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# Wolf: State Taxation of Government Contractors

Robert Sheriffs Moss

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# BOOK REVIEWS

**State Taxation of Government Contractors.** By Karl E. Wolf. New York: Commerce Clearing House, Inc. 1964, Pp. vii, 448.

The expenditure by the federal government of a substantial part of its annual multi-billion dollar budget for the procurement of supplies, property and services is now recognized as a permanent part of the United States economy. In the process of accomplishing this fact, the federal government has become the owner of large quantities of production facilities, industrial plants and real estate. The leasing or bailment of these properties to government contractors for their own use, or for use in the performance of government contracts has also become a substantial part of the federal government's activity. The activities of government contractors and lessees of government property have become, therefore, of such magnitude as to provide an interesting, if not necessary, source of tax revenues for state and local taxing authorities.

As these activities of the federal government expanded and became a permanent part of the economy, the efforts of state and local taxing authorities to derive tax revenues from such activities ran head on into the doctrines of specific and implied federal immunity from such taxation. In an effort to resolve the conflict, inroads have been made in these doctrines which present serious problems to government contractors as well as to government procurement officials. These problems can best be illustrated by the language of Section 11 of the Armed Services Procurement Regulation.[1] This section has specific application to the treatment of the problem of taxes—federal, state and local. As to state and local taxes, section 11-302 of the regulation states:

> (a) As a general rule, purchases made by the Government itself are exempt from State and local sales and use taxes; similarly, personal and real property are exempt from State and local property taxes when the property is both owned and possessed by the Government. These exemptions shall be made use of to the fullest extent available when Government property is located in a State or local tax jurisdiction, or when purchases are made directly by the Government, by asserting the Government's immunity from taxation of its property by States and localities, and in case of purchases, by executing an approved tax exemption certification.
>
> (b) However, when purchases are not made by the Government itself, but by a prime contractor of the Government or by a subcontractor under a prime contract, the right to an exemption of the transaction from the sales or use tax may not rest on the Government's immunity from direct taxation by States and localities. It may rest instead on provisions of the particular State or local law involved, or in some cases, the transaction may not in fact be

[1] 41 C.F.R. § 1-11.302 (1965). This regulation was originally promulgated under the provisions of the Armed Services Procurement Act of 1947, ch. 65, 62 Stat. 21–26 (1948).

> expressly exempt from the tax. Similarly, when the property is owned by the Government, but the property is in the possession of a contractor or subcontractor on tax day, situations may arise where States or localities believe they may have the right to tax the property directly or to tax the contractor's or subcontractor's possession of, interest in, or use of that property.
>
> (c) Whenever there is any doubt as to the availability of the Government's immunity or exemption from any State or local tax, the matter shall be handled in accordance with § 1-11.000 (b).

Section 1-11.000 of the regulation points out the wide variation in the problems of administering the tax aspects of a contract or transaction. It states that the right to immunity, exemption, refund, credit or drawback depends upon the nature of the tax, the particular tax law, the party sought to be taxed, the items being procured and the provisions of the contract. Since these problems are essentially legal, contracting officers are instructed to request the assistance of counsel when they arise. In the interest of uniformity and consistency, negotiations by procuring activities with any taxing authority, for the purpose of determining the validity or applicability of a tax, or for obtaining an exemption from or refund of any tax, or where the constitutional immunity of the United States may be in issue, are not to be engaged in without the prior approval of the Judge Advocate General's representative in the case of the Army or the Air Force, or the Office of General Counsel in the case of the Navy.

To the extent that the government contractor has tax problems, therefore, he tends to be caught between the efforts of state and local taxing authorities to impose a tax upon some phase of the performance of the government contract on the one hand, and the efforts of procuring activities to take full advantage of government immunity on the other. As Karl Wolf points out,[2] a resourceful contractor armed with full knowledge of which aspects of his defense work as subject to state and local taxation may be able to reduce his state and local tax costs by the proper use of authorized procurement procedures. However, the doors open to a contractor for reducing property taxes are fairly limited in number. In general, the areas in which property taxes may be reduced because of federal immunity are limited to those involving property, title to which is in the government. Mr. Wolf adds that, except for the exemption provided by location in a federal area, a government contractor normally cannot claim exemption from property taxes imposed upon property which he owns.

