# **ARTICLE: RETHINKING THE IMPACT OF SALES TAXES ON GOVERNMENT PROCUREMENT PRACTICES: UNINTENDED CONSEQUENCES OR GOOD POLICY?**

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**Highlight**

*An unlimited power to tax involves, necessarily, a power to destroy.* [[1]](#footnote-2)1

**Text**

**[\*86]** I. INTRODUCTION

Tax considerations influence financial decisions of all businesses and the impact of sales taxes on Government [[2]](#footnote-3)2 procurement practices is no exception. [[3]](#footnote-4)3 It is estimated that federal procurement is a $ 378-billion-a-year business, involving nearly six million procurement actions. [[4]](#footnote-5)4 The most obvious burden imposed by any form of taxation is the economic burden of the tax itself. As the Government continues to contract out more functions which are traditionally done in-house, the Government will face an increasing tax burden. [[5]](#footnote-6)5 Although the United States Constitution is silent regarding state taxation of Government instrumentalities, immunity has nonetheless been implied by the courts.

Government immunity from state taxation derives from the United States Supreme Court's decision in *McCulloch v. Maryland.* [[6]](#footnote-7)6 In *McCulloch,* the Court recognized that the freedom of one sovereign from taxation by another sovereign is a fundamental aspect of the United States federal system. [[7]](#footnote-8)7 This absolute federal immunity from state taxation was greatly restricted in the decades following *McCulloch* but the core of the doctrine remains. [[8]](#footnote-9)8 At present, protection from state taxation is determined by the "legal incidence of tax." [[9]](#footnote-10)9 Thus, purchases made directly by the Government are immune from state and local taxation. [[10]](#footnote-11)10 However, when the Government decides to contract-out a **[\*87]** particular project or tap into the expertise of industry leaders, the right to an exclusion from state and local taxes may not necessarily rest on the Government's immunity. [[11]](#footnote-12)11 Instead, absent an exemption by the taxing jurisdictions, the contractor's purchase of goods and services might trigger state and local sales taxes. [[12]](#footnote-13)12 Consequently, state and local sales taxes imposed on private contractors and passed through to the Government, whether through cost-reimbursement or otherwise built into the overall contract price, [[13]](#footnote-14)13 can severely reduce the Government's buying power. [[14]](#footnote-15)14

This article analyzes whether the "legal incidence of tax" is the appropriate test to apply in Government contractor immunity cases when United States sovereignty is at stake. This article also addresses the need to critically look at the federal immunity doctrine and explores an alternative approach that examines the economic substance of a particular state sales tax through the common law doctrine of substance over form. A firm understanding of the impact of state and local sales tax on Government contracting initiatives, like the Department of Defense's (DOD) competitive sourcing program [[15]](#footnote-16)15 and the privatization of military housing, [[16]](#footnote-17)16 is crucial to formulating successful contract strategies, developing effective contracts, and achieving maximum efficiencies and savings. Failure to achieve projected savings from competitive sourcing and military housing privatization will handicap the DOD's ability to maintain its day-to-day readiness or continue critical modernization programs without seeking additional funding **[\*88]** from Congress. [[17]](#footnote-18)17 Obtaining additional funds will prove to be a challenging and painful process for future military leaders as the battle for the taxpayers' dollar escalates. [[18]](#footnote-19)18 In fact, many states have already made a preemptive strike by proposing big sales tax increases to pump up their own sluggish revenues. [[19]](#footnote-20)19

Part II of this article begins with an introduction to state sales and use taxes including a look at their increasing importance to state governments. [[20]](#footnote-21)20 Part III outlines the development of the federal immunity doctrine from *McCulloch* to the present, and includes an in-depth examination of the tests developed by the Supreme Court in determining a contractor's implied constitutional exemption from state taxation. Part IV tests the current federal tax immunity law against two of the DOD's cost-savings initiatives--competitive sourcing and military housing privatization--demonstrating its inadequacy. Part V then proposes an alternative solution by examining the substance of the state levied sales or use tax rather than its form. Finally, Part VI addresses the future of the federal immunity doctrine and the policy decisions that must be addressed before any changes are made.

II. BACKGROUND AND GENERAL PRINCIPLES APPLICABLE TO SALES AND USE TAXES

Before addressing the impact of sales taxes on Government procurement initiatives, this article will preview the basic principles and guidelines associated with a state imposed sales or use tax. This section introduces key concepts associated with a tax levied upon the sale of goods and services and forms the foundation for the analysis and conclusions presented in subsequent parts of this article.

**[\*89]** A. Sales and Use Taxes Defined

Sales taxes are creatures of state law comprising the most significant source of tax revenue for state governments in the nation. [[21]](#footnote-22)21 Three distinguished authorities have defined a sales tax as "any tax which includes within its scope all business sales of tangible personal property at the retailing, wholesaling, or manufacturing state, with the exceptions noted in the taxing law." [[22]](#footnote-23)22 The most significant form of sales taxation in the United States is the state retail sales tax (hereinafter "state sales tax"), which consists of a "broad-based tax on the sale of goods and selected services to the ultimate consumer." [[23]](#footnote-24)23 Although various types of sales taxes have endured a long history throughout the world, [[24]](#footnote-25)24 the state sales tax movement was the states' response to an acute revenue need borne of the Great Depression. [[25]](#footnote-26)25 Currently, forty-five states and the District of Columbia impose some form of sales tax. [[26]](#footnote-27)26

State sales tax statutes generally contain similar features operating in a uniform manner. [[27]](#footnote-28)27 Despite their similarities, however, **[\*90]** sales taxes typically fall into one of three categories--vendor taxes, consumer taxes and a hybrid category. [[28]](#footnote-29)28 Under vendor type sales tax statutes, the legal incidence of the tax falls on the gross receipts of the seller, who, therefore, has primary responsibility for paying the tax. [[29]](#footnote-30)29 For example, Illinois imposes a tax on the seller's gross receipts for the privilege of selling tangible personal property to consumers. [[30]](#footnote-31)30 With consumer type sales taxes, however, states impose a tax on the retail "sale" of tangible personal property or services, and are measured by the sales price to the buyer. [[31]](#footnote-32)31 Thus, rather than being a tax on the seller's gross receipts, the legal incidence of the tax falls on the purchaser or consumer who is primarily responsible for paying the tax. [[32]](#footnote-33)32 The seller serves purely as an agent who is responsible for collecting the tax on the state's behalf. Hybrid taxes contain features of both with the primary **[\*91]** responsibility for paying the tax falling upon both the purchaser and the seller who charges, collects and remits the tax to the state. [[33]](#footnote-34)33

As a way to avoid paying a particular sales tax or to obtain a lower sales tax rate, consumers would often travel outside the state to purchase property. [[34]](#footnote-35)34 A state cannot tax the privilege of selling property where the sale takes place beyond its borders. [[35]](#footnote-36)35 To compensate for such tax avoidance and the resultant loss of revenue, state legislatures enacted the compensating, or use tax, to tax the privilege of using, storing, or consuming property within the state, regardless of the place of purchase. [[36]](#footnote-37)36 Thus, a use tax is designed to protect a state's revenues by eliminating the advantages of shopping for the forum with the lowest tax rate. It also protects local sellers from out-of-state competitors who are able to offer the same goods and services at a much lower price because of a lower or nonexistent tax burden. [[37]](#footnote-38)37 A use tax also complements the sales tax and generally applies to the use of goods and services that have not already been subjected to a sales tax. [[38]](#footnote-39)38 As such, unless otherwise noted, all references in this article to sales taxes and exemptions apply to use taxes as well.

B. Tax Computation

As previously mentioned, the seller either pays or collects sales taxes from the purchaser on a transaction-by-transaction basis. [[39]](#footnote-40)39 The sales tax is thus maintained as a discrete charge apart from the price of the item purchased. [[40]](#footnote-41)40 In determining the sales tax due, the applicable sales tax rate is applied against the purchase or sales price, which is generally the consideration paid for goods or services by the buyer. [[41]](#footnote-42)41 **[\*92]** For example, the amount of sales tax due on a $ 1,000,000 purchase at a rate of six percent would be $ 60,000. [[42]](#footnote-43)42 The seller collects this amount and remits it to the taxing authority. [[43]](#footnote-44)43 In comparison, the measure of a state's use tax generally is at the same rate as the sales tax, although it may be described as consideration paid to the seller. [[44]](#footnote-45)44

The example above illustrates the tax implications in a relatively small purchase pursuant to a Government contract. Projects involving the purchase of higher value of supplies will involve much higher sales taxes. Unless a state exemption applies or the Government contractor is immune from taxation, sales taxes can greatly reduce the DOD's purchasing power and undercut cost-savings goals sought under housing privatization and competitive sourcing initiatives by increasing the cost of the Government's contracts.

**[\*93]** III. THE DEVELOPMENT OF THE FEDERAL IMMUNITY DOCTRINE

The United States Constitution does not directly address the conflict of intergovernmental taxation. [[45]](#footnote-46)45 Instead, federal immunity from state taxation derives from the Supreme Court's decisions. [[46]](#footnote-47)46 Any theory of federal tax immunity, whether judicially implied constitutional immunity or a congressional shielding of federal operations from state and local taxation, rests upon an effort to prevent one sovereign from interfering with the governmental functions of another. [[47]](#footnote-48)47 Recognition of federal immunity, however, restricts a state's taxing power. [[48]](#footnote-49)48 Historically, states have aggressively asserted jurisdiction over Government contractors denying constitutional tax immunity. [[49]](#footnote-50)49 Indeed, the evolution of the federal tax immunity doctrine has undergone a number of transformations with the courts left trying to protect United States sovereignty while not derogating state taxing powers. [[50]](#footnote-51)50

The seminal case of *McCulloch v. Maryland* [[51]](#footnote-52)51 first launched the intergovernmental tax immunity doctrine. Since then, Supreme Court decisions have gone through two relatively distinct phases. [[52]](#footnote-53)52 First, for more than a century, the Court invalidated a number of state and local tax statutes that directly, and often rather indirectly, impacted the Government. [[53]](#footnote-54)53 In the second phase, the 1937 *James v. Dravo Contracting Co.* [[54]](#footnote-55)54 decision began a period of constriction of the federal immunity doctrine which continues to this day. [[55]](#footnote-56)55

A. Implied Constitutional Immunity

The doctrine of implied constitutional immunity derives from the Supreme Court's decision in *McCulloch v. Maryland.* [[56]](#footnote-57)56 In *McCulloch,* the state of Maryland sought to impose a tax on the operations of the Bank of the United States. [[57]](#footnote-58)57 The tax statute provided **[\*94]** that banks operating in Maryland "without authority from the state" [[58]](#footnote-59)58 could issue bank notes only on stamped paper sold by the state. [[59]](#footnote-60)59 The amount of the tax was two percent of the face value of the notes. [[60]](#footnote-61)60 Chief Justice Marshall, speaking for a unanimous Court, rejected the Maryland taxing scheme. [[61]](#footnote-62)61 Marshall reasoned in his now famous dictum that because the power to tax is the power to destroy, Maryland's efforts to tax the Bank of the United States' operations amounted to an unconstitutional "tax on the operation of an instrument employed by the Government of the Union to carry its powers into execution." [[62]](#footnote-63)62 Thus, the Court invalidated Maryland's tax law as applied to the federal entity based on its application of the Supremacy Clause. [[63]](#footnote-64)63

Ultimately, the *McCulloch* Court was concerned with the lack of political checks in place to prevent the state from abusing its taxing power with respect to federal activities. [[64]](#footnote-65)64 Therefore, a per se rule was **[\*95]** needed to avoid the "perplexing inquiry, so unfit for the judicial department, what degree of taxation is the legitimate use, and what degree may amount to the abuse of power." [[65]](#footnote-66)65 Therefore, absent political representation in state legislatures, the Court established an absolute immunity from state taxation. [[66]](#footnote-67)66 As a result, the doctrine of federal immunity from state and local taxation emerged.

For more than a century after the *McCulloch* decision, the Court broadened the immunity doctrine into a sweeping prohibition against nondiscriminatory [[67]](#footnote-68)67 state taxes on the Government and its instrumentalities. [[68]](#footnote-69)68 Relying on *McCulloch,* the Court declared state taxes invalid if the direct economic burden was borne either directly or indirectly by the Government. [[69]](#footnote-70)69 In addition, the Court applied the federal immunity umbrella to invalidate gross receipts and taxes on Government contractors, [[70]](#footnote-71)70 property taxes imposed on federal securities owned by private parties, [[71]](#footnote-72)71 and income taxes on the wages of federal employees. [[72]](#footnote-73)72 The courts continued the broad application of federal immunity from state taxation from the McCulloch decision in 1819 for more than one hundred years.

B. The Rejection of Absolute Immunity

Beginning in the 1930s, the Supreme Court began to narrow its broad view of constitutional immunity from state taxation as the **[\*96]** Government's commercial role increased and with it the volume of activity exempt from state taxation. [[73]](#footnote-74)73 Also during this time the Great Depression caused many states to enact sales tax statutes, replacing the income tax as a primary revenue source. [[74]](#footnote-75)74

Recognizing the expanding commercial role of the Government and the dependency of the states on sales tax revenues, the Supreme Court changed its view of federal immunity in the landmark case of *James v. Dravo Contracting Co.* [[75]](#footnote-76)75 *Dravo* rejected the concept of absolute immunity and began a rapid retreat of burgeoning federal constitutional freedom from taxation. [[76]](#footnote-77)76 Remarkably, the *Dravo* Court appeared to turn its back on clear and overwhelming precedent [[77]](#footnote-78)77 in holding that a state can impose a nondiscriminatory tax on the gross receipts of a private contractor under a construction contract with the Government. [[78]](#footnote-79)78 What followed was the emergence of the legal incidence test.

