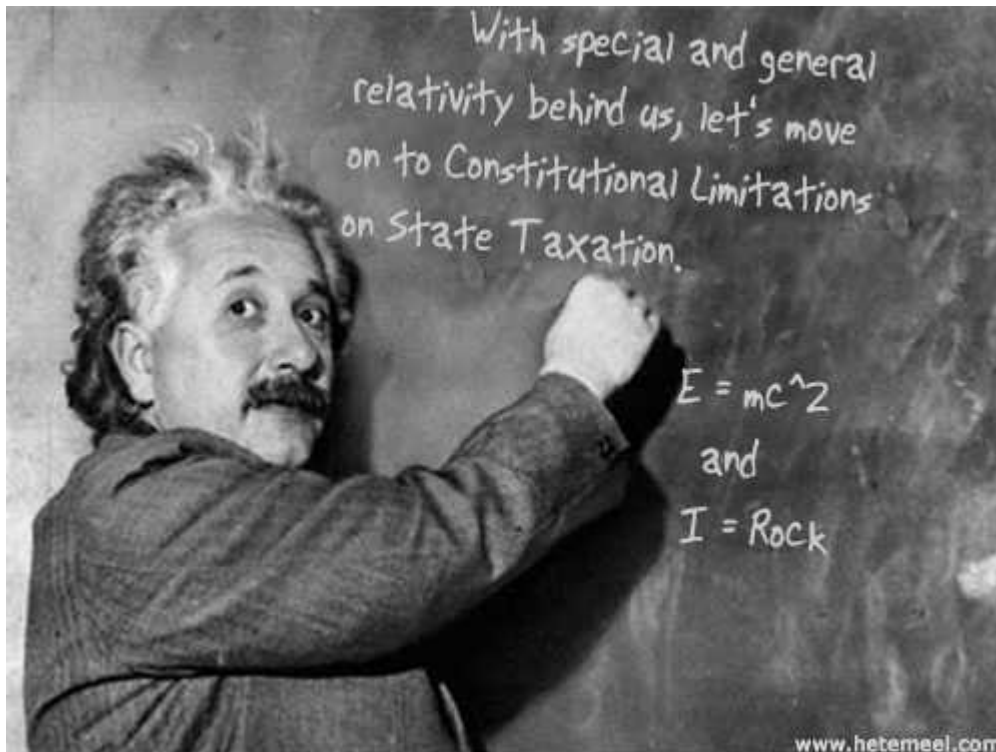


**CONSTITUTIONAL LIMITATIONS ON STATE TAXATION  
(Discussion Outline)**

**Summer Tax Institute  
June 12, 2017**

**PRENTISS WILLSON  
415.819.7985**



**CONSTITUTIONAL LIMITATIONS ON STATE TAXATION  
(Discussion Outline)**

**Prentiss Willson  
415.819.7985  
June 12, 2017**

**I. Summary of the Restraints Imposed by the U.S. Constitution.**

**A. Commerce Clause.**

Is an affirmative grant of power to Congress “to regulate Commerce with foreign nations, and among the several States, and with the Indian Tribes.” U.S. Const. Art I, sec 8, cl 3.

**B. Due Process Clause of the Fourteenth Amendment.**

No state may “deprive any person of life, liberty, or property without due process of law.” U.S. Const. amend. XIV, sec. 1.

**C. Equal Protection Clause of the Fourteenth Amendment.**

No state may “deny to any person within its jurisdiction the Equal Protection of the Laws.” U.S. Const. amend. XIV, sec. 1.

**D. Import-Export Clause and Duty of Tonnage Prohibition.**

No state may “lay any imposts or duties on imports or exports.” U.S. Const. art. 2, sec. 10.

**E. Supremacy Clause and State Tax Immunity of the Federal Government.**

The laws of the United States “shall be the supreme law of the land.” U.S. Const. art. VI, sec. 2.

**F. The First Amendment.**

“Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof; or abridging the freedom of speech, or other press.” U.S. Const. amend. I.

**G. The Privileges and Immunities Clause.**

The Privileges and Immunities Clause of Article IV of the Constitution provides that “[t]he Citizens of each State shall be entitled to all of the Privileges and Immunities of Citizens in the several States.” U.S. Const. art. IV, sec. 2.

**H. The Full Faith and Credit Clause.**

“Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.” U.S. Const. Art. IV, sec 2.

**II. Historical and Current Analysis of Constitutional Restraints on State Taxation.**

**A. The Commerce Clause.**

**1. Background.**

- Direct taxes violate CC
- Taxes with substantially similar impact are accorded different constitutional treatment (e.g., tax on tonnage transported in interstate commerce versus tax on gross receipts from tonnage transported in interstate commerce).
- Taxes discriminating against interstate commerce struck down.