As to sales and use taxes,[3] Mr. Wolf suggests that a contractor may be able to reduce sales tax costs on supplies by a wise selection of the place and method of delivery and by the use of the title-passing provisions of a progress payments and government property clause in a defense contract. On the basis of *Kern-Limerick, Inc. v. Scurlock*,[4] contractors in cost-type contracts should take care that the contract makes them agents of the

[2] P. 293.

[3] Pp. 296-300.

[4] Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110 (1954).

federal government in the purchase of materials, supplies and facilities for use in the performance of the contract. A careful reading by government contractors and their attorneys of this section of Mr. Wolf's book is recommended.

In this framework of complicated problems involving federal immunity, passage of title to materials, supplies and property, and agency, Mr. Wolf has chosen to make a detailed and careful study of the over-all problem. His method is academic, which is not surprising, for, as he indicates in his foreword, he accomplished the major portion of the work in partial satisfaction of the requirements for the degree of Doctor of Juridical Science at George Washington University Law School.[5] His approach to the problems presented is complete and thorough, and he recognizes that the subject matter is complicated by "the everchanging concept of the federal government's immunity from taxation by state and local jurisdictions."[6] His book reflects an awareness of the numerous cases and decisions of state and federal courts, as well as the fact that current studies are being made by executive and legislative officials of federal, state and local governments. He believes that the interest that federal contractors have in avoiding additional tax burdens stems from their conclusion that it "hamper(s) their competitive position."[7]

From this posture, the author chooses to analyze the decisions on the basis of *before* and *after* 1925. Before 1925, he declares, the courts strictly enforced immunity of the federal government and concludes that subsequent changes in the economic climate resulted in changes in the concept of federal immunity from state taxation. One might differ with Mr. Wolf in this regard and conclude that the concept remains unchanged; under such an interpretation, the only change was in the concept of which types of state and local taxes constitute direct or indirect taxation of the federal government.

With this as a basic premise, Mr. Wolf commences his book with an excellent summary of the development of state and local taxation of government contractors. He then divides his book into four parts, devoting Part 1 to the creation and expansion of the federal government's tax immunity during the period from 1825 to 1925, and Part 2 to the curtailment of such immunity since 1925. The topics treated in both parts are similar. Part 1 begins with a discussion of the basis and concept of federal immunity. Then, in both Part 1 and Part 2, the author discusses state taxation of the means employed and the privileges granted by the federal government; of federal banks and the power to borrow money; of property in which the federal government has an interest; of Indian lands; and of federal enclaves. Both parts also contain discussions of the effect of state discrimination against the federal government in tax laws and administration. Inasmuch as the concept

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[5] It is interesting to note that Mr. Wolf received his B.S. Degree in 1943 from the United States Military Academy, his LL.B. in 1953 from the University of Pennsylvania Law School, and his S.J.D. in 1963 from George Washington University. He is now with Philco Corp. as Associate Counsel on Government Business, and serves with the author of this review on the Bureau of National Affairs Advisory Board, Federal Contracts Report.

[6] P. iv.

[7] Ibid.

of state excise, sales and use taxes in government procurement are not involved prior to 1925, this subject is discussed only in Part 2.

Part 3 of this work discusses the status of federal immunity today, with special focus upon property taxes, sales taxes, use taxes and taxation of federal enclaves.

Part 4 of Mr. Wolf's work, "Tax Treatment and Tax Savings in Government Procurement," discusses tax treatment in government procurement regulations, tax litigation and the decisions of the Comptroller General. Provisions of Section 11 of the Armed Services Procurement Regulation, some of which are cited above, are also discussed, with particular attention paid to state and local tax clauses, which, in effect, grant the right to recover by way of price adjustment to the contractor for state and local taxes imposed *after* a contract price is established. These clauses, of course, as Mr. Wolf points out, preserve to the Government the right to require the contractor to institute action for refund, even though the refund may not entitle the Government to a reduction in the contract price, and the contractor may, thereby, receive a windfall.[8] This Part also contains those methods of tax reduction proposed for government contractors by Mr. Wolf, to which reference has already been made, and analyzes the possibility of tax savings to the limited extent that they are available.

Mr. Wolf concludes his book with an appendix of the sales and use tax features and application of the various state statutes, which should be of considerable use to counsel for the government contractor. As a part of the appendix, he has included an excellent bibliography and a case table.

