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Tax Avoidance by the Federal Government

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other enterprises entails the keeping of numerous books and records essential to its conduct or useful in its efficient operation . . . The engineer's statement which was held inadmissible in this case falls into quite a different category. It's not a record made for the systematic conduct of the business as a business." In brief, the Court ruled that, within the contemplation of the statute, the business of a railroad is railroading and not causing accidents. The decision of the Court is sound in principle for it is a reaffirmance of the Commonwealth Fund proposal. As Professor Maguire stated in a note in the *Harvard Law Review*,[21] "The majority opinion in the *Hoffman* case quite correctly emphasizes the morbid judicial fear of deliberate falsification expressed by the early English formulations of the hearsay rule and its exceptions. Correctly again, the opinion speaks of the judicial effort to indicate guaranties of trustworthiness connected with the documents admitted as business entries . . ."

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TAX AVOIDANCE BY THE FEDERAL GOVERNMENT

Tax avoidance, customarily associated with private firms and individuals, is applied on by far the largest scale of all—by our own Federal Government. This is not to imply, however, that the Government has thereby breached any ethical standards, for it is now well recognized that despite the evils which result from the promiscuous application of dubious tax reduction practices, the use of sound legal principles for reducing taxes is "above reproach" [1] and not even "mildly unethical".[2]

Since 1819, when Chief Justice Marshall in *McCulloch v. Maryland* [3] expounded the principle that the Constitution of the United States implies that properties, functions, and instrumentalities of the Federal Government are immune from taxation by its constituent parts, the Government has attempted to obtain the maximum possible exemption from all state and local taxes.

However, although the doctrine of implied immunity appeared to be clear when applied to direct taxes levied on the Government, its precise reach became obscure when applied to indirect taxes.

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[21] (1942) 56 HARV. L. REV. 464.

[1] *See* PAUL, STUDIES IN FEDERAL TAXATION (1937) 85.
[2] Rands, Inc., 34 B. T. A. 1094.
[3] 4 Wheat. 316, 4 L. ed. 579 (U. S. 1819).

Perhaps the most perplexing problem with respect to the extent of the Federal Government's immunity arose in connection with private contractors performing work for the Government. The problem came to a climax with the advent of World War II. As a result of the critical emergency, the Government entered into an unprecedented number of cost type contracts designed to expedite the production of war material. Under this type of contract, the Government obligated itself to reimburse the contractor for all proper costs incurred in performing the contract, plus a profit. Almost immediately thereafter, many state tax authorites in States which impose sales, use, occupational, privilege, and gasoline taxes applied those taxes to cost type contractors and demanded payment thereof.

This situation brought to the fore the question of whether the Government's exemption from taxes could be applied to cost type contractors, on the theory that a tax levied on the contractor would, in turn, increase the cost to the Government in like amount.

The War and Navy Departments were seriously concerned with the prospect of greatly increased costs to the war program as a result of the action taken by the States. In the belief that state sales, use, privilege, occupational, gasoline and similar taxes were inapplicable to cost type contractors with the United States, the War and Navy Departments requested the Attorney General of the United States to undertake resistance to such taxes for and on behalf of the War and Navy Departments.[4]

Thereupon, arrangements were consummated with a co-operative vendor of a Government cost type contractor for the use of the vendor's litigating position with reference to the sales tax. The issue was thereby presented to the Supreme Court of Alabama in the case of *King & Boozer v. Alabama*.[5] The Alabama court held that the State had no authority to levy a sales tax on purchases of a Government cost type contractor and stated, "The contractor here was acting for the Government in the accomplishment of a governmental purpose. . . The conclusion is inescapable that the burden of the tax in the instant case falls directly and immediately upon the Government. The addition of the tax raises the cost of construction which the Government is bound to pay."

On appeal, however, the decree of the state court was reversed by the United States Supreme Court in *Alabama v. King & Boozer*.[6] In upholding the validity of the state sales tax on purchases made by a cost type contractor, the Court rejected the contention that the contractor was so acting as to place the Government in the role of a purchaser of the material necessary for the performance of the contract. The legal effect of the transaction, the Court concluded, was to obligate the contractor for the purchases inasmuch as the contract contemplated that the contractor was to purchase all the

[4] 22 COMP. GEN. (1942) 109, 112.
[5] 241 Ala. 557, 3 So. (2d) 572 (1941).
[6] 314 U. S. 1, 86 L. ed. 3 (1941).

materials required in its own name and on its own credit.

