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State & Local Tax Insights

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Inside

Challenging Discriminatory Taxes: The Commerce Clause at a Crossroads?

Thomas H. Steele & Andres Vallejo

The United States Supreme Court's recent decision to vacate the *Cuno* judgment on standing grounds resolves the immediate constitutional threat to state tax incentives to promote local economic growth. *DaimlerChrysler Corp. v. Cuno*, 126 S. Ct. 1854 (2006).[1] However, the decision does nothing to resolve the doctrinal conflict that spawned the litigation, and the plaintiffs have vowed to renew their challenge through the Ohio courts where they maintain the broader standing requirements will set the stage for another appeal to the Court. *See* Karen Setze, *Supreme Court: Plaintiffs in Ohio Incentive Case Lack Standing*, State Tax Notes, May 16, 2006, at 573. Moreover, other litigants have similar tax challenges in the state courts in Minnesota and Wisconsin where the standing rules may prove more accommodating. *See, e.g., Olson v. Minnesota*, No. 62-C8-05-2727 (Minn. Dist. Ct., filed Mar. 17, 2005); *Northwest Airlines, Inc. v. Wis. Dep't of Revenue*, No. 02CV3533 (Wis. Cir. Ct. Dec. 8, 2003), *appeal pending*, No. 2004AP319 (Wis. Ct. App.).[2] Meanwhile, proponents of the "Economic Development Act of 2005"[3] continue to push for congressional legislation to ward off future challenges of the type advanced in *Cuno*.

As the parties regroup and consider their next moves, we take the opportunity to reflect upon the current state of Dormant Commerce Clause

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jurisprudence and the future role the courts, Congress, and others might play in developing a more coherent and predictable approach to identifying and evaluating discriminatory state taxes.

In doing so, we proceed as follows: First, we describe in very broad terms the structure of the Commerce Clause and the United States Supreme Court's historical (pre-*Complete Auto Transit*) approach to taxation of interstate and foreign commerce. Thereafter, we describe the analytical framework the Court currently appears to use in evaluating claims of discriminatory taxation. Our goal here is not so much to describe the taxes that are or are not discriminatory. Rather, we are simply trying to identify the "rules," or at least the guidelines, the Court applies in evaluating whether state taxes are discriminatory under the Commerce Clause. Because the state courts are on the front line of these developing principles, this section of the article also offers an opportunity to provide a brief roundup of some of the more important, recent state court decisions considering discrimination under the Dormant Commerce Clause.

Next, we revisit the basic question presented in *Cuno*. That issue, considered in connection with the Court's other recent Dormant Commerce Clause case, *American Trucking Ass'ns v. Michigan Public Service Commission*, 545 U.S. 429 (2005), illustrates the difficulties the Court has had in developing a fully consistent and workable analytical framework for its Dormant Commerce Clause jurisprudence. With respect to *Cuno*, court decisions striking down taxes that favor local commerce appear to be in profound tension with other decisions where the Court recognizes that states should be free to compete for and attract interstate business. In the *American Trucking Ass'ns* decision, the Court set aside one of its most consistent guiding principles for evaluating discriminatory taxes, the internal consistency test, in approving a state flat tax that plainly failed the requirements of that test, and grounded that action on formalistic distinctions that are reminiscent of the Court's pre-*Complete Auto Transit* jurisprudence.

That discussion leads to an examination and evaluation of the proposed congressional fix, *i.e.,* the Economic Development Act of 2005. This legislation would identify those taxes which, in the future, will be viewed as permissible state economic incentives and those taxes which, in the future, will be viewed as discriminatory. Because we are skeptical that such a system is likely to prove workable in the long run, we pose the question whether other approaches might better serve the purposes of the Dormant Commerce Clause, and outline an alternative system drawn from the model currently used by the European Union ("EU").

Finally, we offer a brief preview of a few of the more important state tax issues that are likely to call for Court attention in the future. In this regard, we describe briefly a case currently pending before the Court on a Petition for Certiorari involving a new brand of discrimination implemented through a "shifting tax base." In addition, we touch upon the Commerce Clause questions presented by state "addback statutes,"[4] as well as the continuing question whether states should be permitted to apportion income based upon a single sales factor.

Before embarking upon this full agenda, we wish to offer a couple of caveats. First, our purpose here is not to offer an in-depth review of the Court's Commerce Clause decisions. Professor Hellerstein and his late father have fully occupied that field.[5] We are grateful to have that resource in trying to sort out the broad themes we dwell upon in this article. Second, although we suggest a possible realignment of the Supreme Court's role in deciding Commerce Clause cases, until that role is supplanted, if ever, by congressional legislation, the Court's participation in the field of state taxation remains vital. While the Court may have had difficulty in developing a fully workable analysis for evaluating discriminatory state taxes, taxpayers continue to require the Court's attention as a counterweight to the inevitable pressures upon states (and their localities) to favor local commerce and export the burdens of taxation to outsiders. In short, the Court has been

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Upcoming 2006 Conferences

Following is a list of SALT conferences through December 2006, in which Morrison & Foerster attorneys will be participating.

JULY 18
SEATA Conference
Memphis, TN
Paul H. Frankel

JULY 25
FIST Conference
Houston, TX
Paul H. Frankel

AUGUST 3
COST Conference
Newport, RI
Paul H. Frankel

AUGUST 16
MTC Conference
Topeka, KS
Paul H. Frankel

SEPTEMBER 18
NESTOA Conference
Burlington, VT
Paul H. Frankel

SEPTEMBER 27
IPT Conference
Tucson, AZ
Paul H. Frankel

OCTOBER 5
Arizona Tax Conference
Tucson, AZ
Paul H. Frankel

OCTOBER 17
Morrison & Foerster Breakfast Conference
New York, NY

OCTOBER 20
Hartman Tax Conference
Nashville, TN
Paul H. Frankel

OCTOBER 23
TEI Annual Conference
Scottsdale, AZ
Paul H. Frankel

OCTOBER 25
COST Annual Conference
San Francisco, CA
Paul H. Frankel

NOVEMBER 15
Chicago Tax Club Conference
Chicago, IL
Paul H. Frankel

NOVEMBER 17
TEI NJ State Tax Day
Morristown, NJ
Paul H. Frankel

DECEMBER 6 (a.m.)
New Jersey CPA Society Tax Conference
Holmdel, NJ
Paul H. Frankel

DECEMBER 6 (p.m.)
TEI Holiday Symposium
New York, NY
Paul H. Frankel

DECEMBER 18-19
NYU Annual Tax Conference
New York, NY
Craig B. Fields
Paul H. Frankel
Hollis L. Hyans
Thomas H. Steele

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the guardian of our free-trade interstate system, and we need its continuing vigilance unless or until a more workable system is developed.

OVERVIEW OF THE COMMERCE CLAUSE[6]

Notably, the text of the Commerce Clause is short and to the point:[7]

> The Congress shall have the Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

Logically, this assignment of authority has two distinct elements. First, Congress has the power to limit state taxing authority. Public Law 86-272, 86th Cong. (1959) ("P.L. 86-272"), is a familiar illustration. By this statute, Congress has forbidden states from imposing a tax on the income of sellers of tangible personal property so long as these sellers restrict their conduct within the state to certain prescribed activities generally limited to soliciting sales. Absent this statute, states plainly would have constitutional authority to impose an income tax upon taxpayers who conduct such activities (beyond some *de minimis* amount).

Second, Congress has the power to expand state authority to tax. To those who like to fish or hunt, *Schutz v. Thorne*, 415 F.3d 1128 (10th Cir. 2005), *cert. denied*, 126 S. Ct. 1340 (2006), provides a familiar illustration of that power. In that case, a nonresident challenged a statute that charged higher fees for out-of-state hunters than for in-state hunters. In dismissing the Commerce Clause challenge, the United States Court of Appeals for the Tenth Circuit noted that congressional legislation recently had been enacted to authorize such disparate fees and concluded the plaintiff's action was simply "moot" under the circumstances. Another, more prosaic example of this power may be found in the current congressional attempts to expand state authority to collect taxes on remote (non-physically present) sellers for states that are members of the simplified sales tax project. *See* Sales Tax Fairness and Simplification Act, S. 2152, 109th Cong. (2005), *and* Streamlined Sales Tax Simplification Act, S. 2153, 109th Cong. (2005).

In addition to this express delegation of authority to Congress, since at least 1873, the Supreme Court has also read the Commerce Clause to authorize the Court to strike down taxes that unduly burden interstate or foreign commerce, even in the absence of congressional legislation. *See Case of State Freight Tax v. Pennsylvania*, 82 U.S. 232 (15 Wall.) (1873). The Court found this so-called "Dormant Commerce Clause" authority by implication from the Constitution's exclusive delegation to Congress of the right to regulate interstate commerce. Because taxation is an exercise of state legislative authority indistinguishable in substance from state regulation and arguably simply a form of regulation, taxation that unduly burdens interstate commerce thereby impinges upon congressional authority to regulate interstate commerce and, in the Court's view, is inconsistent with the Commerce Clause. The Court's assumption of this authority has, as a practical matter, meant that the Court is the primary guardian of free trade among the states.

EVOLUTION OF THE COURT'S DECISIONAL FRAMEWORK

In what might be called the "pre-modern" era, *i.e.*, prior to 1977, the Court's Dormant Commerce Clause jurisprudence was largely shaped by the principle that interstate commerce should operate free from any state tax impositions that could be viewed as regulation. As such, the Court's decisions provided a dismaying patchwork of formalistic distinctions as to what constituted "local" versus

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Settlements May Be Available in New Mexico and Oklahoma

By Hollis L. Hyans

In both New Mexico and Oklahoma, recent court decisions have upheld the states' efforts to impose income tax on companies that are licensing intangibles to affiliates doing business in those states. While this issue is still being litigated in many states, and the United States Supreme Court has yet to address it, many companies may be interested in taking advantage of opportunities that may be available in New Mexico and Oklahoma to resolve potential liabilities and avoid lengthy audits and assessments.

In *Kmart Corp. v. Taxation & Revenue Dep't of New Mexico*, 131 P.3d 22 (N.M. 2005), the New Mexico Supreme Court quashed the review it had previously granted, thereby upholding the Court of Appeals' determination allowing the Department to assert nexus over an out-of-state trademark licensing company despite the lack of physical presence. However, the Supreme Court also held that gross receipts tax could not be imposed on the licensing company under the New Mexico statute.

In the wake of *Kmart*, the New Mexico tax authorities are interested in settling income and franchise tax liabilities, both for companies that have already been assessed (whose cases were on hold pending the determination in *Kmart*), and for those companies who have not been audited on this issue. For assessed companies or those already under audit, the State's offer is to accept a reduced payment of tax, along with statutory interest, and to waive all penalties. Gross receipts tax will be eliminated in accordance with the court's decision in *Kmart*. Details are still being worked out on such issues as the apportionment percentage that must be applied and the type of return that must be filed. For those companies that have not yet been identified by New Mexico, and that wish to come forward and identify themselves under New Mexico's "Managed Audit Program," in addition to the reduction of tax, and the waiver of penalties, interest would also be waived, and the "look back" period would be limited to seven years. The window of opportunity for these settlements is expected to close by August 1, both for companies with pending cases and those which have not yet been approached by New Mexico's auditors but who wish to come forward.

In Oklahoma, the Oklahoma Court of Civil Appeals reached a decision similar to that in *Kmart*, and upheld the imposition of Oklahoma corporate income tax against a trademark licensing company, finding that it had "substantial nexus" with the State, and that the physical presence nexus requirement under *Quill* was limited to sales and use taxes. *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005), *cert. denied,* No. 99,938 (Okla. Mar. 20, 2006).

Oklahoma may be willing to allow companies that have been licensing intangible property to affiliates doing business in Oklahoma and have not been audited yet to come forward and enter into Voluntary Disclosure Agreements. The terms of these agreements are still being addressed by the Oklahoma Tax Commission, but are expected to include waiver of all penalties.

The Departments in both Oklahoma and New Mexico have stated that they are in the process of compiling lists of companies to pursue for audit, so companies with potential exposure may want to consider coming forward if they have not yet been approached. We have been advised that, as is usually the case, the voluntary disclosure offers may no longer be available once a company has been identified and selected for audit. ■

For more information, please contact Holly L. Hyans at (212) 468-8050 (concerning New Mexico) and Amy F. Nogid at (212) 468-8226 (concerning Oklahoma).

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"interstate" commerce and when a tax should be viewed as "direct" (impermissible) versus "indirect" (permissible). *See, e.g., McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33 (1940) (upholding tax on an interstate sale of coal into taxing state because delivery constituted a "local activity" rather than interstate commerce).

In 1977, the Court abandoned what remained of this analytical model when it ruled that interstate commerce may be made to bear its fair share of a state's tax burden so long as the tax met four criteria: *i.e.*, the tax must (1) be applied to an activity with respect to which the state has substantial nexus; (2) be fairly apportioned to reflect the instate activities or values; (3) not discriminate against interstate commerce; and (4) be fairly related to services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).[8]

Experience demonstrates that among the four factors articulated in *Complete Auto Transit*, the prohibition against discriminatory taxes plays the most important role in the Court's efforts to ensure free trade among the various states. Moreover, the Court itself has observed that the requirement of fair apportionment in many cases may be viewed simply as a subset of the discrimination prong because an apportionment system that inappropriately sources income or values invites multiple taxation as other states, with more legitimate claims over the income or values, impose their taxes as well. *See Armco Inc. v. Hardesty*, 467 U.S. 638 (1984).[9] Thus, the Court's discrimination decisions far outnumber its decisions resting upon one or more of the other prongs of *Complete Auto Transit*.[10]

THE COURT'S FRAMEWORK FOR IDENTIFYING A DISCRIMINATORY TAX

The Court's basic principle for determining whether state action (and, therefore, a state tax) discriminates against interstate commerce is broad and flexible. In *Granholm v. Heald*, 544 U.S. 460, 472 (2005) (citation omitted), the Court articulated the principle as follows:

> Time and again this Court has held that, in all but the narrowest circumstances, state laws violate the Commerce Clause if they mandate "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."

As such, tax discrimination is forbidden equally if it is effected through a higher tax rate imposed upon interstate commerce (*Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994)); through the denial of a tax exemption to out-of-state interests (*Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997)); or through a tax base that is higher for interstate commerce than for local commerce (*Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963)).

In general, the Court's modern decisions focus upon the conceptual possibility of an undue burden rather than upon factual evidence of actual harm to the commerce. In that regard, a challenge to a state tax need not establish that interstate commerce was actually impeded or that income was actually subject to double taxation to be successful. *See Armco Inc. v. Hardesty*, 467 U.S. 638 (1984). Nor must a taxpayer prove that the discrimination was motivated by an intention to favor local commerce over interstate commerce. *See, e.g., Halliburton Oil Well Cementing Co.*, 373 U.S. at 72 (striking down a discriminatory tax base that admittedly "may have been an accident of statutory drafting").[11]

The Court has also made clear that where discrimination exists there is no *de minimis* exception:

> Under our cases, unless one of several narrow bases of

> justification is shown, actual discrimination, wherever it is found, is impermissible, and the magnitude and scope of the discrimination have no bearing on the determinative question whether discrimination has occurred.

Associated Indus., 511 U.S. at 649-50 (citation omitted).

Broadly speaking, the Court's protection extends to the commerce itself, rather than to the individual taxpayers. *See Gen. Motors Corp. v. Tracy*, 519 U.S. 278 (1997). Because the purpose of the protection is to ensure that interstate commerce is not placed at a competitive disadvantage, logically, the disfavored interstate commerce must be in competition with the favored local commerce for unconstitutional discrimination to exist.

Discrimination against interstate commerce is not immunized simply because its burden is somehow tied to a "local event." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 332 n.12 (1977) ("Because of the discrimination inherent in [the taxing statute], we also reject the . . . argument that the tax should be sustained because it is imposed on a local event at the end of interstate commerce."). Indeed, the Court has made it clear that the stage of commerce bearing the discriminatory burden is simply immaterial. *W. Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 202 (1994)

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Lanco: It Isn't Over Yet

By Paul H. Frankel, Hollis L. Hyans, & Amy F. Nogid

On January 30, 2006, the New Jersey Supreme Court granted Lanco, Inc.'s petition for certification.[1] The petition seeks reversal of the Appellate Division decision, which had reversed the well-reasoned decision of the New Jersey Tax Court, and had held that physical presence is not a prerequisite to tax imposition under New Jersey's Corporation Business Tax. While the New Jersey Supreme Court's agreement to review the decision is naturally a welcome development for Lanco, the ultimate decision on the economic nexus issue is of critical importance to any corporation or person that might be said to derive revenue from use of its intangible property or product in a state in which it has no physical presence – no office, no tangible personal property, no realty, and no personnel.

Although the highest courts of other states have ducked the issue,[2] it is not entirely surprising that New Jersey's highest court has stepped up to the plate. In a somewhat unusual move, the Appellate Division itself urged the court to take the case; in a footnote to its decision the Appellate Division strongly suggested that the constitutional question on which it had ruled was substantial and stayed its remand of its decision "pending decision on a petition for certification."[3] Also notable was the stand-up position taken by the New Jersey Director of the Division of Taxation ("Director"), not to oppose Lanco's bid to seek New Jersey Supreme Court review of the Appellate Division decision. In fact, the Director's counsel represented to the court that the Director "agrees that the Appellate Division decision addresses a substantial question under the Constitution of the United States on which there is a divergence of precedent and that it is in the [Director's] interest to have the question resolved by the Court."

FACTS

The case involves Lanco's challenge to a subjectivity notice issued by the Director, based upon the Director's position that Lanco

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could be subjected to New Jersey's Corporation Business Tax ("CBT") solely by virtue of Lanco's economic presence in the State. Unlike the facts, or the spin on the facts given by taxing jurisdictions and certain courts, which arguably might not present a clear "economic nexus" scenario, *e.g.*, finding an agency relationship or the "functional equivalent" to physical presence, the facts in *Lanco* leave no room for a nexus assertion on an alternative basis. The parties stipulated that Lanco, a trademark protection company incorporated in Delaware, owned certain trademarks, tradenames, and service marks (the "Marks"), which it licensed to a sister company, Lane Bryant, at arm's-length royalty rates. Also stipulated was that Lane Bryant, a nationwide retailer of women's clothing and accessories, used Lanco's Marks in its business throughout the United States, including New Jersey. The parties also agreed that Lanco had no physical presence in New Jersey; it had no New Jersey office, employees, agents, real property, or tangible personal property, and it conducted all of its licensing activities outside of New Jersey.

NEW JERSEY TAX COURT DECISION

Based on those facts, the New Jersey Tax Court had no problem concluding that Lanco did not have "substantial nexus" with New Jersey and could not therefore be subjected to the CBT. The Tax Court, which has considerable familiarity with and understanding of the tax issues, scrutinized the parties' positions and critically reviewed their cited authorities; its decision was well reasoned and scholarly, unlike the decisions hailing from administrative agencies and many courts – including New Jersey's Appellate Division – which ignore the holding of *Quill Corp. v. North Dakota*,[4] relying instead on its *dicta* and tone.

First, the Tax Court rejected the common ownership of Lanco and Lane Bryant as providing a basis that would impact upon its constitutional analysis, concluding that their relationship was "not material to the constitutional issue."[5]

Next, the Tax Court addressed the Director's contention that the *Quill* Court only grudgingly followed its earlier pronouncement in *Bellas Hess*[6] of the physical presence requirement and that the requirement is obsolete. In rejecting the Director's argument, the Tax Court found that "[t]he majority clearly undertook an analysis of the physical presence requirement on its own merits."[7]

The Tax Court also rejected the Director's argument that the Commerce Clause does not require physical presence in the income tax context, concluding that "[i]t is difficult to see distinctions that give virtue to physical presence as a necessary element of nexus in [the use tax] area and not for purposes of income taxation."[8] The Tax Court joins the ranks of other courts in understanding that there is but one Commerce Clause and it applies regardless of the type of tax involved. For example, the Texas Court of Appeals said it well:

> While the decisions in *Quill Corp*. and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp*. and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.[9]

More importantly, however, the Tax Court's determination that the Commerce Clause applied to the CBT also comports with Justice Scalia's observation in his concurring decision in *Quill*: "[i]t is difficult to discern any principled basis for distinguishing between jurisdiction to regulate and jurisdiction to tax. As an original matter, it might have been possible to distinguish between jurisdiction to tax and jurisdiction to compel collection of taxes as agent for the State, *but we have rejected that*."[10]

THE APPELLATE DIVISION DECISION

The Appellate Division reversed the Tax Court decision and held that the Commerce Clause standard is higher for use tax collection than for income-based taxes. The CBT, as an income-based tax, could therefore be imposed against Lanco or any other corporation if that corporation derives income somehow connected to New Jersey.

To support that conclusion, the Appellate Division relied primarily on *Quill*'s *dicta* rather than its holding, and on three cases from other states, *A&F Trademark*[11] from North Carolina, *Geoffrey*[12] from South Carolina, and *Gap (Apparel)*[13] from Louisiana. The *Geoffrey* decision has been called by renowned experts in state taxation "extremely shoddy" and criticized as having "legal underpinnings . . . [that] may be questioned."[14] *A&F Trademark* relies extensively on that "extremely shoddy" decision,[15] and the third case, *Gap (Apparel)*, is not even a Commerce Clause case, but a Due Process case.

By its reliance on *Geoffrey* and *A&F Trademark*, the Appellate Division seems to have agreed with the courts' conclusions in those cases that businesses that have no physical presence still receive benefits for which the State deserves to be compensated. That argument was directly addressed – and rejected – by the U.S. Supreme Court in both *Bellas Hess* and *Quill*, and it is troubling that courts have paid no heed to precedent. During the oral argument in *Quill*, the Attorney General mentioned some of the benefits he believed were provided – and for which North Dakota was deserving of compensation – particularly "the customer base." Justice Rehnquist responded that "[t]hat's the argument that was rejected in *Bellas Hess* after being quite eloquently portrayed by the dissent."[16] The *Bellas Hess* majority, however, agreed with Bellas Hess, which in its briefing to the Court characterized Illinois' argument as: "[s]ince Illinois confers benefits upon persons within its borders, it indirectly confers upon anyone outside its borders who deals with them sufficient benefit to sustain subjecting him to extraterritorial obligations. Upon this theory, Massachusetts could tax Florida hotels because the prosperity it bestows upon Massachusetts residents enables them to visit those resorts. Minnesota could tax Michigan factories because her farmers are a market for Michigan's tractors and cars. . . . It was to prevent just such mutual aggressions that the States entered into the federal union."[17]

> The Appellate Division reversed the Tax Court decision and held that the Commerce Clause standard is higher for use tax collection than for income-based taxes.

It is unclear why the Appellate Division relied so heavily on the cases it did and why it chose not to undertake the type of detailed substantive analysis the Tax Court did. This approach may be attributed to the fact that, while these issues are common fodder for the Tax Court, such issues are not often dealt with by the Appellate Division. Taxpayers across the country are hoping that the New Jersey Supreme Court will give the issue the reasoned consideration it warrants.

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CONCLUDING THOUGHTS

New Jersey has long advocated against the physical presence requirement and had filed an *amicus* brief in *Quill* requesting that the Court overturn *Bellas Hess*. As an *amicus* in *Quill*, New Jersey set out a laundry list of purported benefits that the State provides to entities that derive revenue from in-State customers: the exploitation of commercial markets, the protection provided by New Jersey's judiciary, the availability of New Jersey's highways, the existence of New Jersey's educated workplace, and police and fire protection. While we all know that the Court in *Quill* reviewed, considered, and *rejected* those "benefits" as insufficient to support a finding of "substantial nexus," the Appellate Division and the courts of several other jurisdictions seem to have forgotten or overlooked that precedent.

Bellas Hess' warning to the Court on the wide-ranging implications of taxation without physical presence has proved prophetic. States have sought to tax companies on the mere receipt of income from all manner of intangibles purportedly used in the state – from trademarks, to computer software, to music. Without a physical presence standard to place reasonable constraints on states' attempts to collect tax, virtually everyone will be taxable virtually everywhere. Such a tax system would be impossible to fairly administer.

Further, the need for Commerce Clause protection is *more* compelling for direct imposition of income taxes than for use tax collection. Businesses' payments of income taxes affect their bottom line, while use taxes are collected from customers and merely remitted to states, which often compensate the collector for its administrative costs. Administrative burden pales in comparison to actual taxation.

It is hoped that the New Jersey Supreme Court will not be swayed by fiscal concerns that may have motivated the courts whose decisions were relied on by the Appellate Division. The potential implications of the decision are significant; all eyes will be turned to that court. ■

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1 *Lanco, Inc. v. Director, Div. of Taxation*, 879 A.2d 1234 (N.J. Super. App. Div. 2005), rev'g 21 N.J. Tax 200 (2003), *certification granted*, C-548 (N.J. Jan. 30, 2006).

2 *See, e.g., Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 2006 Okl. Civ. App. 27 (2005); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 126 U.S. 353 (2005).

3 *Lanco*, 879 A.2d at 1242 n.5.

4 504 U.S. 298 (1992).

5 21 N.J. Tax at 203.

6 *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967).

7 21 N.J. Tax at 206.

8 21 N.J. Tax at 209.

9 *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 300 (Tex. App. 2000). *See also J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

10 *Quill*, 504 U.S. at 319 (Scalia, J., concurring) (emphasis added).

11 *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 126 U.S. 353 (2005).

12 *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993).

13 *Secretary v. Gap (Apparel), Inc.*, 886 So. 2d 459 (La. Ct. App. 2004).

14 I Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 6.11[2], at 6-34 (3d ed. 2001).

15 *Lanco*, Appendix to Revised Brief on Appeal and Petition for Certification, at PPa 60.

16 *Quill Corp. v. North Dakota*, No. 91-194, 1992 U.S. TRANS LEXIS 189, at *28 (U.S. Jan. 22, 1992).

17 Reply Brief for Appellant at 8-9, *Bellas Hess*.

This article appeared in State Tax Notes.

Paul H. Frankel, Hollis L. Hyans, and Amy F. Nogid represent Lanco in this matter

IRS Notice Creates Opportunities for Refunds of Federal Excise and California Utility User Taxes on Long Distance Communications Services

By Thomas H. Steele & Pilar M. Sansone

On May 25, 2006, the Internal Revenue Service ("IRS") announced its intention to discontinue collection and authorize refunds of federal excise tax ("FET") on long distance communications services. *See* IRS Notice 2006-50. The announcement represents the government's decision to cease years of litigation and follow the holdings of five circuit courts, which unanimously concluded that long distance services were not "toll telephone service" within the meaning of IRC 4252(b)(1) and were not subject to FET when the charge for such services varied by elapsed transmission time but not distance. *See Am. Bankers Ins. Group v. United States*, 408 F.3d 1328 (11th Cir. 2005); *OfficeMax, Inc. v. United States*, 428 F.3d 583 (6th Cir. 2005); *Nat'l R.R. Passenger Corp. v. United States*, 431 F.3d 374 (D.C. Cir. 2005); *Fortis v. United States*, 2006 U.S. App. LEXIS 10749 (2d Cir. Apr. 27, 2006); *Reese Bros. v. United States*, 2006 U.S. App. LEXIS 11468 (3d Cir. May 9, 2006).

More specifically, IRS Notice 2006-50 directs collectors to cease collecting and paying over the 3% FET on "nontaxable service," which it defines as bundled service and long distance service, beginning July 31, 2006. In addition, taxpayers are entitled to seek a credit or refund for FET paid on long distance service and bundled service that was billed after February 28, 2003 on their 2006 income tax returns (to be filed in 2007). For the purpose of the Notice, "bundled service" is defined as "local and long distance service provided under a plan that does not separately state the charge for the local telephone service" and includes "Voice over Internet Protocol service, prepaid telephone cards, and plans that provide both local and long distance service for either a flat monthly fee or a charge that varies with the elapsed transmission time for which the service is used," whether through landline or wireless service. "Long distance service" is deemed to constitute "telephonic quality communication with persons whose telephones are outside the local telephone system of the caller." The IRS will continue to collect FET on separately stated charges for local telephone service, although Treasury Secretary John Snow has called upon Congress to "terminate the remainder of this antique tax by repealing the excise tax on local service as well." U.S. Treas. Dep't Press Release dated May 25, 2006.

Notice 2006-50 also creates refund opportunities for utility user taxes imposed by various California municipalities and counties, which may range from 5–10%, as well. For example, San Jose Municipal Code § 4.68.080.C provides that its telephone users tax "shall not be imposed upon any person for using intrastate telephone communication services to the extent that the amounts paid for such services are exempt from or not subject to the tax imposed under Section 4251 of Title 26 of the United States Code, or as that section may be amended from time to time." *See also* Irvine Muni. Code § 2-9-704.D; Sunnyvale Muni. Code § 3.12.080; Oakland Muni. Code § 4.28.030.C. Accordingly, long distance and bundled services that are no longer subject to FET similarly will be exempt from local utility taxes in jurisdictions with such FET provisions. Taxpayers thus are encouraged to review their local ordinances to determine whether refund opportunities exist and to file protective refund claims. ■

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("For over 150 years, our cases have rightly concluded that the imposition of a differential burden on any part of the stream of commerce – from wholesaler to retailer to consumer – is invalid, because a burden placed at any point will result in a disadvantage to the out-of-state producer."). Nor is it of material significance that some forms of local commerce also suffer the discrimination borne by interstate commerce. For example, the Kansas Supreme Court recently struck down a tax that assessed both interstate and intercounty pipelines at a higher assessed value and rate than intracounty pipelines. *In re Appeals of CIG Field Servs. Co.*, 112 P.3d 138 (Kan. 2005). The Kansas court concluded that the discrimination suffered by certain forms of intrastate commerce, *i.e.*, intercounty pipelines, when compared to intracounty pipelines, was simply beside the point when considering whether interstate commerce had been disadvantaged.

Discrimination against interstate commerce will not be countenanced simply because a state is attempting to coordinate its taxes to avoid imposing tax on the same income twice. *See Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976 (2003) (striking down California's dividends-received deduction that was limited to the payer's California income), *cert. denied*, 540 U.S. 1178 (2004); *D.D.I., Inc. v. North Dakota*, 657 N.W.2d 228 (N.D. 2003) (striking down a North Dakota deduction that mirrored the dividends-received deduction at issue in *Farmer Bros.*). In effect, these cases hold that while a policy against multiple taxation may be rational, where the policy is not extended to taxes of other states, it constitutes discrimination that skews economic decisions in favor of local investments. *See also Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (striking down a tax on intangible property, such as stock, that was inversely related to the investor's presence in the state).

As a corollary, the mere fact that interstate commerce may be subject to multiple taxes does not establish a discriminatory tax regime. The point is illustrated by the recent decision of the Ohio Supreme Court in *Diehl, Inc. v. