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# Observations on the Tax Immunity of Federal Properties and Operations in Virginia

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# OBSERVATIONS ON THE TAX IMMUNITY OF FEDERAL PROPERTIES AND OPERATIONS IN VIRGINIA

## I. *Background*

"It is a fundamental principle that a state and its subdivisions are without power, in the absence of express consent of Congress, to tax property owned by the United States. Such consent, being in derogation of the sovereign power of the federal government, is found only where Congress has spoken with the clearest language."

This was the dictum of Virginia's Supreme Court of Appeals in *County of Prince William* v. *Thomason Park, Inc.*[1] At that time (1956) it appeared an accurate statement of Constitutional law as to the tax immunity of federal property. Unfortunately the language in which Congress has spoken on tax matters is seldom clear, and the courts when called upon to interpret the law have been forced to grope among conflicting Congressional policies and indistinct legislative intentions. The resultant pattern of decision has revealed a sharp difference of opinions in the courts. By 1958 three significant controversies on the

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[1] 197 Va. 861, 91 S. E. 2d. 441 (1956). This case arose as result of the attempt by the County of Prince William to exercise the authority thought to have been extended by Congress in the Military Leasing Act (see note 8*) and the Wherry Act (see note 11*). In 1950 unimproved property near the Quantico Marine Base had been leased at a nominal rent to the defendant by the federal authorities per the above acts for 75 years to erect a residential development. Upon the termination of the lease the property was to revert to the government without compensation to the lessee for the improvements made by him. The County appraised the buildings at their full value and levied a tax on the same basis as if the lessee owned the buildings. The Supreme Court of Appeals rejected the County's contention on the following grounds:

a) The buildings attached to the land and therefore became immediately property of the U. S. Government.

b) The Acts of Congress referred to authorized tax by state and local government on the INTEREST OF THE LESSEE only and the real property of the government therefore retained its immunity.

c) The State Code provision 58-758 which authorized local taxation of realty retained at state level the authority to tax intangible property and the amendment as of 1 January, 1955, was not applicable to the issue before the Court.

d) The leasehold interest was an intangible outside the reach of local tax authorities.

The excerpt quoted applied to (b) above.

subject, all generated in the State of Michigan, had come to the United States Supreme Court. To resolve these cases the Court boldly cut through the involved knots of Constitutional interpretation and accounting niceties and affirmed the authority of the state of Michigan to tax users of federal realty and personalty on the full value of the property in use without any attempt to separate the user's interest from the owner's interest, nor to differentiate between tax burdens borne by the United States and those borne by private parties. It would appear from the circumstances examined here that the time has come for the State of Virginia, among others, to reexamine its law, its procedure and its judicial philosophy as to such tax collections.

## *II. Judicial Pronouncements*

In the three Michigan immunity cases, three quite different circumstances were resolved by the Court against the interest of the United States on the same principle, i.e., that the immunity conferred must be specific and cannot be presumed a general immunity. In a narrowly divided case (5-4), *Murray Corporation* v. *City of Detroit*[2] the taxpayer, a subcontractor, had in his custody, as work-in-process, some aircraft components which he had assembled for his prime contractor, who was selling to the Air Force. Upon these the subcontractor had performed certain work. Despite the fact that title to the components had at all times remained in the government under a progress payment procedure, the city of Detroit, under state law, levied a tax on the manufacturer based upon the full value of the chattels in his custody. The court rejected the contention of the federal government and the contractor that the tax was unconstitutional. Although the Michigan statute described this a "property tax" the Court declared it a "privilege tax" in substance, and sustained it.

