

## Quasi-Governmental Entities and Governmental Immunity from Sales and Use Taxes

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*Companies in, e.g., the banking, insurance, investment, and auto industries, while subject to state and federal regulation in the past, may now be, in some ways, virtually indistinguishable from the government itself.*

The line between state and federal governmental powers and activities versus traditionally "private enterprise" activities has become blurred, as governmental entities are requiring additional control, stricter regulation, "bailout" investment, and outright ownership over a variety of ostensibly private businesses. Banks, insurance agencies, investment entities, automobile companies, and others that, although subject to state and federal governmental regulation in the past, are now, in many cases, virtually indistinguishable from the government itself in many key ways. For example, governmental entities have taken over traditional "private enterprise" activities for these businesses, such as leadership choices, who to employ and at what level, compensation, product creation and sale, insurance coverage, branding, and even the terms and conditions of loans being made. This raises an interesting question as to how the shift towards government regulation impacts state and local taxation in light of past authorities on the subject. Given that there may be a variety of state and local, as well as federal, tax implications regarding the "nationalization" of many businesses that are beyond the scope of this article, what happens when a state or local government attempts to impose a sales and use tax on the purchases of a quasi-governmental entity?

### Legal Principles of Immunity from State and Local Taxation

The principle that a state is prohibited from taxing the federal government and its instrumentalities has at its source a clause of the document that is the blueprint of our republic, the U.S. Constitution. The Supremacy Clause provides the following:

"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."<sup>1</sup>

### The fundamental jurisprudence.

Countless state and federal court cases have resulted from this basic constitutional principle. Arguably, the most significant of these cases is *McCulloch v. Maryland*.<sup>2</sup> The core principle in *McCulloch* is simply that a state has no power to tax the federal government or its instrumentalities, if federal law is to remain supreme.

As Justice Marshall, writing on behalf of the Court, so compellingly and familiarly declared in *McCulloch*: "That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance, in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied."

Justice Marshall further declared: "If the States may tax one instrument, employed by the government in the execution of its powers, they may tax any and every other instrument. They may tax the mail; they may tax the mint; they may tax patent rights; they may tax the papers of the custom-house; they may tax judicial process; they may tax all the means employed by the government, to an excess which would defeat all the ends of government. This was not intended by the American people. They did not design to make their government

dependent on the States." Justice Marshall then concluded: "The court has bestowed on this subject its most deliberate consideration. The result is a conviction that the States have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations of the constitutional laws enacted by congress to carry into execution the powers vested in the general government. *This is, we think, the unavoidable consequence of that supremacy which the constitution has declared.*" (Emphasis added.)

While the holding in *McCulloch* clearly supports the notion that a state may not tax the federal government or its instrumentalities, since that decision federal and state courts have struggled with the establishment and determination of the scope of this prohibition.

## Application to private entities.

Some 145 years after Justice Marshall's words in *McCulloch*, the Supreme Court ruled in *U.S. v. Boyd*<sup>3</sup> that the imposition of a state use tax on tangible personal property used by private contractors in the performance of a federal government contract was permissible because the contractors were not "so incorporated into the government structure as to become instrumentalities of the United States." This standard crafted by the Court created a somewhat subjective line of demarcation between taxable and immune transactions. It provides little room beyond immunity for direct governmental activities but nonetheless does leave room for the principle that an entity contracting with the federal government can also be immune from state taxation as an instrumentality of the government.

Quoting *U.S. v. Township of Muskegon*,<sup>4</sup> the *Boyd* Court stated that "the case might well be different if the Government had reserved such control over the activities and financial gain of [the contractor] that it could properly be called a 'servant' of the United States in agency terms." But, as in *Muskegon*, the *Boyd* Court did not believe that the contractors in question were "so assimilated by the Government as to become one of its constituent parts."

In both *Boyd* and *Muskegon*, the Supreme Court held that the relationship between the governmental and nongovernmental entities did not rise to the level of an "agency" relationship, while clearly affirming that such a relationship can arise and intergovernmental immunity apply.

Several years later, in *Department of Employment v. U.S.*,<sup>5</sup> the Supreme Court further defined the circumstances in which the Supremacy Clause and intergovernmental tax immunity would prevent a state from taxing an entity that was contracting with the federal government. There, Colorado sought to impose its unemployment compensation tax upon wages paid to Colorado-based employees of the American National Red Cross. In a unanimous decision, the Court ruled that the Red Cross, a private nongovernmental entity, was immune from state taxation as a "federal instrumentality." The Court acknowledged that there was "no simple test for ascertaining whether an institution is so closely related to governmental activity as to become a tax-immune instrumentality." Nevertheless, the Court ruled that the Red Cross was "clearly" and "beyond dispute" such an instrumentality. The Court made this determination despite the fact that the Red Cross is a private entity, financed primarily from voluntary private contributions. Further, the employees working for the Red Cross were not considered federal employees and the charity's day-to-day business affairs were not directed by the federal government.