Faced by the prospect of a large increase in the cost of the war program, as a result of the Supreme Court's decision, the Government made extensive studies of the various state and local tax regulations to determine methods for avoiding such taxes. The results of these carefully developed methods, which have proved so successful in reducing the cost of the war program, are worthy of careful analysis as a guide for tax savings by private individuals and concerns.

An interesting example is afforded by the practice developed by the Federal Government for avoiding the New York City Sales Tax and similar taxes levied by other localities. The Government had many cost type contracts in process for the repair of vessels, under which, the contractor purchased all the required material and employed all the necessary labor on its own account. The resulting costs were reimbursed to the contractor by the Government.

The Comptroller of the City of New York ruled that all purchases of tangible personal property by a contractor for use in connection with ship repairs are at retail [7] and therefore subject to the sales tax. The conclusion was based on the theory that:

1. ship repair and alteration contractors are engaged primarily in the business of rendering services,
2. the use of tangible personal property is only incidental in the rendering of such services, and
3. reimbursement by the Government to the contractor is made for the aggregate cost of the services and material, and often after the incorporation of the material into the work.

As a result of the Comptroller's decision, the sales tax was levied on all purchases of tangible personal property by ship repair contractors, thus increasing the cost of the material to the contractor, and in turn, the Government.

To avoid this situation, the Government developed a new form of ship repair contract to take advantage of the fact that a sale is defined by the New York City Sales Tax Law as "Any transfer of title or possession or both . . . in any manner or by any means whatsoever for a consideration, or any agreement therefor . . ." [8] Since, under this definition, a sale may be consummated by any agreement for the transfer of title or possession,[9] the new form of

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[7] Article 41a of the Regulations of the Comptroller of the City of New York under the New York City Sales and Compensating Use Tax Laws Pertaining to War Contracts, Nov. 25, 1942.

[8] Section N41-1.0, Local Law 18 of 1943.

[9] The first section of the Uniform Sales Act (Personal Property Law of New York § 82) defines a sale as follows: "A sale is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price."

ship repair contract [10] was prepared so as to contain the following provisions:

Title to all material and equipment to be incorporated in the vessel or its equipment or to be used in doing any work hereunder or in connection therewith shall vest in the Government as payment is made therefor by the Government or by the Contractor, or upon delivery thereof to the Government or to the Contractor, whichever of said events shall first occur.

The Contractor shall, as soon as practicable, identify any property which is to become a part of the vessel by marking or segregation in such a way as to indicate ownership thereof by the Government and its allocation to the vessel.

The effect of these provisions was to render all purchases by ship repair contractors non-taxable by the simple legal expedient of transferring title (thus creating a resale to the Government which is tax immune) prior to the incorporation of the material in the work. The results were so successful that all outstanding ship repair contracts were cancelled and renegotiated in the new form.

The proper control of the date of vesting title was also used to great advantage by the Government in avoiding real estate taxes.

At the start of the present emergency, the Government let out numerous contracts for the construction of facilities, required for the production of war material. The contracts provided that the contractors were to construct the facilities on their own account and would be reimbursed by the Government for the costs thereof over a period of sixty consecutive calendar months beginning at the time the facilities were completed. The title to all such facilities vested in the contractor until the final payment and completion of the contract, at which time, title would pass to the Government (unless the contractor elected to purchase the facilities).

Under this form of contract, the contractor was subjected to real estate taxes based on the value of the facilities. The cost of such taxes were, in turn, included in the contractor's statement of costs and subsequently reimbursed by the Government; thus, the ultimate cost of the tax was borne by the Government.

To avoid this situation, the Government developed a revised form of facilities contract providing, in part, that:

Title to any and all facilities shall at no time be in the Contractor but shall pass directly from the vendor of such facilities to the Government upon any payments made on account thereof either by the Government or by the Contractor, upon the delivery of such facilities to the Contractor on account of the Government or upon the happening of any event upon the occurrence of which the title passes out of the vendor.

This effort on the part of the Government to avoid real estate taxes on facilities used by its contractors was vigorously resisted by local taxing authorities. It was contended that increased municipal services, to serve and protect the influx of war workers, are

[10] Navy Department, Bureau of Ships' NObs Contract for the Repair or Alteration of Vessels (Revised April 19, 1943).

required in all communities where large war contracts are placed; that such local services rely heavily on real estate taxation; that to exclude property acquired by the Government imposes the increased cost on others. While it was conceded that the allowance of assessments on such property would measurably increase the cost of waging the war, it was argued that the Federal Government may diffuse the cost throughout the country instead of putting a back-breaking burden on local governments where war plants are located.