1. *Emergence of the Legal Incident Test*

The *Dravo* Court rejected the economic burden argument for federal immunity and instead formulated the legal incidence doctrine. [[79]](#footnote-80)79 The essence of this doctrine is that a state tax is valid if it is not directly levied on the Government, if it is not discriminatory, and if it is not declared invalid by the Congress. [[80]](#footnote-81)80 Additionally, *Dravo* abandoned the idea that shifting of the financial burden of a tax to the Government is enough, by itself, to prohibit a state or local tax. [[81]](#footnote-82)81 Still, the Supreme Court recognized the competing interest of the two sovereigns. In a slight twist from its previous decisions regarding federal immunity, the Court produced the following passage from a Supreme Court decision on state immunity from federal taxation:

**[\*97]** The power to tax is no less essential than the power to borrow money, and, in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption from taxation to those subjects which fall within the general application of nondiscriminatory 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 the government. [[82]](#footnote-83)82

In distinguishing its past precedents, the Court made a conscious effort to accommodate both competing interests while partially rejecting *McCulloch's* absolute immunity doctrine. [[83]](#footnote-84)83

Under the *Dravo* facts, the tax was found to be upon the gross receipts of a private contractor, not the Government. [[84]](#footnote-85)84 The Court decided that even if it assumed that the tax on the private contractor may increase the cost to the Government, that fact alone would not invalidate the state tax. [[85]](#footnote-86)85

This assumption by the *Dravo* Court eventually became law when the Supreme Court, in *Alabama v. King & Boozer,* [[86]](#footnote-87)86 upheld Alabama's authority to collect a sales tax from a Government contractor performing a cost-plus-fixed-fee contract. [[87]](#footnote-88)87 The Alabama statute in question makes the contractor as purchaser liable for the tax to the seller, who then adds to the sales price the amount of the tax. [[88]](#footnote-89)88 The Government argued that the legal incidence of the tax was on the Government and not the contractor who ordered and paid for the **[\*98]** supplies. [[89]](#footnote-90)89 However, the Court held that the nondiscriminatory character of the tax made it permissible, even though the full economic incidence of the tax indisputably fell on the Government. [[90]](#footnote-91)90 As a result, the Court sanctioned a tax which was passed through in total to the Government. [[91]](#footnote-92)91 The Alabama tax went further than the tax in *Dravo* which was merely a possible or potential burden on the government; the tax was a clear and ascertainable economic burden on the Government. [[92]](#footnote-93)92

*2. State Taxation of Government Contractors*

Following the *Dravo* and *King & Boozer* decisions, the analysis regarding constitutional immunity of the United States from state and local taxation is two fold. [[93]](#footnote-94)93 First, absent Congressional consent, no state or local government may impose taxes directly on the Government itself, or an agency or instrumentality so entwined with the Government that the two cannot realistically be viewed as separate entities. [[94]](#footnote-95)94 Nor may a state or local government impose taxes the legal incidence of which falls upon the Government or its instrumentalities. [[95]](#footnote-96)95 Second, even though the legal incidence of a tax may not fall on the Government, the tax may not discriminate against or severely interfere with Government operations. [[96]](#footnote-97)96

a. Examining the Relationship Between the Government and Its Contractors

In determining whether Government contractors are immune from state taxation, the Supreme Court has examined a number of differing contractual arrangements between the Government and its contractors. In *United States v. New Mexico,* [[97]](#footnote-98)97 three contractors held **[\*99]** management contracts with the Atomic Energy Commission (AEC). [[98]](#footnote-99)98 These contracts were unique in that they were intended to facilitate long-term private management of Government owned research and development facilities. [[99]](#footnote-100)99 The terms of the contracts were typical of all AEC atomic facility management agreements and provided for the Government to reimburse the contractors for their allowable costs under the contract plus a fixed annual fee. [[100]](#footnote-101)100 However, there were other contractual terms which are significant to understanding the Court's holding.

For example, title to all tangible personal property purchased by the contractors passed directly from the seller to the Government and the Government bore the risk of loss. [[101]](#footnote-102)101 The contracts also provided for Government control over the disposition of all Government-owned property. [[102]](#footnote-103)102 In addition, an advance funding procedure was used whereby the Government provided funds in advance of contract performance to meet the contractors' costs. [[103]](#footnote-104)103 These factors, taken together, appear to portray the contractors as "agents" of the government and therefore immune from taxation. [[104]](#footnote-105)104 However, prior to July 1, 1977, the Government's contracts with the three contractors did not even refer to the contractors as Government agents. [[105]](#footnote-106)105

On the other hand, the Supreme Court listed the following factors indicating the three contractors were not agents of the AEC. **[\*100]** First, the contractors placed orders with third-party suppliers in their own name and held themselves out as the buyers. [[106]](#footnote-107)106 Second, the contractors were not required to obtain advance approval from the Government for each purchase. [[107]](#footnote-108)107 Third, the Government readily disclaimed liability for acts committed by the contractors' employees. [[108]](#footnote-109)108 In addition, the Government maintained that the contractor's employees could not have any direct claim against the Government for labor-related grievances. [[109]](#footnote-110)109 Finally, the Court noted that the contracts had been amended two years after commencement of litigation to provide that the contractors were agents of the Government for certain limited purposes. [[110]](#footnote-111)110

The Government conceded that the legal incidence of the gross receipts and use taxes fell on the contractors. [[111]](#footnote-112)111 The Supreme Court unanimously agreed and showed little hesitation in concluding that "the contractors remained distinct entities pursuing 'private ends,' and that their actions remained commercial activities carried on for profit." [[112]](#footnote-113)112 However, with greater difficulty, the Court also concluded that New Mexico had also properly applied its sales tax to sales from other vendors to the contractors. [[113]](#footnote-114)113 Here, the Government, relying on the case of ***Kern****-Limerick v. Scurlock,* [[114]](#footnote-115)114 argued that the contractors were procurement agents of the Government and therefore the sales should be treated, in essence, as a sale to the Government. [[115]](#footnote-116)115

In ***Kern****-Limerick,* the government contractor, ***Kern***-Limerick, acted as a purchasing agent for the Government under a cost-plus-fixed-fee contract to supply tractors to the Navy. [[116]](#footnote-117)116 In this capacity, ***Kern***-Limerick was subject to an Arkansas sales tax for tractors purchased in Arkansas. [[117]](#footnote-118)117 Much like *New Mexico,* the contract provided that title passed directly from the seller to the Government and the Government **[\*101]** was directly responsible to the seller for the purchase price. [[118]](#footnote-119)118 However, in this case the Supreme Court ruled that the Arkansas sales tax was invalid holding the legal incidence of the tax fell directly upon the Government through its agent, ***Kern***-Limerick. [[119]](#footnote-120)119

Despite the complexity of the *New Mexico* sales tax, the Court highlighted the factual differences between ***Kern****-Limerick* and *New Mexico* and concluded 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." [[120]](#footnote-121)120 Therefore, even though title to the property passed directly from the seller to the Government, the transaction did not constitute a purchase by Government. [[121]](#footnote-122)121

Seventeen years later, in *Arizona Department of Revenue v. Blaze Construction Co.,* [[122]](#footnote-123)122 the Supreme Court reaffirmed its decision in *New Mexico* in holding that Arizona may impose a nondiscriminatory tax upon a private company's proceeds from contracts with the Government. [[123]](#footnote-124)123 Under the facts of *Blaze,* the Federal Lands Highways Program gives the Government the authority to finance road construction and improvement projects on federal public roads, including those on Indian reservations. [[124]](#footnote-125)124 The allocation of funds and the planning of specific projects are distributed among various Government agencies. [[125]](#footnote-126)125 The authority to construct Indian reservation roads lies with the Commissioner of Indian Affairs. [[126]](#footnote-127)126 For a period of several years, Blaze Construction Company (Blaze) contracted with the Government, through the Bureau of Indian Affairs, to construct, repair, and improve roads on a number of Indian reservations. [[127]](#footnote-128)127 Upon contract completion, the Arizona Department of Revenue issued a tax deficiency **[\*102]** assessment against Blaze for failing to pay Arizona's transaction privilege tax on the contract proceeds. [[128]](#footnote-129)128

In reaching its decision in Blaze, the Court articulated the following three rationales for upholding the Arizona tax: Blaze was not an agency or instrumentality of the Government, [[129]](#footnote-130)129 the incidence of the tax fell on Blaze, not the Government, [[130]](#footnote-131)130 and Congress had not expressly exempted Government contractors from taxation. [[131]](#footnote-132)131 Not surprisingly, these rationales are identical to those the Court outlined in its *New Mexico* opinion. [[132]](#footnote-133)132 The Court commented that "this 'narrow approach' to the scope of governmental tax immunity 'accorded with competing constitutional imperatives, by giving full range to each sovereign's taxing authority.'" [[133]](#footnote-134)133 Thus, according to the Court, any expansion of constitutional immunity given to the Government and its instrumentalities must be expressly provided for by Congress. [[134]](#footnote-135)134

b. State Discrimination Against Government Contractors

Despite the Supreme Court's narrowing of the Government's immunity in cases involving nondiscriminatory taxes, the Court has adhered to the fundamental principle that the Supremacy Clause prohibits state taxes that discriminate against the Government. [[135]](#footnote-136)135 Thus, state taxes on Government contractors are invalid if they discriminate against the Government. [[136]](#footnote-137)136 As will be shown, this is not always the case.

In *Washington v. United States,* [[137]](#footnote-138)137 the Government sought declaratory and injunctive relief and an order for refund of sales tax revenues which the state of Washington had collected from contractors engaged in construction of Government projects. [[138]](#footnote-139)138 The Government alleged that the sales tax was invalid under the Supremacy Clause of the **[\*103]** United States Constitution. [[139]](#footnote-140)139 Prior to 1941, the State of Washington treated building contractors as consumers for sales tax purposes. [[140]](#footnote-141)140 The legal incidence of the tax was on the contractor; whether he was under contract with the Government or with a private entity. [[141]](#footnote-142)141

In 1941, Washington amended its sales tax system as applied to private construction contractors by defining the landowner, rather than the private contractor, as the consumer. [[142]](#footnote-143)142 In doing so, Washington shifted the legal incidence of the tax to the landowner, who was then required to pay tax on the full price of the construction project. [[143]](#footnote-144)143 This change was aimed at increasing the overall tax base by including the contractor's mark-up on materials, labor costs and profit. [[144]](#footnote-145)144 When the Government was the landowner, however, Washington could not collect any tax on the sale because the Supremacy Clause also prohibits states from taxing the Government directly. [[145]](#footnote-146)145 Thus, Washington lost all sales tax revenues on Government construction projects. [[146]](#footnote-147)146

In 1975, Washington eliminated the complete tax exemption for construction work purchased by the Government. [[147]](#footnote-148)147 As a result, the state now divided construction contractors into two categories: (1) those performing construction services on real property owned by the Government; and (2) those performing construction services for the state or a private party. [[148]](#footnote-149)148 With regard to the first category, the legal incidence of the sales and use taxes was on the Government construction contractors and they were liable for the taxes on material incorporated in their projects. [[149]](#footnote-150)149 With respect to construction contractors for the state or private parties, however, there were no sales or use tax liability for materials incorporated in their projects. Instead, the legal incidence of the taxes fell upon the landowners and they were liable for tax on the full price of the project including labor costs, costs of materials and mark-ups thereon, and profit. [[150]](#footnote-151)150 Thus, taxes on Government contracts are applied at the contractor level, whereas taxes on state or private parties are applied at the landowner level for nonfederal projects. The Government argued that the tax was invalid **[\*104]** because Washington had circumvented the Government's tax immunity by unconstitutionally discriminating against its private contractors. [[151]](#footnote-152)151

In response to the Government's argument that the Supreme Court not consider the economic burden on the contractor and the land owner together, 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 Government contractor was that the amount of tax was less for the Government contractor. [[152]](#footnote-153)152 The Court further stated, "[t]he Federal Government and federal contractors are both *better off* than other taxpayers because they pay less tax than anyone else in the State. This hardly seems, on its face, to be the mistreatment of the Federal Government against which the *Supremacy Clause* protects." [[153]](#footnote-154)153 Looking at the whole tax structure, the Court rejected the notion that the Washington statutory scheme did not provide a political check on abusive taxations by the state. [[154]](#footnote-155)154 Instead, the Court concluded that as long as the tax imposed on Government contractors is an integral part of a Washington's tax system that applies equally to the entire state, "there is little chance that the State will take advantage of the Federal Government by increasing the tax." [[155]](#footnote-156)155

In the end, the Supreme Court concluded that the state of Washington, through its amended tax scheme, had not singled out Government contractors for discriminatory treatment. [[156]](#footnote-157)156 Instead, the state of Washington took measures to avoid imposition of a tax directly on the Government, while at the same time not forfeiting tax revenues. [[157]](#footnote-158)157 Therefore, according to the Court, the state did not violate the Supremacy Clause. [[158]](#footnote-159)158

C. Federal and State Statutory Immunity

Congress has the power to expand, modify, waive, or define the scope of immunity from state taxation by specific legislation. [[159]](#footnote-160)159 In fact, Congress did just that for the AEC by passing the Atomic Energy Act of **[\*105]** 1946. [[160]](#footnote-161)160 The sales tax protection contained in the Atomic Energy Act was short lived as it was repealed six years later following the Supreme Court's decision in *Carson v. Roane-Anderson.* [[161]](#footnote-162)161

In *Roane-Anderson,* the Supreme Court considered a Tennessee sales and use tax imposed on AEC management contractors. [[162]](#footnote-163)162 This case differed from other tax immunity cases in that section 9(b) of the Atomic Energy Act of 1946 expressly prohibited state and local taxation of AEC activities. [[163]](#footnote-164)163 As a result, the Court found that Congress had expressly exempted AEC contractors from state taxation because; the "operations of management contractors were AEC activities." [[164]](#footnote-165)164 In response to the *Roane-Anderson* decision Congress repealed the tax exemption provision of section 9(b), [[165]](#footnote-166)165 in an effort to "place the Commission and its activities on the same basis, with respect to immunity from State and local taxation, as other Federal agencies." [[166]](#footnote-167)166 In explaining the statutory change, the Senate Report contained the following:

This decision has the effect of affording the Atomic Energy Commission an exemption from State and local taxation much broader in scope than that available to the other departments and agencies of the Federal Government, which rely only upon the constitutional immunity of the Federal Government for their exemption from taxation. The Supreme Court, in Alabama v. King and Boozer, 314 U.S. 1 (1941), established the principle that the constitutional immunity does not extend to cost-plus-fixed-fee contractors of the Federal Government, but is limited to taxes imposed directly upon the United States. Thus, the Atomic Energy Commission's contractors, by reason of the statutory exemption as interpreted by the Supreme Court, are entitled to an exemption from taxation which is not enjoyed by comparably situated contractors of other agencies and departments. A number of States have expressed the view that section 9 (b), as interpreted in the *Roane-Anderson* decision carves out an area of exemption from State and local **[\*106]** taxation which deprives State and local governmental units of substantial revenue, particularly in those areas in which the Atomic Energy Commission carries on large scale activities. [[167]](#footnote-168)167

Rather than according all Government contractors the same treatment by exempting all from state and local sales tax, Congress chose to eliminate the AEC exemption. The states' tax revenue apparently required the repeal. Congress appeared content with the additional costs the lack of statutory immunity would likely add to the Government's procurement budget.