- In 1959, Court holds fairly apportioned, nondiscriminatory net income tax on corporations engaged exclusively in interstate commerce constitutional, leading to enactment by Congress of Public Law 86-272.
- Still, apparently a tax on the privilege of doing business measured by net income would be unconstitutional.

**2. The Four-Part Test under *Complete Auto Transit, Inc. v. Brady*.**

In *Complete Auto*, 430 U.S. 274, 97 S.Ct. 1076 (1977), the Court repudiated the doctrine that the privilege of doing interstate business was immune from state taxation. In addition, it set forth a four-part test that is the starting point today for commerce clause analysis:

- nexus,
- fair apportionment,
- discrimination,
- fair relation between tax and services.

**a. NEXUS:**

- *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (representatives in-state provide nexus whether employees or independent contractors).
- *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992) (mail order seller not liable to collect use tax where no physical presence, no “substantial nexus”).
- How much physical presence is required?
- Does the holding in *Quill* apply to income taxes? Cases involving the issuance of credit cards, or licensing of intangible assets are being litigated in many states.

- Under what circumstances does someone acting on behalf of the taxpayer create nexus? Bookseller examples (e.g., *Scholastic* and *Troll, Borders*). Warranty repair.
- What is the meaning of “establish and maintain the market?”

**b. FAIR APPORTIONMENT:**

**(1) Apportionability.**

There are two basic concepts here: is the income apportionable? Is the apportionment formula fair?

- *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982) (nondomiciliary state cannot treat as apportionable income dividends, interest and capital gains from subsidiaries because the subsidiaries were not unitary, despite certain close connections; Court found no “functional integration, centralization of management, and economies of scale”).
- *F.W. Woolworth Co. v. Taxation & Revenue Dept.*, 458 U.S. 354, 102 S.Ct. 3128, 73 L.Ed.2d 819 (1982) (ditto).
- *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992) (gain on sale of stock not taxable by New Jersey because no connection existed between the activity in New Jersey and the gain being taxed).
- *MeadWestvaco v. Illinois Department of Revenue*, 553 U.S.16 (2008) (gain on sale of Lexis/Nexis division not apportionable to Illinois; the “operational function” test of *Allied Signal* not a different test from the ordinary test for a unitary business).
- Keep in mind the difference between apportionability (above cases) and fair

apportionment (cases below)

**(2) Fair apportionment on its face.**

- *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 98 S.Ct. 2340 (1978) (Iowa’s single-factor apportionment formula based on sales constitutional).
- *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983)<sup>1</sup> (foreign subsidiaries unitary with US operations; no distortion results from combination; world-wide combination is constitutional)
- *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 443, 100 S.Ct. 1223 (1980) (dividends from unitary foreign subsidiaries taxed on apportioned basis by nondomiciliary state).
- *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 100 S.Ct. 2109 (1980) (despite taxpayer’s separate accounting for the three phases of its business—exploration and production, refining, and retail--Wisconsin entitled to tax by use of formulary apportionment)
- *Goldberg v. Sweet*, 488 U.S. 252, 259-60, 109 S.Ct. 582 (1989) (upholds telephone surcharge based on gross receipts from interstate calls which originate or terminate in Illinois, and are billed to Illinois address).

---

<sup>1</sup> Note the doctrines of “internal consistency” and “external consistency”, discussed below, originate here.

- *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 115 S. Ct. 1331 (1995) (upholds sales tax on entire ticket price for interstate bus travel).

**(3) Formula fair on its face versus fair in application.**

- *Underwood Typewriter Co. v. Chamberlain*, 254 U.S., 113, 41 S.Ct. 45 (1920) (upholds Connecticut single factor property formula against taxpayer which manufactured in Connecticut and sold throughout the US).
- *Hans Rees' Sons v. North Carolina Ex Rel. Maxwell*, 283 U.S. 123, 51 S.Ct. 385 (1931) (strikes down single factor property formula which apportioned 80% of income to state because taxpayer evidence showed income taxed “out of all appropriate proportion to the business transacted” in the state).
- *Norfolk and Western Railway Company v. Missouri State Tax Commission*, 390 U.S. 317, 88 S.Ct. 995 (1968) (struck down apportioned property tax under facts of this case as “out of all appropriate proportion”).

**c. DISCRIMINATION:**

- *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 104 S.Ct. 3049 (1984) (invalidated excise tax on liquor from which locally-produced beverages were exempt).

- *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 104 S.Ct. 1856 (1984) (invalidated income tax credit for corporations who engaged in export-related activity in the state).
- *Fulton Corp. v. Faulkner*, 516 U.S. 325, 116 S.Ct. 848 (1996) (North Carolina intangibles tax that required shareholders of out-of-state corporations to pay tax on a higher percentage of share value than shareholders of corporations operating solely within the State violated the Commerce Clause).
- *South Central Bell Telephone Co. v. Alabama*, 119 S.Ct. 1180 (1999) (Alabama franchise tax based on par value of corporation's stock for domestic corporations and on actual amount of capital employed in the state for foreign corporations facially discriminates against interstate commerce, and is not justified as a "compensatory" tax).
- *West Lynn Creamery*, 512 U.S. 186, 114 S.Ct. 2205 (1994) (struck down tax on all milk producers where funds collected were rebated to Massachusetts milk producers).
- *General Motors Corporation v. Roger W. Tracy, Tax Commissioner of Ohio*, 519 U.S. 962; 117 S.Ct. 383; 136 L. Ed. 2d 300; (1996) (upheld tax that exempted natural gas sales by public utilities based on conclusion that regulated local public utilities were not in competition with unregulated independent marketers).
- What is consequence of this line of authority to the standard state practice of granting incentives for relocation/expansion activities in a particular state?

**d. FAIR RELATION BETWEEN TAX AND SERVICES PROVIDED:**

- *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 101 S.Ct. 2946 (1981) (upheld 30% coal severance tax against challenge that value of services provided by the state not quantitatively related to tax paid).

**3. Internal Consistency (an analytical tool first appearing in *Container*).**

- *Armco, Inc. v. Hardesty*, 467 U.S. 638, 104 S.Ct. 2620 (1984) (invalidated business and occupation tax that exempted from tax imposed on wholesaling activity in the state wholesalers who engaged in manufacturing activity in the state.).
- *National Can Corp. v. State Department of Revenue and Tyler Pipe Industries, Inc. v. State Department of Revenue*, 483 U.S. 232 (1987) (invalidated Washington's business and occupation tax that exempts from tax imposed on manufacturing activity in the state, manufacturers who sell at wholesale in the state).
- *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266, 291, 107 S.Ct. 2829 (1987) (invalidated Pennsylvania flat axle tax imposed on all trucks as discriminating against interstate commerce, as unfairly apportioned because tax unrelated to in-state activity, and as violating internal consistency).
- Thus the key internal consistency question: if every jurisdiction applied the same set of rules, would there be a greater burden on the interstate taxpayer?
- *American Truckers Ass'ns v. Michigan*, 125 S. Ct. 2419 (2005) (sustained flat taxes on truckers,

despite acknowledged violation of internal consistency, on the basis that the tax was on “local” deliveries--point to point within the State--and lack of evidence as existed in earlier *Truckers* case regarding heavier burden on interstate truckers). Court appears to retreat from mechanical application of internal consistency doctrine.)

- *Comptroller of the Treasury v. Wynn*, 575 U.S. \_\_\_\_ (2015) (tax lacking credit for county income taxes struck down 5-4 for violating internal consistency by creating risk of multiple taxation on income earned out of state; doctrine applies to personal income taxes.)

#### 4. **Complementary Tax as a Defense to State Tax Discrimination.**

- *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 114 S.Ct. 1345 (1994) (higher waste disposal fee for out of state generated waste than for in-state generated waste struck down; complementary tax defense rejected).
- The court set forth a three-prong test:
  - State must identify the intrastate tax burden for which the state is attempting to compensate, the classic, permissible example being the use tax on out of state purchases
  - Tax on interstate commerce must be shown to roughly approximate the tax on intrastate commerce
  - The events on which the interstate and intrastate taxes are imposed must be “substantially equivalent.”

## 5. Foreign Commerce.

- *Japan Line, Limited v. County of Los Angeles*, 441 U.S. 434, 99 S.Ct. 1813 (1979) (apportioned property tax on cargo containers used in foreign commerce struck down).
- *Kraft General Foods, Inc. v. Iowa Department of Revenue*, 505 U.S. 71, 112 S.Ct. 2365 (1992) (invalidated tax on dividends from foreign subsidiaries when dividends from domestic subsidiaries not taxed).
- *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 114 S.Ct. 2268, 2276 (1994) (worldwide combination to foreign based parent upheld).

## B. The Due Process Clause.

- Generally, due process is implicated
  - When a state seeks to tax an out-of-state taxpayer whose connections with the state are insubstantial (a nexus analysis), or
  - Where nexus exists but the measure of the tax doesn't fairly reflect the taxpayer's activities in the state (a fair apportionment analysis)
- *Quill Corp. v. North Dakota*, 504 U.S. 298, 310, 112 S.Ct. 1904 (1992) (use tax collection obligation permissible under the due process clause if the out-of-state vendor **purposefully** directs its solicitations efforts to the taxing state).
- *Hunt Wesson, Inc. v. Franchise Tax Board*, 120 S.Ct. 1022, 145 L.Ed.2d 974 (2000) (California interest offset unconstitutional, the Court reminding us that a tax on sleeping measured by the number of shoes in your closet is a tax on shoes).

