INTO AND OUT OF THE BOG: THE INTERGOVERNMENTAL TAX IMMUNITY DOCTRINE

ROB GUNNING*

"[T]he power to tax involves the power to destroy."[1] With that famous phrase, Chief Justice Marshall launched the intergovernmental tax immunity doctrine. The doctrine rocketed on a fairly straight course for more than 100 years. During that time, the United States Supreme Court invalidated a number of state and local tax statutes that directly, and often rather indirectly, impacted the federal government. Under this expansive view of the Supremacy Clause, state and local taxes were struck if the economic incidence of the tax fell, even slightly, on the United States government.[2]

However, in 1937, a 5-4 Court reversed course.[3] In *James v. Dravo Contracting Co.*, the economic incidence of the state's tax fell partially on the United States.[4] In the face of more than one hundred years of precedent, the Court held that a state or local tax infringed on the Supremacy Clause and the federal government's tax immunity

* J.D., UC Berkeley School of Law (Boalt Hall) 1993; B.A., College of William & Mary 1990. Mr. Gunning is Of Counsel in the Denver, CO office of Silverstein & Pomerantz, LLP. The author expresses his gratitude to Neil I. Pomerantz for his insightful comments and thoughts provided on a draft of this Article.

1. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

2. The relatively straight course ultimately proved deceptive, given the inherent problems created by our system of federalism. These inherent problems were noted by Luther Martin, Maryland's Attorney General and a member of the Constitutional Convention, in his oral argument before the Supreme Court in *McCulloch*. He stated:

> The whole of this subject of taxation is full of difficulties, which the convention found it impossible to solve, in a manner entirely satisfactory. The first attempt was to divide the subjects of taxation between the state and the national government. This being found impracticable or inconvenient, the state governments surrendered altogether their right to tax imports and exports, and tonnage; giving the authority to tax all other subjects to congress, but reserving to the states a concurrent right to tax the same subjects to an unlimited extent. This was one of the anomalies of the government, the evils of which must be endured, or mitigated by discretion and mutual forbearance.

Id. at 376.

3. James v. Dravo Contracting Co., 302 U.S. 134 (1937).

4. *Id.* at 159-60.

only if (1) the tax discriminated against the federal government, or (2) the tax reached the United States government or its property.[5]

Since 1937, the line between the immune and the taxable has wavered somewhat erratically. The confusion and baffling line-drawing exercises seemingly embedded in the intergovernmental tax immunity doctrine have prompted jurists to consider this field of law a "bog,"[6] a "much litigated and often confused field,"[7] and a field "that has been marked from the beginning by inconsistent decisions and excessively delicate distinctions."[8] Indeed, as early as 1944, Justice Jackson opined that the field was already heavily litigated because of the "recurring conflicts between the power to tax and the right to be free from taxation which are inevitable where two governments function at the same time and in the same territory."[9]

The field will continue to be heavily litigated because the commercial use of government property is expanding rapidly. Government-owned property generally is exempt from state and local taxation. Oftentimes, however, private parties contract with governmental entities to use otherwise tax-exempt property for a wide variety of private purposes. These possessory interests include: the use of publicly owned rangeland for private grazing purposes; the use of mountainous national forest land by ski resorts; the use of national parks, municipally owned airports, and sports arenas by concessionaires; and the use of federally owned property by defense contractors. Publicly owned property is also increasingly being leased for more pedestrian purposes, with private parties leasing government-owned buildings for warehouse, office, and research park space.[10] In the absence of a possessory interest tax, based on the fee value of the underlying property, the leasing of publicly owned property is considered advantageous to both the government lessor and the private lessee, because both parties theoretically save resources in taking advantage of the government's tax exemption.[11]

As discussed herein, most states tax at least some form of pos-

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5. *Id.* at 158, 161.

6. United States v. Nye County, 178 F.3d 1080, 1083 (9th Cir. 1999) [hereinafter *Nye County II*].

7. United States v. City of Detroit, 355 U.S. 466, 473 (1958).

8. United States v. New Mexico, 455 U.S. 720, 730 (1982).

9. United States v. Allegheny County, 322 U.S. 174, 175 (1944).

10. John A. Swain, *The Taxation of Private Interests in Public Property: Toward a Unified Theory of Property Taxation*, 2000 UTAH L. REV. 421, 421.

