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Federal Immunity of Government Contractors from State and Local Taxation: A Survey of Recent Decisions and Their Impact on Government Procurement Policies

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FEDERAL IMMUNITY OF GOVERNMENT CONTRACTORS FROM STATE AND LOCAL TAXATION: A SURVEY OF RECENT DECISIONS AND THEIR IMPACT ON GOVERNMENT PROCUREMENT POLICIES

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INTRODUCTION

Although the Constitution of the United States does not expressly prohibit state and local taxation of federal activities, the federal courts have developed a constitutionally implied tax immunity. The immunity doctrine, although a fundament of our federalism, has undergone a number of transformations. These transformations have caused confusion in the area and have compelled the Supreme Court to observe that "the line between the taxable and the immune has been drawn by an unsteady hand."[1] More recently, the Court described the tax immunity doctrine as "a 'much litigated and often confused field,' one that has been marked from the beginning by inconsistent decisions and excessively delicate distinctions."[2] It is not, however, the purpose of this article to criticize the Court for its judicial wanderings. Instead, this article is designed to provide practical guidance to federal procurement officials concerning the extent to which the federal immunity doctrine may be applied to immunize government contractors and their activities from state and local taxation. Part I traces the development of the federal immunity doctrine and, in particular, the development of Government contractor's immunity from state and local taxation. Part II discusses three recent decisions concerning federal immunity and its application to Government contractors. Part III discusses the impact of these decisions on Government procurement policies. Part IV concludes the article.

I. DEVELOPMENT OF THE FEDERAL IMMUNITY DOCTRINE

Few constitutional concepts have been as elastic as the federal immunity doctrine. Following the announcement of the doctrine in *M'Culloch v. Maryland*,[3] the Court went through two distinct phases. First, for more than

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1. United States v. County of Allegheny, 322 U.S. 174, 176 (1944).

2. United States v. New Mexico, 455 U.S. 720, 730 (1982) (*quoting* United States v. City of Detroit, 355 U.S. 466, 473 (1958)).

3. 17 U.S. (4 Wheat.) 316 (1819).

a century, the Court expanded the scope of the doctrine to encompass almost every conceivable entity and activity related to the activities of the Federal Government. Second, there was a significant contraction of the expanded doctrine. Part I is designed to give the reader a general understanding of the historical development of the federal immunity doctrine as it applies to Government contractors and has been divided into two subparts: (A) the origin and expansion of the federal immunity doctrine; and (B) the contraction of the federal immunity doctrine.

A. *Origin and Expansion of the Federal Immunity Doctrine*

In *M'Culloch*, the State of Maryland sought to impose a tax on the operations of the Bank of the United States. The Maryland statute required any bank established in Maryland, without authority of the State, to purchase stamped paper for the printing of certain notes. The amount of the tax was two percent of the face value of the notes.[4] In the alternative, the Bank could make an annual, advance payment of $15,000 to the State.[5] Chief Justice Marshall, speaking for a unanimous Court, rejected the Maryland taxing scheme as unconstitutional.[6]

After disposing of the state's assertion that Congress was without constitutional authority to create the Bank, the Court proceeded to answer the question of whether the State of Maryland could constitutionally tax a federal instrumentality. The supremacy clause is clearly the foundation upon which *M'Culloch* rests. While noting that there is no express provision in the Constitution exempting the Bank from the power of the state to tax its operations, Marshall stated that it was the essence of supremacy to exempt the Federal Government from the influence of subordinate governments' activities, and such result was necessarily implied by the declaration of supremacy.[7] And, in response to the state's argument that the Constitution leaves it the power to tax with the confidence that the state will not abuse that power, Marshall noted:

> The only security against the abuse of this power, is found in the structure of the government itself. In imposing a tax the legislature acts upon its constituents. This is in general a sufficient security against erroneous and oppressive taxation.
>
> The people of a state, therefore, give to their government a right of taxing themselves and their property, and as the exigencies of government cannot be limited, they prescribe no limits to the exercise of this right, resting confidently on the interest of the legislator, and on the influence of the constituents over their representative, to guard them against its abuse. But the means employed by the Government of the Union have no such security, nor is the right of a state to tax them sustained by the same theory. Those means are not given by the people of a particular state, not given by the constituents of the legislature, which claim the right to tax

4. *Id.* at 320-21.
5. *Id.* at 321.
6. *Id.* at 436.
7. *Id.* at 427.

> them, but by the people of all the states. They are given by all for the benefit of all—and upon theory, should be subjected to that government only which belongs to all.[8]

Thus, finding that there were no political checks to prevent the state from abusing its taxing power with respect to federal activities, the Court initiated the doctrine of federal immunity from state and local taxation. The doctrine "is so deeply rooted in American constitutional law that it seems fair to characterize it as a cornerstone of our federal system."[9] And, although "the doctrinal declarations and limitations on state and local taxing power set forth in *M'Culloch* have subsequently been reinterpreted, and in some respects very materially changed, . . . the basic immunity concept has never been abrogated."[10]

For more than a century after the *M'Culloch* decision, the Court substantially expanded the federal immunity concept. In addition to federal instrumentalities, the federal immunity umbrella was extended to, *inter alia*, Government employees, lessees of Government property, and independent contractors providing supplies and services to the Government. Since many of the cases rendered during this expansionary period have been subsequently overruled or significantly limited, they do not deserve extended coverage. However, in order to understand the significance of the subsequent contraction of federal immunity which is discussed at subpart B of this Part, a brief survey of the more notable decisions is appropriate.

Ten years after *M'Culloch*, in *Weston v. Charleston*,[11] the Court ruled that a property tax imposed by a local government on federal securities owned by private parties was unconstitutional. The issue in *Weston* was whether a local government could require private parties to include federal securities in their property tax base. A divided *Weston* Court held that the tax was an unconstitutional interference with the power of Congress to borrow money on the credit of the United States. The tax was, in the Court's view, "a tax on the contract [between the Government and the individual that owned the securities], a tax on the power to borrow money on the credit of the United States, and . . . repugnant to the Constitution."[12] Thus, *Weston* expanded *M'Culloch*'s federal immunity umbrella by extending it to contractual relationships between private parties and the Government.

In *Dobbins v. Commissioners of Erie County*,[13] the doctrine of federal immunity was expanded to cover state and local taxes on employees of the Federal Government. In *Dobbins*, the State of Pennsylvania authorized the imposition of a tax, roughly measured by compensation, on "all offices and posts of profit."[14] The taxpayer was a captain in the United States revenue cutter service; his office was created by an Act of Congress to regulate the collection

8. *Id.* at 428-29.

9. *P. Hartman, Federal Limitations on State and Local Taxation*, § 6:2, at 236-37 (1981) [hereinafter cited as *Hartman*].

10. *Id.* at 237.

11. 27 U.S. (2 Pet.) 449 (1829).

12. *Id.* at 469.

13. 41 U.S. (16 Pet.) 435 (1842).

14. *Id.* at 445.

of duties on imports.[15] The taxing authority assessed a tax measured by the taxpayer's compensation and taxpayer challenged the tax on constitutional grounds. The Court, holding for the taxpayer, found the tax to be constitutionally offensive under the federal immunity doctrine announced in *M'Culloch*. The *Dobbins* Court noted that the congressionally created office of the taxpayer was a means chosen by Congress to execute its sovereign powers.[16] As such, taxation of the taxpayer is no less objectionable than the taxation of the vessel he commands, which is clearly not subject to tax by state or local authorities.[17] The Court then noted that its decision was not based on a technical reading of the statute, and was "applicable to exempt the salaries of all officers of the United States from taxation by the states."[18] In this context, the Court expressed that Congress had absolute discretion to determine the compensation of an officer of the United States, and that a state may not constitutionally diminish this compensation.[19]

The case of *Gillespie v. Oklahoma*[20] extended the federal immunity doctrine to cover lessees of Government lands. In *Gillespie*, the State of Oklahoma imposed a nondiscriminatory tax on net income derived by a lessee of Government lands from sales of oil and gas received under the lease.[21] With regard to a tax on leases, the *Gillespie* Court cited the following passage from an earlier opinion: "A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them."[22] The Court also noted that a tax on the net profits from those leases constitutes a "direct hamper upon the effort of the United States to make the best terms that it can for its wards."[23] Therefore, because the tax upon lessees profits from the lease might interfere with the negotiation process, *Gillespie* extended federal immunity to lessees of Government property whose only connection with the Government was the leased property.

Shortly after *Gillespie*, in *Panhandle Oil Co. v. Mississippi*,[24] the Court applied the federal immunity doctrine to exempt an independent contractor from a state sales tax on the sale of goods to the Federal Government. In *Panhandle*, the State of Mississippi imposed an excise tax of one cent per gallon on the contractor for the privilege of selling gasoline. The contractor argued that with respect to its sales to the Federal Government the federal immunity doctrine conferred immunity. The *Panhandle* majority agreed with the taxpayer finding the tax a burden on the constitutional powers of the United States. In this regard, the *Panhandle* majority, noting that the right to make sales to the United States Government was not given by the

15. *Id.* at 436.
16. *Id.* at 448.
17. *Id.*
18. *Id.* at 449. While the tax was expressly on "all offices and posts of profit," the state argued that the subject of the tax was the compensation received. The Court did not agree with the state's interpretation, but noted that its decision was not based on such a technicality. *Id.*
19. *Id.* at 450.
20. 257 U.S. 501 (1922).
21. *Id.* at 503.
22. *Id.* at 505 (*quoting*, Indian Territory Illuminating Co. v. Oklahoma, 240 U.S. 522, 530 (1916)).
23. *Id.* at 506.
24. 277 U.S. 218 (1928).

state nor dependent on state laws, held that states could not impose any tax upon transactions with the United States.[25] But, *Panhandle* is best remembered for the telling dissent by Justice Holmes which predicted the upcoming constriction of the federal immunity doctrine.

Holmes felt that the Mississippi tax should be sustained. He recognized, however, in light of the dicta in *M'Culloch* that "the power to tax is the power to destroy," that his view was not plainly right.[26] Holmes responded to Marshall's famous, absolutist dicta in the following fashion:

> In those days it was not recognized as it is today that most of the distinctions of the law are distinctions of degree. If the states had any power it was assumed that they had all power, and that the necessary alternative was to deny it altogether. But this court which so often has defeated the attempt to tax in certain ways can defeat an attempt to discriminate or otherwise go too far without wholly abolishing the power to tax. The power to tax is not the power to destroy while this court sits.[27]

In conclusion, Holmes noted that the question of interference is not one of absolutes but rather "one of reasonableness and degree and it seems to me that the interference in this case is too remote [to support the majority's position]."[28]

B. *Contraction of the Federal Immunity Doctrine: The Legal Incidence Test*

In subpart A the origin and expansion of the federal immunity doctrine were covered. Following this expansionary period, the doctrine was significantly contracted. The contraction of the doctrine, as it relates to contractors of the Federal Government and their activities, will be covered in this subpart.

The judicial constriction of the federal immunity doctrine began in 1937 with the *James v. Dravo Contracting Co.*[29] decision and has generally continued to date as evidenced by recent Supreme Court decisions.[30] But, "[e]ven the Court's post-*James* decisions . . . cannot be set in an entirely unwaivering line."[31] The "post-*James* decisions" referred to by the Court in *New Mexico* will be examined in this subpart. These decisions can be profitably divided into two groups according to the nature of the tax involved: (1) those concerning other than possessory use taxes;[32] and (2) those concern-

25. *Id.* at 221.
26. *Id.* at 223.
27. *Id.*
28. *Id.* at 225.
29. 302 U.S. 134 (1937).
30. 455 U.S. 720; Washington v. United States, 103 S.Ct. 1344 (1983).
31. 455 U.S. at 732.
32. Other than possessory use taxes is meant to encompass all other taxes, but in this paper it principally concerns gross receipts, sales and compensating use taxes. Although the definition of these taxes may vary from state to state, the model state legislation suggested by the Multistate Tax Commission provides generally accepted definitions. In this regard, Article II of the model legislation provides in part:

> 6. "Gross receipts tax" means a tax, other than a sales tax, which is imposed on or measured by the gross volume of business, in terms of gross receipts or in other terms, and in the determination of which no deduction is allowed which would constitute the tax an income tax.

ing possessory use taxes.[33] Each group will be treated separately below. A separate section will also be devoted to the development of the legal incidence test and the issue of discrimination.

1. Other Than Possessory Use Taxes

The *James* case was a landmark decision which marked the end of an expansionary period spanning more than a century and the beginning of a period of contraction that has carried the Court to the present day. The case involved a West Virginia gross receipts tax on the privilege of conducting business within the State.[34] The taxpayer, an independent contractor constructing locks and dams for the Government, argued that the tax as applied to these activities was an unconstitutional interference with the Government's activities.[35] In sustaining the tax, the closely divided *James* Court noted by way of comparison the various debilitating characteristics of the taxes which the Court had scrutinized before.[36] In this context, the Court stated: "The tax is not laid upon the Government [or] its property . . . [; it] is not laid upon an instrumentality of the Government . . . [; it] is nondiscriminatory [; and it] is not laid upon the contract of the Government."[37] And, notwithstanding the Court's assumption that the tax in issue might be an economic burden to the Government, the Court would not invalidate the tax.[38] Instead, the Court, after making an effort to distinguish and limit its prior decisions in the area, concluded that "the West Virginia tax . . . does not interfere in any substantial way with the performance of federal func-

7. "Sales tax" means a tax imposed with respect to the transfer for a consideration of ownership, possession or custody of tangible personal property or the rendering of services measured by the price of the tangible personal property transferred or services rendered and which is required by State or local law to be separately stated from the sales price, but does not include a tax imposed exclusively on the sale of a specifically identified commodity or article or class of commodities or articles.

