FEDERAL IMMUNITY AND THE ARIZONA TRANSACTION PRIVILEGE TAX ON PRIME CONTRACTING: IS ARIZONA'S TAX UNCONSTITUTIONAL?

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INTRODUCTION

The state of Arizona imposes a transaction privilege tax,[1] which is a tax on the gross income, gross receipts or gross proceeds of the taxpayer, for the privilege of conducting business within the state. The administration of the tax is governed by sections 42–1301 to –1306 and sections –1317 to –1347 of the Arizona Revised Statutes.[2] Eighteen different classifications of businesses are outlined in the statutory scheme, and each is treated somewhat differently for purposes of the tax.[3] Section 42–1310.16 applies specifically to the business of prime contracting.[4]

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1. ARIZ. REV. STAT. ANN. tit. 42, ch. 8, art. 1 (1991 & West Supp. 1991).

2. ARIZ. REV. STAT. ANN. §§ 42–1301 to –1306 and §§ 42–1317 to –1347 (1991 & West Supp. 1991).

3. ARIZ. REV. STAT. ANN. §§ 42–1310.01 to –1310.18 (1991 & West Supp. 1991).

4. "Prime contracting" is defined as "engaging in business as a prime contractor." ARIZ. REV. STAT. ANN. § 42–1310.16(F)(4) (West Supp. 1991). The statute defines a "prime contractor" as a

> contractor who supervises, performs or coordinates the construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition of any building, highway, road, railroad, excavation or other structure, project, development or improvement including the contracting, if any, with any subcontractors or specialty contractors and is responsible for the completion of the contract.

ARIZ. REV. STAT. ANN. § 42–1310.16(F)(5).

"Contracting" is defined as "engaging in business as a contractor." ARIZ. REV. STAT. ANN.§ 42–1310.16(F)(1). This section defines a "contractor" as being

> synonymous with the term 'builder' and means a person, firm, partnership, corporation, association or other organization, or a combination of any of them, that undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does himself or by or through others, construct, alter, repair, add to, subtract from, improve, move, wreck or demolish any building, highway, road, railroad, excavation or other structure, project, development or improvement, or to do any part thereof, including the erection of scaffolding or other structure or works in connection therewith, and includes subcontractors and specialty contractors.

ARIZ. REV. STAT. ANN. § 42–1310.16(F)(2). That section further states, "For all purposes of taxation or deduction, this definition shall govern without regard to whether or not such contractor is acting in fulfillment of a contract." ARIZ. REV. STAT. ANN. § 42–1310.16(F)(2).

ARIZ. REV. STAT. ANN. § 42–1310.16 also applies to those engaged in the dealership of manufactured buildings. ARIZ. REV. STAT. ANN. § 42–1310.16(A).

Section 42–1310.16 of the Arizona Revised Statutes states:

> Every person engaging or continuing in this state in the business of prime contracting ... shall present to the purchaser of such prime contracting ... a written receipt of the gross income or gross proceeds of sales from such activity *and shall separately state the taxes to be paid pursuant to this section.*[5]

By requiring prime contractors to separately state the taxes to be paid,[6] the Arizona legislature has expressed its intent that the burden of the tax be borne by the purchaser of prime contracting. Thus, if the purchaser of prime contracting is the federal government, then clearly the economic burden of the Arizona tax will fall upon the federal government.

However, direct taxation of the federal government or any of its instrumentalities by any state is unconstitutional.[7] The critical question is whether the state taxing scheme requires the purchaser of prime contracting to bear the legal incidence[8] of the tax or merely the economic burden of the tax. If the federal government must bear only the economic burden of the tax, then the tax is constitutional.[9] However, if the legal incidence of the tax is also borne by the federal government, then the tax constitutes an illegal direct tax upon the federal government.[10]

This Note examines the Arizona transaction privilege taxation scheme in light of the doctrine of federal immunity. The first section outlines the principle of federal immunity from state taxation from its origins through its contemporary interpretation and application. It shows how current judicial interpretation of federal immunity is often confusing and lacking in continuity, but it suggests that the most conclusive test looks at the economic consequences of the practical operation of the taxing scheme. The next section applies the tests suggested by the caselaw under the Arizona statute. This Note concludes that under current law, the Arizona tax improperly taxes the federal government when the federal government is the purchaser of prime contracting in Arizona. Finally, this Note offers an alternative to the current taxing scheme which neither violates the immunity of the federal government nor results in a reduction in revenue to the state.

THE ORIGIN AND LEGAL DEVELOPMENT OF FEDERAL IMMUNITY

The right of the states to impose taxes on all who come within their borders derives from the Tenth Amendment to the United States

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5. ARIZ. REV. STAT. ANN. § 42–1310.16(G) (West Supp. 1991) (emphasis added).

6. Under this chapter of the Arizona Revised Statutes, no other business classification is required to provide the purchaser with a document that separately states the transaction privilege taxes to be paid. *See* ARIZ. REV. STAT. ANN. §§ 42–1310.01 through –1310.18.

7. M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

8. For further discussion regarding the legal incidence of a tax, *see infra* text accompanying notes 19–47.

9. *See, e.g.,* United States v. New Mexico, 455 U.S. 720 (1982); United States v. Boyd, 378 U.S. 39 (1964); Alabama v. King & Boozer, 314 U.S. 1 (1941); James v. Dravo Contracting Co., 302 U.S. 134 (1937). In each of these cases, the Court held that the legal incidence of the tax in question did not rest upon the federal government, even though in each case the government bore at least part of the economic burden of the tax.

10. *See infra* text accompanying notes 19–47.

Constitution.[11] The states' right of taxation was judicially confirmed in a now famous opinion by Chief Justice Marshall in *M'Culloch v. Maryland.*[12] In that same case, however, the Supreme Court held that it is unconstitutional for the states to tax the federal government or any of its instrumentalities.[13] This is known as the doctrine of federal immunity.

The federal immunity doctrine has, however, been modified by later cases. For example, in *James v. Dravo Contracting Co.*[14] the Court held that a state gross receipts tax is not necessarily unconstitutional because it ultimately increases the cost to the government.[15] In addition, in *United States v. Boyd* [16] the Court stated, "*M'Culloch v. Maryland* ... does not forbid a tax whose legal incidence is upon a contractor doing business with the United States, even though the economic burden of the tax ... is ultimately borne by the United States."[17]

Thus, for the purpose of determining whether federal immunity from state taxation has been violated, the Supreme Court has established an important distinction between the legal incidence of a tax and what might be termed the "economic incidence," or the ultimate economic consequences of a tax.[18]

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11. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.

12. 17 U.S. (4 Wheat.) at 316. Chief Justice Marshall stated

> [t]hat the power of taxation is one of vital importance; that it is retained by the States; that it is not abridged by the grant of a similar power to the government of the Union; that it is to be concurrently exercised by the two governments: are truths which have never been denied.

Id. at 425.

13. *Id. M'Culloch* involved an attempt by the state of Maryland to impose a stamp tax upon the Baltimore branch of the Bank of the United States, a bank incorporated by Congress. In this landmark decision the Supreme Court held that the state tax imposed upon the federal bank was unconstitutional. *See* C. Crady Swisher III, Note, *United States v. Mexico: Reassessment of Federal Contractor's Constitutional Immunity from State Taxation,* 25 WASH. U. J. URB. & CONTEMP. L. 361, 361 n.1, 366–70 & nn.14–30 (1983). *See also* Maureen Mahoney, Note, *Federal Immunity from State Taxation: A Reassessment,* 45 U. CHI. L. REV. 695 (1978).

14. 302 U.S. at 134.

15. *Id.* at 160. Prior to *Dravo,* the Court struck any taxation by the states when the tax imposed any economic burden on the United States such as an increase in the federal government's cost on a project. This was the holding of Weston v. City Council of Charleston, 27 U.S. (2 Pet.) 449 (1829) (Marshall, C.J.). *See* Swisher, *supra* note 13, at 368.

16. 378 U.S. at 39.

17. *Id.* at 44 (citation omitted).

18. Professor Tribe describes the distinction as the difference between who is "hit" and who is "hurt" by the tax. Laurence H. Tribe, *Intergovernmental Immunities in Litigation, Taxation, and Regulation: Separation of Powers Issues in Controversies About Federalism,* 89 HARV. L. REV. 682, 706 n.104 (1976).

The legal incidence of a transaction-based tax rests upon the party to the transaction legally responsible for paying the tax. The economic incidence of such a tax rests upon the party who bears the economic burden of the tax, that is, the party who actually *pays* the tax. In many cases, depending somewhat upon the applicable taxing scheme, both the legal incidence and the economic incidence may be shifted to either party of the transaction by contract. *See* Mahoney, *supra* note 13, at 702–04 (discussing aspects of the legal incidence doctrine and the contractual alteration of incidence).

Determining the Legal Incidence of a Tax

The Court has defined the legal incidence of a tax as falling upon the party whom the legislative body intended should pay the tax.[19] When inquiring into the legislative intent, the Court may or may not defer to state determinations of who is legally responsible to pay the tax.[20]

In some cases, the plain language of a well-worded statute conclusively establishes legislative intent regarding placement of the legal incidence of the tax. For example, in *First Agricultural National Bank of Berkshire County v. State Tax Commission,*[21] the Court found that the clear wording of the statute required the taxpayer vendor to collect the tax from the purchaser.[22] Thus, while the vendor was legally *liable* to submit the funds to the taxing authority, the Court held that the legal *incidence* of this tax was on the purchaser.[23]

When courts use the "plain language" test to determine the intent of the legislature, they look at the taxing statute in its entirety. Some state taxing statutes are worded in such a way that the "plain language" of one provision clearly places the legal incidence on one particular party to a transaction, for example, the seller of goods or services. Yet other provisions of the same taxing scheme may place incentives upon the seller to shift the burden of the tax onto the purchaser. Thus, the "plain language" of the statute disguises the economic reality. In these cases, the courts have looked beyond the plain lan-

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19. Note that the party whom the legislature defines as "taxpayer" is not necessarily the party whom the legislature intends should pay the tax. The party defined as "taxpayer" is simply the party whom the legislature has designated to turn the amount of the tax over to the taxing authority. The legislature may expressly or impliedly require that the "taxpayer" collect the tax from another party, and it is upon that party that the legal incidence of the tax rests. *See* United States v. Tax Comm'n, 421 U.S. 599, 608–09 (1975) (expressly rejecting the lower court's holding that "[t]he legal incidence of a tax [is] ... determined by 'who is responsible ... for payment to the state of the exaction,'" and holding that "where a State requires that its sales tax be passed on to the purchaser and be collected by the vendor from him, this establishes as a matter of law that the legal incidence of the tax falls upon the purchaser").

20. *Compare* American Oil Co. v. Neill, 380 U.S. 451, 455 (1965) (indicating that the state court's determination as to the operating incidence is given great weight and will be deemed conclusive as long as it is consistent with the statute's reasonable interpretation) *and King & Boozer,* 314 U.S. at 9 (holding that the determination of who is a "purchaser" within the meaning of a taxing statute is a question of state law) *with* Diamond Nat'l Corp. v. State Bd. of Equalization, 425 U.S. 268 (1976) (stating that in determining where the legal incidence of the tax falls, the Court is *not* bound by the state court's contrary conclusion). *See also* Mahoney, *supra* note 13, at 703 (suggesting that recent Supreme Court decisions indicate that state law determination of legal incidence is entitled only to minimum deference).

21. 392 U.S. 339 (1968).

22. The taxing provision stated as follows:

> Reimbursement for the tax hereby imposed *shall be paid by the purchaser* to the vendor and each vendor in this commonwealth *shall add to the sales price and shall collect from the purchaser the full amount of the tax imposed by this section,* or an amount equal as nearly as possible or practicable to the average equivalent thereof; *and such tax shall be a debt from the purchaser to the vendor,* when so added to the sales price, and shall be recoverable at law in the same manner as other debts.

Id. at 347 (emphasis added by the Court).

23. The Court stated, "It would appear to be indisputable that a sales tax which by its terms must be passed on to the purchaser imposes the legal incidence of the tax upon the purchaser." *Id.* The Court further held, "There can be no doubt from the clear wording of the statute that the Massachusetts Legislature intended that this sales tax be passed on to the purchaser." *Id.* at 348.

guage of the statutes and have considered the economic realities in order to locate the legal incidence of the tax.[24] Where the substance of a taxing scheme results in some compelling inducement upon the taxpayer to pass the burden of the tax on to another party, courts have held that the legal incidence of such a tax falls on the party from whom the tax is actually collected.[25]

In *United States v. California State Board of Equalization*,[26] the United States leased data processing equipment from lessors in California. California imposed a sales tax on these transactions based on the gross rentals paid by the United States to the lessors. In 1974 the district court held the sales tax infringed on the United States' constitutional immunity from state taxation because it placed the legal incidence of the tax on the United States.[27] In 1978 California repealed the sections of its tax code found unconstitutional. It also added a new section which purported to leave the decision of who would pay the tax to the agreement of the buyer and seller. Pursuant to the modified scheme, California resumed imposing a sales tax on leases to the United States.[28]

The United States filed an action for a declaratory judgment in the United States District Court.[29] The government sought to enjoin the state of California from assessing or collecting the sales tax on government leases.[30] Additionally, the government requested a refund of all taxes paid by the United States to its lessors in California.[31] The district court granted the United States' cross-motion for summary judgment, and the California State Board of Equalization appealed.[32]

On appeal, the Ninth Circuit considered whether the legal incidence of the 1978 revised tax fell upon the United States. It began with the premise that the "legal incidence of a tax falls on the party who[m] the legislature intends will pay the tax."[33] The court considered it unimportant which party bore the ultimate economic burden of the tax.[34]

In determining whom the legislature intended would pay the tax, the Ninth Circuit considered the operation of the entire state taxation scheme in addition to the express words of the statute.[35] Other provisions of the California revenue code provided that the sales tax be levied on the lessor's gross receipts measured by the total lease price.[36] The code also provided that

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24. Mahoney, *supra* note 13, at 703.

25. This was the case in *Tax Comm'n of Mississippi*, 421 U.S. at 599. The Court noted in a footnote that, "even in the absence of this clear statement of the Tax Commission's intentions, obviously economic realities compelled the distillers to pass on the economic burden of the markup." *Id.* at 610 n.8.

26. 650 F.2d 1127 (9th Cir. 1981), *aff'd*, 456 U.S. 901 (1982).

27. United States v. State Bd. of Equalization Code, 536 F.2d 294 (9th Cir. 1976).

28. *California State Bd. of Equalization*, 650 F.2d at 1128.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.* at 1129.

33. *Id.* at 1130.

