unlikely that the District Court ruling will be reversed. Although the decision in *Phillips* concerned itself with a property tax, as differentiated

30. 191 F. Supp. 723 (1961).

from a sales tax in *Olin Mathieson,* the distinction is one without a real difference, for the Court's statements in the former most assuredly apply to the entire spectrum of state-local taxes. An interesting aftermath to the *Olin Mathieson* decision was the action by the Illinois Supreme Court in *People ex rel Holland Coal Co., v. Isaacs,*[31] wherein the exemptions in the *Retailers' Occupation (Sales) Tax Act* on sales to the State and local governments and on sales for charitable, religious or educational purposes were considered. In holding the *Phillips* case controlling, the Court said, "The exemption provisions have failed to include the Federal Government within the class to which it belongs, and therefore, this works an unconstitutional discrimination against the Federal Government. For that reason we hold that [all] the exemption provisions of the [acts] in question are unconstitutional and void." Thus, it would appear that sales to the Federal Government might again be taxable, since the constitutional objection in the *Olin Mathieson* case is no longer available to the Federal Government. However, a petition for rehearing in the *Holland Coal Co.* case has been filed with the Illinois Supreme Court. Nevertheless, the Illinois Department of Revenue has refrained from collecting the tax in sales to contractors for the Federal Government,[32] as indeed it would be obliged to do under the existing restraining order (*Olin Mathieson, supra*). A motion to have the injunction removed was denied by the Federal District Court on the basis that the court no longer had jurisdiction since the matter was on appeal to the United States Supreme Court.

The two cases, immediately preceding, pertain to discrimination apparent in the text of the state statutes. In the *City of Detroit and Continental Motors cases, supra,* the U. S. Supreme Court made it abundantly clear that unlawful discrimination might also result from the manner in which tax laws were administered.

CONCLUSION

From the foregoing it may be concluded: The Federal Government and/or its property is constitutionally immune from direct state and local tax impositions. Government owned property in the possession of a contractor and contractor

31. Ill. Sup. Ct., 10 May 1961, CCH State Tax Reporter, Ill. 200-200.
32. CCH State Tax Review, 12 June 1961, Vol. 22, No. 24.

owned property, located within an area over which the Federal Government exercises exclusive legislative jurisdiction, is beyond the reach of state and local taxing authorities. Congress may waive, or, conversely, confer, immunity. Persons dealing with the Federal Government may be subjected to taxation by reason of their dealings with the Federal Government (sales, use, etc., tax) or possession of Federally owned real or personal property, (the latter subject to its being without a Federal enclave, *supra*). The measure of the tax may be the full value of the property. This is so notwithstanding that the Federal Government may, and usually does, bear the economic burden of the tax. In every instance, however, the tax may not unlawfully discriminate against the Federal Government or those with whom it deals.