In *U. S.* v. *Township of Muskegon*, [3] a manufacturer had contracted with the Army to operate a defense plant belonging to the Government for a short period for the sole purpose of producing an item for the Army. For operating the plant the manufacturer received reimbursement of expense and a fixed

[2] 355 U. S. 489, 78 S. Ct. 458, 2 L. Ed. 2d 441 (1958)

[3] 355 U. S. 484, 78 S. Ct. 474, 2 L. Ed. 2d 436 (1958).

fee. No lease was involved since the plant was operated by the manufacturer as "bailee for benefit of the bailor." The government in other words had merely contracted with someone to operate its tools for a specific task order. The taxes paid by the manufacturer were to be reimbursed to the manufacturer by the United States under the contract. The township assessed the manufacturer for the plant at full value as per the Michigan statute. The Court sustained the tax.

In *U. S.* v. *City of Detroit,*[4] the manufacturer had leased a defense plant on a year-to-year basis and paid a specific rent to the United States. By the terms of the contract (as required by the Military Leasing Act)[5], the lease was to be renegotiated if the property used were to be subjected to local taxation. Again a local tax, based on the full value of the plant, was levied and the United States bore the tax under the contract by reducing the rental rate accordingly. Again the Court sustained the tax.

In explaining the majority opinion in each case, Mr. Justice Black threw back to the Congress the responsibility of determing to whom to grant immunity. In the *Murray* case he summarized:

> We find nothing in the Constitution which compels us to strike down these state taxes. There was no discrimination against the Federal government, its property or those with whom it does business. There was no crippling obstruction of any of the government's functions, no sinister effort to hamstring its power, not even the slightest interference with its property. In such circumstances Congress is the proper agency as we pointed out in *U. S.* v. *City of Detroit,* to make the difficult policy decisions necessarily involved in determining whether and to what extent private parties who do business with the government should be given immunity from state taxes.

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[4] 355 U. S. 466, 78 S. Ct. 474, 2 L. Ed. 2d 424 (1958).

[5] 61 Stat. 774 (1947).

Commenting on these decisions the former Deputy Attorney General of California, Mr. John L. Nourse, in an article in the Journal of Taxation[6] tracing the meandering course of judicial history on the subject, stated:

> The States have won an important victory in the Borg Warner and Murray cases. There are sound reasons why the States should be permitted to tax federal property and federal activities when the federal government moves into the industrial field. The Congress should make a thorough review of the hodge podge of legislation which permits the taxation of some types of federal property, provides payments in lieu of taxes on other types of federal property and provides outright grants in the States in some cases where the property is entirely exempt. It should adopt a comprehensive plan for the taxation of federal industrial property by the States...
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> Congress is the only agency which has the facilities to make a comprehensive study of the problem to decide upon a fair solution and to lay down a set of rules which will reach a consistently fair result. The Courts lack the research facilities.

While perhaps the most vigorous recent litigation of the tax immunity question has occurred in the industrial field, there is no expression in either the majority or minority opinions in the three Michigan cases which would distinguish the immunity status of industrial property from that of any other property which the government might, in its own interest or for mutual benefit, permit private parties to hold or use. The government has made comparable arrangements for its property in many fields, notably in grazing and agricultural land, in residential property, in electric power facilities, in shipping, in harbor facilities, in air fields, in retail commercial property (incidental to the residential property) and in the recreational and conservation field. Every state in the Union has within its confines federal property and federal operations of sizeable value from which private parties derive some degree of private benefit. Mr. Nourse's comment appears to have

6 "State Taxation of Federal Property still not settled despite Supreme Court Cases." 9 J. Taxation 286.

much broader application than simply the industrial field. To appreciate the full scope of the change in perspective which has occurred in the outlook of the Court, let us compare the historic and orthodox view of the immunity principle with the current view.

As students of Constitutional Law will recall, the great judicial landmark in the question of tax immunity was John Marshall's opinion in the case of *McCulloch* v. *Maryland.*[7] The occasion of Marshall's famous opinion was the effort by the State of Maryland, in 1816, to force an instrumentality of the federal government, the Bank of the United States, to comply with a state law which required any bank operating in the state without having been chartered under Maryland law to pay $15,000 a year for the franchise. Marshall in perhaps his most influential opinion 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 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. . . This opinion does not deprive the states of any of the resources they originally possessed. It does not extend to a tax paid by the real property of the bank, in common with the other real property within the state, nor to a tax on the interest which the citizens of Maryland may hold in this institution, in common with other property throughout the state. But this is a tax on the operation of an instrument employed by the government of the Union to carry its powers into execution. Such a tax must be unconstitutional.