34. *Id.* at 1131. This is consistent with the earlier cases outlining the Supreme Court's interpretation of the immunity doctrine. *See supra* text accompanying notes 14–17.

35. *California State Bd. of Equalization*, 650 F.2d at 1131.

36. *Id.*

the lessor could deduct the amount of the tax from the gross receipts if the lessor required the lessee to pay the tax.[37] This deduction was denied, however, if the lessor instead chose to absorb the tax and pass on to the purchaser only the economic burden in the form of an increased lease price.[38] The court found the interaction of all these provisions resulted in a taxing scheme which granted an economic benefit to the lessor only if it required that the lessee pay the tax.[39]

The court concluded that the taxing scheme economically compelled the lessor to require the lessee to pay the tax. Even though the language of the code was "facially neutral," that is, it did not *expressly* require the lessor to collect the tax from the lessee, the economic incentive on the lessor to do so accomplished the same purpose.[40] According to the court, the economic incentive provided by the legislature was a manifestation of the legislature's intent that the lessee bear the legal incidence of this tax.[41] Thus, when the lessee was the United States government, federal immunity was violated.

The district court in *United States v. Michigan*[42] confronted a similar issue when it had to determine whether the legal incidence of the Michigan sales tax fell upon the retailer or the purchaser, which in this case was a federal credit union.[43] In determining which party bore the legal incidence of this tax, the court relied to a large extent upon *California State Board of*

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37. *Id.*

38. *Id.*

39. *Id.* The court stated that "the lessor maximizes his profit only if he separately states and collects the tax from the lessee." *Id.* The court provided the following examples of how this taxing scheme might operate:

> Assuming a $1,000 lease to the United States and a tax rate of 5 percent:
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> (1) The lessor separately states the sales tax and collects it from the lessee. He collects a total of $1,050—1,000 lease price and 50 tax—from the lessee. Because he separately stated the tax and collected it from the lessee, the $50 he collected in tax is excluded from his gross receipts under § 6012. The lessor is, therefore, taxed on gross receipts of $1,000 and must remit $50 to the state. The lessor nets $1,000 on the lease.
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> (2) The lessor does not separately state the sales tax but instead passes it on to the lessee as an increase in price. He collects a total of $1,050 from the lessee. Because he has absorbed the tax under Cal.Civil Code § 1656.1(b) rather than added the tax to the total sales price under § 1656.1(a) he gets no exclusion from his gross receipts under § 6012. The lessor, therefore, pays a tax on gross receipts of $1,050 and must remit $52.50 to the state. The lessor nets $997.50 on the lease.
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> (3) The lessor does not separately state the sales tax and does not collect the tax from the lessee—his gross proceeds of the sale are considered to be $1,000. He receives $1,000 from the lessee. He pays a tax out of his pocket of $50—he nets $950 on the lease.
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> (4) The lessor separately states the sales tax, but does not collect the tax from the lessee—the statute presumes his gross proceeds of the sale to be $1,050. He receives $1,000 from the lessee. He pays a tax of $52.50 out of his own pocket—he nets $947.50 on the lease.

Id. at 1132 n.6.

40. *Id.* at 1132.

41. *Id.* The court stated, "[T]he California sales tax scheme manifests a legislative intent that the lessee pay the sales tax. It places the legal incidence of the tax on the United States, and, therefore, violates the United States' constitutional immunity from state taxation." *Id.*

42. 635 F. Supp. 944 (W.D. Mich., S.D. 1985), *aff'd*, 851 F.2d 803 (6th Cir. 1988).

43. *Id.* at 945.

Equalization.[44] The court in *United States v. Michigan* also found the "economic realities" of the Michigan tax effectively placed the legal incidence of the tax on the purchaser/government.[45] The Michigan tax, like the California tax, permitted the retailer (the designated taxpayer in the statute) to deduct the sales taxes collected from gross proceeds only if the amount of those taxes was collected from the purchaser.[46] Thus, even though the statute purported to place the legal responsibility for the tax upon the retailer, the entire taxing scheme created "an economic incentive for the retailer to 'pass on' the tax."[47] Therefore, the "economic reality" was that the legal incidence of the tax was borne by the purchaser and not the retailer. Because the purchaser was the federal government, the tax was unconstitutional.

Collateral Concerns

The United States Supreme Court has decided several recent cases concerning the constitutionality of state taxation of prime contracting transactions involving the federal government.[48] Significantly, the constitutionality of the taxes in many of these cases does not turn on the Court's determination of who bears the legal incidence of the tax.[49] The doctrine of federal immunity from state taxation involves issues other than legal incidence, which makes interpretation of these cases somewhat perplexing.

For example, in addition to determining the legal incidence of a tax in cases involving federal immunity, courts must determine whether the party being taxed is the federal government or an instrumentality of the federal government, or simply a private party doing business with the federal government.[50] Thus, after finding that the legal incidence falls upon the purchaser in a transaction, courts must then determine whether the purchaser is the federal government. If the purchaser is the federal government or an instrumentality of the federal government, the tax may not be collected upon that transaction. If the purchaser is merely a party doing business with the federal government,

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44. 650 F.2d at 1127. A significant portion of the case was reproduced in the text of *United States v. Michigan. See* 635 F. Supp. at 950–52.

45. 635 F. Supp. at 952. "Retailers in Michigan are similarly 'compelled' by economic realities—i.e. the maximization of profits—to pass along the sales tax." *Id.*

46. *Id.* at 950.

47. *Id.*

48. *See, e.g.,* Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983) (tax found unconstitutional); Washington v. United States, 460 U.S. 536 (1983) (tax upheld); *United States v. New Mexico*, 455 U.S. at 720 (tax upheld); *California State Bd. of Equalization,* 650 F.2d at 1127, *aff'd* 456 U.S. at 901 (tax found unconstitutional).

49. *See, e.g., United States v. New Mexico*, 455 U.S. at 720 (turning on whether the party bearing the legal incidence was an instrumentality of the federal government); *Washington v. United States*, 450 U.S. at 536 (turning on whether the tax discriminated against parties who deal with the federal government).

50. *See, e.g., King & Boozer*, 314 U.S. at 1 (holding that the legal incidence of the Alabama tax was on the purchaser, but was not a direct tax upon the federal government because the federal government was not the purchaser); *United States v. Michigan*, 635 F. Supp. at 944 (deciding the issue of whether the purchasing party, a federal credit union, was a federal instrumentality subject to immunity from state taxation).

the tax may be upheld even though the purchaser subsequently passes on to the government an added charge to cover the tax.[51]

In *United States v. New Mexico*,[52] the Court held that prime contractors working on federal projects were liable to pay a state compensating use tax for the out-of-state purchases of materials.[53] The United States contended that the contractors should be exempt from the tax because they were acting as "procurement agents" for the federal government.[54] The Supreme Court disagreed finding that the contractors were not sufficiently "connected" with the government to be afforded the protection of federal immunity.[55]

Although identifying whether the party bearing the legal incidence is, in fact, the government or an instrumentality of the government is often determinative, this Note focuses on the constitutionality of the Arizona transaction privilege tax of prime contracting where the purchaser is *assumed* to be the federal government. Therefore, this issue will not be discussed further in this Note.

A second issue which has been determinative in some cases is whether a tax not directly imposed upon the federal government nevertheless discriminates against those who do business with the federal government. Even if the state tax passes the legal incidence test, it will nonetheless violate federal immunity protections if it discriminates against the federal government.[56] A tax is considered discriminatory if it taxes only those who deal with the federal

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51. In other words, as long as the legal incidence is clearly upon the private party, there is no violation of federal immunity. *See supra* text accompanying notes 14–17.