11. *Id*. at 423.

sessory interests. In doing so, many states impose a property tax or possessory interest tax on private parties using federally owned property. It is now settled that the economic incidence of a state or local tax may constitutionally fall on the federal government.[12] Equally settled is the proposition that the state or local tax may not be levied directly against the United States or its property.[13]

Two issues remain largely unsettled, however. First, a split exists among the Circuit Courts regarding the permissibility of a property tax or possessory interest tax that is measured as if the private lessee were the fee simple owner of the federally owned property. While the United States Supreme Court held in 1958 that a tax measured by the property's market value was permissible,[14] subsequent lower court decisions have declined to follow or have attempted to distinguish this portion of the Court's holding. Some of these lower court decisions have held that if the property tax is based on the fee simple value of the property, the tax naturally reaches the federal government's reversionary interest, rendering the tax unconstitutional.

The second increasingly contentious issue lies within the discrimination prong of this doctrine. A state or local tax may not discriminate against the United States or those with whom it deals.[15] This statement is much easier to state than it is to apply. State and local taxes applied to private interests in federally owned property have been struck down because the underlying legislation provides exemptions for state or locally owned property that is used in the same manner. In many cases, possessory interest tax statutes include a multitude of exemptions, with some favoring the federal government and some favoring state and local government. In construing a state statute containing a wide array of exemptions, courts have found the discrimination issue to be a difficult one that often requires fact-intensive inquiry.

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12. For example, a lease between a private party and the federal government may provide that any and all property taxes be borne by the federal government. The federal government's decision to contractually undertake the property tax obligation does not invalidate the underlying property tax.

13. This is known as "legal incidence." The most obvious example is a state or local tax imposed on the United States because of its ownership of property. Based on the Supremacy Clause, federally owned property is exempt from state and local taxation. Only when a private party uses the property may the property become taxable.

14. United States v. City of Detroit, 355 U.S. 466, 474-75 (1958).

15. *See, e.g.*, Phillips Chem. Co. v. Dumas Indep. Sch. Dist., 361 U.S. 376 (1960) (holding that a Texas tax statute unconstitutionally discriminated against the United States and its lessee).

This Article focuses on property or possessory interest taxes imposed on private interests in federally owned property. In the interest of more fully exploring the scope and limitations of the intergovernmental tax immunity doctrine, the Article also discusses several seminal cases addressing the imposition of sales, use, gross receipts, and state income taxes on parties contracting with the federal government. It is hoped that a discussion and analysis of these cases will help to illuminate the two major theses of this Article.

Following a brief discussion of possessory interest taxation in Part I, Part II of this Article traces the history of the intergovernmental tax immunity doctrine through the seminal 1958 *City of Detroit*[16] case. In Part III, the Article ventures into the bog to discuss whether a state statute may lawfully authorize a taxing authority to assess a possessory interest tax on federally owned property as if the possessory interest holder held the property in fee simple ownership.

A primary thesis of this Article, also contained in Part III, is that a possessory interest tax measured by the fee simple value of the underlying property may be unconstitutional as applied to users of federally owned property if there are contractual use restrictions on the use of the property. In such a case, the possessory interest holder should not be taxed on more rights than have been transferred under its agreement with the United States. Otherwise, the legal incidence of the tax reaches the federal government's present reversionary interest, and the tax therefore conflicts with the Supremacy Clause.

On the other hand, a state statute providing that the possessory interest may be valued as if the possessory interest holder held the interest in perpetuity should not violate the Supremacy Clause because the property tax is annual, and the federal government's future interest in the property is not being taxed. Under this analysis, cases that appear inconsistent at first glance can generally be reconciled. Moreover, such an approach enhances uniformity of taxation and equity, and is therefore consonant with sound tax policy.

In Part IV, this Article explores the discrimination prong of the intergovernmental tax immunity doctrine. After a discussion of relevant case law, Part IV advocates that statutory exemptions to possessory interest taxation should apply, so far as practicable, equally to private parties using federal, state, or local government property. For example, a state statute that exempts from tax grazing interests in state and local government-owned land, but does not similarly exempt

16. 355 U.S. 466 (1958).

grazing interests in federally owned land, unconstitutionally discriminates against the federal government and its private lessees.

The more difficult case is a statutory scheme that exempts a variety of possessory interests in federal, state, and locally owned property. For instance, a state statute may provide taxation exemptions to grazing interests in federally owned land, the private use of buildings on state university land, and the private use of municipally owned airports. Might this statute unconstitutionally discriminate against the federal government?

This Article contends that in deciding this question, the focus should be on the particular use in question. Moreover, the focus should be on whether similarly situated taxpayers receive equal treatment. In other words, would the private party receive the same treatment if it made similar use of state or locally owned property? If the private party is able to obtain an exemption only by making similar use of state or locally owned property, the statute discriminates against the United States and those with whom it deals. Exemptions to taxation should generally be narrowly construed, particularly when adversely affected parties have less influence with the state legislature than the parties who benefit from the tax exemption. State governments and private parties with whom they deal typically have inherently more political influence with state legislatures than does the United States and those private parties with whom it deals.