**C. The Equal Protection Clause.**

- *Allegheny Pittsburgh Coal Co. v. County Commissioner of Webster County*, 488 U.S. 336 (1989) (West Virginia Assessor’s “welcome stranger” property tax practice struck down).
- *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (invalidated gross premiums tax that discriminated against out-of-state companies).
- *Williams v. Vermont*, 472 U.S. 14 (1985) (invalidated credit, limited to residents, for sales taxes paid to other states).
- *Hooper v. Bernallilo County Assessor*, 472 U.S. 612 (1985) (invalidated property tax exemption limited to Vietnam veterans residing in the county prior to May 8, 1976 because distinction was not rationally related to purposes).
- *Fitzgerald v. Racing Association of Iowa*, 648 N.W.2d 555 (Iowa SC 2002), 539 U.S.103 (2003) (Iowa Supreme Court invalidated differential tax rate between race tracks and riverboat gambling; major activity of both was use of slot machines; USSC reversed, holding unanimously that rational basis exists for the differential rate enacted by the Legislature; on remand Iowa Supreme Court reaffirms its holding, now based on Iowa’s “equality” clause).

**D. The Import/Export and the Duty of Tonnage Clauses.**

- *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 96 S.Ct. 535 (1976) (ban on “imposts” or “duties” on imports proscribed only if discrimination results; “original package” doctrine overruled).
- *Department of Revenue of the State of Washington v. Association of Washington Stevedoring Companies*, 435 U.S. 734, 98 S.Ct. 1388 (1978) (*Michelin* analysis extended to exports).

- *City of Valdez v. Polar Tankers*, 182 P.3d 614, 616 (Alaska 2008) (upholding a city tax on oil tankers), rev'd, 129 S. Ct. 2277 (2009), reh'g denied, 130 S. Ct. 31 (2009) (property tax struck down because tax applied to oil tankers and not to other personal property and therefore was "a charge for entering, trading in or lying in port" in violation of duty of tonnage clause).

•

**E. Supremacy Clause and State Tax Immunity of the Federal Government.**

- *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 407 (1819) (tax on federal bank struck down because "the power to tax involves the power to destroy").
- *United States v. New Mexico*, 455 U.S. 720, 102 S.Ct. 1373(1982) (taxes on government contractor permitted despite economic burden falling on US government because taxes were not directly on the US). The Court described the new standard it reached as follows:
  - - Tax immunity is appropriate only when levy falls on the United States itself, or an agency or instrumentality so closely connected to the US Government that the two cannot realistically be viewed as separate entities.
    - Thus traditional agency type arguments will not be sufficient.
    - Does this reflect the retreat from formalism that cases such as *Complete Auto* have called for?
- *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 109 S.Ct. 1500 (1989) (invalidated Michigan personal income tax on retired federal employees where state exempted retirement benefits paid to state employees).

**F. First Amendment.**

- *Minneapolis Star & Tribune v. Minnesota Comm'r. of Rev.*, 460 U.S. 575 (1983) (First amendment bars sales tax on paper and ink purchased by newspapers because, inter alia, they are singled out for tax on intermediate purchases and thus discriminated against).

- *Jimmy Swaggart Ministries v. Board of Equalization of California*, 493 U.S. 378; 110 S.Ct. 688; 107 L. Ed. 2d 796; (1990) (generally applicable sales tax applied to sales by religious organization upheld).

**G. The Privileges and Immunities Clause.**

**H. Taxpayer Remedies for Unconstitutional State Taxes.**

- *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 110 S.Ct. 2238 (1990) (prospective only relief to an unconstitutional tax was not a sufficient remedy; meaningful backward-looking relief was required).
- *American Trucking Associations, Inc. v. Smith*, 496 U.S. 167, 110 S.Ct. 2323 (1990) (prospective only relief to discriminatory flat axle taxes permitted by sharply divided Court).
- *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 113 S.Ct. 2510 (1993) (rule in *Davis*, which invalidated Michigan's tax on the basis that it violated intergovernmental tax immunity by taxing the retirement benefits of federal but not state employees, must be applied retroactively).
- *Fulton Corp. v. Faulkner*, 516 U.S. 325, 116 S.Ct. 848 (1996) (Despite fact Court overruled prior US Supreme Court decision in deciding for taxpayer, Court remanded for question of **remedy**, necessarily determining that its decision was retroactive).

**I. Full Faith and Credit Clause.**

- *Franchise Tax Board of California, Petitioner v. Gilbert P. Hyatt et al*, 123 S. Ct. 1683; 155 L. Ed. 2d 702; 2003 U.S. LEXIS 3244; (Nevada not required to defer to rules in California involving allegations of intentional torts committed by FTB auditors in conducting a residency audit over taxpayer living in Nevada).