52. 455 U.S. at 720.

53. The New Mexico compensating use tax was "imposed on property acquired out-of-state in a 'transaction that would have been subject to the gross receipts tax had it occurred within' New Mexico." *United States v. New Mexico*, 455 U.S. at 727. The taxing statute provided that the tax not be "imposed on the 'receipts of the United States or any agency or instrumentality thereof,' or on the 'use of property by the United States or any agency or instrumentality thereof.'" *Id.* at 728 (citing the New Mexico statute).

54. *Id. See* Swisher, *supra* note 13, at 377.

55. The Court stated, "[T]ax 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." *United States v. New Mexico*, 455 U.S. at 735. The Court later determined that the prime contractors claiming immunity in this case were "sufficiently distinct from the Government." *Id.* at 743.

Compare, e.g., Kern–Limerick, Inc. v. Scurlock, 347 U.S. 110, 122 (1954) (holding that, according to the terms of the contract, the prime contractor-purchaser was in fact the federal government); *with King & Boozer*, 314 U.S. at 10 (finding that the prime contractor-purchaser was not the federal government). The language of *United States v. New Mexico*, 455 U.S. at 720, appears to have so limited *Kern–Limerick*, 347 U.S. at 110, that rarely will a prime contractor be deemed an instrumentality of the federal government immune from state taxation. *See* Swisher, *supra* note 13, at 381–82.

56. "It still remains true, as it has from the beginning, that a tax may be invalid even though it does not fall directly on the United States if it operates so as to discriminate against the Government or those with whom it deals." United States v. City of Detroit, 355 U.S. 466, 473 (1958). *See Memphis Bank & Trust Co.*, 459 U.S. at 397; *Washington v. United States*, 460 U.S. at 540; United States v. County of Fresno, 429 U.S. 452, 460 (1977). *See also* Mahoney, *supra* note 13, at 705–06; Cynthia B. Keliher, Note, *Federal Tax Immunity:* Memphis Bank & Trust Co. v. Garner; Washington v. United States, 37 TAX LAW. 375, 376 (1984).

government or if it taxes those parties who deal with the federal government to a greater extent than those who do not.[57]

In *Washington v. United States*,[58] the Supreme Court addressed the issue of whether a special tax assessed upon federal contractors was discriminatory. The Court assessed the constitutionality of a rather creative attempt on the part of the state of Washington to preserve tax revenues derived from federal projects.

Prior to 1941, the state of Washington treated building and construction taxes like sales taxes, placing the legal incidence on the builder.[59] In 1941 the state changed the system so that the legal incidence of the tax was placed on the landowner.[60] Under this new system, the tax could not be applied at all when the landowner was the United States because of the federal immunity from state taxation.[61]

The Washington legislature was dissatisfied with this scheme under which substantial prime contracting revenues acquired on federal projects went completely untaxed. Thus, in 1975 the Washington legislature sought to eliminate the tax exemption for federal projects.[62] It accomplished this by enacting a new tax applicable only to federal projects that placed the legal incidence of the tax on the builder.[63] The result was that on all private projects the regular post–1941 tax applied, placing the legal incidence of the tax on the purchaser-landowner. On the other hand, the new 1975 tax that placed the legal incidence of the tax on the builder-contractor applied to all federal projects.[64] Under this scheme, the state could collect revenues on all construction projects in the state, whether private or federal, while avoiding the federal immunity problem, at least with respect to issue of legal incidence. The United States challenged this scheme.[65]

The United States alleged that the 1975 modification requiring builders in federal projects to pay a tax was discriminatory.[66] The Court held that it was not.[67] The Court compared the special tax on federal contractors to the post–1941 tax on private purchasers. The Court assumed that federal contrac-

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57. Mahoney, *supra* note 13, at 706.
58. 460 U.S. at 536.
59. *Id.* at 538.
60. *Id.*
61. *Id.* Under the post–1941 taxing scheme, the state simply did not collect taxes on the sale of tangible personal property to the contractor, or of the finished building to the Government, whenever the United States was the landowner. *Id.*
62. *Id.*
63. *Id.* at 538–39.
64. *Id.* at 539–40. The tax applicable to contractors on federal projects also employed a lower tax rate because the contractor's labor costs and markup were not included in the base. *Id.* at 540.
65. *Id.*
66. *Id.* at 541. The government contended
> that the tax [was] invalid because Washington [had] circumvented the Federal Government's tax immunity by identifying a federal activity for different tax treatment. ... Because Washington [did] not impose a sales tax on contractor's who [did] not work for the Federal Government, ... it discriminate[d] against the Federal Government and those with whom it [dealt].

Id.
67. *Id.* at 546 (Rehnquist, J., for a 5–4 majority).

tors would pass along the economic burden of the tax to the Government.[68] Again looking at the "economic reality," the Court concluded that the same economic burdens were imposed on both federal contractors and private contractors.[69] Because the economic burdens were assumed to be equal, the court held the tax was not discriminatory.[70]

In *Washington v. United States* and other related cases, the Court has indicated that in evaluating the discriminatory nature of a taxing scheme, the Court will look at the scheme *in toto*.[71] If a particular tax provision that appears discriminatory on its face loses its discriminatory effect by the operation of other provisions in the scheme, then the tax is constitutional. As with the legal incidence determination, "economic realities" determine the result rather than the facial appearance of the taxing provision.

Summary

The courts have defined the legal incidence of a transaction-based state tax as falling on the party whom the state legislature intends will pay the tax. That party is not necessarily the same party that is responsible for submitting the tax to the taxing authority.

Courts look at two factors in determining legislative intent; and thus, legal incidence. The courts must first determine whether the plain language of the statute indicates the legislature's intent in that regard,[72] and whether the statute operates within the entire taxing scheme to compel the taxpayer (economically or otherwise) to collect the tax from a third party.[73] If the court determines that the legislature has manifested an intent that the tax be paid by a particular party to a transaction, and that party is or may be the federal government, the tax violates federal immunity protections and is unconstitutional.[74]

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68. As discussed earlier, this does not in itself violate federal immunity. *See supra* text accompanying notes 14–17.

69. 460 U.S. at 541–42. This reasoning by the Court was criticized in Walter Hellerstein, *Selected Issues in State Business Taxation*, 39 VAND. L. REV. 1033, 1051–53 (1986). Professor Hellerstein suggests that while, theoretically, the economic burdens should be nearly equal between federal and private contractors, in reality, the federal contractor may be required to absorb more of the economic burden of the tax because, for example, the federal contractor's bargaining power with the Government is probably much less than a private contractor's bargaining power with a non-government purchaser. *Id.* at 1052. *See also infra* note 144.

70. 460 U.S. at 546.

71. "[A] determination whether a tax is discriminatory ... requires ... an examination of the whole tax structure of the state.'" *Id.* at 542. *See also* Phillips Chem. Co. v. Dumas Indep. Sch. Dist. No. 40, 361 U.S. 376, 383 (1960); *City of Detroit*, 355 U.S. at 469 ("[I]n determining whether a tax is actually laid on the United States or its property this Court goes beyond the bare face of the taxing statute to consider all relevant circumstances.").

72. *See First Agric. Nat'l Bank*, 392 U.S. at 348 and *supra* text accompanying notes 21–23.