8. "[Compensating] use tax" means a nonrecurring tax, other than a sales tax, which (a) is imposed on or with respect to the exercise or enjoyment of any right or power over tangible personal property incident to the ownership, possession or custody of that property or the leasing of that property from another including any consumption, keeping, retention, or other use of tangible personal property and (b) is complementary to a sales [or gross receipts] tax.

Multistate Tax Commission, Suggested State Legislation And Enabling Act Art. II.

33. In general, the possessory use tax, often referred to as a possessory interest tax, is assessed on the privilege of using or possessing tax-exempt property. It resembles an ad valorem property tax assessed against the owner of the property. But, because the owner is exempt from taxation, the tax is levied on the privilege of using the property and assessed against the nonexempt user. The distinction between an ad valorem property tax and a privilege or excise tax measured by the value of that property, albeit formal, has been critically important to the judicial review of these taxes. The possessory use tax is similar to an ad valorem property tax in that it is a recurring tax which is often based on the fair market value of the underlying property. The possessory use tax is often confused with the compensating use tax which is a nonrecurring tax used to complement a sales or gross receipts tax. In this regard, the possessory use tax is typically assessed annually and without regard to the payment of a sales or gross receipts tax.

34. 302 U.S. at 138.

35. *Id.* at 149. The Federal Government, however, provided an amicus brief to the Court supporting the State's contention that the tax was valid. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at 160.

tions and is a valid exaction."[39]

In a strong dissent, Justice Roberts argued for the continued application of the economic burdens test and objected that the Court was "overrul[ing], sub silentio, a century of precedents."[40] After making a survey of the Court's earlier decisions, Justice Roberts concluded that the tax was imposed upon the Federal Government, and was therefore prohibited by *M'Culloch v. Maryland*.[41]

The *James* case is important because it provided the foundation upon which the legal incidence test would later be built, and marked the demise of the economic burdens test that had theretofore prevailed. In this regard, the following excerpt from *James* is instructive:

> [I]t is not necessary to cripple the [state's authority to tax] by extending the constitutional exemption from taxation to those subjects which fall within the general application of non-discriminatory laws, and where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government.[42]

Thus, *James* held that a non-discriminatory tax would not be rejected on federal immunity grounds unless it was laid directly upon the Government, its instrumentalities, or a contract of the Government.[43]

In *Alabama v. King & Boozer*,[44] the Court went a step further than *James* and sustained a sales tax as applied to Government cost-plus contractors. In *King & Boozer*, the taxpayer sold lumber to Government cost-plus contractors which were constructing an army camp for the Government.[45] The Government argued that the legal incident of the tax was on the Government, and therefore invalid.[46]

In an unanimous decision, the Court expressly overruled the *Panhandle* case and the economic burdens test expressed in that case.[47] In this regard, the Court stated:

> So far as such a non-discriminatory state tax upon the contractor enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of two independent taxing sovereignties. The asserted right of the one to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of those who furnish supplies to the Government and who have been granted no tax immunity.[48]

The Court adopted the Government's legal incidence test, but disagreed with the Government's assertion that the incidence of the tax in issue was on

39. *Id.* at 161.
40. *Id.*
41. *Id.* at 185-86.
42. *Id.* at 150.
43. *Id.* at 149.
44. 314 U.S. 1 (1941).
45. *Id.* at 6.
46. *Id.* at 9.
47. *Id.* For a discussion of the *Panhandle* case *see supra* notes 25-29 and accompanying text.
48. *Id.* at 8-9.

the Government.[49] The Court concluded instead that the incidence of the tax was upon the contractors, and the fact "that they were bound by their contract to furnish the purchased material to the Government and entitled to be reimbursed by it for the cost, including the tax," was of no event.[50]

The *King & Boozer* decision is important because it sanctioned a tax which was passed through in total to the Government. The tax went further than the *James* tax which was merely a possible or potential burden on the Government; it was a clear and ascertainable economic burden on the Government. More importantly, the Court's focus in these cases shifted to the legal formalisms such as the legal incidence of the tax and away from the economic impact of the tax. The *King & Boozer* case suggested, however, that the Federal Government might provide immunity to the contractor by making the contractor its purchasing agent.[51] The Government, in *Kern-Limerick, Inc. v. Scurlock*,[52] seized upon this dicta and successfully argued that a cost-plus contractor, under the terms of the contract, was merely a procurement agent of the Federal Government and therefore immune from state and local taxation.

In *Kern-Limerick*, with three judges dissenting, the Court held that a sales tax had been unconstitutionally applied by the state to a contractor who had purchased two diesel tractors for use in the construction of a Naval ammunition depot.[53] The contract between the Government and the contractor clearly indicated that the contractor was acting as an *agent* for the Government and that the Government, and not the contractor, was legally obligated to the seller for the purchase of the two tractors.[54] Furthermore, title to all materials and supplies purchased by the contractor passed directly to the Government.[55] Based on these considerations, the Court concluded that the Government was the purchaser under the contract and, since the legal incidence of the tax was on the purchaser, that the tax was invalid.[56]

The dissenting Justices in *Kern-Limerick* argued that the "legal incidence" of a state tax is a question with constitutional implications which should not be determined by the contract.[57] In this regard, the dissent was displeased with the possibility that the mere alteration of a few words in the

49. *Id.* at 14.

50. *Id.*

51. *Id.* at 13. There the Court stated:

> But however extensively the Government may have reserved the right to restrict or control the action of the contractors in other respects, neither the reservation nor the exercise of that power gave to the contractors the status of agents of the Government to enter into contracts or to pledge its credit.

52. 347 U.S. 110 (1954).

53. *Id.* at 111.

54. *Id.* at 119-20.

55. *Id.*

56. *Id.* at 122. Although the Government prevailed in the Supreme Court, the victory, presumably because of political pressures, was short-lived for the Department of Defense (DOD). In 1955, only one year after *Kern-Limerick*, DOD issued a policy statement to the effect that the *Kern-Limerick* procurement agent concept should not be used to avoid otherwise validly imposed state or local taxes. But, as indicated below, other federal agencies, most notably the Department of Energy (DOE) and its predecessor the Atomic Energy Commission (AEC), continued to rely on the procurement agent concept.

57. *Id.* at 126-27.

contract could alter the constitutional line of demarcation.[58] The dissent stated: "We should hold that, until the Congress says differently, the states are free to tax all sales to cost-plus government contractors."[59] In other words, the dissent would hold that the facts in *Kern-Limerick* provide no basis for constitutionally implied immunity and, until Congress provides statutory immunity, the states' authority to tax sales to cost-plus Government contractors should not be disturbed.

The statutory immunity referred to by the dissent in *Kern-Limerick* was found by the Court in *Carson v. Roane - Anderson Co.*[60] In that case the State of Tennessee imposed a sales and compensating use tax on certain Atomic Energy Commission (AEC) contractors.[61] The Government argued that the contractors were immune from taxation pursuant to the statutory exemption provided by section 9(b) of the Atomic Energy Act of 1946.[62] That provision provides in pertinent part: "The Commission, and the property, activities, and income of the Commission, are hereby expressly exempted from taxation in any manner or form by any state, county, municipality, or subdivision thereof."[63] Based on this language and the legislative history, the Court had little difficulty holding for the Government.

In reaching its decision the Court initially examined the nature of congressional power to create tax immunities. The power does not depend on the nature of the agency or instrument doing the work for the Government, but rather it "stems from the power to preserve and protect functions validly authorized—the power to make all laws necessary and proper for carrying into execution the powers vested in the Congress."[64] Having determined that Congress had the requisite authority, the Court then defined the scope of the statutory provision in issue to include "all authorized methods of performing the governmental function."[65] Accordingly, finding that Congress was constitutionally empowered to create tax immunities and that the statute in issue was intended by Congress to immunize AEC contractors from state and local taxation, the Court held that the contractors were immune from such taxation.[66]

Yielding to political pressure, however, Congress later repealed the statutory language upon which statutory immunity had been found in the *Carson* decision.[67] While the repeal resolved the question of statutory immunity for AEC contractors, it did not resolve the question of constitutional immunity.[68]

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58. *Id.* (citations omitted).

59. *Id.* at 127.

60. 342 U.S. 232 (1952).

61. *Id.* at 233.

62. 60 Stat. 765 (1946). The provision in issue was repealed by Act of August 13, 1953, 67 Stat. 575 c. 432.

63. *Id.*

64. 342 U.S. at 234 (citations omitted).

65. *Id.* at 235-36.

66. *Id.* at 236.

67. Act of August 13, 1953, 67 Stat. 575, c. 432.

68. *See* United States v. Livingston, 179 F. Supp. 9 (E.D.S.C. 1959), *aff'd per curiam*, 364 U.S. 281 (1960); United States v. Boyd, 378 U.S. 39 (1964). In these cases the Court noted that

The Court in *United States v. Livingston*[69] affirmed without opinion a lower court finding of constitutional immunity for an AEC contractor. In *Livingston*, the State of South Carolina sought to impose its sales and compensating use tax upon the purchases of materials by an AEC contractor.[70] The contractor was paid cost and a nominal fee of one dollar to design, construct and operate an atomic energy plant for the AEC.[71] The contract contained a title vesting provision whereby title to materials purchased under the contract would pass directly from the vendor to the Government.[72] To facilitate and expedite payment, the contract provided for a revolving fund to be deposited for the payment of purchases and expenses.[73] Finding that the contractor was an agent of the Government by implication, and citing the *Kern-Limerick* decision, the lower court concluded that the contractor's "procurement activities resulted in the sale of goods and services to the United States, that the purchases were those of the United States and immune from ordinary sales and use taxes upon the purchaser or upon the purchasing agent."[74] With respect to the issue of the contractor's beneficial use of the property purchased, the court made a factual determination that there were no benefits, profit or otherwise, to the contractor.[75]

The Court, however, did not find constitutional immunity in the next case concerning AEC contractors—*United States v. Boyd*.[76] In *Boyd*, the State of Tennessee collected from certain AEC contractors a sales and compensating use tax upon purchases made by them under their contracts with the AEC.[77] The Tennessee Supreme Court, relying on *Kern-Limerick*, determined that the contractors were merely acting as procurement agents on the Government's behalf and refused to sustain the State's application of the sales tax.[78] That court, however, sustained the collection of the compensating use tax,[79] the only issue which reached the Supreme Court.[80]

The Court, like the Tennessee Supreme Court, sustained the state's collection of the compensating use tax. In sustaining the tax, the Court initially summarized the state of the law with the following passage:

> The Constitution immunizes the [United States from] taxation

repeal of the language providing statutory immunity was only intended to place AEC contractors on an equal footing with other Government contractors.

69. United States v. Livingston, 179 F.Supp. 9 (E.D.S.C. 1959), *aff'd per curiam*, 364 U.S. 281 (1960).

70. 179 F.Supp. at 11.

71. *Id.* at 16.

72. *Id.* at 17.

73. *Id.*

74. *Id.* at 22 (citations omitted).

75. *Id.* at 22-23. The Court distinguished the *Detroit* cases, discussed *infra*, where the contractors used the property in their profit-making capacity. The Court also rejected the State's argument that the contractor was benefitted by the valuable experience received by its employees. Then the Court noted: "There is every indication that [the contractor] accepted this contract and its obligations out of the high sense of public responsibility, despite deprivation, which its president expressed to its stockholders in 1950." *Id.* at 23.

76. 378 U.S. 39 (1964).

77. *Id.* at 43.

78. *Id.* at 43 n.5.

79. *Id.* at 43.

80. *Id.* at 43 n.5.

> by the States, . . . but it does not forbid a tax whose legal incidence is upon a contractor doing business with the United States, even though the economic burden of the tax, by contract or otherwise, is ultimately borne by the United States. . . . Nor is it forbidden for a State to tax the beneficial use by a federal contractor of property owned by the United States, even though the tax is measured by the value of the Government's property, . . . and even though his contract is for goods or services for the United States. . . . The use by the contractor for his own private ends—in connection with commercial activities carried on for profit—is a separate and distinct taxable activity.[81]

Then, noting that the Government had accepted these principles, the Court rejected the Government's contention that the contractors had not used the Government property for their own commercial advantage but exclusively for the benefit of the United States.[82] The Court found this contention "incredible."[83] The critical factor is that the contractors used the property for their own commercial, profit-making activities.[84]

In *Boyd* the Government urged that the work done by the contractors "should be viewed as though the Commission was doing its own work through its own employees, the legal incidence of the tax therefore falling on it."[85] The Court, however, would not indulge in this fiction.[86] The Government may perform its functions either "directly through its own facilities, personnel and staff," or with the assistance of private enterprise.[87] The Government is well aware of these possibilities and in this case it chose the latter.[88] "We cannot conclude that [the contractors], both cost-plus contractors for profit, have been so incorporated into the Government structure as to become instrumentalities of the United States and thus enjoy governmental immunity."[89]

2. Possessory Use Taxes

At this juncture a brief word about possessory use taxes and two related taxes—the ad valorem general property tax and the compensating use tax—is appropriate.

The "old and widely used ad valorem general property tax" was discussed in detail by the Court in *United States v. County of Allegheny*.[90] In that

81. *Id.* at 44.
82. *Id.* at 44.
83. *Id.*
84. The *Boyd* Court noted that reliance by the Government on the *Livingston* case was misplaced. In *Livingston*, the lower court had made a factual determination that the contractor received no benefits from the contract. In this regard, the facts in *Boyd* make it clearly distinguishable as the contractor's receive a substantial fee in the course of their commercial operations. *Id.* at 45 n.6.
85. *Id.* at 46-47.
86. *Id.* at 48.
87. *Id.* at 47.
88. *Id.* at 48.
89. *Id.*
90. 322 U.S. 174 (1944).

case, the Court described the ad valorem general property tax scheme as follows:

> This taxation plan involves the identification and valuation of the variable individual holdings to be taxed, commonly called the assessment, the application of a uniform rate calculated on the need for public revenues, and the collection, in default of payment, by distraint and sale of the property assessed and taxed. . . . While personal liability for the tax may be and sometimes is imposed, the power to tax is predicated upon jurisdiction of the property, not upon jurisdiction of the person of the owner, which often is lacking without impairment of the power to tax. In both theory and practice the property is the subject of the tax and stands as security for its payment.[91]

These property taxes are typically assessed annually. The compensating use tax[92] is usually complementary to either a sales or gross receipts tax. Like the sales or gross receipts tax it is a nonrecurring tax. Unlike those taxes, however, the subject of the tax is the use or enjoyment of the property rather than the sales transaction over which the state may lack taxing authority.

The possessory use tax[93] is seemingly the result of cross-breeding between the ad valorem general property tax and the compensating use tax. It is similar to the ad valorem general property tax in that it is typically measured by the fair market value of the property and assessed on a recurring basis. It is like the compensating use tax in that the subject of the tax is the use or enjoyment of the property rather than the property itself. The possessory use tax is like the compensating use tax in that it is complementary to the ad valorem general property tax. It complements the ad valorem general property tax by reaching some of the property that is otherwise exempt from that tax, *viz.*, Government property used by private contractors.

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91. *Id.* at 184.

92. *See supra* note 32.

93. The Court first reviewed the possessory use tax in United States v. Detroit, 355 U.S. 466 (1958). The tax statute was quoted by the Court as set forth in the passage below. It is representative of the tax statutes that have followed.

> An Act to provide for the taxation of lessees and users of tax-exempt property.
>
> * * * * *
>
> Section 1. When any real property which for any reason is exempt from taxation is leased, loaned or otherwise made available to and used by a private individual, association or corporation in connection with a business conducted for profit, except where the use is by way of a concession in or relative to the use of a public airport, park, market, fair ground or similar property which is available to the use of the general public [sic], shall be subject to taxation in the same amount and to the same extent as though the lessee or user were the owner of such property: Provided, however, That the foregoing shall not apply to federal property for which payments are made in lieu of taxes in amounts equivalent to taxes which might otherwise be lawfully assessed or property of any state-supported educational institution.
>
> * * * * *
>
> Section 2. Taxes shall be assessed to such lessees or users of real property and collected in the same manner as taxes assessed to owners of real property, except that such taxes shall not become a lien against the property. When due, such taxes shall constitute a debt due from the lessee or user to the township, city, village, county and school district for which the taxes were assessed and shall be recoverable by direct action of assumpsit.

355 U.S. at 467 n.1.

In *Allegheny*, the Court was faced with an assessment by a local taxing authority which, under what the Court described as an ad valorem general property tax, sought to tax the full value of Government-owned machinery located on the taxpayer's facilities for use in performance of its contracts with the Government.[94] Notwithstanding state law,[95] the Court determined that title to the machinery was in the Government and that in substance the tax was on the property owned by the Government.[96] The Court recognized that the contractor had some legal and beneficial interest in the Government's property.[97] The assessment, however, did not segregate the contractor's limited interest in the property.[98] On this basis, the Court rejected the tax as unconstitutional holding "that Government-owned property, to the full extent of the Government's interest, therein, is immune from taxation, either as against the Government itself or as against one who holds it as a bailee."[99] But the Court saved for another day the question of whether a contractor's limited interest might be taxed by appropriate proceedings.[100] This question was addressed by the Court in 1958 in three companion cases: *United States v. City of Detroit (Detroit)*,[101] *United States v. Township of Muskegon (Muskegon)*,[102] and *City of Detroit v. Murray Corp. (Murray)*.[103] Except for a few factual differences, the *Detroit* and *Muskegon* cases were substantially the same and presented the same basic questions. The contractor in *Detroit* leased Government property for his private business.[104] The contractor in *Muskegon* used the Government's property under a permit in the performance of his contracts with the Government.[105]

In *Detroit*, with two dissenting, the Court sustained the possessory use tax[106] which was imposed on the contractor and measured by the value of the tax-exempt property in issue.[107] In doing so the Court rejected the Government's argument "that since the tax is measured by the value of the property used it should be treated as nothing but a contrivance to lay a tax on the property."[108] In this regard, the Court noted "that it may be permissible for a state to measure a tax imposed on a valid subject of state taxation by taking into account Government property which is itself tax-exempt."[109] It was on this basis that the Court distinguished *Allegheny* where the subject of

94. 322 U.S. 174 (1944).

95. In the face of the Pennsylvania Supreme Court's decision to sustain the tax, the Court set out its authority as the final arbiter in matters concerning federal rights as follows: "Where a federal right is concerned we are not bound by the characterization given to a state tax by state courts or legislatures, or relieved by it from the duty of considering the real nature of the tax and its effect upon the federal right asserted." *Id.* at 184.

96. *Id.* at 181-86.

97. *Id.* at 186.

98. *Id.* at 187.

99. *Id.* at 189.

100. *Id.* at 186.

101. 355 U.S. 466 (1958).

102. 355 U.S. 484 (1958).

103. 355 U.S. 493 (1958).

104. 355 U.S. at 486.

105. *Id.*

106. *See supra* note 93.

107. 355 U.S. at 468.

108. *Id.* at 470.

109. *Id.* at 471.

the tax was the Government's property.[110] Noting that all users of tax-exempt property were treated the same and that there were several organizations with tax-exempt property, the court determined that "[t]he class defined is not an arbitrary or invidiously discriminatory one."[111]

To Justice Whittaker, however, the majority's position was a victory of form and label over substance.[112] The Justice was convinced that it was "crystal clear" that the tax was a "direct imposition upon the Government's property interests."[113] In the dissent's view, relying on *Allegheny*, the states were constitutionally prohibited from taxing the entire value of Government-owned property.[114] Instead, the States must segregate the private interest and tax only that interest.[115]

In a shorter opinion, the Court concluded that *Muskegon* was controlled by the same principles at work in *Detroit*.[116] The Court referred to the distinction between a lease and a permit as insubstantial.[117] With respect to the fact that the property was being used in the performance of a Government contract, the Court stated that if the Government had retained control over the contractor's activities and financial gains, so that the contractor could properly be called a "servant" of the United States, the tax might not have attached.[118] Notwithstanding this potential distinction for private parties which were excessively controlled by the Government, the Court sustained the tax, finding that the contractor was using the property in connection with its own commercial activities.[119]

Over the dissent of four Justices, the Court in *Murray* sustained a different tax scheme than that examined by the Court in *Detroit* and *Muskegon*. The statutory provisions in *Murray* provided in pertinent part: "The owners or persons in possession of personal property shall pay all taxes assessed thereon."[120] The Court rejected Murray's argument that the tax, like the tax in *Allegheny*, was an ad valorem property tax.[121] In this context, the Court declared that it was concerned only with the "practical operation" of the tax and not "empty formalisms."[122] Then, the Court concluded that the tax in *Murray* and in *Detroit* and *Muskegon* were substantially the same: "We see no essential difference so far as constitutional tax immunity is concerned

110. *Id.*
111. *Id.* at 473.
112. *Id.* at 478.
113. *Id.*
114. *Id.* at 480-83.
115. *Id.*
116. 355 U.S. at 484-85.
117. *Id.* at 486. The Court's reference to form over substance is anomolous considering the fact that under the *Detroit* and *Muskegon* cases the constitutional viability of a tax depends almost entirely on the craft of the statutory draftsman. Under these cases a tax measured by the value of Government-owned property would be sustained if "on the use of" the property but rejected if on the property itself. Accordingly, procedurally different taxes with the same economic impact on the Government might yield different constitutional determinations. Certainly this is not a distinction with economic substance. *Id.*
118. *Id.*
119. *Id.*
120. 355 U.S. at 489, 491 n.1.
121. *Id.* at 492-93.
122. *Id.* at 493-94.

between taxing a person for using property he possesses and taxing him for possessing property he uses when in both instances he uses the property for his own private ends."[123]

The Court distinguished *Murray* from *Allegheny* on two grounds: (1) the state law in *Murray* specifically authorized assessment against the person in possession; and (2) the "taxing authorities [in *Murray*] were careful not to attempt to tax the Government's interest in the property."[124] Although the Court could not find any constitutional limitations on the tax in issue, it reminded the Government that Congress should make the policy decisions, determining whether and to what extent private parties doing business with the Government are immune from state taxes.[125] The dissent, however, finding that the title to the property in question was vested in the Government,[126] and that the tax was nothing more than an ad valorem tax on the property of the Government,[127] found *Allegheny* "entirely controlling."[128]

Although the Michigan trilogy of cases concerned the use of tax-exempt property by a business for profit, in *United States v. County of Fresno*,[129] the Court determined that the principles enunciated in the Michigan cases were equally applicable where the tax-exempt property was put to a beneficial personal use.[130] The tax in *Fresno* was imposed on users of "nontaxable publicly owned real property."[131] Unlike *Allegheny*, the measure of the tax was only on the portion of the total value of property attributable to the users interest.[132] After finding that the legal incidence of the tax in *Fresno* was not

123. *Id.* at 493.

124. *Id.* at 494. The *Murray* case cast considerable doubt on the precedential value of *Allegheny*. In this context, the Court stated:

> Petitioners on the other hand contend that the decision in *Allegheny* is inconsistent with the general trend of our decisions in this field, that it has already been distinguished to the point where it retains no meaningful vitality and that it is erroneous. However that may be, we do not think that case is controlling, essentially for the reasons set forth in *United States v. Detroit* . . . .

Id.

And, Justice Harlan in dissent noted:

> Although the Court here purports to distinguish *Allegheny*, it seems to me that the authority of that case has now been reduced almost to the vanishing point, for neither the tax statute here nor that in *Allegheny* qualified application of the tax to property employed in private commercial activity.

Id. at 508-09 (Harlan, J., dissenting).

125. *Id.* at 495.

126. *Id.* at 514-24.

127. *Id.* at 524-30.

128. *Id.* at 530-33.

129. 429 U.S. 452 (1977).

130. *Id.* at 467.

131. *Id.* at 455 n.3.

132. *Id.* at 466. With respect to the precedential value of *Allegheny* and the distinguishing characteristics of the tax in *Fresno*, the Court noted:

> Insofar as *United States v. Allegheny County* . . . holds that a tax measured by the value of government-owned property may never be imposed on a private party who is using it, that decision has been overruled by *United States v. City of Detroit* . . . and its companion cases . . . . Insofar as it stands for the proposition that Government property used by a private citizen may not be taxed at its full value where contractual restrictions on its use for the Government's benefit render the property less valuable to the user, the case has no application here. Appellee counties have sought to tax only the individual appellants' interests in the Forest Service houses and have reduced their assessments to take account of the limitations on the use of the houses imposed by the Government.

on the Government, the Court focused on the issue of whether the tax was discriminatory as to the Government or its employees.[133] The Court concluded that the tax was not discriminatory and sustained the tax on constitutional grounds.[134]

3. Legal Incidence and Discrimination

A review of the cases discussed above in this subpart reveals a fairly consistent approach used by the Court in determining the constitutional validity of the various tax schemes. Initially, the Court determines whether the legal incidence of the tax falls on the Government or its instrumentalities. If necessary, the Court then examines the question of whether the tax discriminates against the Government or those with whom it deals.

Although the Court often refers to the legal incidence test as though its meaning were self-evident, it has on occasion considered in detail different aspects of the test. In particular, the Court has noted certain factors to be considered in applying the test and considered whether state or federal law should be applied in determining the legal incidence question. The primary factor considered by the Court in its determination of legal incidence is legislative intent.[135] More precisely, the Court considers legislative intent with respect to the intended payor of the tax and not with respect to legal liability for the tax.[136] Generally the legal incidence will be on "the statutorily designated taxpayer from whom the tax is to be collected, unless it is clearly directed that the tax is to be passed on to another."[137] In this regard, in *United States v. Mississippi*, the Court held that when a "[s]tate requires that its sales tax be passed on to the purchaser and be collected by the vendor from him, this establishes as a matter of law that the legal incidence of the tax falls upon the purchaser."[138] The court, in *Gurley v. Rhoden*,[139] made it clear that while the economic burden of a tax incident to the sale of goods is typically shifted to the purchaser, that fact alone is of little consequence to a determination of legal incidence. Although the economic burden of a tax is traditionally shifted to the purchaser, that fact does not mean that the legal incidence of the tax is on the purchaser, unless, as a matter of law, the economic burden must be passed on to the purchaser.[140]

Even if a tax passes the legal incidence test, it may be rejected as discriminatory. As the Court in *United States v. City of Detroit* stated: "A tax may be invalid even though it does not fall directly on the United States if it operates so as to discriminate against the Government or those with whom it deals."[141] The question then becomes what is discriminatory in this context.

Id. at 462 n.10.

133. *Id.* at 464-68.

134. *Id.* For a discussion of the discrimination aspects of the *Fresno* case see *infra* notes 142-44 and accompanying text.

135. United States v. Tax Comm'n, Mississippi, 421 U.S. 599 (1975).

136. *Id.* at 607, *citing* First Agricultural Nat'l Bank v. Tax Comm'n, 392 U.S. 339 (1968).

137. *Hartman, supra* note 9, §6:17, at 328 (1981).

138. 421 U.S. 599, at 608.

139. 421 U.S. 200 (1975).

140. *Id.* at 204.

141. 355 U.S. 466, at 473 (1958).

While the Court has answered this question on an *ad hoc* basis, some general principles have been established. The basic rule in this area, stated by the Court in *United States v. County of Fresno*, is that the burden placed on a federal function by a state tax imposed on a federal contractor is not unconstitutional so long as it is imposed equally on others similarly situated.[142] This does not mean that all similarly situated parties must be treated in precisely the same manner;[143] it does mean, however, that the states may not impose a heavier tax burden on those dealing with the Federal Government than others similarly situated.[144] It apparently also means that the states may not impose a heavier burden on those dealing with governmental or public concerns than on similarly situated parties dealing with the private sector.

The underpinning for the principles concerning discriminatory taxation was summarized by the dissent in *Montana v. United States*[145] as follows:

> There is good reason to insist that a state tax be "imposed equally" on all "similarly situated constituents of the state" . . . whether connected with the public sector or private. Broad application of a tax is necessary to guarantee an efficacious "political check" on potentially abusive taxation. The Montana gross receipts tax, limited as it is to public sector contractors, provides little such assurance. Taxation of contractors dealing directly with the State or state agencies affords no safeguard against discriminatory treatment of federal contracting agencies and the contractors with whom they deal. Any tax increase passed along by a contractor would be borne fully by a federal agency but would be offset by the corresponding tax revenues in the case of the State; from the State's perspective the tax is a washout.[146]

It is for these reasons that a discriminatory tax on the Federal Government or those with whom it deals must be rejected on constitutional grounds.

II. RECENT DECISIONS

Part II is a survey of recent decisions in the federal immunity area

142. 429 U.S. 462 (1977).

143. *See* 355 U.S. 466, at 473; 429 U.S. 452, at 462-65.

144. *See* Phillips Chemical Co. v. Dumas Independent School Dist., 361 U.S. 376 (1960); Moses Lake Homes, Inc. v. Grant County, 365 U.S. 744 (1961).

145. 440 U.S. 147, 164 (1979). In this regard, the dissent was of the opinion that the imposition of Montana's one percent gross receipts tax upon contractors of public, but not private, construction projects was unconstitutional under the Supremacy Clause. In support of his position, Justice White stated:

> In any event, I see no basis whatsoever for extracting from the principle that a State may not favor itself over the Federal Government the further proposition that a State may favor its private-sector constituents so long as contractors working for public bodies are taxed. Indeed, in *Fresno* the Court sustained the tax only after assuring itself that persons who rented federal property were "no worse off under California tax laws than those who work for private employers and rent houses in the private sector." . . . Such laws, reaching broadly across the public and private sectors, are characteristic of those this Court has sustained.

Id. at 170. While this is only the dissent of one justice, Justice White, it is persuasive because Justice White was the author of *Fresno*, and because the majority's decision in *Montana* did not address the Supremacy Clause issue but was decided on the grounds of collateral estoppel. *Id.* at 147, 164.

146. *Id.* at 170-71.

which are of considerable importance in the Government procurement arena. The decisions to be covered, in order of their discussion below, are *United States v. New Mexico*,[147] *Washington v. United States*[148] and *United States v. Colorado*.[149] The first two cases involve gross receipts and sales tax schemes, respectively, and the last case involves a possessory use tax.

A. United States v. New Mexico—*Federal Immunity of Government Contractors Based On An Agency Relationship Between The Government and Its Contractors*

The linchpin of the federal immunity doctrine is that the states cannot, without permission, levy a tax directly on the Federal Government.[150] Federal immunity in its present form, however, is not conferred merely because the tax has an economic impact on the Government.[151] This is true even when the Government bears the entire burden of the tax.[152] By virtue of these rules, Government contractors are not immune from state taxation regardless of where the economic burden falls. Nonetheless, when the contractor is "so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned," tax immunity may be appropriate.[153] The question thus becomes under what circumstances are the contractor and the Government so closely related as to provide for the unity described above. This was the issue confronting the Court in *United States v. New Mexico*, an issue which is largely dependent on the substantive contractual relationship between the parties.[154]

Before commenting on the specific contractual arrangements, the *New Mexico* Court made some general observations about the contracts in issue.[155] The Court noted that the Department of Energy (DOE) contracts in issue, contracts for the management of Government-owned research and de-

147. 455 U.S. 720 (1982).

148. 103 S.Ct. 1344 (1983).

149. 627 F.2d 217 (10th Cir. 1980), *summarily aff'd sub nom* Jefferson County v. United States, 450 U.S. 901 (1981).

150. 455 U.S. at 733, *citing* Mayo v. United States, 319 U.S. 441, 447 (1943).

151. *See supra* notes 34-52 and accompanying text.

152. *Id.*

153. 455 U.S. at 735.

154. *Id.* at 722-27.

155. *Id.* The Court also discussed the distinguishing characteristics of the three contractors and their contracts with the Government. First, the Sandia Corporation—a subsidiary of Western Electric Company, Inc.—engages exclusively in Government-sponsored research; is reimbursed for its costs but receives no fee under its contract; and owns no property except for an amount constituting its paid-in capital. Second, the ZIA Company—a subsidiary of Santa Fe Industries, Inc.—provides services to both the Government and to the private sector; receives its costs and a fixed fee for its Government work; and owns property used primarily in the performance of its nongovernment work. Third, Los Alamos Constructors, Inc.—a subsidiary of ZIA—engages exclusively in Government efforts; owns no tangible personal property; and is reimbursed for costs and receives a fixed fee. While the Court did not view the distinguishing characteristics as sufficient to yield different results, it found it more difficult to distinguish Sandia's situation from the *Livingston* decision wherein the contractor, like Sandia, received no fee. *Id.* at 724, 740 nn. 3, 13. For a discussion of the *Livingston* case *see supra* notes 69-75 and accompanying text.

velopment facilities, were a unique species of Government contracts.[156] Because of the complexity of the contractual relationship, the Court observed that it was virtually impossible to apply traditional agency rules.[157] With regard to the degree of Government control over the contractors, the Court stated: "While subject to the general direction of the Government, the contractors are vested with substantial autonomy in their operations and procurement practices."[158]

Having set the tone, the Court then proceeded to discuss some of the more salient factors concerning the contracts in issue.[159] On the one hand, the Court noted that the contract provided that title to all tangible personal property purchased by the contractors passed directly from the vendor to the Government and that the Government was to bear the risk of loss for property procured by the contractors. The contract also provided for Government control over the disposition of all Government-owned property and, most importantly, for an advance funding procedure whereby the Government provided funds in advance of contract performance to meet contractor costs.[160] These factors, of course, are indicative of a close connection between the Government and the contractors; they portray the contractors as mere agents of the Government. On the other hand, the Court listed the following factors indicative of a more casual relationship: the contractors held themselves out to third-party suppliers as the buyer; the Government disclaimed liability for acts committed by the contractors' employees; and the contractors' employees have no direct claim against the Government for labor-related grievances.[161] The Court then noted that the contracts had been amended two years after the commencement of litigation to provide that the contractors were agents of the Government for certain purposes.[162]

The taxes at issue in the *New Mexico* case were the New Mexico gross receipts and compensating use taxes.[163] The subject of the gross receipts tax is the privilege of engaging in business in New Mexico; its measure is a percentage of gross receipts.[164] The subject of the compensating use tax is the use of property in New Mexico; it only reaches property not previously subject to the gross receipts tax; and it is equivalent in amount to the gross receipts tax that would have been imposed.[165] The "receipts of the United

156. *Id.* at 723.
157. *Id.*
158. *Id.*
159. *Id.* at 723-27.
160. *Id.* at 724-26.
161. *Id.* at 725.
162. *Id.* at 726-27. With some cynicism, the Court observed: "At the same time, however, the United States denied any intent 'formally and directly [to] designat[e] the contractors as agents,' . . . and each modification stated that it did not 'create rights or obligations not otherwise provided for in the contract.'" *Id.* at 727. The Government's ambivalence toward the contractors was important in the Court's eyes. The court was not impressed by the Government's selective approach concerning the agency status of the contractor.
163. *Id.* at 727. For a general description of the gross receipts and compensating use taxes *see supra* note 33.
164. N.M. STAT. ANN. § 72-16A-4 (Supp. 1975), *amended by* N.M. STAT. ANN. § 7-9-4 (Supp. 1981).
165. N.M. STAT. ANN. § 72-16A-7 (Supp. 1975), *amended by* N.M. STAT. ANN. § 7-9-7 (Supp. 1981).

States or any agency or any instrumentality thereof" and "the use of property by the United States or any agency or instrumentality thereof" are exempt from the gross receipts and compensating use taxes, respectively.[166] A deduction from gross receipts is allowed for receipts from the sale of tangible personal property to the United States.[167]

Unable to convince the state that the contractors were constitutionally immune from state taxation, the United States initiated suit in the District Court requesting a declaratory judgment that (1) the use of Government-owned property by the contractors was not subject to the state's compensating use tax; (2) advanced funds used for Government operations under the contracts were not taxable gross receipts to the contractors; and (3) receipts of vendors selling tangible property to the Government, through its management contractors, could not be taxed by the state.[168] The District Court, granting summary judgment for the Government, determined that an agency relationship existed and that the contractors were immune from state taxation.[169] The U.S. Court of Appeals for the Tenth Circuit reversed, holding that the contractor's were sufficiently independent of the Government to justify the imposition of the New Mexico taxes and directing the District Court to enter summary judgment for the State.[170] The United States sought and was granted certiorari.[171]

In an unanimous decision the Supreme Court affirmed the Tenth Circuit. The Court, noting that the Government had conceded that the legal incidence of the taxes was on the contractors, focused on the decisive issue of "whether the contractors can realistically be considered entities independent of the United States."[172] Having focused on the pivotal issue the Court then proceeded to address the specific issues raised by the Government.

First, relying on *United States v. Boyd*,[173] the Court upheld the State's application of its use tax.[174] After finding that "[t]he tax, the taxed activity, and the contractual relationships" in *New Mexico* did not differ from those in *Boyd*,[175] the Court, as in *Boyd*, concluded that "the contractors remained distinct entities pursuing 'private ends,' and that their actions remained commercial activities carried on for profit."[176] Stressing the independent nature of the contractors, the Court stated:

166. N.M. STAT. ANN. § 72-16A-12.1 (Supp. 1975), *amended by* N.M. STAT. ANN. § 7-9-13 (Supp. 1981); and N.M. Stat. Ann. § 72-16A-12.2 (Supp. 1975), *amended by* N.M. Stat. Ann. § 7-9-14 (Supp. 1981).

167. N.M. STAT. ANN. § 72-16A-14.9 (Supp. 1975), *amended by* N.M. STAT. ANN. § 7-9-54 (Supp. 1981).

168. 455 U.S. at 728.

169. *Id.* at 728-29, *citing* 455 F. Supp. 993, 997 (D.N.M. 1978).

170. 455 U.S. at 429-30, *citing* 624 F.2d 111 (10th Cir. 1980).

171. 624 F.2d 111 (10th Cir. 1980), *cert. granted* 450 U.S. 909 (1981).

172. 455 U.S. at 738.

173. *Id.* at 738-40. For a discussion of the *Boyd* case *see supra* notes 76-89 and accompanying text.

174. *Id.* at 738-41.

175. *Id.* at 740.

176. *Id.* at 739 (citing United States v. Boyd, 378 U.S. 39, at 44 (1964)). With respect to Sandia, however, the Court stated: "Sandia does not receive a cash fee, but it obtains obvious benefits from its contractual relationships." *Id.* at 740 n.13.

> It is true, of course, that employees are a special type of agent, and like the contractors here employees are paid for their services. But the differences between an employee and one of these contractors are crucial. The congruence of professional interests between the contractors and the Federal Government is not complete; their relationships with the Government have been created for limited and carefully defined purposes.[177]

Based on these considerations, the Court held that the state's application of its use tax was not constitutionally offensive.[178]

Having already determined that the contractors were independent taxable entities in its discussion of the use tax, the Court addressed the Government's contention that the gross receipts tax had been improperly applied to the advanced funds used by the contractors to meet salaries and internal costs.[179] On this issue, noting the independent nature of the contractors and citing *James v. Dravo Contracting Co.*,[180] the Court had little difficulty holding for the State.[181]

Finally, with greater difficulty, the Court concluded that the state had properly applied its gross receipts tax to sales from other vendors to the contractors in issue.[182] On this point the Government had argued that the contractors were procurement agents of the Government under *Kern-Limerick v. Scurlock*.[183] The Government argued, as in the *Kern-Limerick* case, that the receipts of vendors selling tangible property to the contractors could not be taxed by the state.[184] In passing on this issue, the Court carefully distinguished it from the other two issues by pointing out that a procurement agent can be so closely related to the government that his activity is, in essence, a sale to the government.[185] Observing that this was the Court's conclusion in *Kern-Limerick*,[186] the Court then proceeded to highlight the factual differences between *Kern-Limerick* and the instant case.[187]

In *Kern-Limerick* the contractor identified itself as a federal procurement agent; title to property purchased by the contractor passed directly to the Government; the purchase orders declared that the purchase was made by the Government; the Government, not the contractor, was liable for the

177. *Id.* at 740-41.