Despite the lack of federal statutory authority exempting a contractor from state and local taxation, many states contain exemption clauses of their own. For example, some state statutes may contain an express exemption for sales made to the Government or its instrumentalities, or a provision in general terms declaring that the sales tax shall not be applicable in a situation where it could not be constitutionally imposed. [[168]](#footnote-169)168 Thus, some states will allow the Government's immunity to pass through to the contractor if certain **[\*107]** conditions are met. [[169]](#footnote-170)169 In addition, states may allow an exemption pertaining to the sale of tangible personal property for resale; typically referred to as the "sale for resale" exemption. [[170]](#footnote-171)170

IV. PRIVATIZATION AND COMPETITIVE SOURCING INITIATIVES

In an effort to become more competitive in the marketplace, private corporations have historically slashed costs and increased efficiencies by downsizing workforces, consolidating facilities, and outsourcing non-core functions. [[171]](#footnote-172)171 Similarly, the end of the Cold War and the reduction of DOD spending create a strong need to reform the manner in which the Government procures goods and services. [[172]](#footnote-173)172 To ensure current and future readiness in a fiscally constrained environment, the DOD has turned to privatization and competitive sourcing as a way to free up resources for it highest priorities. [[173]](#footnote-174)173 However, there is one significant difference in outsourcing between the DOD and the private sector--privatization and competitive sourcing for the DOD results in increased exposure to state and local sales taxation.

A. Overview of Competitive Sourcing

According to longstanding national policy, the Government will not compete with its citizens, but instead should rely on commercial sources for the goods and services it needs. [[174]](#footnote-175)174 Provided, of course, these **[\*108]** goods and services can be procured more economically from commercial sources. [[175]](#footnote-176)175 Competitive sourcing is a process used by the Government to procure goods and services from commercial sources outside of the affected agency. [[176]](#footnote-177)176 Traditionally, this means the agency "transfers a function performed by an in-house organization to an outside service provider." [[177]](#footnote-178)177 The agency still provides appropriate oversight, however, the outside organization is typically granted some degree of flexibility regarding the how the work is performed. [[178]](#footnote-179)178

The Federal Activities Inventory Reform (FAIR) Act of 1998 [[179]](#footnote-180)179 outlines the statutory requirements for identifying and reporting commercial activities that may be subject to competitive sourcing. In addition, the Office of Management and Budget (OMB) Circular A-76, dated May 29, 2003, provides instructions for conducting competitions and preparing estimates. [[180]](#footnote-181)180

In general, Circular A-76 provides an analytical framework the Government uses to decide the best provider for the products and services it needs. [[181]](#footnote-182)181 The FAIR Act, on the other hand, originally published as the regulatory guidance of Circular A-76, codified the requirement to conduct an annual inventory of commercial activities. [[182]](#footnote-183)182 **[\*109]** Under the FAIR Act, each Government agency must provide the OMB a list of the commercial functions performed in that agency that are not inherently governmental. [[183]](#footnote-184)183 In addition, the FAIR Act provides that each time the Government agency considers contracting out for the performance of an activity included on the FAIR Act inventory, the agency must use a competitive process in selecting the contractor. [[184]](#footnote-185)184 Moreover, the Government agency must ensure that when a cost comparison is used, all costs are considered and the costs considered are realistic and fair. [[185]](#footnote-186)185 For example, Army Regulation 5-20 requires an evaluation of the impact state and local sales tax payments paid by the contractor for Government materials and supplies will have on any costs savings to the Government. [[186]](#footnote-187)186

B. Overview of Military Housing Privatization Initiative

In general, privatization takes place when the Government stops providing certain goods and services directly. [[187]](#footnote-188)187 Unlike competitive sourcing, however, privatization involves a transfer of ownership and not just a transfer of performance. [[188]](#footnote-189)188 Thus, when an activity is privatized, using the Military Housing Privatization Initiative (MHPI) [[189]](#footnote-190)189 as an example, the level of Government involvement is altered.

In 1996, Congress established the MHPI as a tool to help the military improve the quality of life for its service members by improving the conditions of military provided housing. [[190]](#footnote-191)190 Under the provisions of the MHPI, Congress provided the DOD with a number of special authorities with a goal toward eliminating its aging housing facilities. [[191]](#footnote-192)191 The MHPI implementation provisions are unlike traditional military construction methods. [[192]](#footnote-193)192 Rather, the MHPI contains a number **[\*110]** of unique features designed to meet the intent of Congress--"MHPI was designed and developed to attract private sector financing, expertise and innovation to provide necessary housing faster and more efficiently than traditional Military Construction processes would allow." [[193]](#footnote-194)193 Thus, Congress included the ability to lease existing federal property to private development companies. [[194]](#footnote-195)194 Unlike traditional military construction projects, ownership of the privatized housing units is vested in the private developer--not the DOD. [[195]](#footnote-196)195 After the project is awarded the developers then build, own, and manage the housing units for a number of years. [[196]](#footnote-197)196 In return, the military tenants provide the developer with an income stream through assignment of their Basic Allowance of Housing with pay allotments. [[197]](#footnote-198)197 The military service Secretaries can also enter into direct loans and loan guarantees in order to assist the developer in financing the military housing project. [[198]](#footnote-199)198

In addition to receiving financial assistance from the DOD, the private developer will likely seek private financing as well. [[199]](#footnote-200)199 This is very different from traditional methods where the Government pays a contractor, usually a fixed price, upon completion of the project and owns all the houses, equipment, and eventual management of the new units. [[200]](#footnote-201)200 Under MHPI, however, the private developers own the housing units which are then placed in leaseholds for a suitable period of time. [[201]](#footnote-202)201

**[\*111]** C. Consequences of Applying the Legal Incidence of Tax

Congress has directed the DOD to competitively source their commercial activities in order to produce quality goods and services at fair and reasonable costs. [[202]](#footnote-203)202 Yet, competitive sourcing is useful only to the extent it produces savings. [[203]](#footnote-204)203 As discussed above, purchases of goods and services made directly by the Government are immune from state taxation. [[204]](#footnote-205)204 However, when a contractor in performance of a Government contract makes the purchase, the right to an exclusion from state and local taxes may not necessarily rest on the Government's immunity. [[205]](#footnote-206)205 Instead, immunity must be found in a statutory exemption, if available, from Congress or the particular taxing jurisdiction. [[206]](#footnote-207)206

Consider the following scenario: The Government conducts an A-76 study to determine whether to transfer routine maintenance at a military installation in State X from in-house performance to contract. Pursuant to the terms of the proposed contract, the Government contractor will be required to furnish all supplies and materials needed in performance of the maintenance contract. State X imposes a tax upon the retail sale of tangible personal property and services purchased in the state. Applying the legal incidence of tax test to this procurement action, a court would first determine if the legal incidence of tax fell on the Government.

Prior to the A-76 study, State X could not tax the purchase of supplies and materials by the military installation. This is because the legal incidence of the sales tax would be directly on the Government as the purchaser. However, once the maintenance service is moved to contract, any purchase of supplies or materials by the contractor pursuant to the terms of the contract would be subject to State X sales tax because the legal incidence of tax would fall on the private contractor. This assumes, of course, the State X tax is not applied in a discriminatory manner, which would be the court's second prong of the analysis. [[207]](#footnote-208)207 As a result, these additional sales tax costs, in turn, would be passed through to the Government or otherwise built into the overall contract price, depending on the form of contract used. Although the **[\*112]** legal incidence of the tax falls on a non-governmental entity, the economic incidence of the tax clearly falls on the Government.

Similarly, the move to privatization of military family housing is not going unnoticed by state and local governments. [[208]](#footnote-209)208 The development and construction of several hundred new housing units around a military installation can have a positive impact on the local community's tax revenues. [[209]](#footnote-210)209 Aside from the creation of additional jobs, sales tax revenues are generated as a result of local purchasing of building materials and supplies. [[210]](#footnote-211)210 Ultimately, the potential tax revenues resulting from a MHPI project to state and local authorities can be extraordinary. [[211]](#footnote-212)211

Congress has not exempted MHPI projects from state and local sales and use taxes jurisdiction. Instead, the MHPI authorizes direct loans and loan guarantees, [[212]](#footnote-213)212 rental occupancy guarantees, [[213]](#footnote-214)213 and differential payments to supplement service members' housing allowances. [[214]](#footnote-215)214 By using available Government assets, the DOD seeks to entice the private sector to use its capital to invest in construction and renovation of military housing. [[215]](#footnote-216)215 However, completion of a housing development can be greatly delayed when the private developer is financially unable to complete the housing project or repay the Government loan guarantee.

Despite the various guarantees from the Government, private developers can and will run into financial difficulties. Recently, American Eagle Communities encountered financial difficulties and had to stop construction at three separate Air Force installations and fell two years behind at a fourth. [[216]](#footnote-217)216 As a result, the Air Force is now left to try and re-bid the projects to another developer. The specifics behind the financial difficulties have not been disclosed but the developer indicated **[\*113]** that costs for the projects were expected to exceed anticipated demand for the military houses. [[217]](#footnote-218)217

Sales tax burdens, then, are virtually inevitable. Because all cost savings to the Government resulting from greater efficiency of operation by contractors, or from a system of competitive bidding, would at least partially be offset by the tax burden, an understanding of the tax liability likely to be faced by contract operators is critical to an intelligent evaluation of management options. In addition, an understanding of the impact on United States sovereign resulting from state taxation of Government procurement operations is critical when determining whether the legal incidence of tax is the appropriate test to apply. Perhaps the courts should adopt an alternative test by looking at the economic substance of a transaction rather than its legal form when evaluating state taxation of Government contractors.

V. AN ALTERNATIVE TO THE LEGAL INCIDENCE RULE

The power to tax is one of the most important incidents of sovereignty. [[218]](#footnote-219)218 However, a right to tax without limit or control is essentially a power to destroy. [[219]](#footnote-220)219 Indeed, tax conflicts have existed between states and Government instrumentalities and contractors for nearly one hundred and ninety years. One notable reason for the continuous conflict is the unique sovereignty implications. [[220]](#footnote-221)220 In an effort to forestall this "clashing sovereignty," [[221]](#footnote-222)221 the Supreme Court has 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." [[222]](#footnote-223)222 Moreover, nowhere else in the law does the validity of taxation seem to turn so great an extent on the mere form of taxation in question.

A. Substance Over Form in Federal Tax Cases

According to current Supreme Court jurisprudence, the dispositive analysis in adjudicating Government contractor tax immunity cases is determining where the legal incidence of the tax falls. [[223]](#footnote-224)223 In terms of sales and use tax statutes, the statutory language **[\*114]** determines the legal incidence of the tax. The entity legally responsible for paying the tax bears the legal incidence of the tax. [[224]](#footnote-225)224 Alternatively, economic substance of the tax focuses on the entity that is ultimately responsible for paying the tax. [[225]](#footnote-226)225 Beginning with *Dravo,* the Supreme Court has abandoned the economic incidence test in contractor tax immunity cases. [[226]](#footnote-227)226 Thus, when the legal incidence of the tax falls on the Government, the state cannot enforce the tax. [[227]](#footnote-228)227 When the legal incidence falls on the Government contractor, however, state taxation is permitted, provided it does not discriminate against or severely interfere with Government operations. [[228]](#footnote-229)228 The legal incidence test elevates form over substance, and allows state legislatures to shift the economic burden of tax to the Government.

Some scholars have suggested that "the unique features of tax law, including its high level of detail, frequent revision, and largely self-contained nature, require a special set of interpretive tools." [[229]](#footnote-230)229 In particular, these scholars have argued that the underlying structure or purpose of the tax law may dictate results that are difficult or impossible to reach using nontax interpretive methods. [[230]](#footnote-231)230 Just as important, however, the revenue effect of particular tax decisions and their consequences for real-world transactions is also relevant. As will be shown below, purposive analysis has a strong appeal in tax cases.

Courts use the judicially created doctrine of substance over form to adjudicate tax cases based on the economic substance of a transaction rather than its legal form. [[231]](#footnote-232)231 The doctrine first originated in *Helvering v. Gregory,* [[232]](#footnote-233)232 in which the Court held that the taxpayer's transaction lacked substance and was nothing more than "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." [[233]](#footnote-234)233 In *Gregory,* the taxpayer, Mrs. Gregory, held all of the stock of United Mortgage Corporation (United), which in turn held the stock of Monitor Corporation (Monitor). [[234]](#footnote-235)234 Mrs. Gregory wished to **[\*115]** withdraw the Monitor stock from United so that she could sell it without incurring tax liability. [[235]](#footnote-236)235 Since a straightforward distribution of the Monitor securities to her in anticipation of the sale would have been taxable as a dividend, she devised a scheme whereby the stock was transferred from United to a newly formed subsidiary, Averill Corporation (Averill), in exchange for Averill's stock. [[236]](#footnote-237)236 United then distributed Averill's stock to Mrs. Gregory in a transaction that qualified as a tax-free spin-off or corporate reorganization under the Revenue Act of 1928. [[237]](#footnote-238)237 Mrs. Gregory subsequently sold the Averill stock to a third party, recognizing long-term capital gain on the sale. [[238]](#footnote-239)238 After the series of transactions was complete, it was clear that Mrs. Gregory had used the reorganization rules to secure favorable capital gain treatment for what, in substance was an ordinary dividend distribution. [[239]](#footnote-240)239

The Board of Tax Appeals (BTA) ignored the substance of the transaction and upheld the tax-free corporate reorganization treatment on the ground that "a statute [the reorganization statute] so meticulously drafted must be interpreted as a literal expression of tax policy." [[240]](#footnote-241)240 In the BTA's view, Averill was entitled to recognition, despite its transitory life as a vehicle to transfer the securities from United to Mrs. Gregory, the sole shareholder. [[241]](#footnote-242)241 The Second Circuit, however, reversed the BTA's decision, holding that the transaction did not qualify as a "reorganization" when the purpose of the statutory definition of that term was taken into account. [[242]](#footnote-243)242

The Supreme Court affirmed the Second Circuit's decision [[243]](#footnote-244)243 In the Court's view, the purpose of the conveyance was not to reorganize the business, but rather to transfer the original corporation's assets to the shareholder, Mrs. Gregory. [[244]](#footnote-245)244 With this decision, the Court created the substance over form doctrine.

Two other cases of notable importance in the substance over form area are *Crane v. Commissioner* [[245]](#footnote-246)245 and *Commissioner v. Tufts.* [[246]](#footnote-247)246 *Crane* involved the treatment of gain when the taxpayer transferred property encumbered by liabilities. In *Crane,* the taxpayer was the sole **[\*116]** beneficiary under the will of her deceased husband. [[247]](#footnote-248)247 At his death, they owned an apartment building that was mortgaged for an amount equal to its fair market value of $ 262,000. [[248]](#footnote-249)248 The amount of the mortgage was $ 255,000 and included additional interest in default in the amount of $ 7000. [[249]](#footnote-250)249 Following her husband's death the taxpayer operated the building just over six years. [[250]](#footnote-251)250 During this time she claimed tax deductions for depreciation and other expenses, but did not make payments upon the mortgage principal. [[251]](#footnote-252)251 Unable to make a profit and facing foreclosure, the taxpayer sold the building to a third party for $ 3000. [[252]](#footnote-253)252 Upon the sale, the taxpayer reasoned that her basis was limited to the equity in the property (zero), and that her gain on the sale was limited to the amount received, $ 2500. [[253]](#footnote-254)253 The Tax Commissioner disputed this claim and asserted that the taxpayers' basis was $ 262,000, reduced by $ 28,000 in depreciation deductions. [[254]](#footnote-255)254 The Supreme Court agreed and further found that the taxpayer realized $ 255,000 in income when the buyer relieved her of the mortgage. As a result, her net gain was not $ 2500, but instead was $ 24,000. [[255]](#footnote-256)255

*Commissioner v. Tufts* involves facts similar to *Crane,* except the taxpayer's property had declined in value to an amount less than the nonrecourse loan. The property was conveyed to a third party purchaser, subject to the original loan, but without any additional consideration. [[256]](#footnote-257)256 The Supreme Court held that the taxpayer must include in the amount realized on the transaction the full face amount of the nonrecourse loan, even though the property was worth less than this amount at the time of the transfer and the taxpayer accordingly would have been unlikely ever to repay the loan. [[257]](#footnote-258)257 *Tufts* extends the logic of *Crane,* suggesting that relief from nonrecourse debt must be treated as **[\*117]** income regardless of whether it would have been in the taxpayer's economic interest to repay the loan. [[258]](#footnote-259)258

The statute at issue in both *Crane* and *Tufts* stated that the amount realized on a sale of property shall be "the sum of any money received plus the fair market value of the property (other than money) received." [[259]](#footnote-260)259 The statute was silent, however, regarding whether a transfer of debt-encumbered property results in taxable income. As such, the taxpayers in *Crane* and *Tufts* argued the literal meaning of the statute, albeit unsuccessfully, that the amount realized from the transfer should not include the debt. [[260]](#footnote-261)260 However, *Crane* and *Tufts* can be classified as purposive decisions where the Court has placed substance over form to prevent taxpayers from being unjustly enriched through loan provisions. [[261]](#footnote-262)261

Although these cases involve the Internal Revenue Service's (Service) use of substance over a taxpayer's form, the substance over form doctrine extends concordant treatment to both the Service and taxpayers. "This preference for substance over form in tax matters extends to claims of petitioner and respondent alike." [[262]](#footnote-263)262 Moreover, "one should not be garroted by the tax collector for calling one's agreement by the wrong name." [[263]](#footnote-264)263 Thus, just as the Service can look through the form initially adopted by the taxpayer, the taxpayer can similarly disregard her own form in favor of a transaction's true substance.

One of the classic cases articulating a taxpayer's right to assert substance over form is *Bartels v. Birmingham.* [[264]](#footnote-265)264 In *Bartels,* the taxpayers, dancehall operators, entered into contracts with various bandleaders. [[265]](#footnote-266)265 Those contracts provided that the taxpayers were the employers of the bandleaders and their musicians. [[266]](#footnote-267)266 At trial, the **[\*118]** taxpayers argued, in direct contravention of the contracts, that the bandleaders were themselves independent contractors and were the employers of their own musicians. [[267]](#footnote-268)267 The Supreme Court disregarded the Service's attempt to hold the taxpayers to the legal form they had adopted and instead allowed the dancehall operators to argue, and ultimately to establish, that in substance the bandleaders were independent contractors. [[268]](#footnote-269)268 The Court concluded that "the contractual language did not authorize the Service to collect taxes from one not covered by the taxing statute." [[269]](#footnote-270)269

These cases demonstrate that courts have employed the use of the judicially created doctrine of substance over form to protect the integrity of the tax system. Substance over form provides the courts with the ability to adjudicate tax cases based on the economic reality of the transaction and helps ensure that taxpayers abide by the purpose of the particular taxing statute. Conversely, examining a taxpayer's purpose behind a particular transaction over the Service's literal interpretation also enforces the legitimacy of the tax code. Thus, without substance over form, the tax law becomes a hollow shell subject to the whim of a few carefully structured transactions. [[270]](#footnote-271)270

B. Analysis of the Rationales in Support of Economic Incidence of Tax

Sales and use taxes have been the subject of many, perhaps a majority, of the cases dealing with federal immunity in the context of Government contracts. The impact of cases like *New Mexico* and *Washington,* in a formalistic sense, indicates that any sales or use tax, the incidence of which is on the contractor, is valid. Moreover, these cases expose the potential revenues that may be obtained by a state under the proper tax scheme. *New Mexico* is particularly notable because of the amount of tax liability ultimately stipulated between New Mexico and the United States. [[271]](#footnote-272)271 The amount agreed to and ultimately paid to the state was approximately $ 280 million. [[272]](#footnote-273)272 In *Washington,* the state legislature amended its sales tax scheme in order derive additional revenue from contractors doing business with the Government. Indeed, reexamination of federal tax immunity seems all the more urgent in view of the Supreme Court's tendency to reason across the various areas of constitutional tax immunity.

**[\*119]** Substance-over-form principles can override a result achieved by a technical reading of the text of a particular statute. [[273]](#footnote-274)273 Textualism, on the other hand, requires that statutes be implemented on the basis of what the text means. [[274]](#footnote-275)274 *Washington* is a decision where the Supreme Court put form over substance to the benefit of the state because the amended sales tax statutes had no relationship to economic realities. The Court could have used the common law doctrine of substance over form to evaluate the policy underlying the Washington tax scheme. Washington's principal source of revenue was the sales and use tax. [[275]](#footnote-276)275 In order to eliminate the tax exemption enjoyed by Government contractors and increase revenues, Washington amended its sales tax system moving the legal incidence of the sales tax back on the contractor. [[276]](#footnote-277)276 As a result, the Court determined that for Government **[\*120]** projects the legal incidence of the tax fell on the contractor rather than the Government landowner. [[277]](#footnote-278)277 Although the Court focused its decision on whether the state circumvented the Government's immunity by identifying a federal activity for different tax treatment, the Court nevertheless took a textualist approach missing an opportunity to decide the case based on economic realities. This approach has its perils, however, because it shows how a state can manipulate a tax statute so that the legal incidence falls on a non-governmental instrumentality. Thus, by changing a few words in a tax statute, the state is able to essentially tax Government operations as long as the nondiscriminatory legal incidence of the tax is on the contractor. The fact that the economic incidence of the tax falls on the Government has been deemed irrelevant by the Court. [[278]](#footnote-279)278 However, analysis of the economic incidence may be evidence of legislative intent as to who is actually intended to pay the tax.

For example, in *United States v. Mississippi Tax Commission,* [[279]](#footnote-280)279 a Tax Commission regulation required payment of a tax in the form of a wholesale markup to be collected by out-of-state liquor distillers and suppliers to military installations in the state. [[280]](#footnote-281)280 The amount of the markup was between 17-20%. [[281]](#footnote-282)281 The Tax Commission did not attempt to collect the tax directly from the nonappropriated fund activities, but instead compelled the out-of-state suppliers to collect the tax for it. [[282]](#footnote-283)282 The Supreme Court found that the Tax Commission clearly intended that out-of-state suppliers pass on the markup to the military purchasers. [[283]](#footnote-284)283 As such, according to the Court, the legal incidence of the markup was plainly upon the military and therefore prohibited. [[284]](#footnote-285)284 In **[\*121]** deciding this case, the Court looked at the economic burden of the tax in determining the Tax Commission's intent. Thus, statutory incidence depends not on legal liability for the tax but on legislative intent. In addition to considering substance over form, the economic realities may be a strong indication of intent.

Seven years later, the Supreme Court decided *New Mexico,* which involved the application of New Mexico's gross receipts and use taxes upon three Government contractors. The state of New Mexico imposed a gross receipts tax which operated as a tax on the sale of goods and services. [[285]](#footnote-286)285 In addition, a compensating use tax was also levied "for the privilege of using property in New Mexico." [[286]](#footnote-287)286 Neither tax, however, was imposed on the "receipts of the United States or any agency or instrumentality thereof," or on the "use of property by the United States or any agency or instrumentality thereof." [[287]](#footnote-288)287 The Court determined that because the statute places the legal incidence on the Government contractors, the gross receipts and compensating use taxes were valid. [[288]](#footnote-289)288

The Court applied a substance over form analysis in determining that constitutional tax immunity requires something more than "the invocation of traditional agency notions." [[289]](#footnote-290)289 The Court further stated, "[W]e cannot believe that an immunity of constitutional stature rests on such technical considerations, for that approach allows 'any governmental functionary to draw the constitutional line by changing a few words in a contract.'" [[290]](#footnote-291)290 However, this is exactly what the state did in *Washington* when it amended its sales tax system.

By not continuing its substance over form analysis when determining the legal incidence of the gross receipts and use tax, the **[\*122]** *New Mexico* Court ignored it previous decision in *Mississippi* [[291]](#footnote-292)291 and took a textualist approach in deciding the case on the plain-language of the statues. Thus, according to the Court, if the government performs the work itself, then tax immunity applies. [[292]](#footnote-293)292 However, when the government contracts out, for example, to tap the expertise of industry, then its operations will be subject to taxation. [[293]](#footnote-294)293 Even though the legal incidence falls on the Government contractor, the economic costs are ultimately passed on to the Government. There are, however, some limitations imposed by the Federal Acquisition Regulation (FAR). [[294]](#footnote-295)294

The FAR addresses state and local taxes in one of two ways. First, cost-reimbursement types of contracts provide for payment of allowable incurred costs, to the extent prescribed in the contract. [[295]](#footnote-296)295 This type of contract is generally suitable for use when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use a fixed-price contract. [[296]](#footnote-297)296 State and local taxes are generally allowable costs and reimbursable to the contractor under cost-type contracts. [[297]](#footnote-298)297 Thus, under cost-reimbursement contracts, contractors serve as conduits for the payment of taxes. However, as they have primary responsibility for the payments of taxes incurred as the result of purchasing goods and services, their position is not without some degree of risk. For example, liability under a consumer type sales tax would be imposed on the contractor upon the retail sale of tangible personal property or services in performance of the contract. Provided the terms of the contract allow reimbursement, the sales taxes would be considered allowable costs. [[298]](#footnote-299)298 Conversely, improper payment of taxes or taxes not accrued in accordance with generally accepted accounting principles may result in non-reimbursable costs to the contractor. [[299]](#footnote-300)299

Firm-fixed-price contracts, on the other hand, generally provide for a price that is not subject to any adjustment on the basis of the contractor's cost-experience in performing the contract. [[300]](#footnote-301)300 This type of contract places upon the contractor maximum risk and full responsibility for all costs and resulting profit or loss. [[301]](#footnote-302)301 Thus, as opposed to a cost-type **[\*123]** contractor, a fixed price contractor usually includes its estimated taxes in the contract price and is not otherwise compensated for such expenses. [[302]](#footnote-303)302 There are circumstances, however, when special tax clauses may include or exclude from the contract price a specific after-imposed or after-relieved federal, state or local tax. [[303]](#footnote-304)303

Despite these restrictions, an examination of the substance and economic reality of a particular sales or use tax statute provides a better outcome and results in greater savings to the Government. Applying the rationale adopted in *Washington,* states are generally free to structure statutes to shift the tax's legal incidence. From a purposive approach, the purpose of the statute seems clear, to tax the Government's procurement activities by statutorily placing the legal incidence of the tax on non-government instrumentalities. Thus, unless the state tax discriminates or interferes with the Government's operations, it will be allowed. If this remains the test, no tax, however great, can prevent the functioning of the government, "so long as the United States' taxing and borrowing powers remain adequate to meet the ordinary expenses of its operations and the added costs of state taxes." [[304]](#footnote-305)304

VI. THE FUTURE OF THE FEDERAL IMMUNITY DOCTRINE

If the purpose of any intergovernmental tax immunity doctrine is to prevent one sovereign from interfering with the governmental functions of another, it must also take into account countervailing state interests and the policy reasons behind them. An absolute prohibition against states levying taxes legally incident on the Government undoubtedly serves a legitimate interest in preventing interference with Government operations. [[305]](#footnote-306)305 However, such absolutism could also have the affect of eroding the state tax base.

The power of taxation by the states is vitally important to the United States system of government. [[306]](#footnote-307)306 Many years before the Supreme Court decided *McCulloch,* Alexander Hamilton thought that the individual states should possess their own separate and independent authority to "raise their own revenues for the supply of their own wants." [[307]](#footnote-308)307 In addition, the courts have also been mindful of the policy **[\*124]** considerations surrounding a state's ability to tax. For example, in *Michelin Tire Corp v. Wages,*[[308]](#footnote-309)308 the Supreme Court addressed the ability of a state to impose a nondiscriminatory ad valorem property tax on imports which increased the cost of the goods. [[309]](#footnote-310)309 In upholding the state tax, the Court stated:

[S]uch taxation is the quid pro quo for benefits actually conferred by the taxing State. There is no reason why local taxpayers should subsidize the services used by the importer; ultimate consumers should pay for such services as police and fire protection accorded the goods just as much as they should pay transportation costs associated with those goods. [[310]](#footnote-311)310

From a policy perspective, it may make more sense that a purchaser of goods and services be held financially accountable for the very protections it enjoys from the state. [[311]](#footnote-312)311 The *Michelin* case further illustrates this point by also highlighting the Court's ability to safeguard the states' power to tax while also balancing the equitable considerations at stake. [[312]](#footnote-313)312 Such equitable trade-offs, however, should be decided in the proper forum--through the political process.

The Court in *McCulloch* was concerned with the lack of political checks in place to prevent the state from abusing its taxing power with respect to Government activities. [[313]](#footnote-314)313 However, by the time *Dravo* [[314]](#footnote-315)314 was decided, this concern had subsided as the Court recognized the power of Congress to protect the performance of the functions of the Government by preventing any attempted state taxation. [[315]](#footnote-316)315 Forty-five years later in *New Mexico,* [[316]](#footnote-317)316 the Court **[\*125]** expounded upon this rationale when it stated that any expansion of tax immunity for Government contractors must come from Congress. [[317]](#footnote-318)317 The Court further explained that the allocation of responsibility is more appropriate for the political process because "it is uniquely adapted to accommodating the competing demands" between two sovereigns. [[318]](#footnote-319)318 Thus, the Court has drawn the line with respect to expansion of the federal immunity doctrine instead leaving any future changes in the hands of Congress.

If Congress is to make any meaningful policy decisions concerning the state and local taxation of Government contractors, it will likely want to consider other areas where the states' ability to tax has been limited. First, Congress has already enacted legislation to prevent state taxation in areas where the states otherwise would be free to tax. The Servicemembers Civil Relief Act [[319]](#footnote-320)319 limits the states' power to tax the personal income and personal property of military personnel who are stationed in the state solely by reason of military orders. [[320]](#footnote-321)320 In general, the states are not allowed to treat military personnel as residents of the state for personal income or property tax purposes. [[321]](#footnote-322)321 The states are also prohibited from treating military compensation of such service member as compensation derived from sources within the state. [[322]](#footnote-323)322 The second area Congress must take into consideration is whether or not the federal reservation or military installation is exempt from property tax and ad valorem taxes as this could also deprive the states of much needed revenue. [[323]](#footnote-324)323

When debating the competing interests at stake, an analysis of the amount of contracting activity across the various states should also be considered. For example, in those states with very little or no Government procurement activity, the competing interests at stake are minimal. However, those states where a large portion of the procurement budget is spent are in the best position to increase their sales tax revenues at the expense of the Government. [[324]](#footnote-325)324 In turn, the Government has a legitimate interest in controlling this additional cost. However, from a policy perspective, it makes no sense why local taxpayers should subsidize the benefits actually received by the **[\*126]** Government and its employees from the taxing state. [[325]](#footnote-326)325 These issues, to include numerous others, will likely need to be debated before any changes are made to the intergovernmental tax immunity doctrine.

VII. CONCLUSION

Sales and use tax implications encompass the entire spectrum of Government procurement practices. As a result, controversies have arisen with disagreements over sovereignty--one sovereign's ability to tax against the others ability to be immune. Historically, conflicts have arisen when states attempt to impose their sales and use taxes on Government contractors. Despite the judicial constriction of federal immunity, the Supreme Court has maintained the central theme to federal immunity from state taxation is the protection of federal functions from interference. [[326]](#footnote-327)326 However, by ignoring the judicially created doctrine of substance over form, the Court has not found it necessary to protect the federal fisc in order to protect the federal function. When applied to tax disputes involving federal income tax, substance over form provides the courts the ability decide cases based on the economic reality of the tax statute. Similarly, courts can use this judicially created tool in determining whether a state's sales and use tax law violates U.S. Constitutional principles. Thus, while the legal incidence of the tax may fall on the Government contractor, the economic reality is that the burden falls on the United States.

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1. 1 McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 327 (1819). [↑](#footnote-ref-2)
2. 2 The use of the term "Government" herein refers to the United States Federal Government. [↑](#footnote-ref-3)
3. 3 *See* Kenneth Weckstein & David Kempler, *Tax Considerations in Government Contracting,* 85-10 Briefing Papers 1 (October 1985). [↑](#footnote-ref-4)
4. 4 *See* FEDERAL PROCUREMENT REPORT FY 2005, FEDERAL PROCUREMENT DATA SYSTEM 13, http://www.fpdsng.com/downloads/FPR\_Reports/2005\_fpr\_section\_I\_total\_federal\_views.pdf (last visited Nov. 26, 2007). [↑](#footnote-ref-5)
5. 5 *See* Memorandum from Edward R. Jones, Deputy Assistant Inspector General for Auditing, Department of Defense, subject: Report on the Audit of DOD Immunity from State Taxation (Project No. OCA-0075) (15 Feb. 1991) (on file with author) [hereinafter Jones Memo]. [↑](#footnote-ref-6)
6. 6 McCulloch, 17 U.S. (4 Wheat.) at 316. [↑](#footnote-ref-7)
7. 7 *Id.* at 432. [↑](#footnote-ref-8)
8. 8 *See* United States v. New Mexico, 455 U.S. 720, 733 (1982) ("While '[one] could, and perhaps should, read M'Culloch . . . simply for the principle that the Constitution prohibits a State from taxing discriminatorily a federally established instrumentality'") (quoting First Agricultural Bank v. State Tax Comm'n, 392 U.S. 339, 350 (1968) (dissenting opinion)). [↑](#footnote-ref-9)
9. 9 New Mexico, 455 U.S. at 735. [↑](#footnote-ref-10)
10. 10 *See* id. at 733 ("[a] State may not, consistent with the Supremacy Clause, U.S. Const. Art VI, cl 2, lay a tax 'directly upon the United States'" (citing Mayo v. United States, 319 U.S. 441, 447 (1943)); *see also* 48 C.F.R. § 29.302(a) (2007) (stating that purchases and leases made by the Government are generally immune from state and local taxation). [↑](#footnote-ref-11)
11. 11 *See* New Mexico, 455 U.S. at 734-36. [↑](#footnote-ref-12)
12. 12 *See* 48 C.F.R. § 29.303(b). [↑](#footnote-ref-13)
13. 13 *See infra* Section V discussing firm-fixed-price and cost-reimbursement contracts provided under the Federal Acquisition Regulation. [↑](#footnote-ref-14)
14. 14 *See generally* American Forces Press Service, *Army Business Initiative Council Recommendations,* DEFENSE AT&L, Jan-Feb 2005, at 52. [↑](#footnote-ref-15)
15. 15 *See* OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, OMB CIRCULAR NO. A-76, PERFORMANCE OF COMMERCIAL ACTIVITIES, Aug. 4, 1983 (Revised May 29, 2003) [hereinafter CIRCULAR A-76]; *see also* Valerie Bailey Grasso, CRS REPORT FOR CONGRESS, *Defense Outsourcing: The OMB Circular A-76 Policy,* Jun. 30, 2005 at 1, *available at* http://www.fas.org/sgp/crs/natsec/RL30392.pdf [hereinafter CRS REPORT] ("Outsourcing is a decision by the government to purchase goods and services from sources outside of the affected government agency"). [↑](#footnote-ref-16)
16. 16 *See* National Defense Authorization Act for Fiscal Year 1996, Pub. L. No. 104-106, § 2801(a)(1), 110 Stat. 186 (Feb. 1996), which amended chapter 169 of title 10 United States Code, to add a new subchapter entitled Alternative Authority to Construct and Improve Military Housing (codified as amended at 10 U.S.C.S §§ 2871-2885 (Lexis 2007)); CRS REPORT, *supra* note 15, at 2 ("[U]nder the umbrella of outsourcing, privatization occurs when the government ceases to provide certain goods or services. When an activity is privatized, the level of the government's involvement is altered, and the government may exercise any one of a number of options"). [↑](#footnote-ref-17)
17. 17 *See generally* CRS REPORT, *supra* note 15, at 1 (stating that as a result of the reduction in force structure following the end of the Cold War, the DOD must further reduce spending to achieve greater cost savings to finance weapons and military equipment modernization). [↑](#footnote-ref-18)
18. 18 *See* ROBERT D. HORMATS, THE PRICE OF LIBERTY: PAYING FOR AMERICA'S WARS 281 (2007) (stating that "Social Security, Medicare, and Medicaid dwarf defense spending and all other parts of the budget and their costs are accelerating rapidly"). [↑](#footnote-ref-19)
19. 19 *See, e.g.,* Dennis Caucon, *States Look to Sales Tax for Funds,* U.S.A. TODAY, Oct. 30, 2007, at A-1 (stating that the governors of Maryland and Indiana each propose increasing their state's sales tax 1 cent in order to raise over $ 1 billion in revenue for their respective states). [↑](#footnote-ref-20)
20. 20 It is beyond the scope of this article to discuss property tax and ad valorem taxes and their application to government procurement activities. In his article, *Article: State Property Tax Implications for Military Privatized Family Housing Program,* Philip Morrison presents an excellent overview of state property tax implications applicable to the military housing privatization initiative. *See* Philip D. Morrison, *Article: State Property Tax Implications for Military Privatized Family Housing Program,* 56 A.F. L. REV. 261 (2005). [↑](#footnote-ref-21)
21. 21 U.S. Census Bureau, State Government Tax Collections: 2006 (Mar. 30, 2007), http://www.census.gov/govs/statetax/0600usstax.html [hereinafter State Collections]. [↑](#footnote-ref-22)
22. 22 WALTER HELLERSTEIN, STATE TAXATION, P 12.01, (3d ed. 2007), *available at* 1999 WL 1398962 (quoting R. HAIG & C. SHOUP, THE SALES TAX IN THE AMERICAN STATES 3 (1934)). [↑](#footnote-ref-23)
23. 23 HELLERSTEIN, *supra* note 22. [↑](#footnote-ref-24)
24. 24 *See* ALFRED BUEHLER, GENERAL SALES TAXATION: ITS HISTORY AND DEVELOPMENTS, 2-5 (1932). [↑](#footnote-ref-25)
25. 25 RICHARD POMP & OLIVER OLDMAN, STATE AND LOCAL TAXATION, 6-6 (3d ed. 1998). The first state to enact a sales tax in response to the economic problems brought on by the Great Depression was Mississippi in 1932. John Due, *The Nature and Structure of Sales Taxation,* 9 VAND. L. REV. 123, 127 (1956). [↑](#footnote-ref-26)
26. 26 Delaware, New Hampshire, Montana, Oregon and Alaska do not have state sales taxes. Alaska, however, uses the sales tax extensively at the local level. *See generally* POMP & OLDMAN, *supra* note 25. [↑](#footnote-ref-27)
27. 27 *See* HELLERSTEIN, *supra* note 22. The broadly drafted manner in which the terms "gross receipts" and "retail sale" are defined is markedly consistent between the states. *See, e.g.,* N.M. STAT. ANN. § 7-9-3.5(A)(1) (LEXIS 2007). New Mexico defines the term "gross receipts" as:

    The total amount of money or the value of other consideration received from selling property in New Mexico, from leasing or licensing property employed in New Mexico, from granting a right to use a franchise employed in New Mexico, from selling services performed outside New Mexico, the product of which is initially used in New Mexico, or from performing services in New Mexico. In an exchange in which the money or other consideration received does not represent the value of the property or service exchanged, 'gross receipts' means the reasonable value of the property or service exchanged.

    *Id.* Kansas defines the term "gross receipts" as:

    The total selling price or the amount received as defined in this act, in money, credits, property or other consideration valued in money from sales at retail within this state; and embraced within the provisions of this act. The taxpayer, may take credit in the report of gross receipts for: (1) An amount equal to the selling price of property returned by the purchaser when the full sale price thereof, including the tax collected, is refunded in cash or by credit; and (2) an amount equal to the allowance given for the trade-in of property.

    KAN. STAT. ANN. § 79-3602(o) (2006). Kansas further defines "retail sale" or "sale at retail" as "any sale, lease or rental for any purpose other than for resale, sublease or subrent." KAN. STAT. ANN. § 79-3602(jj). Missouri defines "gross receipts" as:

    The total amount of the sale price of the sales at retail including any services other than charges incident to the extension of credit that are a part of such sales made by the businesses herein referred to, capable of being valued in money, whether received in money or otherwise; except that, the term 'gross receipts' shall not include the sale price of property returned by customers when the full sale price thereof is refunded either in cash or by credit.

    Mo. REV. STAT. § 144.010(1)(1) (LEXIS 2007). Missouri further defines "sale at retail" as "any transfer made by any person engaged in business as defined herein of the ownership of, or title to, tangible personal property to the purchaser, for use or consumption and not for resale in any form as tangible personal property, for a valuable consideration." Mo. REV. STAT. § 144.010(1)(10). [↑](#footnote-ref-28)
28. 28 HELLERSTEIN, *supra* note 22 (citing JOHN DUE & JOHN MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 28-29 (2d ed. 1994)). [↑](#footnote-ref-29)
29. 29 *Id.* [↑](#footnote-ref-30)
30. 30 HELLERSTEIN, *supra* note 22 (citing Illinois Retailers' Occupation Tax 35 ILL. COMP. STAT. ANN. § 120/2). [↑](#footnote-ref-31)
31. 31 HELLERSTEIN, *supra* note 22 (citing JOHN DUE & JOHN MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 28-29 (2d ed. 1994). [↑](#footnote-ref-32)
32. 32 HELLERSTEIN, *supra* note 22. [↑](#footnote-ref-33)
33. 33 *Id.* (citing JOHN DUE & JOHN MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 28-29 (2d ed. 1994) (operationally hybrid type taxes are closer to consumer type taxes because sellers are not given the opportunity to absorb the tax). [↑](#footnote-ref-34)
34. 34 *See* WALTER HELLERSTEIN, STATE TAXATION, P 16.01, (3d ed. 2007), *available at* 1999 WL 1399001 (citing JOHN DUE & JOHN MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 245 (2d ed. 1994). [↑](#footnote-ref-35)
35. 35 The taxing power of any state extends to all persons, property and business within its jurisdiction. 84 C.J.S. TAXATION 7, 14 (2001). [↑](#footnote-ref-36)
36. 36 *See* HELLERSTEIN, *supra* note 34 (citing JOHN DUE & JOHN MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 245 (2d ed. 1994)). [↑](#footnote-ref-37)
37. 37 *See id.* [↑](#footnote-ref-38)
38. 38 *See, e.g.,* Consumers Co-operative Ass'n v. State Comm'n of Rev and Taxation, 256 P.2d. 850, 853 (Kan. 1953) (describing the Kansas Retailers Sales Tax Act and Kansas Compensating Tax Act as "complementary and supplementary to each other and are construed together generally"); *see also* HELLERSTEIN, *supra* note 34 ("[I]n order to avoid double taxation, every state imposing a use tax allows a credit against its use tax for sales or use tax paid to other states."). [↑](#footnote-ref-39)
39. 39 *See supra* Section II.A. [↑](#footnote-ref-40)
40. 40 *See* HELLERSTEIN, *supra* note 22. [↑](#footnote-ref-41)
41. 41 *See, e.g.,* WASH. REV. CODE § 82.08.020 (LEXIS 2007). The state of Washington levies a tax on each retail sale which is equal to six and five-tenths percent of the selling price. *Id.* Washington further defines the terms "selling price" or "sales price," as:

    The total amount of consideration, except separately stated trade-in property of like kind, including cash, credit, property, and services, for which tangible personal property, extended warranties, or services defined as a 'retail sale' under WASH. REV. CODE § 82.08.050 are sold, leased, or rented, valued in money, whether received in money or otherwise.