73. This is the "economic realities" test. *See supra* text accompanying notes 24–25 and text accompanying notes 33–47.

74. In some cases, the tax will not be invalid, but rather will be denied in any particular transaction where federal immunity is violated. Such a case would occur, for example, whenever the taxing scheme provides for nonapplication of the tax under situations where the tax would violate immunity. Thus, in that situation, the court would simply require that the nonapplication provision be invoked. This was the case in *Kern–Limerick*, 347 U.S. at 110. In that case, the

If the court finds that there is no legislative intent to place the legal incidence on the government, it must then determine whether the tax discriminates against parties who deal with the federal government. If it does, the court will strike the tax.[75] If not, the tax does not violate federal immunity and will be upheld.

APPLYING THE LAW TO THE ARIZONA TRANSACTION PRIVILEGE TAX

The History of Arizona's Transaction Privilege Tax on Prime Contracting

The Arizona Excise Revenue Act of 1935 provided for a privilege tax "measured by the amount or volume of business done by persons on account of their business activities."[76] In subsequent years, the tax underwent several modifications.[77] In 1978 special provisions for the taxation of prime contracting were added.[78] In particular, a new section of the code was added which read:

> Every person engaging or continuing within this state in the business of prime contracting ... shall present to the purchaser of such prime contracting a written receipt of the gross income or gross proceeds of sale from such prime contracting and *shall separately state the additional charge made to cover the taxes levied* ....[79]

In 1984 the above-emphasized phrase was modified to read "... *shall separately state the taxes to be paid* ...."[80]

Additional modifications were made that same year. For example, section 42–1302(A)(1) was modified so that the amount of the transaction privilege tax was automatically deducted from gross income regardless of whether the amount of the tax was separately stated or absorbed by the seller. Prior to

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Court was called upon to determine "the legality of the application of the Arkansas Gross Receipts Tax ...." *Id.* at 111. The Arkansas tax contained a provision which exempted from taxation gross receipts derived from sales to the federal government. *Id.* at 112.

75. The court might also limit its operation. *See supra* note 74.

76. 1935 Ariz. Sess. Laws 310–13. The Excise Revenue Act of 1935 contained a special section entitled "Constitutional Prohibition" which stated

> The taxes herein levied shall not be construed to apply to transactions in interstate commerce which, under the constitution of the United States, the state of Arizona is prohibited from taxing or upon any sales made to the United States government, its departments or agencies, nor to businesses or transactions exempted from taxation under the Constitution of the United States or the Constitution of the state of Arizona.

1935 Ariz. Sess. Laws 321–22. *See also* Arizona Code of 1939 § 73–1308 (1935), *repealed by* 1954 Ariz. Sess. Laws 267.

77. In 1959 a new excise tax levied upon "the privilege of doing business in this state measured by the amount or volume of business transacted by persons on account of their business activities ..." was enacted and given the name "Education Excise Tax." 1959 Ariz. Sess. Laws 148. Minor modifications were made in 1963 (1963 Ariz. Sess. Laws 117) and 1965 (1965 Ariz. Sess. Laws 423).

78. 1978 Ariz. Sess. Laws 257. *See supra* note 4 and accompanying text for a discussion of what constitutes prime contracting.

79. ARIZ. REV. STAT. ANN. § 42–1310.02 (1978) *amended by* 1984 Ariz. Sess. Laws 1305 (emphasis added). *See* 1978 Ariz. Sess. Laws 259.

80. 1984 Ariz. Sess. Laws 1305 (emphasis added). This modification was presumably in response to the Ninth Circuit's holding, which was affirmed by the United States Supreme Court in *California State Board of Equalization*, 650 F.2d at 1127. *See supra* text accompanying notes 26–41.

the modification, deduction of the amount of the tax was allowed when the tax was separately stated, creating an economic compulsion to separately state the tax as in the California scheme in *California State Board of Equalization.*[81] Following this modification, that economic compulsion was eliminated. Thus, businesses (other than prime contractors) dealing with the federal government could absorb the tax, mark up the sale price, and pass the tax on to the United States only as an economic burden without violating federal immunity. This modification, however, did not affect the business of prime contracting because another statute, section 42–1310.02,[82] required prime contractors in every circumstance to separately state to the purchaser the tax to be paid.

A special section of the code relating specifically to prime contracting was added in 1985.[83] This section was a precursor to the current prime contracting tax and contained a slightly modified version of the above-quoted text of the 1984 amendment.[84]

In 1988 the organization and numbering structure of the transaction privilege tax was changed without modification to the text of the statute as it related to the business of prime contracting.[85] Despite the latest modification in 1991,[86] the relevant language and import of the 1985 scheme has remained unchanged.

The Legal Incidence Analysis of the Arizona Statute

If the legal incidence of the Arizona transaction privilege tax on prime contracting is found to fall on the purchaser of prime contracting, then the tax violates federal immunity whenever the purchaser of prime contracting is the federal government.[87] This is because the federal government is constitutionally immune from bearing the legal incidence of any state tax under the doctrine of federal immunity.[88]

The legal incidence of the general transaction privilege tax scheme was evaluated in 1955 in *Arizona State Tax Commission v. Garrett Corp.*[89] In

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81. 650 F.2d at 1127.

82. ARIZ. REV. STAT. ANN. § 42–1310.02 (1978) *amended by* 1984 Ariz. Sess. Laws 1305. *See supra* notes 79–80 and accompanying text.

83. ARIZ. REV. STAT. ANN. § 42–1308 (1985). *See* 1985 Ariz. Sess. Laws 952.

84. ARIZ. REV. STAT. ANN. § 42–1308(D) (1985) provided as follows:

> Every person engaging or continuing in this state in the business of prime contracting or dealership of manufactured buildings shall present to the purchaser of such prime contracting or manufactured building a written receipt of the gross income or gross proceeds of sales from such activity and shall separately state the taxes to be paid pursuant to this section.

1985 Ariz. Sess. Laws 952.

85. 1988 Ariz. Sess. Laws 467, 480. In that year ARIZ. REV. STAT. ANN. § 42–1308 (1985) was repealed, and in its place, ARIZ. REV. STAT. ANN. § 42–1310.17 (1988) was enacted. Subsection (E) of the new ARIZ. REV. STAT. ANN. § 42–1310.17 (1988) was exactly the same as subsection (D) of the old ARIZ. REV. STAT. ANN. § 42–1308 (1981).

86. ARIZ. REV. STAT. ANN. § 42–1310.17 (1988) was renumbered as ARIZ. REV. STAT. ANN. § 42–1310.16 which is as it appears today. In 1991 subsections (C) (dealing with solar energy devices) and (E) (regarding contractor-subcontractor relationships) were added.

87. *See supra* note 74. Note that if the legal incidence of a state transaction-based tax indeed falls on the purchaser, the tax may be upheld if it provides for an exemption for gross receipts derived from sales to the federal government.

88. *See supra* text accompanying notes 11–75 (discussing doctrine of federal immunity).

89. 79 Ariz. 389, 291 P.2d 208 (1955).