One can only applaud the thorough, complete and detailed analysis which Mr. Wolf makes within the outline he has chosen for the basis of the presentation of his work. The government contractor, his contract administration personnel, and his attorney, will find the book to contain thorough discussions of all the cited cases. This detail contributes strongly to making the book a most attractive source of information.

The author's excellent work paints an intriguing picture of the never-ending game between state and local taxing officials and the federal government over the taxation of the activities of federal government contractors in the respective states. Anticipating and analyzing the moves and countermoves of the opponents would challenge the ability of a chess expert. State and local tax officials attempt to impose a tax on the government contractor, which the federal government challenges as violating its immunity. Should the Government prevail, the state and local tax officials carefully analyze the situation and come up with a new theory of taxation. If this new tax meets with court approval, federal procurement officials move by changing contract provisions or regulations. A detailed analysis of these various moves is not possible in this review, but brief reference may be made to some of them.

One of the tests the courts have applied in determining the existence of federal immunity is the legal incidence test. If the United States is liable for the tax, or if the effect of the assessment results in a lien on government-

[8] Comptroller v. Pittsburgh-Des Moines Steel Co., 231 Md. 132, 189 A.2d 107, cert. denied, 375 U.S. 821 (1963).

owned property, the legal incidence of the tax is on the United States and the assessment is invalid. This was the holding in *United States v. Allegheny County*.[9] In that case the County of Allegheny had assessed a property tax on land and buildings owned by Mesta Machine Company in which, bolted to the floor, were machine tools that had been furnished to Mesta under a facilities contract with the Government. Separate taxes were assessed upon the value of the land and the buildings and upon the value of the machine tools. Under the terms of the facilities contract Mesta could have recovered the amount of the tax paid had it been liable therefor. The Supreme Court held that the tax was invalid because the legal incidence was upon the United States and not upon Mesta, and since an ad valorem tax attaches against the property, it was analagous to a proceeding in rem rather than in personam.

State and local tax officials noted the distinction made in the decision and the concept of a tax assessed against the contractor rather than directly against the United States developed. In order to do this, it was necessary to find a theory of taxation which would withstand the challenge of violation of implied, as well as direct, federal immunity. In *Allegheny*, the Supreme Court had suggested the solution by noting that Mesta had some legal and beneficial interest in the property as it was a bailment for the mutual benefit of the Government and the company. The Court said:

> Whether such a right of possession and use in view of all the circumstances could be taxed by appropriate proceedings we do not decide.[10]

This suggestion was too tempting to be ignored. In 1953, the Michigan Legislature enacted a statute authorizing the imposition of taxes on private lessees and users of tax-exempt property, who used such property in a business conducted for profit. The city of Detroit, in January 1954, levied such a tax against the Borg-Warner Corporation, a lessee of a government-owned industrial plant. Borg-Warner was authorized, by the terms of the lease, to deduct from the stipulated annual rental any taxes it was required to pay under the state statute. This it did, and then, as required by the lease agreement, brought an action together with the United States to recover the tax on the ground that it was levied in violation of federal immunity.

In *United States v. City of Detroit*,[11] the Supreme Court upheld the tax, noting that it was levied against the private lessee or user and that the owner was not liable for the tax, nor the property itself subject to any lien if the tax remained unpaid. There was no attempt, the Court concluded, to levy against the property or treasury of the United States. Of course, this ignored the fact that the tax was deductible from the rent. In a companion case,[12] the Court upheld the levy on the same ground, although the property was

[9] 322 U.S. 174 (1944). Most government lawyers welcomed this decision. Many of us were serving in uniform as administrators of government contracts, including facilities contracts. We saw no justification at the time for state efforts to add to World War II contract problems.

[10] Id. at 186.

[11] 355 U.S. 466 (1958).

[12] United States v. Township of Muskegon, 355 U.S. 484 (1958).

held under permit rather than lease and was used in the performance of a government contract. In a second companion case,[13] a levy against government-owned personal property in the possession of a subcontractor was upheld. This tax, although called a personal property tax, the Court found, was a possessory interest tax. The Court declared its policy, in passing on the constitutionality of state taxes, to concern itself with the practical application of the tax, rather than its definition or precise form of descriptive words.

The Government's countermoves to these decisions have not as yet completely emerged. It would appear that in those states where efforts have been made to levy a similar tax, but without basic enabling legislation, the Government has consistently and successfully opposed the levy.[14] So far, however, the Government has not found a case to present to the Supreme Court in the proper posture to permit a concerted effort to obtain the Court's reconsideration of its position. However, there is no sign of a suspension of the game, and it must be presumed that the next move is that of federal procurement authorities.