The vigor of Marshall's opinion long survived the ill-fated Bank which Andrew Jackson summarily removed from the scene a few years later. It remained the orthodox legal veiw view for more than a hundred years, as the Virginia Court of

[7] 4 Wheat 432, 436. (1819)

Appeals declared it, i.e., that any property or instrumentality of the United States Government was immune to State taxation except as Congress might specifically declare otherwise.

The text of Mr. Justice Black's opinions in the three Michigan cases of 1958 discussed above appears to restate the Court's position to the extent that the immunity rather than the taxability must be specifically legislated to be effective. Mr. Justice Whittaker, in his emphatic dissents to each of the three Michigan cases discussed, clearly so read the import of the majority opinions. If taxability may be presumed where the law is otherwise unclear or silent, a major reorientation of judicial thought has occurred. Let us examine more closely the specific legislation and circumstances which brought about this reinterpretation.

### *III. Legislative Trends*

In the demobilization period which followed World War II, the United States Government found itself confronted with an unprecedented task in the disposition of many billions of dollars worth of property of a capital nature not previously common to government use and which had been acquired or developed in great urgency to sustain the war effort. For over a decade one of the major concerns of the federal government was properly to select and convert certain of this capital investment to peacetime use, to arrange the adequate maintenance of another selected portion in readiness for possible future emergency, and finally to consign to the scrap heap that which had insufficient asset value in either the current peacetime economy or a prospective emergency to warrant further custodial effort by the government.

A major step in this task was the passage of the Military Leasing Act [8] in 1947. This Act authorized the heads of the military departments to take over from the Reconstruction Finance Corporation and the Defense Plant Corporation such industrial properties as the heads of the military departments might select as potentially useful in future emergencies, and to arrange, where ever it was deemed advantageous to the govern-

[8] 61 Stat. 774, P. L. 364, 1st Sess. 80th Congress 5 August 1947

ment, leases of any property in their control and not currently required for public use, to private parties "under such terms and conditions as will promote defense or be in the public interest."

Recognizing the broad scope of the policy and the major repercussions which might be felt in the disparate tax treatment of lessees as compared with their competitors, a significant retreat from the traditional tax immunity of government property was spelled out in section 7 of the Act which declared:

> The lessee's interest made or created pursuant to the provisions of this act shall[9] be made subject to State or local taxation. Any lease of property authorized under the provisions of this act shall contain a provision that if and to the extent that such property is made taxable by the State and local government by Act of Congress, in such event the terms of such lease shall be renegotiated.[10]

In 1949 the defense posture of the United States in the Cold War began to take on a semi-permanent form. Temporary deployments were being converted to established bases. Grossly unsatisfactory housing conditions developed in the vicinity of many of the new or expanded bases. Congress attempted to remedy the situation by passage of an Amendment to the National Housing Act.[11] That Act, originally passed in 1934 as an anti-depression measure to restore confidence in the financing of home ownership and construction, had been expanded in 1942 to facilitate home mortgages at the sites of war industry and in 1949 was modified to encourage construction of suitable housing near military activities. Clearly, if the government were to insure loans on homes, some

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[9] As originally enacted.

[10] In 1956 this provision was incorporated into 10 U. S. C. 2667 in the following language:
"(e) The interest of a lessee of property leased under this section may be taxed by State or local governments. A lease under this section shall provide that if and to the extent that the leased property is later made taxable by State or local governments under an Act of Congress, the lease shall be renegotiated."