Garrett, the Arizona Supreme Court determined that under the Excise Revenue Act of 1935[90] the legal incidence of the tax always fell upon the seller, and therefore, was constitutional.[91]

The Garrett Corporation was a manufacturing corporation doing business in Arizona.[92] Products manufactured by Garrett were sold to the United States Government.[93] Garrett challenged the Excise Revenue Act on grounds that it was in effect a sales tax that, when exacted from Garrett, resulted in a direct tax upon the federal government.[94] Garrett was specifically attacking the 1952 and 1954 amendments to the Act. The 1952 amendment defined gross income for purposes of computing the tax as the amount received from the purchaser exclusive of the tax received as long as the tax was added to the sale price and not absorbed by the seller.[95] The 1954 amendment required sellers to remit to the taxing authority the total amount of tax collected from the purchasers of their goods or services.[96]

Garrett's position was that the amendments expressly authorized sellers to pass on the tax to the purchasers, thereby imposing a sales tax on purchasers.[97] If Garrett's contention was correct, the tax would violate federal immunity if levied upon Garrett's federal contracts.

The Arizona Supreme Court noted several prior cases in which it had held that the taxes imposed by the Excise Revenue Act constituted taxes on the "privilege or right to engage in business" and not sales taxes.[98] The court

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90. 1935 Ariz. Sess. Laws 310.

91. 79 Ariz. at 393, 291 P.2d at 210.

92. *Id.* at 390, 291 P.2d at 208.

93. *Id.*

94. *Id.*

95. The statute quoted in *Garrett* stated as follows:

> For the purpose of this act the total amount of gross income, gross receipts or gross proceeds of sales shall be deemed to be the amount received, exclusive of the tax imposed by [this] article ..., provided the person upon whom the tax is imposed shall establish to the satisfaction of the commission that the tax has been added to the sale price and not absorbed by him. ...

Id. at 392, 291 P.2d at 209–10.

Note that the 1952 amendment provided an economic incentive to require the purchaser to pay the tax. This scheme is similar to the one that was found unconstitutional by the Ninth Circuit in *California State Bd. of Equalization*, 650 F.2d at 1127, in 1981. *See supra* text accompanying notes 26–41. Indeed, the legislature repealed the 1952 amendment after *California State Bd. of Equalization* was decided. *See supra* note 80 and text accompanying note 81. Thus, *Garrett* would be decided differently today.

96. The statute provided that "in no event shall the person upon whom the tax is imposed, where an added charge is made to cover the tax levied by this act, remit less than the amount so collected to the commission." *Garrett*, 79 Ariz. at 390, 291 P.2d at 210. This language currently appears substantially intact in ARIZ. REV. STAT. ANN. § 42–1302(A)(1) (1990).

97. *Garrett*, 79 Ariz. at 391, 291 P.2d at 209.

98. *Id.* Cases listed by the court included Trico Elec. Coop. v. State Tax Comm'n, 79 Ariz. 293, 288 P.2d 782 (1955); Arizona State Tax Comm'n v. Ensign, 75 Ariz. 220, 254 P.2d 1029 (1953), *on reh'g*, 75 Ariz. 376, 257 P.2d 392 (1953); State Tax Comm'n v. Quebedeaux Chevrolet, 71 Ariz. 280, 226 P.2d 549 (1951); Duhame v. State Tax Comm'n, 65 Ariz. 268, 179 P.2d 252 (1947); Pratt-Gilbert Hardware Co. v. O'Neil, 64 Ariz. 393, 173 P.2d 91 (1946), *on reh'g*, 65 Ariz. 90, 174 P.2d 620 (1946); Arizona State Tax Comm'n v. Frank Harmonson Co., 63 Ariz. 452, 163 P.2d 667 (1945); Moore v. Pleasant Hasler Constr. Co., 50 Ariz. 317, 72 P.2d 573 (1937); White v. Moore, 46 Ariz. 48, 46 P.2d 1077 (1935).

was unpersuaded that the 1952 modifications altered the legal incidence of the tax so as to make it a sales tax.[99]

Garrett was decided more than thirty-five years ago when prime contracting had not yet been made a separate classification under the taxing scheme, and the taxing scheme did not yet contain the provision requiring prime contractors to provide their customers with a receipt separately stating the amount of the tax.[100] Therefore, it is not controlling as to whether the *current* statute violates federal immunity.

Moreover, the 1952 amendment gave the taxpayer an economic incentive to collect the tax from the purchaser.[101] The resulting tax scheme was thus similar to the California tax in *California State Board of Equalization.*[102] The Ninth Circuit in *California State Board of Equalization* held that an economic incentive to collect the tax from the purchaser was equivalent to a compulsion to collect the tax from the purchaser.[103] It further held that such a compulsion is sufficient to place the legal incidence of the tax on the purchaser.[104] The *Garrett* court upheld the 1952 amendment without addressing the economic compulsion issue. Therefore, under the Ninth Circuit's analysis, *Garrett* was wrongly decided.

Nevertheless, *Garrett* may provide some guidance in analyzing the current tax scheme. The *Garrett* court stated that the 1952 amendments effectively neutralized the tax so that the choice whether to separately state the tax was the seller's alone.[105] According to the court, the amended Act "d[id] not specifically authorize such practice; neither d[id] it forbid it."[106] The court further noted that it had not been shown "that the government ha[d] been presented with a voucher or billing separately itemizing the tax."[107]

By this language the *Garrett* court implied that the reason the 1952 tax did not violate federal immunity was because a separate statement of the tax to the purchaser *was not required.* It follows, then, that under a scheme where the seller *is* required to separately state the tax, the legal incidence falls upon

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99. The court stated that the purpose of the modification was to prevent the practice engaged in by some vendors in which one cent was added to the sales tax when the amount of the tax was between 15¢ and 50¢, and two cents was added when the sales tax amount was greater than 50¢. The court noted that

> [i]t is thus apparent that by the amendment the seller is prevented from profiting at the expense of the purchaser under the guise of a compulsory tax. *The amendment tends to cause the seller to absorb the tax rather than add it as a separate item to the sale price since it eliminates at least in part the incentive for a continuation of that practice.*

Garrett, 79 Ariz. at 393, 291 P.2d at 210 (emphasis added).

100. ARIZ. REV. STAT. ANN. § 42–1310.16(G) originally enacted as § 42–1310.02 in 1978. *See supra* notes 79–80 and accompanying text.

101. *See supra* note 95.

102. 650 F.2d at 1127. *See supra* text accompanying note 40.

103. *See supra* text accompanying note 40.

104. *See supra* text accompanying note 41.

105. *But see supra* note 95.

106. 79 Ariz. at 393, 291 P.2d at 210.

107. *Id.*, 291 P.2d at 211.

the purchaser.[108] When the purchaser is the federal government, such a scheme is unconstitutional.[109]

The Plain Language of the Arizona Statute.

In *First Agricultural National Bank*[110] the United States Supreme Court determined that the Massachusetts legislature clearly intended to place the legal incidence of its sales tax on the purchasing party in a sales transaction. The key language in the Massachusetts tax statute provided that the tax "... *shall be paid by the purchaser ...*" and that the vendor "... *shall add to the sales price and shall collect from the purchaser the full amount of the tax ... and such tax shall be a debt from the purchaser to the vendor ....*"[111] This language was sufficient for the Court to conclude that the state legislature intended that the purchaser pay the tax.

The key language in the Arizona tax statute provides that "[e]very person engaging or continuing in this state in the business of prime contracting ... *shall present to the purchaser of such prime contracting ... a written receipt of the gross income or gross proceeds* of sales from such activity and *shall separately state the taxes to be paid pursuant to this section.*"[112] Although this language is not as clear as the language of the Massachusetts sales tax, a similar inference may be drawn. That is, the legislature's requirement that the contractor present to the purchaser a separate statement of the tax permits an inference that the legislature intended the amount of that tax to be paid to the contractor by the purchaser.