178. *Id.* at 741. In passing, citing two possessory use tax cases, *Murray* and *Colorado*, the Court noted: "While a use tax may be valid only to the extent that it reaches the contractor's interest in government-owned property, . . . there has been no suggestion here that the contractors are being taxed beyond the value of their use." *Id.* at 741 n.14. By this passage the Court has unnecessarily obscured the inherently different characteristics of possessory use and compensating use taxes. *See infra* notes 258-61 and accompanying text.

179. *Id.* at 741.

180. 302 U.S. 134 (1937). For a discussion of the *James* decision see *supra* notes 34-43 and accompanying text.

181. 455 U.S. at 741. In passing, the Court compared the use of Government-owned property and advanced funding as follows: "In any event, [the use of advance funding] to achieve contractual ends is not significantly different from using property for the same purpose." *Id.*

182. *Id.* at 741-43.

183. 347 U.S. 110 (1954). For a discussion of *Kern-Limerick* see *supra* notes 52-59 and accompanying text.

184. 455 U.S. at 741-43.

185. *Id.* at 742.

186. *Id.*

187. *Id.* at 742-43.

purchase price; specific Government approval was required for each transaction; and the statutory procurement scheme envisioned the use of federal purchasing agents.[188] The *New Mexico* case is different from *Kern-Limerick* in the following respects: the contractors made purchases in their own names; there was no formal intention to denominate the contractors as purchasing agents; and two of the three contractors were not required to obtain advance Government approval for purchases.[189] These factors, the Court concluded, "demonstrate that the contractors have a substantial independent role in making purchases, and that the identity of interests between the Government and the contractors is far from complete."[190] Moreover, the Court continued, the fact that title passes directly to the Government from the vendor is not in itself sufficient to immunize the Government from taxation.[191]

Although not necessary to its holding in *New Mexico*, the Court made two noteworthy points concerning federal immunity under the Constitution. First, the Court expressed a lack of enthusiasm for the Government's attempt to confer immunity with cosmetic contractual provisions drafted by Government functionaries.[192] Second, while holding that the Constitution did not immunize the contractors in *New Mexico*, the Court invited the agencies to seek legislation expanding federal immunity.[193]

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188. *Id.*

189. *Id.*

190. *Id.* at 743.

191. *Id.*

192. *Id.* at 737. On this point, the Court expressed its views as follows:

> Granting tax immunity only to entities that have been "incorporated into the Government structure" can forestall, at least to a degree, some of the manipulation and wooden formalism that occasionally have marked tax litigation—and that have no proper place in determining the allocation of power between co-existing sovereignties. In this case, for example, the Government and its contractors modified their agreements two years into the litigation in an obvious attempt to strengthen the case for nonliability. Yet the Government resists using its own employees for the tasks at hand—or, indeed, even formally designating Sandia, Zia, and LACI as agents—because it seeks to tap the expertise of industry, without subjecting its contractors to burdensome federal procurement regulations. . . . Instead, the Government earnestly argues that its contractors are entitled to tax immunity because, among other things, they draw checks directly on federal funds, instead of waiting a time for reimbursement. . . . We cannot believe that an immunity of constitutional stature rests on such technical considerations, for that approach allows "any government functionary to draw the constitutional line by changing a few words in a contract." Kern-Limerick, Inc. v. Scurlock, 347 U.S. at 126 (*dissenting opinion*). [emphasis added].

Id.

193. *Id.* at 737-38, 743-44. In this regard, the Court stated:

> [I]t is Congress that must take responsibility for the decision, by so expressly providing as respects contracts in a particular form, or contracts under particular programs. . . . And this allocation of responsibility is wholly appropriate, for the political process is "uniquely adapted to accommodating the competing demands" in this area. . . . But absent congressional action, we have emphasized that the States' power to tax can be denied only under "the clearest constitutional mandate."

Id. at 737-38. And, the court observed in conclusion:

> [I]t is worth remarking that DOE is asking us to establish as a constitutional rule something that it was unable to obtain statutorily from Congress. For the reasons set out above, we conclude that the contractors here are not protected by the Constitution's guarantee of federal supremacy. If political or economic considerations suggest that a broader immunity rule is appropriate, "[s]uch complex problems are ones which Congress is best qualified to resolve."

Id. at 744.

B. Washington v. United States—*Federal Immunity and Discrimination Against Federal Contractors*

The question of constitutional immunity of the United States from state and local taxation has evolved over the years into a two-tiered analysis.[194] First, without the consent of the United States, the legal incidence of a tax may not be placed on the United States. This is the underpinning of federal immunity; it is the test for determining whether a tax is directly on the United States.[195] Second, even though the legal incidence of a tax is not on the United States, the tax may not discriminate against the United States or those with whom it deals.[196] This is a necessary corollary to the technical legal incidence test. It is the second part of the two-tiered analysis that was the focal point of the Court's recent decision in *Washington v. United States*.[197]

Before considering the *Washington* case, it is useful to note that the concept of tax discrimination does not carry a universal meaning. Even within the confines of the United States Constitution the tax discrimination concept has many different faces. For instance, the Court has held that the Equal Protection Clause of the Constitution prohibits the states from invidiously discriminating between different classes of taxpayers.[198] This principle is distinguishable from the federal immunity tax discrimination inquiry.[199]

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194. This two-tier approach is discussed at Part I.B.3, *supra*.

195. The Court in *New Mexico* expressed "the underlying constitutional principle" as follows: "[A] state may not, consistent with the Supremacy Clause, . . . lay a tax 'directly upon the United States.' " 455 U.S. at 733. And, noting the fundamental nature of the principle, the Court observed: "[T]he Court has never questioned the propriety of absolute federal immunity from state taxation." *Id.*

196. In passing, the Court in *New Mexico* observed the discrimination aspect of the two-tier analysis as follows: "It remains true, of course, that state taxes on contractors are constitutionally invalid if they discriminate against the Federal Government, or substantially interfere with its activities." *Id.* at 735, n. 11.

197. 103 S. Ct. 1344 (1983).

198. The Court has allowed the states a great deal of latitude in the tax area. So long as a scheme of taxation is not "palpably arbitrary" or "invidious" it will be sustained by the Court. In this context, the Court in *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973) stated:

> There is a presumption of constitutionality which can be overcome 'only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes.' . . . The burden is on the one attacking the legislative arrangement to negative every conceivable basis which might support it.

Id. at 364. And, on the difficulty of upsetting a tax under the Equal Protection Clause, the Court noted:

> A state legislature, in the enactment of laws, has the widest possible latitude within the limits of the Constitution. In the nature of the case it cannot record a complete catalogue of the considerations which move its members to enact laws. In the absence of such a record courts cannot assume that its action is capricious, or that, with its informed acquaintance with local conditions to which the legislation is to be applied, it was not aware of facts which afford reasonable basis for its actions. Only by faithful adherence to this guiding principle of judicial review of legislation is it possible to preserve to the legislative branch its rightful independence and its ability to function.

Id. at 364-65. According to this, then, it is abundantly clear that the states may, *inter alia*, impose a heavier tax burden on some taxpayers than others. But as discussed, *infra*, when the classification of taxpayers is based on the taxpayer's relationship with the Federal Government, the Supremacy Clause imposes more stringent restrictions on the states.

199. In general, under the Supremacy Clause, the Federal Government and those with whom it deals may be taxed in a different manner so long as there is not discriminatory economic impact. *See supra* notes 141-146 and accompanying text. The distinction between tax discrimination under the Equal Protection Clause and tax discrimination under the Supremacy

But the Court's decisions are not always clear on this point.[200] Notwithstanding occasional judicial indiscretions in this area, the Court has generally kept the various tax discrimination theories disentangled.

The tax discrimination concept in general, and in particular as it relates to federal immunity, is not an absolute limitation. Instead, it is a characterization of various discriminatory classifications as permissible or impermissible based on legal and policy considerations. This was the approach taken by the Court in the *Washington* decision. By a 5-4 majority, the Court in *Washington* sustained as nondiscriminatory the Washington sales and use tax scheme as applied to Government construction contractors.[201] The tax scheme in issue is best understood against its distinct three-stage development.[202] In the first two stages all construction contractors were treated the same. In the final stage, however, Federal Government construction contractors were singled out for special consideration. From its inception in 1935 until 1941, the Washington sales and use tax was applied to all construction contractors in a similar manner.[203] The sales tax was applied to all sales of tangible personal property to the contractors, and the use tax was applied to the use of tangible personal property by the contractor not previously subjected to the sales tax.[204] The legal incidence of these taxes were on the contractors.[205]

In 1941, Washington changed its tax scheme by redefining "consumer"

Clause was alluded to by the Court in *Phillips Chemical Co. v. Dumas Independent School District*, 361 U.S. 376 (1960) as follows:

> It is true that perfection is by no means required under the equal protection test of permissible classification. But we have made it clear, in the equal protection cases, that our decisions in that field are not necessarily controlling where problems of intergovernmental tax immunity are involved. In *Allied Stores of Ohio, Inc. v. Bowers*, [358 U.S. 522 (1959)], for example, we noted that the State was "dealing with [its] proper domestic concerns, and not trenching upon the prerogatives of the National Government." . . . When such is the case, the State's power to classify is, indeed, extremely broad, and its discretion is limited only by constitutional rights and by the doctrine that a classification may not be palpably arbitrary. . . . But where taxation of the private use of the Government's property is concerned, the Government's interest 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.

200. *See, e.g.*, United States v. City of Detroit, 355 U.S. 466, 473-74 (1958). In *Detroit*, referring to the class of taxpayers covered by the Michigan possessory use tax, the Court observed:

> The class defined is not an arbitrary or invidiously discriminatory one. As suggested before the legislature apparently was trying to equate the tax burden imposed on private enterprise using exempt property with that carried by similar businesses using taxed property. Those using exempt property are required to pay no greater tax than that placed on private owners or passed on by them to their business lessees. In the absence of such equalization the lessees of tax-exempt property might well be given a distinct economic preference over their neighboring competitors, as well as escaping their fair share of local tax responsibility.

Id. at 473-74.

201. The Washington sales and use tax is imposed on the buyer or consumer in all retail sales and consumer uses of tangible personal property. 51 U.S.L.W. at 4306. The sales tax is imposed by Chapters 82.08 and 82.14 of the Revised Code of Washington. The use tax is imposed by Chapters 82.12 and 82.14. The terms "buyer" and "consumer" are defined at sections 82.04.190, 82.08.010, and 82.12.010.

202. 103 S.Ct. at 1346-47, 1352.

203. *Id.* at 1352.

204. *Id.* at 1346, 1352.

205. *Id.* at 1346.

as the landowner who purchases construction work from the contractor.[206] The legal incidence of the tax was thereby shifted to the landowner and the tax was measured by the total amount paid to the contractor.[207] The effect of this change was to increase the overall tax base, which theretofore included only the cost of the material, by including the contractor's mark-up on materials, labor costs and profit.[208] As before, the federal contractors were treated essentially the same as state and private contractors. Under this system, when the Federal Government was the landowner, Washington did not collect tax on the sale of tangible personal property to the contractor or of the completed project to the Government.[209] The tax base was decreased in this respect.[210]

In 1975, in order to reach federal construction projects without reducing the tax base of other construction projects, the sales and use tax statute was once again amended.[211] The consequence of this change was to divide construction contractors into two categories: (1) those performing construction services on real property owned by the United States; and (2) those performing construction services for the state or a private party.[212] In the first instance, the legal incidence of the sales and use taxes was on the federal construction contractors and they were liable for the taxes on material incorporated in their projects.[213] With respect to construction contractors for the state or private parties, however, there was no sales or use tax liability for materials incorporated in their projects. Instead, for non-federal projects, the legal incidence of the taxes falls upon the landowner and they are liable for tax on the full price of the project including labor costs, costs of materials and mark-ups thereon, and profit.[214] Thus, while the sales and use taxes are in each case applied at only one level, the levels for each are different. Whereas the taxes on federal projects are applied at the contractor level, they are applied at the landowner level for non-federal projects. The Government argued that this difference is unconstitutionally discriminatory against those dealing with the Federal Government.[215]

The United States prevailed in the District Court for the Western District of Washington, with that Court holding that the taxes were unconstitutionally discriminatory against federal contractors.[216] The Court of Appeals for the Ninth Circuit affirmed this decision.[217] The Supreme Court noted probable jurisdiction.[218]

In response to the Government's contention that the different tax treat-

206. *Id.*
207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.* at 1352.
211. *Id.* at 1347 n. 3. This change was affected by redefining certain critical terms, *viz.*, "consumer, retail sale and sale at retail." *Id.*
212. *Id.* at 1353.
213. *Id.*
214. *Id.* at 1347.
215. *Id.*
216. *Id.*
217. United States v. Washington, 654 F.2d 570 (1981).
218. 103 S. Ct. at 1347.

ment of federal contractors was unconstitutionally discriminatory, the Court noted that the tax rate imposed on all construction transactions was always equal, and the difference between the tax imposed on the private contractor and the federal contractor was that the amount of tax was less for the latter.[219] This could hardly be considered discriminatory as to the Federal Government, as the court pointed out.[220] The Court refused to look only at the tax the contractor is legally required to pay.[221] Instead, considering the "whole tax structure of the state," the Court focused on the economic forces that dictate which party ultimately bears the burden of the tax.[222]

> The appropriate question is whether a contractor who is considering working for the Federal Government is faced with a cost he would not have to bear if he were to do the same work for a private party. If he works for the Federal Government, the contractor is required to pay a tax on the materials he buys. The contractor will count the tax among his costs in setting a price for the Government. Depending on his bargaining power, he may pass some or all of the tax on to the Federal Government when he sets his price. If he works for a private party, the contractor is required to collect the tax from the purchaser and remit it to the state. The purchaser will count the tax as part of the price of the building. Depending on his bargaining power, the contractor may reduce his price to make up for some or all of the tax the purchaser must pay. If the tax is the same, and the parties have the same bargaining power, the amounts the purchasers pay and the amounts the contractors receive will be identical in the two cases. *Thus, it makes no difference to the contractor (or to the purchasers) which of them is [legally] required to pay the tax to the State, as long as they have the opportunity to allocate the burden among themselves by adjusting the price*.[223]

In light of these observations and conclusions, the Court discussed its prior decisions in the area.