[11] The Housing Act Amendments of 1949 were popularly known as the "Wherry Act." 63 Stat. 570; see particularly 12 U.S.C. 1706 b, 1747j

borrowers could be expected to default, and the federal government could expect to acquire interests in real property for which it had no use other than as security to recover the funds paid the mortgagee on default of the mortgagor. To avoid the possibility of reducing local tax collections through such acquisition, which would put the property in government hands, the Act provided in section 807:

> Nothing in this title shall be construed to exempt any real property acquired and held by the Commissioner (of Federal Housing) from taxation by any state or political subdivision thereof to the same extent, according to its value, as other real property is taxed.

In 1951 a concurrent policy was established in the "Critical Defense Housing Area" Act[12] whereby there would be paid to the State and local governments, at the discretion of the Administrator, "Sums in lieu of taxes and special assessments on real property acquired and held for residential purposes (or for commercial purposes incidental thereto), such sums to approximate full taxes and special assessments with allowances for expenditures by the federal government for items usually furnished by the taxing authorities."

The change in tenor of legislation through this period should be carefully noted:

a) 1947—The Military Leasing Act declared that the *interest* of the lessee shall be subject to local taxation.

b) 1949—The Amendment to the Housing Act declared it had granted *no exemption.*

c) 1951—"The Critical Defense Housing Area" Act undertook direct payments to localities in lieu of taxes.

As mentioned in the abstract from Mr. Nourse's article, in other legislation, notably that in connection with school operating funds, Congress has provided outright grants to states to compensate for loss of local tax income in the vicinity of federal activities, without any specific relationship to equitable tax burden but rather on basis of need.

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[12] 65 Stat. 307 (1951), 42 U.S.C. 1592

It should be evident from these legislative excerpts, that a majority of Congress had come from the older concept that all operations and instrumentalities of the federal government deserved complete immunity from local taxation, to the idea that the presence of federal property and federal operations in any locality presumably generated costs to the local government for which the federal government must properly arrange reimbursement.

## IV. *Administrative Problems*

From the administrative aspect, the introduction of modern commercial accounting techniques into operations of the federal government and the consequent emphasis on the so-called "performance budget" has gradually forced recognition of the fact that when one arm of an organization performs a service for another arm, there must be an accounting such that the true costs of each operation performed will be known. An inefficient performance of a given function or activity must be made distinguishable from an efficient performance. Otherwise both administrative control of the budget and legislative control over the appropriations would become utterly ineffectual. Hence, if the local government performs services for the federal government, it should be compensated and the cost borne by that arm of the federal government which receives the benefit of local roads, police protection, traffic control, judicial administration, street lights, public parks, schools, sewage, fire prevention, etc. This would appear the equitable solution of the problem of inter-governmental immunities. It brings with it, however, its own knotty problem, that of consistently arriving at a fair accounting of the value of services rendered, i.e., an equitable share of the tax burden in each affected community.

As is evident from the judicial, legislative, and administrative history outlined above, the effective implementation of the presumably permissible taxation of federal operations or property presents a very ticklish problem. Left, as it largely is in Virginia, in the hands of the local Commissioners of Revenue and Assessors, it appears to require too much economic judgment and legal research. In each situation the complex federal legislation under which various properties are operated must be meticulously reviewed. The intent of the authorizing legislation, the contracting policy of the arm of government concerned, the detailed terms of the leases and financial arrangements for each property operated, all must be carefully analyzed. The public advantage in pressing each issue to its full logical conclusion must be intelligently weighed against first, the possible discouragement of enterprise in the jurisdiction involved and second, the danger of inducing Congress to restore complete immunity. And finally, the various concurrent federal financial contributions to the functions of local government must be added together to discern the overall balance.

Understandably Virginia's action in this matter to date has been quite hesitant. In the 1954 session, the General Assembly made a small modification in section 58-758 of the state tax code. This section in its original form was the fulcrum upon which the Court of Appeals would reject Prince William County's attempted tax on a residential development on leased federal land. The Assembly simply changed the definition of "taxable real estate" to include "leasehold interest" in "the land or improvements, or both, where such are exempt for taxation to the owner." The intent was merely to extend to the local governments in Virginia the authority implied in certain federal legislation to make private parties using federal property share proportionately the tax burden in the affected communities. An informal inquiry by the author to Real Estate Assessors and Commissioners of the Revenue in various Virginia localities which contain appreciable federal property apparently taxable under the pertinent federal and state legislation has revealed little implementation of 58-758, as it applies to leasehold interests. The attitude reflected by the local tax administrators is that there are subtler and less controversial ways of raising the necessary revenue.

## V. *Valuation Problems*

The attitude revealed is not surprising. The evaluation of a "leasehold interest" in terms of money is not easy. The valuation of leasehold interests in a given property can be approached by at least three fundamentally different standard methods, each of which has its own merits and demerits. Probably the most common, because of its simplicity, is the so-called capitalization method. Here the annual income of the property to the lessee is multiplied by an arbitrary figure representing the number of years over which it would be normal, commercially, to amortize the investment in such an income-producing property. If income is fluctuating or subject to dispute there is a wide margin of error in the resulting valuation.

Next is the so-called "market value" approach. Here the value of the property leased is first appraised at the current price such a property would bring, judging from recent transactions in similar property where willing sellers found willing buyers. Then the interest of the lessee is evaluated as the difference between the current sale value of the property and the discounted remainder value at the conclusion of the lease, less an allowance for rental to be paid and plus depreciation anticipated. The difficulty here is that it is a basic principle of law that each tract of land is unique and frequently, as to government properties, there is no comparable property recently traded upon which to develop a fair price.

A third method of valuation is based upon replacement cost less depreciation. Here, having made an engineer's estimate of the expense involved in reproducing the improvements and allowing for wear and tear to date in the leased property, the factors of discount for tenure and rental cost are introduced as in the market value method to segregate the lessee's interest from that of the lessor in fiscal terms. The weakness of this engineering approach is that it is unrelated to the income potential of the property and applies only to improvements since ordinarily land cannot be replaced.

Obviously some types of property are much better suited to one method of valuation than another. Each method is open to quite wide variations in the hands of different appraisers. A fair appraisal should consider the results to be derived from all three methods of analyses.

Two complex valuation problems are worthy of note. Both occurred in California and were resolved by the Courts under the segregation of interest principle where federal property was employed by private contractors. In *Kaiser Co. Inc.* v. *Reid*[13], a shipyard facility owned by the United States was operated rent free by a contractor for war time construction of government vessels. The contractor had no specific period of occupancy and had no right to assign his "interest" to anyone else. The construction contracts undertaken in the yard were subject to arbitrary termination clauses and in fact were abruptly terminated, unilaterally, by the Government. Nevertheless the contractor was found to have a "possessory" interest in the property, taxable as real property. The only question, the court found, was whether the ratio of the contractor's "usufructory interest" to the "full cash value" of the shipyard had been properly determined. The assessors had determined the initial cost of construction of the facility, then made allowance for abnormal wartime costs. They then depreciated the facility to the end of the tax year in question and subtracted this "reversionary interest" of the Government. The difference between the initial adjusted value and the reversionary value, plus a similar calculation on the land based on its annual earning power, was found to be the contractor's taxable interest.

In *De Lux Homes* v. *County of San Diego*,[14] a contractor had leased land under the Wherry Act to build a large housing development (entirely with borrowed money) near a major military installation. Unlike the Virginia case the problem was not whether the property could be taxed but how to properly delineate the contractor's interest. The capitalization of income method was used by the court. The central issue was how to compute net income. The court denied the contractor the rental expense as well as the amortization of the construction loan and the interest paid thereon. It declared that valuation by the capitalization method for property tax purposes must be based on the actual income of the property, and not upon the imputed income for income tax purposes. A discount of future installments of income by a rate of interest that took account of the hazards of the investment and the "accepted concept of a fair return" was allowed in determining the taxable value of the property.

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[13] 30 Cal. 2d 610, 184 P. 2d 879 (1947).

[14] 45 Cal. 2d. 546, 290 P. 2d 544 (1955).

In the case of *City of Norfolk* v. *Snyder*,[15] the opinion of the Virginia Court of Appeals quite cogently expresses the situation in Virginia as regards the assessment problem. Said the Court therein:

> (1) The Constitution of Virginia, section 169, provides that property, both real and personal, shall be assessed at its fair market value, and section 168 provides that all taxes shall be uniform upon the same class of property. The primary consideration therefore is to procure an assessment of property (a) at its fair market value and (b) one that will be uniform upon the same class.
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> (2) This Court has held that the fair market value of a property is the price it will bring when offered for sale by one who desires but is not obliged to sell, and is bought by one under no necessity of having it.
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> (3) It has been recognized that securing equality in the assessment of property has many difficulties and that no machinery has yet been devised by which these difficulties may be fully overcome.
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> (4) In Virginia it is settled law that there is a clear presumption in favor of the assessment made by the assessors and the burden is upon those who seek relief to show that the value as fixed is excessive or out of proportion to like surrounding property.
>
> (5) There is no statute in Virginia providing a rule by which assessors should be guided in ascertaining the fair market value of property. It is common knowledge that different persons equally well qualified use different methods in fixing a value on a property. Some arrive at their conclusion from a personal inspection and view of the property and fix the value in the light of their experience in appraising the particular property or like property in the same surroundings for loans or sales, while others approach the question from a technical engineering knowledge. It has been held in West Virginia that reproduction costs with allowance for age and depreciation may be considered. *Central Realty* v. *Board of Review*, 110 W. Va. 437, 158 S. E. 537. The value

[15] 161 Va. 288, 170 S. E. 721 (1933).

> of property is a matter of opinion and there must necessarily be left a wide room for the exercise of opinions, otherwise courts would be converted into assessing boards, and, in assuming to act as such, would assume powers lodged elsewhere by the law making branch of Government.

### VI. *Conclusion*

To assure a fair degree of consistency in assessments and stability in the flow of revenue into the State and local treasuries it has been consistent policy in Virginia to segregate the sources of revenue for each. Income, intangible personal property, inheritances, franchises of public service corporations (with certain exceptions) and other subjects of taxation not allocated to the localities are taxed exclusively at state level. Real estate, tangible personal property (with varying exceptions) and merchant's capital are set apart for taxation exclusively at the local level. The proceeds of poll taxes and license taxes are shared between the two levels. But by far the largest expense of both state and local government is in the field of education. Here the state remits to the localities, proportionately out of its revenues, a major part of what becomes available to local government to be spent on school operations. The segregation of revenue sources, while it facilitates administration and stabilizes the tax load on the taxpayer, does not imply a significant redistribution of wealth among the communities nor among the functions of government in the state. The fact that certain property is taxed at state level rather than at local level does not indicate that wealth is being funneled away from the community in which it is generated. The same cannot be said for the federal tax system which quite openly and frankly is designed, inter alia, to redistribute the wealth. Under these circumstances it would appear that no significant dislocation would result internally in the distribution of tax resources were the classification of leasehold interests as "taxable real estate" in 58-758 to be eliminated. Absent the existing legislative fiat in 58-758, leasehold interests of tax exempt property would become reserved for state level taxation, as declared by the Court of Appeals in the *Prince William County* case.[16]

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[16] 197 Va. 861, 91 S. E. 2d 441 (1956).

The study summarized in this article suggests the following plausible conclusions:

1) That the treatment of leasehold interests in tax exempt property as "taxable real estate" per Va. Code 58-758, has proven ineffectual and awkward of administration.

2) That the position of the Supreme Court in the Michigan Immunity cases warrants a re-examination, in the executive and legislative branches in Virginia, of the "presumed immunity" doctrine expressed by the Court of Appeals in *Prince William County* v. *Thomason Park.*

3) That the continuing intricate problem of deriving proportionate state revenues from United States Government operations and property requires placement of primary administrative responsibility at state level rather than at local level, and the exercise there of continuing alert legal effort to keep abreast of federal legislative, administrative and judicial action in this field.

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