Nevertheless, unlike the Massachusetts statute, the Arizona statute does not specifically state that the tax must be paid by the purchaser. Therefore, the plain language test is not conclusive, and the "economic realities" created by the tax must be considered. In fact, the Arizona Supreme Court has apparently adopted the "economic realities" test in evaluating the constitutionality of a tax on federal immunity grounds.[113]

Practical Operation of the Transaction Privilege Taxation Scheme.

Legislative intent is revealed more clearly when the transaction privilege taxation scheme is viewed *in toto*.[114] For example, section 42–1302 of the Arizona Revised Statutes[115] provides that "[i]n no event shall the person upon whom the tax is imposed, when an added charge is made to cover the tax

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108. Also of interest is the statement in *Garrett* that the court was "concerned with [the] practical operation [of the tax] and not the precise form of descriptive words which may be applied to it." *Id.*

109. *See supra* text accompanying note 10.

110. 392 U.S. at 348.

111. *Id.* at 347 (emphasis by the Court). *See supra* note 22.

112. ARIZ. REV. STAT. ANN. § 42–1310.16(G).

113. *Garrett*, 79 Ariz. at 393, 291 P.2d at 211.

114. Several prior cases have held that in determining the validity of a tax under the doctrine of federal immunity, the entire taxation scheme must be considered. *See, e.g., California State Bd. of Equalization*, 650 F.2d at 1131. "In determining who the legislature intends will pay the tax, the entire state taxation scheme and the context in which it operates as well as the express words of the taxing statute must be considered." *Id. See also Washington v. United States*, 460 U.S. at 536; *United States v. Michigan*, 635 F. Supp. at 944. *See also supra* note 71 and accompanying text.

115. ARIZ. REV. STAT. ANN. § 42–1302 (West Supp. 1991).

levied by this article, remit less than the amount so collected to the department."[116] The effect of this provision, along with section 42–1310.16,[117] is that the prime contractor is required to provide the purchaser with a statement separating the tax to be paid from the charges for services rendered. The prime contractor is then required to collect the amount of the tax from the purchaser and remit that amount to the taxing authority.

This result may be illustrated by the following example: Suppose a prime contractor enters into negotiations with the United States for one million dollars in actual services to be performed within the state of Arizona. In order to cover the amount of tax which would be assessed upon the contractor for the proceeds of this project, the contractor would enter into a contract for $1,032,500.[118] Regardless of whether the prime contractor absorbed the tax in the initial contract, however, the statute[119] requires the prime contractor to issue a written receipt of gross income derived from the contract with the United States along with a separate statement of the transaction privilege taxes to be paid.

Section 42–1302(A)(1) by definition excludes from gross income the amount of the transaction privilege tax. Thus, in this example, the receipt presented to the United States by the contractor would state as follows:

$ 1,000,000	Gross Income from Prime Contracting
$ 32,500	Taxes to Be Paid Pursuant to Arizona Transaction Privilege Tax
$ 1,032,500	Total Contract Amount

The effect of such a statement to the government purchaser is that the government is separately billed for the actual value of the work performed by the contractor and for the amount of the transaction privilege tax—much the same as a retail purchaser is separately billed for the actual value of the property purchased and the sales tax imposed on the sale.[120] Upon receipt of the payment from the United States, the prime contractor is then required to remit the amount of the tax collected on the transaction to the state taxing authority.[121]

The practical operation of the Arizona tax may also be viewed in comparison to examples provided by the Ninth Circuit in *California State Board of Equalization*.[122] When the Arizona scheme is applied to the scenarios posed by the Ninth Circuit, the Arizona tax operates like the unconstitutional California

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116. ARIZ. REV. STAT. ANN. § 42–1302(A)(1).
117. ARIZ. REV. STAT. ANN. § 42–1310.16.
118. The amount of the tax, $32,500, is derived by multiplying the prime contracting tax rate of 5% times the contractor's tax base of 65% of the gross proceeds of the sale. ARIZ. REV. STAT. ANN. §§ 42–1310.16(B) (1991 & West Supp. 1991), 42–1317(A)(1)(h) (West Supp. 1991).
119. ARIZ. REV. STAT. ANN. § 42–1310.16(G).
120. *Cf. First Agric. Nat'l Bank*, 392 U.S. at 347. "It would appear to be indisputable that a sales tax which by its terms must be passed on to the purchaser imposes the legal incidence of the tax upon the purchaser." *Id.*
121. ARIZ. REV. STAT. ANN. § 42–1302(A)(1).
122. 650 F.2d at 1132 n.6. *See supra* note 39.

tax. In each example, assume an actual value of prime contracting services rendered of $1,000.

In the first example, the contractor presents the purchaser with a receipt which separately states the tax, and the contractor collects the amount of the tax from the purchaser.[123] This transaction would result in the following:

Amount Collected	$1,038.50
Gross Income	$1,000.00[124]
Amount of Tax	$38.50[125]
Net Income	*$1,000.00*

In the fourth example,[126] the contractor separately states the sales tax but does not collect the tax from the purchaser. This transaction would result in the following:

Amount Collected	$1,000.00
Gross Income	$968.52[127]
Amount of Tax	$31.48[128]
Net Income	*$968.52*

This example illustrates that if a prime contractor simply fulfills its statutory obligation to separately state the tax but does not collect the tax, the contractor will suffer reduced profits on the project. Therefore, as in *California State Board of Equalization,* the prime contractor in Arizona is economically compelled to collect the amount of the tax from the purchaser.

Moreover, the Arizona prime contractor is *statutorily* compelled to separately state the tax. The statutory compulsion to separately state the tax, combined with the economic compulsion to collect the tax from the purchaser, manifest the legislature's intent that the tax on prime contracting be paid by the purchaser.[129] When the United States is the purchaser, this is clearly unconstitutional.

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123. *Id.*

124. This equation is derived from ARIZ. REV. STAT. ANN. § 42–1302(A) which defines gross income as the amount collected minus the amount of taxes imposed by the transaction privilege tax.

125. *See supra* note 118.

126. In the second and third examples given by the Ninth Circuit, the contractor does not separately state the tax. These options are not available to a prime contractor in Arizona who is statutorily required to separately state the tax; consequently, they will not be considered here.

127. The amount of the tax is based on gross income, but gross income by definition does not include the amount of the tax. Therefore, the following equation was derived in order to calculate the amount of the tax from the amount collected: TAX = 3.148% of AMOUNT COLLECTED. The equation was derived by rewriting the equation given in the statute for determining the tax, *see supra* note 118, as 5% of 65% of (AMOUNT COLLECTED – TAX) to eliminate one of the unknown values leaving one remaining unknown value—the amount of the tax. The equation was algebraically rearranged to arrive at the equation given above.

128. *See supra* note 118. Note that the statutory equation, 5% of 65% of GROSS INCOME, yields the correct amount of tax, i.e., 5% of 65% of $968.52 = $31.48.

129. *California State Bd. of Equalization,* 650 F.2d at 1131–32.

Although the economic compulsion may be averted if the federal government negotiates its contract with the contractor so that the federal government does not pay, this is insufficient to cure the federal immunity problem created by the tax. It is important to remember that the Ninth Circuit in *California State Board of Equalization*[130] approached the issue of legal incidence "generically," that is, assuming the lessee was an ordinary private lessee. The court determined that under ordinary circumstances, where the lessor had equal bargaining power with its lessee, the economic incentive to collect the tax from the lessee nearly rose to the level of a *compulsion*.[131] According to the Ninth Circuit, therefore, under ordinary circumstances the legal incidence of the tax was on the lessee.

