

Tax Immunities

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Definition: The constitutional principle that exempts federal and state government agencies, activities, and property from taxation by the other.

Significance: Intergovernmental tax immunities protect the constitutional autonomy of federal and state governments by preventing them from using their taxing power to unduly interfere with each other's government.

The U.S. Constitution does not expressly immunize the federal government from state taxation, nor states from federal taxation. *McCulloch v. Maryland* (1819) inferred the federal government's immunity from Article VI, section 2, the supremacy clause. *McCulloch* held that Maryland could not impose a tax on notes issued by the Bank of the United States, because a state may not tax those it does not represent. Otherwise, any state could use its taxing power "to retard, impede, burden, or ... control" the federal government that the Constitution declared to be supreme in exercising its delegated powers. *McCulloch* did not directly address the issue of federal taxation of state governments, but suggested that states did not enjoy reciprocal immunity.

Tax Immunities From McCulloch to the New Deal. After *McCulloch*, however, the Court inferred state tax immunity from the Tenth Amendment and crafted the doctrine of intergovernmental tax immunity defined by the principle of dual federalism. The Court began by extending doctrine from the primary immunity of government itself to bar taxation by one government of the employees of another. *Dobbins v. Commissioners* (1842) invalidated a state tax on a federal officer while *Collector v. Day* (1871) held that the salaries paid state judges were immune from federal taxation. The Court further extended state immunity to protect increasingly diverse state proprietary activities, such as utility and railroad operations, and private businesses selling goods to state governments. Then *Pollock v. Farmer's Loan & Trust Co.* (1895) held that the interest earned from state bonds was immune from federal taxation. The Court also expanded the doctrine of intergovernmental tax immunity to bar state taxation of private businesses selling goods to and leasing land from the federal government, because the economic incidence or burden of the tax would be passed on to the federal government. In *Long v. Rockwood* (1928), the Court even made royalties on federally-issued patents immune from state income taxation.

These increasingly expansive interpretations deprived federal and state governments of substantial revenues and moved the Court to narrow the scope of intergovernmental tax immunities in the late 1930's. *James v. Dravo Construction Co.* (1937) discarded the economic incidence test, limited federal tax immunity to its legal incidence, and upheld a non-discriminatory state tax on a private business that had built locks and dams under a federal contract, because the federal government did not have a direct legal obligation to pay the tax. Then *Helvering v. Gerhardt* (1938) overruled *Day* and permitted the federal government to levy a non-discriminatory income tax on state civil servants. Finally, *Graves v. New York ex rel. O'Keefe* (1939), overruled *Dobbins* and permitted non-discriminatory state taxation of federal employees. After *Graves*, the intergovernmental tax immunity doctrine became even more limited barring only taxes imposed directly on one government by another and taxes that discriminated against the employees and private businesses who had dealings with the government.

Federal Tax Immunity Today. Federal tax immunity exists only when the legal incidence of the tax falls directly upon the federal government, its property, or one of its entities. The Court further limited the immunity of federal employees from state taxation in *United States v. County of Fresno* (1977) where it upheld a state tax on the use by federal employees of housing supplied to them by the U.S. Forest Service as part of their compensation, because the tax was similar to a state tax on the owners of non-tax exempt property who passed the economic incidence on to their renters. States may not, however, impose discriminatory taxes on federal employees. In *Davis v. Michigan* (1989), the Court rejected a state income tax on federal government employee retirement benefits which exempted state employee retirement benefits from taxation.

Private businesses who use federal property are no longer immune from non-discriminatory state taxes. In *Detroit v. Murray Corp.* (1958), the Court sustained state taxes on a private company's use of machinery owned by the federal government and leased to the company for use in the business. A companion case, *United States v. Detroit* (1958), upheld a state tax on those who used tax exempt federal property, because the state had imposed a similar tax on the owners of non-exempt private property. Since *United States v.*

New Mexico (1982), the Court has taken a narrow approach in determining federal tax immunity. *New Mexico* rejected the claim that private contractors were federal agents who were paid by an advanced funding procedure, because the private taxpayer and the government must be so closely connected that the taxpayer “stands in the government’s shoes.”

State Tax Immunity Today. While the immunity of the federal government and its entities has not been at issue since 1937, the Court has limited state tax immunity to the performance of its basic governmental functions. *New York v. United States* (1946) rejected the distinction between government and proprietary activities as unworkable in an age of increasingly diverse state governmental activities and articulated a new state immunity principle that permitted a federal non-discriminatory tax to be applied to the state’s bottling and sale of water. The Court further limited the reach of the state immunity doctrine in *Massachusetts v. United States* (1977) where the Court sustained the application of a federal annual registration tax on civil aircraft to a state police helicopter, because it was based on a fair approximation of the state’s use of the national aviation system. Since *Massachusetts*, the federal government may tax even a basic state government activity if the non-discriminatory tax recoups the cost of benefits received from the federal government.

Bibliography

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