    WASH. REV. CODE § 82.08.010(1)(a). The terms "buyer," "purchaser," and "consumer" are defined as:

    Every individual, receiver, assignee, trustee in bankruptcy, trust, estate, firm, co-partnership, joint venture, club, company, joint stock company, business trust, corporation, association, society, or any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise, municipal corporation, quasi municipal corporation, and also the state, its departments and institutions and all political subdivisions thereof, irrespective of the nature of the activities engaged in or functions performed, *and also the United States or any instrumentality thereof.*

    WASH. REV. CODE § 82.08.010(3) (emphasis added). [↑](#footnote-ref-42)
42. 42 This assumes there are no applicable state sales tax exemptions. The amount of the sales tax will vary by state taxing authority. [↑](#footnote-ref-43)
43. 43 *See, e.g.,* KAN. STAT. ANN. § 79-3607 (2006) (stating that the levied tax must be remitted to the director of taxation). [↑](#footnote-ref-44)
44. 44 *See, e.g.,* KAN. STAT. ANN. § 79-3703(a) (2006) (use tax levied on "consideration paid by the taxpayer"); Mo. REV. STAT. § 144.610 (2007) (use tax levied on "sales price"). The use tax measure will never be broader than the sales tax measure as it would then lose its character as a complementary tax and would constitute a facially discriminatory tax on out-of-state purchases. *See also* HELLERSTEIN, *supra* note 34. [↑](#footnote-ref-45)
45. 45 *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 427 (1819). [↑](#footnote-ref-46)
46. 46 *See id.* at 427-28; United States v. New Mexico, 455 U.S. 720, 735 (1982). [↑](#footnote-ref-47)
47. 47 *See* James v. Dravo Contracting Co., 302 U.S. 134, 150 (1937). [↑](#footnote-ref-48)
48. 48 *Id.* [↑](#footnote-ref-49)
49. 49 *See* CHARLES TROST & PAUL HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAX § 6:19 (2d ed. 2007). [↑](#footnote-ref-50)
50. 50 *See generally* New Mexico, 455 U.S. at 730-35. [↑](#footnote-ref-51)
51. 51 17 U.S. (4 Wheat.) 316 (1819). [↑](#footnote-ref-52)
52. 52 *See* Sealy H. Cavin, Jr., *Federal Immunity of Government Contractors from State and Local Taxation: A Survey of recent decisions and their impact on Government Policies,* 61 DENV. L.J. 797, 797 (1983-1984). [↑](#footnote-ref-53)
53. 53 Id. at 798. [↑](#footnote-ref-54)
54. 54 302 U.S. 134 (1937). [↑](#footnote-ref-55)
55. 55 *See* Cavin, *supra* note 52, at 798. [↑](#footnote-ref-56)
56. 56 McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819). [↑](#footnote-ref-57)
57. 57 *See* id. at 320. [↑](#footnote-ref-58)
58. 58 *Id.* [↑](#footnote-ref-59)
59. 59 Id. at 321. [↑](#footnote-ref-60)
60. 60 *See* id. at 320-21. [↑](#footnote-ref-61)
61. 61 *Id.* at 436. [↑](#footnote-ref-62)
62. 62 *Id.* at 427, 436-37. [↑](#footnote-ref-63)
63. 63 *Id.* at 427. Finding no express provision in the Constitution exempting the Bank of the United States from the state's power to tax, the Court stated "[I]t is so involved in the declaration of supremacy, so necessarily implied in it, that the expression of it could not make it more certain. We must therefore keep it in view, while construing the constitution." *Id.* The Supremacy Clause, provides:

    This Constitution, and the Laws of the United States which shall be made in pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme law of the Land; and the Judges in every state shall be bound thereby, any thing in the Constitution or Laws of any State to the contrary notwithstanding.

    U.S. CONST. art. VI, cl. 2. [↑](#footnote-ref-64)
64. 64 *See* McCulloch, 17 U.S. (4 Wheat.) at 428-29. The Court stated:

    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 it constituents. This is in general a sufficient security against erroneous 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 are 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 them, but by the people of the 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.

    *Id.* [↑](#footnote-ref-65)
65. 65 Id. at 430. [↑](#footnote-ref-66)
66. 66 Id. at 431-32. [↑](#footnote-ref-67)
67. 67 The Supreme Court has approached the question of discrimination by inquiring into whether the Government or those with whom it deals are bearing an economic burden not borne by other similarly situated taxpayers. *See* United States v. City of Detroit, 355 U.S. 466 (1958); United States v. County of Fresno, 429 U.S. 452 (1977); Washington v. United States, 460 U.S. 536 (1983). [↑](#footnote-ref-68)
68. 68 *See* Cavin, *supra* note 52, at 799. [↑](#footnote-ref-69)
69. 69 *See, e.g.,* Owensboro National Bank v. Owensboro, 173 U.S. 664 (1899) (nondiscriminatory Kentucky state tax on national bank invalidated); Osborn v. Bank of United States, 22 U.S. (9 Wheat.) 738 (1824) (Ohio tax of $ 50,000 per year on Second Bank of the United States invalidated). [↑](#footnote-ref-70)
70. 70 *See, e.g.,* Panhandle ***Oil*** Co. v. Mississippi, 277 U.S. 218 (1928) (finding independent contractor exempt from a state sales tax on the sale of goods to the Government). [↑](#footnote-ref-71)
71. 71 *See, e.g.,* Weston v. Charleston, 27 U.S. (2 Pet.) 449 (1829) (holding property tax imposed by a local government on federal securities owned by private parties was unconstitutional). [↑](#footnote-ref-72)
72. 72 *See, e.g.,* Dobbins v. Commissioners of Erie County, 41 U.S. (16 Pet.) 435 (1842) (holding tax on compensation of a captain in the United States revenue cutter service to be constitutionally offensive under the federal immunity doctrine announced in *McCulloch).* [↑](#footnote-ref-73)
73. 73 *See* WALTER HELLERSTEIN, STATE TAXATION, P 22.01, (3d ed. 2007), *available at* 1999 WL 1399067. [↑](#footnote-ref-74)
74. 74 *See* Tax History Project, Franklin Roosevelt, Agriculture and New York Property Taxation (Nov. 14, 2003), http://www.taxhistory.org/thp/readings.nsf/cf7c9c870b600b9585256df80075b9dd/9acfled9d129fee785256dfe005981fd?OpenDocument. [↑](#footnote-ref-75)
75. 75 302 U.S. 134 (1937). [↑](#footnote-ref-76)
76. 76 *See* United States v. Detroit, 355 U.S. 466 (1958) (upholding a city use tax imposed on nonexempt users of federal tax exempt property); United States v. County of Fresno, 429 U.S. 452(1977) (upholding state imposed taxation of federal employees on their use of housing owned by the Government's Forest Service). [↑](#footnote-ref-77)
77. 77 *See* Dravo Contracting Co., 302 U.S. at 161-86 (Roberts, J., dissenting) and cases cited therein. [↑](#footnote-ref-78)
78. 78 Id. at 161. [↑](#footnote-ref-79)
79. 79 *See* Thomas Reed Powell, *The Remnant of Intergovernmental Tax Immunities,* 58 HARV. L. REV. 757, 758 (1945). [↑](#footnote-ref-80)
80. 80 Dravo Contracting Co., 302 U.S. at 149, 161. [↑](#footnote-ref-81)
81. 81 *See id.* [↑](#footnote-ref-82)
82. 82 Id. at 150 (quoting Willcuts v. Bunn, 282 U.S. 216, 225 (1931)). State immunity from federal taxation originated with the Court's decision in Collector v. Day, 78 U.S. (11 Wall.) 113 (1871). [↑](#footnote-ref-83)
83. 83 *See* Dravo Contracting Co., 302 U.S. at 155-57. [↑](#footnote-ref-84)
84. 84 Id. at 159. [↑](#footnote-ref-85)
85. 85 Id. 157-58. As to possible dangers to the Government from resulting burdens, the Court stated:

    There is the further suggestion that if the present tax of two per cent is upheld, the State may lay a tax of twenty per cent or fifty percent or even more, and make it difficult or impossible for the Government to obtain the service it needs. The argument ignores the power of Congress to protect the performance of the functions of the National Government and to prevent interference through any attempted state action.

    Id. at 160-61. [↑](#footnote-ref-86)
86. 86 314 U.S. 1 (1941). [↑](#footnote-ref-87)
87. 87 Id. at 14. *See infra* Section V.B discussing cost-reimbursement contracts. [↑](#footnote-ref-88)
88. 88 Id. at 9. On this point, the Court stated "[W]ho, in any particular transaction like the present, is a "purchaser" within the meaning of the statute, is a question of state law on which only the Supreme Court of Alabama can speak with final authority). Id. at 9-10. [↑](#footnote-ref-89)
89. 89 *Id.* [↑](#footnote-ref-90)
90. 90 Id. at 8-9. [↑](#footnote-ref-91)
91. 91 King & Boozer sold lumber to Government cost-plus contractors which were constructing an Army camp for the Government. Id. at 6. [↑](#footnote-ref-92)
92. 92 Id. at 8. [↑](#footnote-ref-93)
93. 93 *See* Cavin, *supra* note 52, at 819. [↑](#footnote-ref-94)
94. 94 United States v. New Mexico, 455 U.S. 720, 735 (1982). The Court has consistently defined the nature of a federal instrumentality when determining immunity from state and local taxation. *See* id. at 736-37 ("virtually . . . an arm of the Government") (quoting Department of Employment v. United States, 385 U.S. 355, 359-60 (1966); New Mexico, 455 U.S. at 737 ("integral parts of [a governmental department]," and "arms of the Government deemed by it essential for the performance of governmental functions," (quoting Standard ***Oil*** Co. v. Johnson, 316 U.S. 481, 485 (1942). [↑](#footnote-ref-95)
95. 95 *See* James v. Dravo Contracting Co., 302 U.S. 134, 149 (1937); New Mexico, 455 U.S. at 735. [↑](#footnote-ref-96)
96. 96 *See* Cavin, *supra* note 52, at 819 (citing New Mexico, 455 U.S. at 735, note 11). [↑](#footnote-ref-97)
97. 97 455 U.S. 720 (1982). [↑](#footnote-ref-98)
98. 98 Id. at 722-23. Responsibility for the Government's nuclear program was transferred from the AEC to the Energy Research and Development Administration in 1975, and to the Department of Energy in 1977. Id. at 723, note 1. [↑](#footnote-ref-99)
99. 99 Id. at 723. Due to the complex and intricate contractual provisions, the Court noted that it was "virtually impossible to describe the contractual relationship in standard agency terms." *Id.* [↑](#footnote-ref-100)
100. 100 Id. at 723-24. [↑](#footnote-ref-101)
101. 101 Id. at 724-25. [↑](#footnote-ref-102)
102. 102 Id. at 725. [↑](#footnote-ref-103)
103. 103 Id. at 724-26. [↑](#footnote-ref-104)
104. 104 Id. at 735 ("tax immunity is appropriate . . . when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities.") [↑](#footnote-ref-105)
105. 105 Id. at 726. The Court stated that "On that date--some two years after the commencement of this litigation--the agreements were modified to state that each contractor 'acts as an agent [of the Government] . . . for certain purposes,' including the disbursement of Government funds and the 'purchase, lease, or other acquisition' of property." *Id. But see* 48 C.F.R. § 29.303 (2007).

     (a) Prime contractors and subcontractors shall not normally be designated as agents of the Government for the purpose of claiming immunity from State or local sales or use taxes. Before any activity contends that a contractor is an agent of the Government, the matter shall be referred to the agency head for review. The referral shall include all pertinent data on which the contention is based, together with a thorough analysis of all relevant legal precedents.

     *Id.* [↑](#footnote-ref-106)
106. 106 Id. at 725. [↑](#footnote-ref-107)
107. 107 Id. at 743. [↑](#footnote-ref-108)
108. 108 Id. at 725. [↑](#footnote-ref-109)
109. 109 Id. at 725. [↑](#footnote-ref-110)
110. 110 Id. at 726-27. The Court observed: "At the same time, however, the United States denied any intent 'formally and directly [to] [designate] 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 Court went on to state: "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.'" Id. at 737 (citing ***Kern***-Limerick, Inc. v. Scurlock, 347 U.S. 110, 126 (1954) (dissenting opinion). [↑](#footnote-ref-111)
111. 111 New Mexico, 455 U.S. at 738. [↑](#footnote-ref-112)
112. 112 Id. at 739 (citing United States v. Boyd, 378 U.S. 39, 44 (1964)). [↑](#footnote-ref-113)
113. 113 *See* New Mexico, 455 U.S. at 741-43. [↑](#footnote-ref-114)
114. 114 347 U.S. 110 (1954). [↑](#footnote-ref-115)
115. 115 New Mexico, 455 U.S. at 742. [↑](#footnote-ref-116)
116. 116 ***Kern***-Limerick, 347 U.S. at 111. [↑](#footnote-ref-117)
117. 117 *Id.* [↑](#footnote-ref-118)
118. 118 *Id.* [↑](#footnote-ref-119)
119. 119 *See* id. at 122-23. [↑](#footnote-ref-120)
120. 120 *See* United States v. New Mexico, 455 U.S. 720, 742-43 (1982). In this regard, the Court stated:

     In ***Kern****-Limerick . . .* [t]he contractor . . . identified itself as a federal procurement agent, and when it made purchases title passed directly to the Government; the purchase orders themselves declared that the purchase was made by the Government and that the United States was liable on the sale. Equally as important, the contractor itself was not liable for the purchase price, and it required specific Government approval for each transaction.

     Id. at 742 (quoting ***Kern***-Limerick, 347 U.S. at 120-21). [↑](#footnote-ref-121)
121. 121 New Mexico, 455 U.S. at 743. [↑](#footnote-ref-122)
122. 122 526 U.S. 32 (1999). [↑](#footnote-ref-123)
123. 123 Id. at 36-38. [↑](#footnote-ref-124)
124. 124 *See* id. at 34-35. [↑](#footnote-ref-125)
125. 125 *See* id. at 34. [↑](#footnote-ref-126)
126. 126 *See id.* [↑](#footnote-ref-127)
127. 127 *See id.* [↑](#footnote-ref-128)
128. 128 *See id.* [↑](#footnote-ref-129)
129. 129 Id. at 36. [↑](#footnote-ref-130)
130. 130 *Id.* [↑](#footnote-ref-131)
131. 131 *Id.* [↑](#footnote-ref-132)
132. 132 Because the Bureau of Indian Affairs contracted with Blaze to build, repair, and improve roads on the Navajo, Hopi, Fort Apache, Colorado River, Tohono O'Odham, and San Carlos Apache Indian Reservations, the Supreme Court also held that federal law did not shield Blaze from the Arizona tax because Blaze was considered the equivalent of a non-Indian for purposes of the Court's analysis and the tribes on whose reservations the work was performed had not assumed contracting responsibility under the Indian Self-Determination and Education Assistance Act. Id. at 35, 38. [↑](#footnote-ref-133)
133. 133 Id. at 35 (quoting United States v. New Mexico, 455 U.S. 720, 735-36 (1982)). [↑](#footnote-ref-134)
134. 134 Blaze, 526 U.S. at 36. [↑](#footnote-ref-135)
135. 135 *See* New Mexico, 455 U.S. at 735 note 11. [↑](#footnote-ref-136)
136. 136 *Id.* [↑](#footnote-ref-137)
137. 137 460 U.S. 536 (1983). [↑](#footnote-ref-138)
138. 138 *Id.* [↑](#footnote-ref-139)
139. 139 Id. at 538. [↑](#footnote-ref-140)
140. 140 *Id.* [↑](#footnote-ref-141)
141. 141 *Id.* [↑](#footnote-ref-142)
142. 142 *Id.* [↑](#footnote-ref-143)
143. 143 *Id.* [↑](#footnote-ref-144)
144. 144 *Id.* [↑](#footnote-ref-145)
145. 145 Id. at 538 (citing United States v. New Mexico, 455 U.S. 720 (1982)). [↑](#footnote-ref-146)
146. 146 Washington, 460 U.S. at 538-39. [↑](#footnote-ref-147)
147. 147 Id. at 538-39, note 3. This change was affected by redefining certain critical terms, such as "consumer, retail sale and sale at retail." *Id.* [↑](#footnote-ref-148)
148. 148 Id. at 539. [↑](#footnote-ref-149)
149. 149 Id. at 540. This did not include labor costs, mark-ups and any profit. [↑](#footnote-ref-150)
150. 150 Id. at 550. [↑](#footnote-ref-151)
151. 151 Id. at 541. [↑](#footnote-ref-152)
152. 152 Id. at 542. [↑](#footnote-ref-153)
153. 153 *Id.* (emphasis in original). [↑](#footnote-ref-154)
154. 154 Id. at 545. [↑](#footnote-ref-155)
155. 155 Id. at 546. [↑](#footnote-ref-156)
156. 156 *Id.* [↑](#footnote-ref-157)
157. 157 *Id.* [↑](#footnote-ref-158)
158. 158 *Id.* [↑](#footnote-ref-159)
159. 159 *See, e.g.,* Federal Land Bank of St. Paul v. Bismark Lumber Co., 314 U.S. 95 (1941) (Congress has the power under the Necessary and Proper Clause, U.S. CONST. art I, § 8, in furtherance of its lending function, to immunize federal land banks from state sales taxes); *see also* Director of Revenue v. CoBank ACB, 531 U.S. 316 (2001) ("[I]mplied immunity becomes an issue only when Congress has failed to indicate whether an instrumentality is subject to state taxation"). [↑](#footnote-ref-160)
160. 160 Atomic Energy Act of 1946, Pub. L. No. 79-585, 60 Stat. 765. [↑](#footnote-ref-161)
161. 161 342 U.S. 232 (1952). [↑](#footnote-ref-162)
162. 162 Id. at 232-33. [↑](#footnote-ref-163)
163. 163 Id. at 233. [↑](#footnote-ref-164)
164. 164 United States v. New Mexico, 455 U.S. 720, 744 (1982) (citing Carson, 342 U.S. at 234). [↑](#footnote-ref-165)
165. 165 Amendment to Atomic Energy Act of 1946, Pub. L. No. 83-262, 67 Stat. 575. [↑](#footnote-ref-166)
166. 166 New Mexico, 455 U.S. at 744 (quoting S. REP. NO. 83-694, at 3 (1953)). [↑](#footnote-ref-167)
167. 167 S. REP. NO. 83-694, at 2 (1953). [↑](#footnote-ref-168)
168. 168 *See, e.g.,* N.M. STAT. ANN. § 7-9-13(A)(1) (exempting from the gross receipts tax the receipts of the United States or any agency, department or instrumentality thereof); *see also* FAR 29.302:

     (a) Generally, purchases and leases made by the Federal Government are immune from State and local taxation. Whether any specific purchase or lease is immune, how-ever, is a legal question requiring advice and assistance of the agency-designated counsel.

     (b) When it is economically feasible to do so, executive agencies shall take maximum advantage of all exemptions from State and local taxation that may be available. If appropriate, the contracting officer shall provide a Standard Form 1094, U.S. Tax Exemption Form (see Part 53), or other evidence listed in 28.305 (a) to establish that the purchase is being made by the Government.

     *Id.;* FAR 29.303, which states, in relevant part:

     (b) When purchases are not made by the Government itself, but by a prime contractor or by a subcontractor under a prime contract, the right to an exemption of the transaction from a 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 expressly exempt from the tax. The Government's interest shall be protected by using the procedures in 29.101.

     *Id.* [↑](#footnote-ref-169)
169. 169 For example, Colorado permits the purchase of building materials to be exempt from tax for construction work for the U.S. Government. COLO. REV. STAT. § 39-26-114 (LEXIS 2007) Georgia provides an exemption for overhead items that are sold to and used by a contractor in performance of a contract with the federal government. GA. CODE ANN. § 48-8-3 (LEXIS 2007) South Carolina provides a sales and use tax exemption for tangible personal property purchased by contractors that have been appointed in writing as an agent of the federal government. S.C. CODE ANN. § 12-36-2120(29) (LEXIS 2007). [↑](#footnote-ref-170)
170. 170 *See* Richard Wall & Robert Malyska, *Government's Title to Pencils, Paper Clips, and other Overhead Items (or Award Ribbons, Half-Eaten Sandwiches and Funeral Flowers,* 32 PUB. CONT. L.J. 563, 564 (2003). [↑](#footnote-ref-171)
171. 171 *See* Steven Shen, *Motorola to Increase Outsourcing of Handset in 2008,* DIGITIMES, Dec. 17, 2007, *available at* http://www.digitimes.com/news/ a20071217PB205.html (Motorola is expected to expand its outsourcing policy by increasing the ratio of ODM handsets to its total output to 50% in 2008 compared to 40% in 2007); Steve Lohr,*At I.B.M., a Smarter Way to Outsource,* THE NEW YORK TIMES, Jul. 5, 2007, *available at* http://www.nytimes.com/2007/07/05/business/05outsource.html?\_r=1&ref=business&pa gewanted =all&oref=slogin# (I.B.M. employs 53,000 people in India, up from 3,000 in 2002; in India, the salaries for computer programmers are still about a third of those in the United States). [↑](#footnote-ref-172)
172. 172 *See* CRS REPORT, *supra* note 15, at 1. [↑](#footnote-ref-173)
173. 173 *Id.* [↑](#footnote-ref-174)
174. 174 *See* CIRCULAR A-76, *supra* note 15. Circular No. A-76 sets the policies and procedures that executive branch agencies must use in identifying commercial-type activities and determining whether these activities are best provided by the private sector, by government employees, or by another agency through a fee-for-service agreement. The current revised OMB Circular A-76 policy was first issued in 1966. CRS REPORT, *supra* note 15, at 3, note 9. [↑](#footnote-ref-175)
175. 175 *See id.* [↑](#footnote-ref-176)
176. 176 CRS REPORT, *supra* note 15, at 1. [↑](#footnote-ref-177)
177. 177 *Id.* at 2. The CRS REPORT further quotes from a 1996 Report of the Defense Science Board:

     Outsourcing often refers to the transfer of a support function traditionally performed by an in-house organization to an outside service provider. Outsourcing occurs in both the public and private sectors. While the outsourcing firm or government organization continues to provide appropriate oversight, the vendor is typically granted a degree of flexibility regarding how the work is performed. In successful outsourcing arrangements, the vendor utilizes new technologies and business practices to improve service and delivery and/or reduce support costs. Vendors are usually selected as the result of a competition among qualified bidders.

     *Id.* at 2 (quoting Department of Defense, Office of the Undersecretary of Defense for Acquisition and Technology, *Report of the Defense Science Board, Task Force on Outsourcing and Privatization,* (Aug. 1996)). [↑](#footnote-ref-178)
178. 178 *See* CRS REPORT, *supra* note 15, at 2. [↑](#footnote-ref-179)
179. 179 Pub. L. No. 105-270, 112 Stat. 2382 (1998), as amended by Pub. L. No. 109-115, Div. A, Title VIII, § 840, 119 Stat. 2505 (2005) (codified as amended at 31 U.S.C.S. § 501 note) (LEXIS 2007). [↑](#footnote-ref-180)
180. 180 *See* CIRCULAR A-76, *supra* note 15. [↑](#footnote-ref-181)
181. 181 CIRCULAR A-76, *supra* note 15. [↑](#footnote-ref-182)
182. 182 *See* Federal Activities Inventory Reform Act of 1998, 31 U.S.C. §501. [↑](#footnote-ref-183)
183. 183 *See id.* at § 2(a). The term "inherently governmental function" means a function that is so intimately related to the public interest as to require performance by Government employees. § 5(2). [↑](#footnote-ref-184)
184. 184 *See id.* at § 2(d). [↑](#footnote-ref-185)
185. 185 *Id.* [↑](#footnote-ref-186)
186. 186 *See* U.S. DEP'T. ARMY REG. 5-20, COMPETITIVE SOURCING PROGRAM para. 1-4(r)(18)(k) (May 23, 2005). [↑](#footnote-ref-187)
187. 187 *See* CRS REPORT, *supra* note 15, at 2. [↑](#footnote-ref-188)
188. 188 *See generally id.* [↑](#footnote-ref-189)
189. 189 National Defense Authorization Act for Fiscal Year 1996, Pub. L. No. 104-106, § 2801(a)(1), 110 Stat. 186 (February 1996), amended chapter 169 of title 10, United States Code, to add a new subchapter entitled Alternative Authority To Construct and Improve Military Housing (codified as amended at 10 U.S.C.S. §§ 2871-2885 (LEXIS 2007)). [↑](#footnote-ref-190)
190. 190 *See id.* [↑](#footnote-ref-191)
191. 191 *See* Captain Stacie A. Remy Vest, *Military Housing Privatization Initiative: A Guidance Document for Wading Through the Legal Morass,* 53 A.F. L. REV. 1, 2 (2002). [↑](#footnote-ref-192)
192. 192 *See* id. at 7.

     Traditionally, the Government conducts an acquisition to retain an architect and engineering firm to develop designs and specifications for housing units, indicating exactly how they are to be built. The Government then conducts another negotiated acquisition, issuing a solicitation structured under FAR Part 36 to obtain offers from construction contractors. Once received, the Government will negotiate with the offerors regarding the specifications of the project, price, and other factors, make a selection decision and award a contract to the offeror whose proposal represents the best value to the Government. The contractor then builds the houses on the installation.

     *Id.,* note 38. [↑](#footnote-ref-193)
193. 193 OFFICE OF THE DEPUTY UNDER SECRETARY OF DEFENSE, INSTALLATIONS AND ENVIRONMENT, MILITARY HOUSING PRIVATIZATION, *available at* http://www.acq.osd.mil/housing/mhpi.htm (last visited Dec. 21, 2007). [↑](#footnote-ref-194)
194. 194 *See* 10 U.S.C.S. § 2878. [↑](#footnote-ref-195)
195. 195 *See* Morrison, *supra* note 20, at 266. [↑](#footnote-ref-196)
196. 196 *See id.* [↑](#footnote-ref-197)
197. 197 *See* 10 U.S.C.S. § 2882. The amount of the basic allowance for housing for a member will vary according to the pay grade in which the member is assigned or distributed for basic pay purposes, the dependency status of the member, and the geographic location of the member. 37 U.S.C.S. § 403(a)(1). [↑](#footnote-ref-198)
198. 198 *See* 10 U.S.C.S. § 2873. [↑](#footnote-ref-199)
199. 199 *See* Morrison, *supra* note 20, at 266. [↑](#footnote-ref-200)
200. 200 *See id.* [↑](#footnote-ref-201)
201. 201 *See* 10 U.S.C.S. §§ 2874 and 2878. [↑](#footnote-ref-202)
202. 202 CRS REPORT, *supra* note 15, at 14 (citing U.S. OFFICE OF MANAGEMENT AND BUDGET, THE PRESIDENT'S MANAGEMENT AGENDA FOR FY 2002 (Washington: OMB, 2001)). [↑](#footnote-ref-203)
203. 203 *See generally* CIRCULAR A-76, *supra* note 15 (stating one of the policies of competitive sourcing is to ensure the American people receive maximum value for their tax dollars). [↑](#footnote-ref-204)
204. 204 *See* United States v. New Mexico, 455 U.S. 720, 733 (1982). *See also supra* Section III. [↑](#footnote-ref-205)
205. 205 FAR, supra note 10, at 29.303(b). *See also supra* Section III. [↑](#footnote-ref-206)
206. 206 *See id.* [↑](#footnote-ref-207)
207. 207 *See supra* Section III.B.2. discussing the Supreme Court's two-pronged analysis. [↑](#footnote-ref-208)
208. 208 *See* Morrison, *supra* note 20, at 266. [↑](#footnote-ref-209)
209. 209 *See id.* [↑](#footnote-ref-210)
210. 210 *See id.* [↑](#footnote-ref-211)
211. 211 *See id.* [↑](#footnote-ref-212)
212. 212 *See* 10 U.S.C.S. §2873. [↑](#footnote-ref-213)
213. 213 *See id.* at § 2876. [↑](#footnote-ref-214)
214. 214 *See id.* at § 2877. [↑](#footnote-ref-215)
215. 215 *See* GENERAL ACCOUNTING OFFICE, MILITARY HOUSING: CONTINUED CONCERNS IN IMPLEMENTING THE PRIVATIZATION INITIATIVE, GAO/NSIAD-00-71 (Mar. 30, 2000), http://www.gao.gov (GAO Reports, Fiscal 2000, National Defense). Available assets may include existing housing units and land.10 U.S.C.S. § 2878. It may also include BAH members are authorized to receive when renting MHPI housing units. 10 U.S.C.S. § 2882. [↑](#footnote-ref-216)
216. 216 *See* Erik Holmes, *Privatized Houses Cut Way Back at 4 Bases,* AIR FORCE TIMES, Nov. 2, 2007 (American Eagle Communities and a related company stopped work at Little Rock AFB, AR; Patrcick AFB, FL; Moody AFB, GA; and fell two years behind at Hanscom AFB, MA). [↑](#footnote-ref-217)
217. 217 *See id.* [↑](#footnote-ref-218)
218. 218 *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 370 (1819). [↑](#footnote-ref-219)
219. 219 *Id.* at 427. [↑](#footnote-ref-220)
220. 220 The Supreme Court granted certiorari in United States v. New Mexico, 455 U.S. 720 (1982) to consider "the seemingly intractable problems posed by state taxation of federal contractors." Id. at 730. [↑](#footnote-ref-221)
221. 221 McCulloch, 17 U.S. (4 Wheat.) at 430. [↑](#footnote-ref-222)
222. 222 New Mexico, 455 U.S. at 730 (quoting United States v. City of Detroit, 355 U.S. 466, 473 (1958)). [↑](#footnote-ref-223)
223. 223 *See* Arizona Dept of Revenue v. Blaze Const. Co. Inc., 526 U.S. 32, 36 (1999). [↑](#footnote-ref-224)
224. 224 Id. at 36. [↑](#footnote-ref-225)
225. 225 *See* Panhandle ***Oil*** Co. v. Mississippi, 277 U.S. 218, 222-23 (1928). [↑](#footnote-ref-226)
226. 226 *See* Section III, *supra* and the discussion of cases cited therein. [↑](#footnote-ref-227)
227. 227 New Mexico, 455 U.S. at 735. [↑](#footnote-ref-228)
228. 228 *Id.* [↑](#footnote-ref-229)
229. 229 Michael Livingston, *Practical Reason, "'Purposivism, "and the Interpretation of Tax Statutes,* 51 TAX L. REV. 677, 678. (1998). *See* Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose,* 2 FLA. TAX REV. 492 (1995); Deborah A. Geier, *Commentary: Textualism and Tax Cases,* 66 TEMP. L. REV. 445 (1993); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code, 64* N.C.L. REV. 623 (1980. [↑](#footnote-ref-230)
230. 230 *See* Livingston, supra note 229, at 678. [↑](#footnote-ref-231)
231. 231 Allen D. Madison, The *Tension Between Textualism and Substance-Over-Form Doctrines in Tax Law,* 43 SANTA CLARA L. REV. 699, 700 (2003). [↑](#footnote-ref-232)
232. 232 69 F.2d 809 (2d Cir. 1934), *affd,* 293 U.S. 465 (1935). [↑](#footnote-ref-233)
233. 233 293 U.S. at 470. [↑](#footnote-ref-234)
234. 234 Id. at 467. [↑](#footnote-ref-235)
235. 235 *Id.* [↑](#footnote-ref-236)
236. 236 *Id.* [↑](#footnote-ref-237)
237. 237 Revenue Act of 1928, § 112(i)(1)(b) (currently I.R.C. § 368(a)(1) (1991)), discussed *in* Gregory, 293 U.S. at 468-69. [↑](#footnote-ref-238)
238. 238 Gregory, 293 U.S. at 467. [↑](#footnote-ref-239)
239. 239 *Id.* [↑](#footnote-ref-240)
240. 240 Gregory v. Commissioner, 27 BTA 223, 225 (B.T.A. 1932), rev., 69 F.2d 809 (2d Cir. 1934). [↑](#footnote-ref-241)
241. 241 *Id.* [↑](#footnote-ref-242)
242. 242 Gregory, 69 F.2d at 809. [↑](#footnote-ref-243)
243. 243 Gregory, 293 U.S. at 470. [↑](#footnote-ref-244)
244. 244 *Id.* [↑](#footnote-ref-245)
245. 245 331 U.S. 1 (1947). [↑](#footnote-ref-246)
246. 246 461 U.S. 300 (1983). [↑](#footnote-ref-247)
247. 247 Crane, 331 U.S. at 3. [↑](#footnote-ref-248)
248. 248 Id. at 4. For simplicity, the numbers in *Crane* have been rounded. [↑](#footnote-ref-249)
249. 249 Id. at 3. [↑](#footnote-ref-250)
250. 250 Id. at 3-4. [↑](#footnote-ref-251)
251. 251 *Id.* [↑](#footnote-ref-252)
252. 252 *Id.* [↑](#footnote-ref-253)
253. 253 Taxpayer sold the apartment to a third party for $ 3,000 cash, subject to the mortgage, and paid $ 500 expenses of the sale. Id. at 3. [↑](#footnote-ref-254)
254. 254 Id. at 4-5. [↑](#footnote-ref-255)
255. 255 Id. at 4. The Internal Revenue Code provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis" I.R.C. § 1001(a) (1994). Amount realized is the "sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b) (1994). [↑](#footnote-ref-256)
256. 256 Commissioner v. Tufts, 461 U.S. 300, 302-03 (1983). The property had been purchased for approximately $ 1.85 million and its basis reduced, by depreciation deductions, to $ 1.45 million. /d. at 303, notel. [↑](#footnote-ref-257)
257. 257 Id. at 317. [↑](#footnote-ref-258)
258. 258 Id. at 312-13. [↑](#footnote-ref-259)
259. 259 I.R.C. § 1001(b). [↑](#footnote-ref-260)
260. 260 *See* Livingston, supra note 229, at 693. [↑](#footnote-ref-261)
261. 261 *Id.* at 691. [↑](#footnote-ref-262)
262. 262 Schmitz v. Commissioner, 51 T.C. 306, 317 (1968), *aff'd sub nora.* Throndson v. Commissioner, 457 F.2d 1022 (9th Cir. 1972). [↑](#footnote-ref-263)
263. 263 Pacific Rock & Gravel Co. v. United States, 297 F.2d 122, 125 (9th Cir. 1961). [↑](#footnote-ref-264)
264. 264 332 U.S. 126 (1947). In 1971, Unemployment Insurance Code Section 680 (Stats. 1971, ch. 1281, § 1), was enacted stating:

     Certain persons contracting for the services of musicians are 'employers' for unemployment insurance purposes. The undisputed underlying legislative intent of section 680 was to reverse the effect of judicial rulings that musicians who contracted to provide services under the form B union contract were nevertheless independent contractors and not common law employees of the entertainment entity which hired them.

     Far West Services, Inc. v. Livingston, 156 Cal. App. 3d 931,935 (Cal Ct. App. 1984). [↑](#footnote-ref-265)
265. 265 Bartels, 332 U.S. at 127-28. [↑](#footnote-ref-266)
266. 266 *Id.* [↑](#footnote-ref-267)
267. 267 Id. at 130. [↑](#footnote-ref-268)
268. 268 Id. at 131. [↑](#footnote-ref-269)
269. 269 Id. at 132. [↑](#footnote-ref-270)
270. 270 Noel Cunningham & James Repetti, *Texmalism and Tax Shelters,* 24 VA. TAX. REV. 1, 2-3 (2004). [↑](#footnote-ref-271)
271. 271 *See* Cavin, *supra* note 52, at 832. [↑](#footnote-ref-272)
272. 272 *Id.* [↑](#footnote-ref-273)
273. 273 *See* Madison, *supra* note 231, at 717. [↑](#footnote-ref-274)
274. 274 *Id.* at 700-01. [↑](#footnote-ref-275)
275. 275 Washington v. United States, 460 U.S. 536, 537 (1983). [↑](#footnote-ref-276)
276. 276 Id. at 538-39. In this regard, the Court noted from the decision of the Court of Appeals:

     The manner in which this was accomplished is somewhat complex. The change was effected by substitute House Bill No. 86, enacted into law as Chapter 90, Laws of 1975 (amending Wash. Rev. Code §8 82.04.050 and 82.04.190); Section 5 of Substitute House Bill No. 2736, enacted into law as Section 5 of Chapter 291, Laws of 1975 (amending Wash. Rev. Code § 82.04.050) and House Bill No. 1229, enacted into law as Chapter 1, Laws of 1975-76 (amending Wash. Rev. Code 88 82.12.010 and 82.12.020). These statutes added the following definition of 'consumer' to Wash. Rev. *Code § 82.04.190:*

     'Consumer' means the following:

     . . .

     '(6) Any person engaged in the business of constructing, repairing, decorating, or improving new or existing buildings or other structures under, upon or above real property of or for the United States, any instrumentality thereof, or a county or city housing authority created pursuant to chapter 35.82 RCW, including the installing or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation. Any such person shall be a consumer within the meaning of this subsection in respect to tangible personal property incorporated into, installed in, or attached to such building or other structure by such person.'

     'These statutes further expressly excluded from the definition of 'consumer' 'the United States, instrumentalities thereof, and county and city housing authorities created pursuant to chapter 35.82 RCW in respect to labor and services rendered to their real property.' Wash. Rev. Code 8 82.04.190(4). Wash. Rev. Code 8 82.04.050 was also amended so as to redefine 'retail sale' and 'sale at retail' to exclude expressly from their scope contracts calling for the improvement, repair or construction of real property owned by the

     United States or any of its instrumentalities and to include sales of materials to prime contractors engaged in construction work on federally-owned property. As with the sales tax, the liability of federal prime construction contractors for the State's use tax arose basically from the inclusion of such contractors within the meaning of the term 'consumer,' and the use of that term in Wash. Rev. Code § 82.12.020, under which the use tax is levied.

     Id. at 540, note 3 (quoting United States v. Washington, 654 F.2d 570, 573, note 6 (9th Cir. 1981). [↑](#footnote-ref-277)
277. 277 Washington, 460 U.S. at 539-40. [↑](#footnote-ref-278)
278. 278 *See* United States v. New Mexico 455 U.S. 720, 735-36 (1982). [↑](#footnote-ref-279)
279. 279 421 U.S. 599 (1975). [↑](#footnote-ref-280)
280. 280 Id. at 605-06. [↑](#footnote-ref-281)
281. 281 *Id.* [↑](#footnote-ref-282)
282. 282 Id. at 607. [↑](#footnote-ref-283)
283. 283 Id. at 609. The Tax Commission had informed the distillers and suppliers that the markup "must be invoiced to the Military and collected directly from the Military (Club) or other authorized organization located on the Military base." *Id.* [↑](#footnote-ref-284)
284. 284 *Id.* The courted noted: "Finally, even in the absence of this clear statement of the Tax Commission's intentions, obviously economic realities compelled the distillers to pass on the economic burden of the markup." Id. at 610 note 8. [↑](#footnote-ref-285)
285. 285 *See* United States v. New Mexico, 455 U.S. 720, 727 (1982). *See also supra* Section III. [↑](#footnote-ref-286)
286. 286 Id. at 727 (quoting N.M. STAT. ANN. § 72-16A-7). [↑](#footnote-ref-287)
287. 287 New Mexico, 455 U.S. at 728 (quoting N.M. STAT. ANN. §§ 72-16A-12.1, 72-16A-12.2). [↑](#footnote-ref-288)
288. 288 New Mexico, 455 U.S. at 735. Prior to 1967, the New Mexico Bureau of Revenue did not attempt to tax government contractors. Id. at 728, note 9. [↑](#footnote-ref-289)
289. 289 Id. at 737. [↑](#footnote-ref-290)
290. 290 *Id.* (quoting ***Kern***-Limerick, Inc., 347 U.S.110, 126 0954) (dissenting opinion)). In further response to the government's argument that its contractors were tax-exempt because they were federal agents, the Court stated:

     Should the [Atomic Energy] Commission intend to build or operate the plant with its own servants and employees, it is well aware that it may do so and familiar with the ways of doing it. It chose not to do so here. 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.

     New Mexico, 455 U.S. at 736 (quoting United States v. Boyd, 378 U.S. 39, 48 (1964). [↑](#footnote-ref-291)
291. 291 United States v. Tax Comm'n of Mississippi, 421 U.S. 599 (1975). [↑](#footnote-ref-292)
292. 292 New Mexico, 455 U.S. at 736. [↑](#footnote-ref-293)
293. 293 Id. at 737. [↑](#footnote-ref-294)
294. 294 The FAR is a system that codifies and publishes "uniform policies and procedures for acquisition by all executive agencies." 48 C.F.R. §1.101. [↑](#footnote-ref-295)
295. 295 *Id.* at 16.301-1. [↑](#footnote-ref-296)
296. 296 *Id.* at 16.301-2. [↑](#footnote-ref-297)
297. 297 *Id.* at 31.205-41. [↑](#footnote-ref-298)
298. 298 *See id.* at 31.205-41(a)(1) (stating that "Federal, State and local taxes are allowable types of costs provided they are required to be and are paid or accrued in accordance with generally accepted accounting principles"). [↑](#footnote-ref-299)
299. 299 *Id.* at 31.205-41(a)(1) and (2). [↑](#footnote-ref-300)
300. 300 *Id.* at 16.202-1. [↑](#footnote-ref-301)
301. 301 *Id.* at 16.202-1. [↑](#footnote-ref-302)
302. 302 *Id.* at 16.202-1. [↑](#footnote-ref-303)
303. 303 *Id.* at 29.401-3, 52.229-3, 52.229-4. [↑](#footnote-ref-304)
304. 304 James v. Dravo Contracting Co., 302 U.S. 134, 172 (1937) (Roberts, J., dissenting,,). [↑](#footnote-ref-305)
305. 305 *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 427-31 (1819). [↑](#footnote-ref-306)
306. 306 *Id.* at 425 ("That the power of taxation is one of vital importance; that it is retained by the states; that it is not abridged by the grant of a similar power to the government of the Union; that it is to be concurrently exercised by the two governments--are truths which have never been denied"). [↑](#footnote-ref-307)
307. 307 THE FEDERALIST NO. 32 (Alexander Hamilton) (Daily Advertiser ed., 1788). Hamilton further stated:

     And making this concession, I affirm that (with the sole exception of duties on imports and exports) they would, under the plan of convention, retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national government to abridge them in the exercise of it, would be a violent assumption of power, unwarranted by any article or clause of its Constitution.

     *Id.* [↑](#footnote-ref-308)
308. 308 423 U.S. 276 (1976). [↑](#footnote-ref-309)
309. 309 *See* id. at 288. [↑](#footnote-ref-310)
310. 310 Id. at 289 (citing Cooley v. Board of Wardens of Port of Philadelphia, 53 U.S. (12 How.) 299 (1852)). [↑](#footnote-ref-311)
311. 311 *See generally* Peggy Venable, *School Finance Drives Texas Budget, Tax Talks,* BUDGET AND TAX NEWS, Apr. 1, 2005 (Texas proposes raising the state sales tax in order to cover a shortfall in school finance). [↑](#footnote-ref-312)
312. 312 Michelin, 423 U.S. at 288-89. [↑](#footnote-ref-313)
313. 313 *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 317, 428-29 (1819). [↑](#footnote-ref-314)
314. 314 James v. Dravo Contracting Co., 302 U.S. 134 (1937). [↑](#footnote-ref-315)
315. 315 Id. at 161. [↑](#footnote-ref-316)
316. 316 United States v. New Mexico, 455 U.S. 720 (1982). [↑](#footnote-ref-317)
317. 317 Id. at 737 (citing James v. Dravo Contracting Co., 302 U.S. 134, 161 (1937); Carson v. Roane-Anderson Co., 342 U.S. 232, 234 (1952); *see also* Arizona Dept. of Rev. v. Blaze Const. Co. Inc., 526 U.S. 32, 38 (1999) (finding Congress had not expressly exempted the contractor's activities from taxation). [↑](#footnote-ref-318)
318. 318 New Mexico, 455 U.S. at 737-38. [↑](#footnote-ref-319)
319. 319 Servicemembers Civil Relief Act, 50 U.S.C.S. § 501-593 (LEXIS 2007). [↑](#footnote-ref-320)
320. 320 *Id.* at § 571. [↑](#footnote-ref-321)
321. 321 *Id.* at § 571(a). [↑](#footnote-ref-322)
322. 322 *Id.* at § 571(b). [↑](#footnote-ref-323)
323. 323 *See generally* Morrison, *supra* note 20. [↑](#footnote-ref-324)
324. 324 *See* Cavin, *supra* note 52, at 835. [↑](#footnote-ref-325)
325. 325 *See generally* Timothy Wheeler, *Army Urged to Share Cost of Local BRAC Upgrades,* BALTIMORESUN.COM, Sep. 11, 2007, http://www.baltimoresun.eom /news/local/bal-te.md.bracllsepll,0,7889852,print.story (State and local officials are asking the Army assist with road and transit upgrades due to millions of dollars in tax revenues being lost as a result of the developments being built on tax exempt military installations. Although the Fort Meade expansion could reach $ 1 billion, eotmty officials have estimated $ 5 billion in infrastructure improvements to serve the work force and associated households). [↑](#footnote-ref-326)
326. 326 *See* James v. Dravo Contracting Co., 302 U.S. 134, 156-57 (1937); United States v. New Mexico, 455 U.S. 720, 736, note 11 (1982). [↑](#footnote-ref-327)