At first blush, these factors seem to run directly counter to the finding of an "agency" relationship, which the Court so heavily relied upon in the *Boyd* and *Muskegon* decisions. The factors against the existence of an agency relationship were countered and outweighed by the fact that the Red Cross's activities were created by federal statute, subjecting it to general governmental supervision and financial audit, and perhaps most important, the Red Cross serves a great national governmental purpose in the performance of its activities

(e.g., meeting the nation's commitments under various Geneva Conventions, performing a variety of functions indispensable to the workings of the U.S. Armed Forces, and assisting the federal government in providing disaster assistance). Therefore, a significant difference between *Boyd* and *Muskegon* and the *Department of Employment* case dealing with the Red Cross relates to the business mission of the party seeking immunity from taxation. In *Boyd* and *Muskegon*, where the Court determined no immunity applied, the parties seeking immunity from state taxation were pursuing purely commercial endeavors with the federal government. In contrast, in *Department of Employment*, the Court determined that state tax immunity applied because the American Red Cross pursued a great national governmental purpose or activity in conjunction with the commercial aspects of its activities with the federal government.

Perhaps the most cited case regarding intergovernmental immunity, decided 16 years after *Department of Employment*, is *U.S. v. New Mexico*.<sup>6</sup> In another unanimous decision, the Supreme Court ruled that two management companies that contracted with the U.S. were not immune from state taxation (here, New Mexico's gross receipts tax and compensating use tax) because they were not so closely connected to the federal government as to be viewed as agents for the government. It is important to understand that *New Mexico* did not overrule the decision in *Department of Employment*. Rather, in *New Mexico* the Court proposed the following test to be used to determine that state tax immunity applies: "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, at least insofar as the activity being taxed is concerned." (Emphasis added.)

The Supreme Court specifically pointed to *Boyd* in making its determination in *New Mexico*. Based on the "immunity test" language quoted above, the Court reaffirmed that the purpose or activity being performed is a significant factor in determining whether immunity applies. To harmonize its holdings in *Department of Employment* and *Boyd*, the Court implied that a strong agency relationship alone is not enough for the state's taxation authority to be barred and the activity or transaction to be immune. Where there is, however, a strong agency relationship with the federal government, coupled with a great national governmental purpose, such as with the American Red Cross in *Department of Employment*, a sufficient connection exists to support a finding of immunity from state and local taxation.

Based upon this analysis, where there is a strong agency relationship between the government and the entity performing an activity, coupled with the activity's serving a great national governmental purpose, it is reasonable to conclude that the legal incidence of the state or local taxation falls directly on a governmental instrumentality that should be immune from taxation under the Supremacy Clause of the U.S. Constitution. The Supreme Court cases acknowledge that there is a difference between an entity that merely contracts with the U.S. government for a general commercial purpose and engages in *transactions in fulfillment of that commercial purpose*, and an entity that is engaged in *transactions in furtherance of a great governmental purpose*. The former is more akin to the taxpayer in *New Mexico* and is not immune from state and local taxation, while the latter is similar to the American Red Cross and should be immune from taxation, as was determined in *Department of Employment*.

## Potential Applicability to Today's Quasi-Governmental Businesses

According to the public portion of the federal budget, the U.S. government spends trillions of dollars to purchase goods and services from the private sector.<sup>7</sup> Most of this purchasing is done through intermediaries, agents, and representatives. Therefore, in the sales and use tax context, where the line is ultimately drawn between immune and taxable purchases by a quasi-governmental entity is significant in that even a small shift in how to test and analyze this issue can have a huge fiscal impact.

The U.S. government has been forced to respond in an unprecedented manner to the numerous threats and challenges resulting from a tumultuous decade that included the events of 9/11/01, the series of hurricanes that impacted the Gulf Coast, and the recent economic downturn. The continuing "war on terror," national disaster relief, governmental bailouts, and outright government ownership interests in troubled industries are manifestations of the U.S. government's responses, as a means to achieve the overarching governmental purpose of protecting its citizens from the foreign and domestic forces that have shaped this decade. These responses, which can be considered part of the primary and highest duty of the federal government, require an ever-expanding level of purchasing that is done directly at the federal government's behest and control.

Such purchases, however, are not always made by the government itself. In the government's place, private entities (referred to herein as quasi-governmental entities) are taking on increased levels of purchasing activity directly related to traditional governmental national security and disaster-related activities. For example, in the financial sector, the bailouts that resulted in federal governmental ownership interests in private entities have been facilitated by a newly created hybrid, public/private entity. Are the purchases of the hybrid public/private entity subject to state sales and use taxes? Are the federally owned private entities' purchases subject to these taxes? Should they be immune from taxation? Under the Constitution and Supreme Court precedent, the answers to these questions could depend upon whether this entity is serving a great national governmental purpose.

The analysis could be extended to quasi-governmental entities that are owned primarily by private interests. Airlines, trucking, shipping, financial, insurance, travel, and telecommunications companies, to name a few, are asked to engage in terror-threat surveillance, along with national disaster-related housing and transportation. Large retail vendors are asked—and in some cases, directed—by the U.S. government to stockpile emergency food and water goods. Likewise, drug companies are directed by the U.S. government to stockpile drugs with limited current commercial value but that are crucial to stave off potential chemicals and pathogens used in chemical and bio-weapony operations. Communications, media, and Internet companies are asked by the U.S. government to devote significant assets to national disaster communications and data services. In exchange for the U.S. government's bailout funds, automotive manufacturing, insurance, and financial entities have been required to give up controlling interests to the U.S. government. All these activities are performed in furtherance of a great national purpose, which has been described by many as national security itself.

These "private" entities expend significant funds to make expansive purchases in furtherance of these activities in the national interest. It can be argued that many of these purchases are no less important to a great national purpose than the purchases and activities of the Red Cross, and like the Red Cross, may well deserve, under the law, the same protections against state and local taxation. While litigation is sure to follow on this issue, at a minimum it may be reasonable to conclude that *McCulloch* and its progeny should have at least some application where a private entity is owned or controlled by the U.S. government. If one were to conclude that this broad interpretation of purchases by businesses owned and controlled by the U.S. government applies, such view would result in significant consequences for states that could be required to exclude from the imposition of sales and use taxes a large swath of transactions touched by the U.S. government.

## Conclusion

As other traditionally private enterprises, such as doctors, hospitals, and other health care services, continue to be added to the role of "federal governmental authority" in furtherance of a stated "national purpose," this question of the reach of state and local taxation must be carefully considered. Private enterprise has always been subject to varying forms and degrees of federal regulatory authority that could in some cases, arguably rise to the level of federal governmental control.<sup>8</sup> When, however, the federal government, in furtherance of an "important national purpose," voluntarily takes over actual ownership and control of a once-private entity, or

directs its activities in certain transactions, the ability of any state or local authority to tax that entity or transaction remains an open question worthy of careful consideration.

And so, the location of the line between immune and taxable purchases by quasi-governmental entities is moving, evolving, and possibly blurring. The uncertainty has increased in an era where the demarcation between "federal government" and "private enterprise" may no longer be clear. With the lack of clarity in this area, a state or local government's authority to tax a quasi-governmental entity's activities comes into reasonable question. As the very role of the federal government continues to enmesh, expand, and grow into private enterprise, it becomes increasingly difficult, factually and legally, to clearly understand when a state and local governmental authority can impose its taxing authority and when it cannot.

## Sidebar

### Practice Note: The Supreme Court's Standard for Immunity from State Taxation

In *U.S. v. New Mexico*, 455 US 720, 71 L Ed 2d 580 (1982), the U.S. Supreme Court set forth a test to determine when state tax immunity applies with regard to sales, use, service, and gross receipts taxes in connection with transactions involving the federal government, or its agencies or instrumentalities. According to the Court, "tax immunity is appropriate in only one circumstance: 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, at least insofar as the activity being taxed is concerned. This view, we believe, comports with the principal purpose of the immunity doctrine, that of forestalling 'clashing sovereignty,' ... by preventing the States from laying demands directly on the Federal Government."

Applying this standard also to private entities, the Court suggested "that a state tax is impermissible when the taxed entity is so intimately connected with the exercise of a power or the performance of a duty by the Government that taxation of it would be a direct interference with the functions of government itself" (internal quotation marks and citation omitted).

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<sup>1</sup> U.S. Const. Art. VI, cl. 2.

<sup>2</sup> 4 AFTR 4491, 17 US (4 Wheat.) 316, 4 L Ed 579 (1819).

<sup>3</sup> 378 US 39, 12 L Ed 2d 713 (1964).

<sup>4</sup> 355 US 484, 2 L Ed 2d 436 (1958).

<sup>5</sup> 385 US 355, 17 L Ed 2d 414 (1966).

<sup>6</sup> 455 US 720, 71 L Ed 2d 580 (1982).

<sup>7</sup> See Budget of the United States, FY2008.

<sup>8</sup> In fact, when the U.S. government requires a private entity to act, it becomes a question of whether the "takings clause" of the U.S. Constitution has been triggered. (The Fifth Amendment's "takings clause," made applicable to the states through the Fourteenth Amendment, provides: "[N]or shall private property be taken for public use, without just compensation.") See, e.g., *Youngstown Sheet & Tube Co. v. Sawyer*, 343 US 579, 96 L Ed 1153 (1952); *Kelo v. City of New London, Connecticut*, 545 US 469, 162 L Ed 2d 439 (2005). This aspect of the discussion, however, is beyond the scope of this article.

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