Once the court determined that the "generic" placement of the legal incidence was on the lessee, it remained on the lessee when the lessee was the federal government. This was assumed to be so even if in some cases the federal government might have been able to negotiate a lease contract in which it required the lessor to absorb the tax. Likewise, the Arizona tax has been shown to place the legal incidence on the purchaser of prime contracting without regard to whom the purchaser may be. It must, therefore, remain on the purchaser when the purchaser is the federal government. This violates federal immunity.

RESOLUTION OF THE PROBLEM

The current Arizona transaction privilege tax on prime contracting may violate federal immunity from state taxation because it places the legal incidence of the tax upon the purchaser even when the purchaser of prime contracting is the federal government.[132] One way in which the tax scheme may be amended to avoid this problem is to simply remove the requirement that the tax be separately stated when presenting the bill to the purchaser.[133] Eliminating the requirement of a separate statement would make prime contracting consistent with all other business classifications subject to the Arizona transaction privilege tax that are not required to separately state the tax.[134]

Eliminating the requirement of a separate statement would also eliminate the economic compulsion to collect the tax from the purchaser.[135] If the prime contractor in Arizona was not statutorily required to separately state the tax when presenting its bill to the purchaser, the prime contractor could pass the economic burden of the tax on to the purchaser as an increase in the total price.[136] This is like the second example presented by the court in *California*

130. 650 F.2d at 1127.

131. *Id.* at 1132. "Despite the facial neutrality of [the California tax], the strong economic incentive created by Section 6012 all but *compels* the lessor to collect the tax from the lessee." *Id.* (emphasis added).

132. *See supra* text accompanying notes 7–10.

133. ARIZ. REV. STAT. ANN. § 42–1310.16(G).

134. *See supra* note 6.

135. *See supra* text accompanying notes 114–31.

136. In *California State Bd. of Equalization,* 650 F.2d at 1127, the second example resulted in less net income to the lessor and thus contributed to the economic compulsion to collect the tax from the lessee. The same result would not occur under Arizona law because, unlike the California statute, ARIZ. REV. STAT. ANN. § 42–1302 (West Supp. 1991) states that

State Board of Equalization.[137] Thus, the prime contractor would not be economically compelled to collect the tax from the purchaser as, for example, a retail business is compelled to collect a sales tax from a purchaser. In other words, the prime contractor need not be acting as a "tax collector" on behalf of the state, but it would still be able to recover the cost of the tax as if it were simply another cost of doing business.

Simply striking subsection (G) from section 42–1310.16 seems to be a rather elementary solution to a somewhat complicated problem. Indeed, it is difficult to speculate why the Arizona legislature deemed it necessary to require prime contractors to provide the separate statement of the tax to their purchasers while other business classifications are not required to separately state the tax.[138]

If the Arizona legislature truly intended that the purchaser of prime contracting be responsible for payment of the tax, then perhaps a tax scheme similar to the one devised in Washington may be adopted.[139] Under that scheme, the state could continue to keep the legal incidence of the tax upon the purchaser on private contracts, and shift the legal incidence to the contractor on federal contracts.

The Washington scheme, however, proves to be more problematic. First, the Washington scheme, while ultimately upheld by the Supreme Court, was sufficiently complex to subject the state of Washington to litigation over its validity.[140] Second, the Arizona Supreme Court has emphasized in earlier cases that the transaction privilege tax has traditionally been a tax imposed "on the privilege or right to engage in business."[141] If that is true, then it seems to be a well-settled policy in Arizona that the legal incidence of the transaction privilege tax should fall upon the businessperson benefiting from that privilege. In fact, the most striking evidence of this overall policy of the legislature is in the transaction privilege taxation scheme itself. In the entire taxation scheme, only prime contractors are expressly required to present the purchaser with a separate statement of the tax.[142]

As the foregoing analysis illustrates, it is that separate statement which places the legal incidence of the tax on the purchaser of prime contracting. Accordingly, for every other business classification subject to the Arizona transaction privilege tax, the businessperson is taxed for the privilege of doing business in Arizona. Removing subsection (G) would subject prime contractors to treatment more consistent with the overall scheme.[143]

It is curious to note that while simply striking the mandatory separate statement from the tax validates the tax, the prime contractor would still have

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gross income does not include the amount of the tax, regardless of whether the tax is separately stated on the bill.

137. 650 F.2d at 1132 n.6.

138. *See supra* note 6.

139. *Washington v. United States*, 460 U.S. at 536. *See supra* text accompanying notes 58–70.

140. *Id.*

141. *Garrett*, 79 Ariz. at 391, 291 P.2d at 209.

142. *See supra* note 6.

143. Perhaps the inconsistent treatment is simply inadvertence. Another possibility may have been a belief in the legislature that promotion of prime contracting in Arizona required that prime contractors not be taxed for their privilege of conducting business in the state.

an economic incentive to at least *try* to get the federal government to pay the amount of the tax.[144] Thus, one might argue that the economic compulsion to collect the tax from the federal government is not really eliminated. Perhaps there is a distinction to be made between an unconstitutional compulsion to *collect* the tax (with the prime contractor taking the role as appointed tax collector for the state) and merely an implicit incentive to be *reimbursed* for the cost of the tax (in which the amount of the tax is merely recovered by the prime contractor as a cost of doing business).[145] The latter would merely place the "economic incentive" of the tax on the purchaser. This, as shown above, would not be unconstitutional.[146]

CONCLUSION

The Arizona Transaction Privilege Tax as applied to prime contractors places the legal incidence of the tax on the purchaser. When the purchaser is the federal government, the result is direct taxation of the federal government by the state. Because the state is not allowed to directly tax the federal government under the doctrine of federal immunity, this tax is unconstitutional. Simply eliminating the requirement that prime contractors present their purchasers with a receipt separately stating the amount of the transaction privilege tax would render the tax valid.[147]

When the Arizona transaction privilege tax on prime contracting is applied to the various fact patterns illustrated by the Ninth Circuit in *California State Board of Equalization*, the similarity between the Arizona scheme and the unconstitutional California scheme is apparent.[148] The statutes are sufficiently similar that the Arizona scheme will likely suffer the same fate as the California scheme.

A simple solution that would fully "neutralize" the tax would be to eliminate the requirement that the transaction privilege tax be separately stated. This solution would keep the legal incidence of the tax on the contractor while allowing the contractor to shift the economic burden whenever it is able to negotiate such an arrangement with its purchaser. Eliminating the mandatory requirement of a separate statement of the tax would prevent Arizona's statute from violating the federal government's constitutional immunity from state taxation.

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144. *See Washington v. United States*, 460 U.S. at 554–55 n.4 (Blackmun, J., dissenting) which states, "[T]he Court's assumption ... that a federal contractor will be able to pass the tax through to the Federal Government is highly suspect. ... [T]he Court seems to believe that a federal contractor has the same amount of bargaining power with the Federal Government as his private counterpart has with his contractual partner. I suspect that in most circumstances this is not correct." *Id. See also supra* note 69.

145. In practical terms, this distinction is nebulous at best. Either way, the federal government pays.

146. *See supra* text accompanying notes 14–17.

147. *See supra* text accompanying notes 133–43.

148. *See supra* text accompanying notes 122–31.