Looking at the "whole tax structure" rather than the isolated tax on Federal contractors, the Court easily distinguished *Washington* from its prior decisions invalidating state tax schemes which placed a heavier tax burden on those dealing with the Federal Government than on those dealing with the state.[224] Again looking at the "whole tax structure," the Court rejected the notion that the Washington statutory scheme did not provide a political check on abusive taxation by the state.[225] Instead, the Court concluded that in light of the broad application of the tax scheme in issue, "there is little chance that the State will take advantage of the Federal Government by increasing the tax."[226]

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219. *Id.* at 1348.
220. *Id.*
221. *Id.* at n. 4.
222. *Id.* at n. 4, 1348.
223. *Id.* at 1348 n. 4 (emphasis added).
224. *Id.* at 1348-44 (distinguishing Phillips Chemical Co. v. Dumas Independent School Dist., 361 U.S. 376 (1960); Moses Lake Homes, Inc. v. Grant County, 365 U.S. 744 (1961).
225. 103 S. Ct. at 1350. In this regard, the Ninth Circuit had concluded that there was "no broad state constituency taxed as are the prime contractors who deal with the Federal Government." 654 F.2d at 577.
226. 103 S. Ct. at 1350.

The Court also recognized striking similarities between the Washington tax system and those in *United States v. City of Detroit*[227] and *United States v. County of Fresno*.[228] In those cases the Court had sustained the differential tax treatment used by Michigan and California, respectively, to get at otherwise tax-exempt property.

In the *Detroit* case, Michigan provided differential tax treatment for users of property depending on the tax status of the property.[229] If the property being used was taxable, the user would not be subject to the tax. Instead, the owner of the property would be assessed with a general ad valorem property tax.[230] On the other hand, if the property enjoyed tax-exempt status, the tax, measured as though the user were the owner of the property, would be imposed on the user.[231] The *Detroit* Court approvingly described the impact of the tax by pointing to the legislature's attempt to equalize the tax burden on a private enterprise using tax-exempt property and the tax burden of a business using taxed property.[232] In the *Fresno* case, the Court sustained a similar tax scheme.

Finding the tax schemes in *Fresno* and *Detroit* indistinguishable from that in *Washington*, the Court concluded:

> This answers the United States' contention that the Washington tax is invalid simply because it is an attempt to circumvent the Federal Government's tax immunity. The Washington statute is no different from any other taxing scheme that switches the incidence of the tax from one party to a transaction to another when the party that would ordinarily be taxed is immune. In this respect, this case is no different from *Fresno* or *Detroit*.[233]

The Court then observed that the "important consideration . . . is not whether the state differentiates in determining what entity shall bear the legal incidence of the tax, but whether the tax is discriminatory with regard to the economic burdens that result."[234] This does not require, however, that the economic burdens of the tax be equal, in fact, on all similarly situated parties.[235] It does require, however, that the parties have an *opportunity*

227. 355 U.S. 466 (1958). *See supra* notes 106-115 and accompanying text.
228. 429 U.S. 452 (1977). *See supra* notes 129-134 and accompanying text.
229. 355 U.S. at 467, 473.
230. *Id.*
231. *Id.*
232. *Id.* at 474.
233. 130 S. Ct. at 1349 n.9.
234. *Id.* at 1349.
235. *Id.* at 4307. On this point the Court was responding to the Ninth Circuit opinion wherein that court commented on the state's burden in tax discrimination cases as follows:

> Nor is there anything in the record from which to conclude that the economic incidence of the sales and use taxes would necessarily be shifted from the owners of non-federal land to their prime contractors. Therefore, it has not been demonstrated that the tax burdens on all contractors are, in fact, equalized.

654 F.2d at 576.

And, in a footnote the Ninth Circuit suggested the nature of the documentation to be provided as follows:

> In the instant case, there are no findings, economic data, or demonstrated market assumptions in the record from which to conclude that: 1) the owners of non-federal property have sufficient market power vis-a-vis prime contractors to pass on the economic incidence of the subject tax; 2) even if such market power exists generally, why

to allocate the economic burden of the tax by adjusting the price.[236] Since in the Court's view Washington's tax system satisfied these requirements, it was determined to be nondiscriminatory. The Court concluded: "Washington has not singled out contractors who work for the United States for discriminatory treatment. It has merely accommodated for the fact that it may not impose a tax directly on the United States as the project owner."[237]

The four dissenting Justices, however, cast the Washington tax scheme as a circumvention of "the United States' absolute constitutional immunity from state taxation."[238] They questioned the Court's decision as a matter of law and as a matter of fact.

First, as a matter of law, the dissenters cited three of the Court's earlier decisions which, in their view, compelled an affirmance of the Ninth Circuit's decision.[239] And, in passing the dissenting mentioned *Fresno* by pointing out that in that case "the United States expressly abandoned any claim that the tax treated federal employees differently from state employees who lived in state owned houses".[240] But it was the omitted discussion of the *Detroit* case that was most noteworthy.[241] The dissent also challenged as "glib" and "unwarranted" the majority's conclusion "that the Federal Government is really better off than others because the tax consequence to it is a lesser amount inasmuch as the contractor's labor costs and markup are not included in the tax base."[242] The dissent questioned the Court's holding on this point by noting that the cost of putting the tax money "up front" and of maintaining special records required only of the Federal contractor, could well exceed the tax increments on the labor and profit components.[243] The dissent also found "highly suspect" the Court's assumption that a federal contractor will be able to pass the tax through to the Federal Government.[244]

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all owners of non-federal property would necessarily have sufficient market power to allow each of them to pass on all of the economic incidence to prime contractors; and 3) even if both of these conclusions are now true, that they will remain so, notwithstanding any changes in economic conditions.

Id. at 576 n.12.

236. 103 S. Ct. at 1348 n.4.

237. *Id.* at 1350.

238. *Id.* at 1351.

239. *Id.* at 1354. The cases cited were *Miller v. Milwaukee*, 272 U.S. 713 (1927); *Phillips Chemical Co. v. Dumas School Dist.*, 361 U.S. 379 (1969); *Moses Lake Homes, Inc. v. Grant County*, 365 U.S. 744 (1961). It is clear from a reading of these cases, however, that they are far from compelling and, in fact, easily distinguished from the *Washington* situation. Moreover, these cases were apparently considered by the dissent without regard for the Court's other decisions in this area. Most notably among these are the *Fresno* and *Detroit* cases.

240. 103 S.Ct. at 1355 (*quoting* 429 U.S. at 452, 464 n. 13). The import of this cryptic revelation is not entirely clear. Was it intended to vitiate the majority's comparison of *Fresno* and *Washington*?

241. Clearly, *Fresno* and *Detroit* present problems to the dissent's position; a position that is not easily reconciled, if at all, with those cases.

242. 103 S. Ct. at 1353.

243. *Id.* at 1355.

244. *Id.* at 1355 n. 4. The dissent states two reasons for its position on this issue:

First, the assumption hardly can be applied to a contract made prior to the 1975 legislation. A contractor trapped with such a contract has the burden of the tax; a private contractor is not at the same risk. Second, the Court seems to believe that a federal contractor has the same amount of bargaining power with the Federal Govern-

On a practical note, the dissent observed that "the Court, in order to prevent abuse, will have to dissect and carefully measure every state system that imposes a tax burden upon the United States."[245] In this regard, the dissent noted "that courts as institutions are poorly equipped to evaluate the relative burdens of various methods of taxation."[246]

C. United States v. Colorado—*Constitutional Limitations on the Application of the Possessory Use Tax to Government Contractors*

The possessory use tax compliments the general ad valorem property tax by taxing the private use of tax-exempt property.[247] The subject of the tax is the private use of tax-exempt property. The tax is typically measured and assessed as though the user were the owner of the property. Although the possessory use tax has been sustained by the Court under certain circumstances,[248] its imposition is not without limits. In particular, questions have been raised concerning the imposition of a tax, measured in terms of full value, on the private use of tax-exempt property when there are contractual restrictions on the use of the property rendering such use less valuable.[249] This was the nature of the Tenth Circuit's inquiry in *United States v. Colorado*.[250]

The *Colorado* case involved a Department of Energy contract with Rockwell International Corporation for the operation and maintenance of the Rocky Flats Plant—Government-owned facilities operated for the development and production of nuclear weapons—located in Jefferson County, Colorado.[251] In return for its services, Rockwell was reimbursed its costs and paid a fixed fee.[252] In light of these contractual undertakings, the Jefferson County Tax Assessor assessed Rockwell with a possessory use tax for the use of tax-exempt property—the Rocky Flats Plant.[253] The tax assessed against

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ment as his private counterpart has with his contractual partner. I suspect that in most circumstances this is not correct. Under Washington's tax, a private contractor charges his client the amount of the state tax on top of the contract price; it is far from clear that a federal contractor is able to pass the tax on in the same way to the Federal Government.

Id.

245. *Id.* at 1356.

246. *Id.* (*quoting* Minneapolis Star Tribune v. Minnesota Comm'n v. Revenue, 103 S. Ct. 1365, 1374 (1983)).

247. For a discussion of the possessory use tax *see supra* notes 32-33, 90-134 and accompanying text.

248. *See, e.g.*, United States v. Detroit, 355 U.S. 466 (1958); United States v. Township of Muskegon, 355 U.S. 484 (1958); Detroit v. Murray Corp., 355 U.S. 489 (1958).

249. *See* United States v. County of Fresno, 429 U.S. 452, 462 n.10 (1977).

250. 627 F.2d 217 (10th Cir. 1980), *summarily aff'd sub nom* Jefferson County v. United States, 450 U.S. 901 (1981).

251. 627 F.2d at 218.

252. United States v. Colorado, 460 F. Supp. 1184, 1185-87 (D. Colo. 1978).

253. The Colorado statute, a typical possessory use tax, provides in part:

(1) When any property . . . exempt from taxation is leased, loaned, or otherwise made available to and used by a . . . corporation in connection with a business conducted for profit, the lessee or user thereof shall be subject to taxation in the same amount and to the same extent as though the lessee or user were the owner of such property . . . .

Id. at 1187.

Rockwell for 1976 was in excess of 4.5 million dollars.[254]

The issue before the Court of Appeals for the Tenth Circuit in the *Colorado* case was whether the possessory use tax, as applied against Rockwell for its use of the Rocky Flats Plant, was a constitutional enactment by the State. As expressed by the court, the key to this issue "is the relationship between Rockwell and the United States and the nature of the activity which the State of Colorado seeks to tax."[255] The district court determined that the tax as applied was unconstitutional and entered a summary judgment for the Government.[256] The state appealed this decision to the Tenth Circuit and ultimately to the Supreme Court.[257]

In reaching its decision, the district court first distinguished *United States v. Boyd* where the Supreme court sustained the application of the Tennessee compensating use tax to Government contractors.[258] In discussing *Boyd*, the district court stressed that the *Boyd* Court had determined that the contractor had a "separate taxable interest." In this context, the district court discussed the Supreme Court's implicit notion that a tax on the cost of supplies and materials obtained with government funds would constitute an appropriate measure of the separate taxable interest.[259] After setting up *Boyd* in this fashion, the court proceeded to distinguish it from the assessment in issue.

The distinction noted by the court was that Colorado, unlike Tennessee in the *Boyd* case, had made no effort to separate out the Government's ownership interest in the property.[260] And, following up on this theme the court observed:

> The Supreme Court has said there is no constitutional impediment to state and local taxation of the benefit to Rockwell as measured by its separate interest in the Government-owned property used in the performance of the contract. When, however, a tax is imposed upon the whole value of the property, it is obvious that the tax is also being imposed upon the Government's interest and that is contrary to the Constitution.[261]

The district court had less difficulty distinguishing the *United States v. County*

254. *Id.* The District Court expressed concern about the tax liability as compared to Rockwell's fee under the contract. *Id.* at 1188.

255. 627 F.2d at 219.

256. 460 F. Supp. at 1189.

257. 627 F.2d 217, *summarily aff'd sub nom* Jefferson County v. United States, 450 U.S. 901 (1981).

258. For a discussion of the *Boyd* decision *see supra* notes 77-90 and accompanying text.

259. 460 F. Supp. at 1188. The district court's reading of *Boyd* is strained. *Boyd* was concerned with legal incidence of the tax rather than the measure of the tax. *See supra* notes 82, 179 and accompanying text. The Court in *Boyd* was clearly not concerned with comparing the relative interests of the Government and its contractors. Indeed, the Court's focus was on the transaction in issue (the use of property not previously subject to a sales tax) and not the relative interests in the property being used.

260. *Id.* To reiterate, it seems that the district court has strayed. The court in *Boyd* did not attempt to segregate the various interests of the parties because the compensating use tax in issue was assessed on a transactional (sale or use) basis. But, the possessory use tax in Colorado is complementary to the general ad valorem property tax which is a tax on ownership. Thus, it is important to keep in mind that the taxes in *Boyd* and *Colorado* are substantially different. *Id.*

261. *Id.*

of Fresno case in which the Supreme Court had sustained a possessory use tax which segregated the user's limited interest in the property.[262] Conversely, the Colorado statute provided that the user would be taxed as though it were the owner.[263] With this, the district court concluded that the tax was "nothing less than a general ad valorem property tax imposed on United States property. It is a tax on the property itself rather than Rockwell's beneficial use of it."[264]

In reaching its decision, the district court determined that the Colorado tax was the same as that invalidated in *United States v. Allegheny County* where the tax assessor had included Government-owned machinery in the assessment of a private plant.[265] Citing footnote 10 of the *Fresno* case, the court noted the continuing validity of *Allegheny*.[266] In particular, with respect to segregating the contractor's limited interest in Government-owned property, the court cited the following excerpt from footnote 10 of *Fresno*:

> Insofar as [Allegheny] stands for the proposition that Government property used by a private citizen may not be taxed at its full value where contractual restrictions on its use for the Government's benefit render the property less valuable to the user, the case has no application here. Appellee counties have sought to tax only the individual appellants' interests in the Forest Service houses and have reduced their assessments to take account of the limitations on the use of the houses imposed by the Government.[267]

Thus, without any meaningful discussion of *United States v. City of Detroit* or its companion cases, the district court, based on the decisions discussed above, held that the tax constituted an unconstitutional infringement on the Government's immunity from taxation.[268]

The Tenth Circuit affirmed the lower court but found it necessary to distinguish three cases relied on by the State of Colorado—*United States v. Boyd*,[269] *United States v. City of Detroit*,[270] and *United States v. Township of Muskegon*.[271] First apparently rejecting the lower court's "separate interests"

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262. 429 U.S. at 452. For a discussion of *Fresno see supra* notes 129-134, 142-144 and accompanying text.

263. *See supra* note 253.

264. 460 F. Supp. at 1189. In light of *United States v. City of Detroit*, 355 U.S. 466 (1958), and its companion cases, *see supra* notes 102-129 and accompanying text, the district court's conclusion, without more, that the Colorado possessory use tax was nothing more than a general ad valorem property tax on the owner of the property is confusing.

265. *Id.* For a discussion of *Allegheny, see supra* notes 90-100 and accompanying text.

266. *Id. See supra* note 132.

267. 429 U.S. at 463 n.10.

268. 460 F. Supp. at 1189.

> By taxing the totality of the land, improvements and personal property used in the operations of the Rocky Flats Plant, without accounting for any of the imposed limitations on Rockwell's use of the property, the defendants have subjected the property and activities of the Federal Government to state and local taxation and thereby infringed upon the immunity of the United States from the imposition of taxes on its own property. *Id.*

269. 378 U.S. 39 (1964).

270. 355 U.S. 466 (1958). For a discussion of the *Detroit* case see *supra* notes 101-115 and accompanying text.

271. 355 U.S. 484 (1958). For a discussion of *Muskegon* see *supra* notes 120-128 and accompanying text.

analysis of *Boyd*,[272] the court distinguished *Boyd* from *Colorado* in terms of the different tax schemes involved.[273] In *Boyd* a sales and compensating use tax was measured by the purchase price or fair market value of the property used by the contractor and collected on a one-time basis.[274] The contractor in *Boyd* had purchased the property from third parties for use in performing its contract.[275] In comparison, the court noted that Colorado was not seeking to impose a tax on goods acquired by Rockwell for its contract with the United States, but rather the tax was measured by the value of the Government-owned Rocky Flats Plant and based on Rockwell's use such facility.[276] The court found this a significant distinction between *Boyd* and *Colorado*.[277]

While the lower court made no effort to distinguish *Detroit* or *Muskegon* from the *Colorado* case, the Tenth Circuit distinguished these cases based on the nature of the use of the Government-owned property in issue.[278] In *Detroit*, the contractor leased part of a Government-owned industrial plant for its private manufacturing business.[279] In *Muskegon*, the contractor used a Government-owned manufacturing plant for the production of goods for the Government.[280] The court concluded that " [n]either [*Detroit* nor *Muskegon*] is akin to the instant case, where Rockwell is merely performing its contractual obligations on Government owned property.[281] Like the lower court, the Tenth Circuit relied on *United States v. County of Allegheny*[282] in rejecting as unconstitutional the Colorado possessory use tax applied to Rockwell.[283] As in *Allegheny*, the court concluded that in substance the tax was an ad valorem general property tax on property owned by the United States.[284] The Supreme Court affirmed without opinion.[285]

D. *Federal Immunity of Government Contractors from State and Local Taxation—Impact of* New Mexico, Washington *and* Colorado *on the State of the Law*

Of course, it is not enough to recount the historical development of the

272. *See supra* notes 259-260 and accompanying text.

273. 627 F.2d at 220. The court distinguished *Boyd* on the particulars of the taxes involved. But the decision in this context is short on analysis; it does not provide any justification for the different treatment of the different tax schemes; and it does not in any meaningful way explain the legal significance of the different characteristics. Implicit in the decision, however, is that these distinctions are of a constitutional dimension. *Id.*

274. *Id.*

275. *Id.* But the compensating use tax could be applied under the Tennessee statute even if the property had not been purchased by the contractor and, therefore, the court may be overstating this factor unless it is implying that the constitutionality of the *Boyd* tax rests on this point. *Id.*

276. *Id.*

277. *Id.*

278. *Id.*

279. *Id.*

280. *Id.*

281. *Id.* As discussed with respect to *Boyd*, the court concludes that the distinctions between these cases are constitutionally significant. And, as in its discussion of *Boyd*, the court apparently believes that the legal significance of these distinctions are self-evident.

282. 322 U.S. at 174.

283. 627 F.2d at 220, 221.

284. *Id.* at 221.

285. Jefferson County v. United States, 450 U.S. 901 (1981).

federal immunity doctrine as it relates to Government contractors and the recent decisions cited above. Indeed, the import of these recent decisions can only be understood in light of their historical background. In this context, three points should be recalled from Part I. First, the doctrine of federal immunity has gone through two distinct phases—an expansionary period and then a period of contraction. Second, a two-tiered test has evolved for determining the constitutional validity of state and local taxes on the Government and those with whom it deals. Third, state and local taxes come in various forms each with different characteristics. These points each bear upon the discussion which follows.

Two of the three decisions—*New Mexico* and *Washington*—mark the continuance of the unmistakeable trend of the Court to constrict where possible the once expansive federal immunity doctrine. *Colorado*, on the other hand, was a departure from this trend. There was, however, unanimity that the constitutional standard for reviewing state taxes was the two-tiered test referred to above. Two of the cases, *New Mexico* and *Colorado*, were decided on the first tier, the legal incidence test, and the other, *Washington*, was decided on the second tier, the discrimination test.

The most direct impact of *New Mexico* on prior law is its effect on the *Kern-Limerick* decision and the procurement agency concept announced therein.[286] While not expressly overruling *Kern-Limerick*, it appears that the Court will carefully consider each case on its particular facts and will apply *Kern-Limerick* strictly, if at all, when considering the agency issue. This implication is evident from the Court's lack of enthusiasm for the Government's attempt to avoid state taxes by creating an agency relationship through contracts with private contractors. The Court stated that "a finding of constitutional tax immunity requires something more than the invocation of traditional agency notions: to resist the state's taxing power, a private taxpayer must actually 'stand in the Government's shoes.' "[287] Along the same lines, the Court, citing in part in *Kern-Limerick* dissent, noted:

> Granting tax immunity only to entities that have been "incorporated into the Government structure" can forestall, at least to a degree, some of the manipulation and wooden formalism that occasionally have marked tax litigation—and that have no proper place in determining the allocation of power between co-existing sovereignties. In this case, for example, the Government and its contractors modified their agreements two years into the litigation in an obvious attempt to strengthen the case for nonliability. . . . [Moreover,] the Government earnestly argues that its contractors are entitled to tax immunity because, among other things, they draw checks directly on federal funds, instead of waiting a time for reimbursement. . . . We cannot believe that an immunity of constitutional stature rests on such technical considerations, for that approach allows "any government functionary to draw the consti-

286. For a discussion of the *Kern-Limerick* decision see supra notes 52-59 and accompanying text.

287. United States v. New Mexico, 455 U.S. at 236.

tutional line by changing a few words in a contract."[288]

So, in addition to its severe constriction of *Kern-Limerick*, the Court expressed its concern for the drawing of constitutional lines based on technical provisions in Government contracts.[289]

Although the impact of *New Mexico* on prior law is essentially limited to its restriction of the procurement agent concept, the Court's recap of the development of the federal immunity doctrine will also be remembered.[290] In addition, the invitation by the Court for congressional intervention in this area is noteworthy.[291]

A reading of *Detroit* and *Fresno* make it difficult to view *Washington* as a significant development in the area of tax discrimination.[292] In those cases, as in *Washington*, the Court sustained a tax scheme which provided a different method of taxation for the Government and those dealing with it than for others similarly situated. Although the tax methodology in all three cases was different for different classes of taxpayers, the economic burden of the tax was in each case judged to be the same for all. Thus, while the legal incidence test had developed into a very formalistic test, the tax discrimination doctrine was concerned with the economic substance of the tax scheme.[293] This theme, expressed in *Detroit* and *Fresno*, was described in greater detail in *Washington*.

While it is clear that the tax discrimination doctrine enunciated by the Court does not allow the states to impose a heavier tax burden on the Government or those with whom it deals, the question of what constitutes a heavier tax burden is not so clear. But the Court in *Washington* did indicate that it considers the tax rate and tax base to be important factors.[294] With respect to the tax rate, the Court noted that it was the same for all construction transactions.[295] And, regarding the tax base, the Court observed that the Government and its contractors were treated more favorably than others because they were taxed on a smaller proportion of the project value.[296] Considering these two characteristics of the tax, the Court concluded that the Government and its contractors are both better off than other taxpayers because they pay less than anyone else in the state.[297] But the majority was clearly not interested in a detailed examination of the relative burdens of the

288. *Id.* at 737.

289. This is seemingly at odds with the *Colorado* case wherein the lower court and the Tenth Circuit held that contractual restrictions on the contractor's use of Government-owned property required the state to segregate the contractor's limited interest in the property. Such contractual restrictions are seemingly the same sort of technical considerations and subject to the same manipulation as those provisions referenced by the Court in *New Mexico*.

290. *See, e.g.*, Washington v. United States, 103 S. Ct. 1344.

291. *See supra* note 193 and accompanying text.

292. 103 S. Ct. at 1349-50. "The only difference between [*Washington*] and *Fresno* and *Detroit* is that the taxpayer here is a vendor of services to the United States, rather than one who receives an economic benefit from the Federal Government. To rest upon such a distinction would be to elevate form over substance." *Id.*

293. *Id.* at 1348-49.

294. *Id.* at 1348. *See supra* note 219 and accompanying text.

295. *Id.*

296. *Id.*

297. *Id.*

tax scheme and, in particular, the majority did not consider in its opinion the burdens outlined by the dissent.[298]

Washington does not, it seems, constitute a departure from previous decisions. But it does put beyond doubt the broad power of the state and local governments to fine tune their tax laws in any manner that does not have a discriminatory economic impact on the Government or those with whom it deals.

Of the three cases, *Colorado* has had the most unsettling effect on the state of the law. It cuts against the basic trend to constrict the once broad federal immunity concept and it raises specific issues concerning both the compensating use and possessory use taxes. The questions raised concerning compensating use taxes revolve around the attempt by the Colorado District Court and the Tenth Circuit to distinguish *Colorado* from *Boyd*. The District Court plainly missed the essential nature of the compensating use tax in its analysis of *Boyd*. The compensating use tax complements the sales tax, which taxes a particular transaction—sales, it is a transactional tax. On the other hand, the possessory use tax complements the ad valorem property tax, which taxes property ownership interests. Unfortunately, the District Court was seemingly unaware of this distinction.[299] Without clarifying the lower court's opinion on this point, the Tenth Circuit, in a conclusory fashion, noted that the tax in *Boyd* was sufficiently different from the tax in *Colorado* to justify a different result.[300]

But *Colorado* is more unsettling because of its limitations on the possessory use tax cases *Detroit* and *Muskegon*, and its resurrection of *Allegheny*. In distinguishing *Detroit* and *Muskegon*, the Tenth Circuit emphasized the nature of the contractors' activities.[301] While both *Detroit* and *Muskegon* concerned the use of government property in manufacturing businesses, the contractor in *Colorado* was merely going onto the property to perform its management services.[302] From this it is clear that the nature of the activity has taken on a new dimension in possessory use tax cases. But, of course, this leaves many questions unanswered. For example, what activities may be taxed under these schemes and what is the proper measurement of the tax.

Following its discussion of *Detroit* and *Muskegon*, the Tenth Circuit, relying on *Allegheny*, determined that the *Colorado* tax was in substance an ad valorem general property tax on property of the United States and, therefore, prohibited by the Constitution.[303] This determination is significant in two ways. First, the court's reliance on substance over form is a marked departure from the formalistic legal incidence test. Second, the court leaves open the question of what measure short of full valuation is constitutionally acceptable under the *Colorado* circumstances.

298. *Id.* at 1355. *See supra* note 243 and accompanying text.
299. *See supra* notes 259-261 and accompanying text.
300. *See supra* notes 272-276 and accompanying text.
301. *See supra* notes 277-280 and accompanying text.
302. *Id.*
303. *See supra* notes 281-283 and accompanying text.

III. THE IMPACT OF *NEW MEXICO, WASHINGTON* AND *COLORADO* ON GOVERNMENT PROCUREMENT POLICIES AND PRACTICES

At one point in its opinion, the *New Mexico* Court stated: "We cannot believe that an immunity of constitutional stature rests on such *technical considerations*, for that approach allows 'any *Government functionary* to draw the constitutional line by changing a few words in the contract.' "[304] The "technical considerations" referred to by the Court were certain contractual provisions included in the contracts between the taxpayer-contractors and the Government. And, of course, the Government functionaries are the Government bureaucrats that prepare, negotiate and administer the Government's contracts, *viz.*, contracting officers and their legal counsel. While the Court may be correct in its assertion that constitutional lines should not be drawn by Government functionaries by merely changing a few words in a contract, it is the same Government functionaries which must react to the constitutional lines drawn by the Court's "unsteady hand."[305] In this regard, contracting officers and their legal counsel must be ready to adjust procurement policies and procedures to comply with the Court's decisions and at the same time, to the extent feasible, protect the federal fisc from over-zealous state and local governments. This task is complicated because many states, already sensitive to the President Reagan's "new federalism" and facing substantial budget deficits, are searching for additional revenues.

To make matters worse, these cases, particularly *New Mexico*, have created a heightened awareness of the potential revenues that may be obtained under the proper tax scheme. While it is true that Supreme Court cases generally have a certain degree of notoriety, *New Mexico* is especially notable because of the unprecedented amount of the tax liability finally stipulated by the parties. The amount agreed to and ultimately paid to the state was roughly $280 million.[306] This figure will undoubtedly arouse other states to take a hard look at their tax structures to ensure that they are not unnecessarily or unwittingly missing Government contractors.

A. *Problems in Contract Formation and Administration*

Government contracts typically deal with state and local taxes in one of two ways depending upon the type contract involved. With respect to cost-type contracts, state and local taxes are generally allowable costs and reimbursable to the contractor.[307] But if there is a claim of illegality or erroneous assessment, the taxes are allowable only if the contractor, prior to payment of such taxes, requests instructions from the contracting officer and takes all

304. United States v. New Mexico, 455 U.S. 737 (1982) (emphasis added).

305. United States v. County of Allegheny, 322 U.S. 176 (1944).

306. This situation has drawn considerable attention from the highest levels of the New Mexico State Government and the Federal Government. Of course, a payment of more than a quarter of a billion dollars in times of enormous budget deficits attracts considerable attention and scrutiny by those concerned with such matters.

307. Federal Procurement Regultions, 41 CFR §1-15.205-41 (1983); Defense Acquisition Regulation 15-205.41 (1983). "In general, taxes . . . which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable . . . ." *Id.* at §1-15.205-41(1).

action directed by the contracting officer.[308] Thus, under cost-type contracts, contractors are essentially conduits for the payment of taxes; however, their position is not without risk as they have primary responsibility for the proper payment of taxes. Improper payment of taxes or the failure to seek the contracting officer's instructions may result in nonreimbursable costs to the contractor.

Conversely, fixed-price contracts generally provide that the contract price includes all applicable taxes.[309] Thus, as opposed to a cost-type contractor, a fixed price contractor must include its estimated taxes in the contract price and is not otherwise compensated for such expenses. There are circumstances, however, when special tax clauses which include or exclude from the contract price a specific tax may be approved.[310] For example, "[s]uch special treatment may be required . . . where the State or local tax law has been recently changed, where there is doubt as to the applicability or allocability of the tax, or where the applicability of the tax is being litigated."[311] In addition to an amount for those taxes which are clearly valid, the contractor may also wish to include in the contract price an amount for questionable taxes.[312]

To the extent the cases discussed above provide clear and straightforward guidance they generally make the contracting process less cumbersome. When liability for tax is not in issue cost-type contractors need not seek guidance concerning the propriety of the tax and fixed-price contractors can estimate contract prices with some certainty, obviating the need for special tax clauses. A degree of certainty in the tax area facilitates the formation and administration of Government contracts. On the other hand, uncertainty in the tax area has just the opposite effect. Cost-type contractors will find it necessary to seek guidance concerning questionable tax laws and procedures and fixed-price contractors may, in the absence of a special tax clause, find it necessary to bid in a contingency amount to cover potential tax liability.

As noted above, *Colorado* has had the most unsettling effect on the state

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308. The Procurement Regulation provides in pertinent part:

> (b) Taxes otherwise allowable under paragraph (a) of this section, but upon which a claim of illegality or erroneous assessment exists, are allowable provided the contractor prior to payment of such taxes:
>
> (1) Promptly requests instructions from the contracting officer concerning such taxes; and
>
> (2) Takes all action directed by the contracting officer arising out of paragraph (b)(1) of this section or an independent decision of the Government as to the existence of a claim of illegality or erroneous assessment, including cooperation with and for the benefit of the Government to (i) determine the legality of such assessment, or (ii) secure a refund of such taxes. 41 CFR §1-15.205-41.

309. 41 CFR §1-11.401 (1983).

310. *Id.* at §1-11.401-4(a).

311. *Id.* These special tax clauses must typically be approved at a high level within the various agencies. *Id.* at § 1-11.401-4(d).

312. If adequate price competition exists, it is unlikely that the bidding contractors will include an unnecessary contingency amount for questionable taxes and, therefore, a special tax clause may not be warranted. In a non-competitive atmosphere, however, contractors cannot be expected to take such risks upon themselves. But, even in a competitive environment, if the potential tax liability is substantial as compared to the contract price, the competing contractors may not be willing to accept the risks and a special tax clause may be in order.

of the law. It has left the states and the Federal Government scrambling to ascertain the constitutional parameters of the possessory use tax; and, by necessity, it has left in its wake a litigious atmosphere. This situation has resulted in numerous contractor requests for guidance and special tax clauses; it has further burdened an already overburdened procurement process.

The *New Mexico* decision left little room for dispute and, therefore, will not complicate matters in the same way as *Colorado*. But for those agencies using the procurement agent concept before *New Mexico*, it seems that a review of the complex contract provisions used to support the procurement agent concept is in order. To the extent such provisions serve no other useful purpose, they should be abandoned.

B. *Contracting-Out for Goods and Services or In-House Performance*

An Agency may satisfy its needs in one of three ways. It may use its own employees, requisition its needs from another agency, or procure its requirements from the private sector. While there are many instances where the choice will be clear-cut, there are other situations where more than one of the three alternatives is practicable. But because of concern that the Government should not compete with private enterprise, the executive branch has expressed a policy favoring the use of the private sector to the maximum extent practicable.[313] In this context, the Office of Management and Budget Circuilar A-76 provides in part:

> In a democratic free enterprise economic system, the Government should not compete with its citizens. The private enterprise system, characterized by individual freedom and initiative, is the primary source of national economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on competitive private enterprise to supply the products and services it needs.[314]

Of course, there are other factors to be considered. Among other things, the agency must determine whether it is more cost-effective to perform the function in-house or to contract with the private sector.[315] This is done by a "cost comparison" study, using detailed cost data to compare the cost of in-house performance with the cost of contracting-out.[316]

One major cost issue associated with contracting-out is state and local taxes. In this regard, tax provisions like those upheld in *New Mexico* and *Washington* and rejected in *Colorado* could have a significant impact on the cost comparison study and, ultimately, on the decision to contract out rather than provide the products or services with in-house capability.

In passing, it should be noted that it is decidedly more difficult to bring in-house a function previously contracted out than to contract out for a

313. OMB Circular A-76, *Policies for Acquiring Commercial or Industrial Products and Services Needed by the Government* (1982).

314. *Id.*

315. *Cost Comparison Handbook, Supplement No. 1 to OMB Circular* A-76 (1979).

316. *Id.*

function previously performed in-house. First, the agencies may lack the expertise or facilities necessary to bring a function in-house. But also, there is a general reluctance to expand the structural bureaucracy. Thus, notwithstanding that it may be more cost effective to perform the function in-house, the institutional bias for contracting out may prevail. In the same context, while state and local taxes may make it more costly to contract out than to perform in-house, as noted above, the reality of the situation may well be that the agency will continue to contract out.

C. *Budget Considerations*

It is estimated that during fiscal year 1982 the Government spent $158 billion on the procurement of supplies and services.[317] Assuming an aggregate state and local tax of 5% on the gross amount of $158 billion, the impact on the procurement budget is $8 billion. But whatever the actual liability may be, it seems certain that it is a significant amount. What is more significant though is that the amount of state and local taxes paid in connection with Government procurements is not considered in the budget process. Moreover, in spite of the substantial amounts involved, the executive agencies do not have any systematic means of ascertaining the amount of state and local taxes paid. The problem is that Congress is generally unaware of this situation when it considers the agencies budget submissions. The problem is exacerbated by the serious fiscal problems facing most state and local governments that have forced them to search out additional revenues.

Aside from the aggregate impact of state and local taxes on the federal budget, there is also a question concerning the allocation of this amount to the various states. Naturally, those states with the largest dollar share of Government procurement activities are in the best position to increase their revenues at the expense of the Federal Government.[318] While there is nothing inherently wrong with such disparate sharing of federal revenues, and while it may be true that there is a rational basis for allocating federal revenue based on the amount of Government activity within a state, it seems that Congress should be made aware of the issue so that there can be a meaningful discussion of the varied and competing interests involved.[319]

In brief, if the Congress is to make any meaningful policy decisions concerning the state and local taxation of Government contractors, the agencies must provide information to the Congress concerning the aggregate taxes paid and the allocation of these taxes.[320] Indeed, it is difficult to imagine

317. Obtained from the Office of Federal Procurement Policy, Federal Procurement Data System.

318. Of course, the extent to which a community takes advantage of the Federal Government's largesse, will depend on its tax policies and procedures.

319. There are many competing interests in this area and plenty of room for reasonable men to differ. For example, the federal agencies might argue that the states are sufficiently benefitted by the performance of Government contracts within their states. On the other hand, the states may argue that the Government and its contractors receive benefits and increase the costs of providing services to the community and, therefore, must share in the responsibility of paying for such service.

320. While the information may not be available in a precise form, particularly with regard to fixed price contracts, it can certainly be estimated with a reasonable degree of accuracy.

how the Congress and the agencies can develop a budget without fully understanding the impact of state and local taxes.

IV. CONCLUSION

The Federal Government and its contractors may find relief from state and local taxes in one of two ways: (1) under the constitutional immunity implied by the courts from the Supremacy Clause; or (2) by congressional statutory immunity. With respect to the former, the Court has established a two-tiered test for determining the constitutional validity of these tests. First, the tax may not be laid directly on the Federal Government, and second, the tax may not discriminate against the Federal Government or those with whom it deals. In practice, these principles have provided little relief to the Government or its contractors when the contractors and their activities are the subject of taxation. Significant questions remain, however, concerning the extent to which possessory use taxes may be applied to the Government and its contractors. But aside from this vestige of the once broad immunity doctrine, it is apparent that if the executive branch wants additional relief from state and local taxation, it must be through the Congress.

If Congress is to consider this complex problem with such vast political and economic implications, the federal agencies must document the magnitude and nature of the problem. The executive branch should begin now to develop the necessary data to demonstrate the aggregate tax burden and the allocation of this amount to the various states. If the agencies expect statutory relief from state and local taxes, they must make a case by demonstrating, *inter alia*, that the state and local taxes are excessive in light of the services provided by the state and local governments. Any effort by the executive branch to obtain statutory immunity will no doubt be met with violent opposition and intense lobbying. But Congress and the agencies should be made aware of the situation if for no other reason than because of the significant impact on the procurement budget. It should be understood by those who scrutinize the budget that state and local taxes are more than an incidental cost of contracting.

In addition to documenting the state and local tax situation, the executive agencies must continue to ferret out and challenge improper tax schemes. In particular, the agencies must remain vigilant in challenging, as appropriate, possessory use tax schemes. And the agencies must make the most of the situation by developing procurement policies and procedures to minimize the impact of the proper tax schemes. To the extent practicable, the agencies may want to channel their procurements to states that impose lesser tax burdens. In the same context, the agencies may want to encourage contractors to locate in such states. Depending on the particular tax scheme, the agencies may also find that it is more economical to purchase the supplies and provide them to the contractor for use in performance of the contract rather than have the contractor purchase the supplies. And, of course, the agencies may find it more economical to perform certain functions in-house rather than contract out for them.