A similar example of the game can be found in the sales and use tax area. In *Alabama v. King & Boozer*,[15] a sales tax imposed against a government cost-plus-a-fixed-fee contractor had been successfully challenged below. Under the contract, the government contractor was required to purchase lumber for transfer to the Government, and the Government had agreed to pay all of the costs thereof, so that a state sales tax levied on the purchases would pass directly and completely to the Government. The Court held that the legal effect of the transaction was to obligate the contractor to pay for the lumber and it was thus the purchaser of the lumber within the meaning of the taxing statute and as such was subject to the tax. In a companion case,[16] the Alabama use tax was sustained even though the operations of the cost-plus-a-fixed-fee contractor involved shifting the economic burden of the tax directly to the United States. The Court proceeded on the theory that the contractor did not become a government agent merely because he purchased goods for use in the government contract.

The Government's countermove consisted in altering the wording of its cost-plus-fixed-fee contracts to state specifically that a contractor purchasing material for use under the contract did so as an *agent* of the United States with title to the goods passing to the United States when purchased. This language was considered in 1954 in *Kern-Limerick, Inc. v. Scurlock*,[17] where the tax was held to violate the Government's immunity. As Mr. Wolf indicates, this principle has been carried over into fixed-price contracts where there are progress payments. In those cases, since title to the goods will be

[13] City of Detroit v. Murray Corp. of America, 355 U.S. 489 (1958).

[14] E.g., General Dynamics Corp. v. County of Los Angeles, 51 Cal. 2d 59, 330 P.2d 794 (1958). In Continental Motors Corp. v. Township of Muskegon, 135 N.W.2d 908 (Mich. 1965), the court found that the tax imposed was actually a specific or excise tax and, therefore, was not a proper subject for an amendment to the general property tax law without a corresponding amendment of the law's title to bring it into compliance with requirements of the Michigan constitution.

[15] 314 U.S. 1 (1941).

[16] Curry v. United States, 314 U.S. 14 (1941).

[17] Supra note 4.

in the United States, if the contract language is carefully prepared, the usual type of sales tax can be avoided. However, the possessory interest tax remains unmitigated.

The rules of the game thus get tighter. The validity of the state tax will turn inevitably upon the precise language of the contract in issue.[18]

The legal problems presented in the field of government contracting, as well as the unusual factual situations which so often occur, are challenging. They demand the full attention of the lawyer who would specialize in the field. Only in the past fifteen years has any real effort been made by practitioners in the field, from both government and private sides, to develop textbook materials in what is now recognized as an established field of legal expertise. While there have been many contributions to the problems posed by the taxation of government contractors, until Mr. Wolf's book, there was no text. Mr. Wolf is to be commended for a thorough and lawyer-like performance of his chosen task. He has made a significant contribution, one without which no procurement library is complete.

ROBERT SHERIFFS MOSS
*Hart, Moss & Tavenner*
*Washington, D.C.*

**A Transactional Guide to the Uniform Commercial Code.** By William D. Hawkland with Chapter Four by William R. Klaus. Philadelphia: Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association. 1964. Two volumes, Pp. xl, 565; 540.

> . . . I consulted the Attorney-General, the Lord Chief Justice, the Master of the Rolls, the Judge Ordinary, and the Lord Chancellor. They're all of the same opinion. Never knew such unanimity on a point of law in my life! *The Mikado*

*A Transactional Guide to the Uniform Commercial Code* is a two volume work, designed to be supplemented, presumably annually. Although it is attuned to transactions, it is not a true transactional guide. The authors have broken their treatment of the Code into four categories which could be loosely described as "transactional divisions." The book treats ordinary sale on open account transactions, transactions where security is taken upon a sale or upon the making of a loan, bulk sales transactions, and transactions involving investment securities. Within these broad groupings, particular transactions are studied as they relate to the various sections of the Code.

The major part of Volume One treats the matter of sales on open account. The remainder of the volume discusses unsecured loans and discounts under the U.C.C., effectively considering the contents of Article 3, Commercial Paper. In Volume Two, the first three hundred pages are devoted to personal property security, Article 9; the next thirty pages concern bulk

[18] See E. I. Dupont de Nemours & Co. v. State, 44 Wash. 2d 339, 267 P.2d 667 (1954).