In the case of *United States* et al. *v. Allegheny County, Pa.* [11] the controversy flared when the assessing authorities of Allegheny County revised a Government contractor's previously determined assessment for ad valorem taxes by adding thereto the value of machinery which the War Department leased to the contractor in order to facilitate the production of greater quantities of large field guns.

The Supreme Court of Pennsylvania ruled [12] that under the state law regardless of who held the title to it the machinery constituted a part of the mill for purposes of assessment and was properly taxed as real estate. It acknowledged that property in the physical possession of the United States is not taxable, but this assessment, it said, is not against the United States but against the contractor, which is operating its mill for private purposes. The Court reasoned that if the contractor defaulted in tax payments, "the paramount rights of the government in the machinery could not be divested or in any way affected," hence the Government could suffer no loss. Evidence that the machinery was not owned by the contractor was, therefore, held to be irrelevant and improperly admitted.

The United States Supreme Court reversed this judgment, holding [13] that the Tax Law of the Commonwealth of Pennsylvania as applied in this case violates the Federal Constitution in so far as it purports to authorize taxation of the property interests of the United States in the machinery in the contractor's plant. The Court stated:

> We think, however, that the Government's property interests are not taxable either to it or its bailee. The "Government" is an abstraction, and its possession of property largely constructive. Actual possession and custody of Government property nearly always are in someone who is not himself the Government but acts in its behalf and for its purposes. He may be an officer, an agent, or a contractor. His personal advantages from the relationship by way of salary, profit, or beneficial personal use of the property may be taxed as we have held. But neither he nor the Government may be taxed for the Government's property interest.

The issue is not completely decided as yet, however, for the Government having won this case may attempt, after the present

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[11] 322 U. S. 174, 64 Sup. Ct. 908 (1944).
[12] Appeal of Mesta Machine Co., 347 Pa. 191, 32 A. (2d) 236 (1943).
[13] United States *et al.* v. Allegheny County, Pa., 322 U. S. 174, 64 Sup. Ct. 908 (1944).

emergency, to extend its immunity to property in which it has an undivided equitable interest. That is, property in which the title vests in a third party but which is partly paid for by the Government, as in the case of 60 Payment Facility Contracts previously discussed.

Thus, it is interesting to observe that the field of tax avoidance is one in which the Federal Government plays a dual role; as tax collector it seeks to extend the scope of its taxes and block all possible loopholes; as a participant in commercial and industrial activities, it musters every legal expedient in an effort to avoid taxes.

RAPHAEL J. MUSICUS.

EQUITABLE RELIEF FROM NEGLIGENT STATEMENTS AND MISREPRESENTATIONS

The traditional doctrine of the law of torts requires one who undertakes to do a thing, even though gratuitously, to act with care if he acts at all. However, this rule is greatly modified when the act is in the form of the spoken or written word rather than in the form of a physical act. In such case the principle has been that "negligent words are not actionable unless they are uttered directly, with knowledge or notice that they will be acted on, to one to whom the speaker is bound by some relation of duty, arising out of public calling, contract or otherwise, to act with care if he acts at all." [1] Liability for misrepresentation is similarly restricted to instances involving a breach of duty.

While it is true that an action will lie for slander or libel, there is a broad field between the truth in a particular case and libel or slander. Many have entered this field, or found themselves in it, only to discover that *damnum absque injuria* is more than a Latin phrase. The fact that the interests of the public are injured by misrepresentations or negligent statements or that the untruth results in a public nuisance appears to be of no concern to a court of equity.

In 1830 the courts of this state set down, and have since quite rigidly followed, the rule that "when the words are spoken, not of the trader or manufacturer, but of the quality of the articles he makes or deals in, to render them actionable *per se,* they must import that the plaintiff is guilty of deceit or malpractice in making or vending them." [2] In the absence of such a libel or slander impeaching the integrity, knowledge, skill, diligence or credit of the plaintiff, the words are not actionable unless special damage be alleged and proved,

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[1] Courteen Seed Co. v. Hong Kong & S. B. Co., 245 N. Y. 377, 157 N. E. 272 (1927).

[2] Tobias v. Harland, 4 Wend. 537 (N. Y. 1830).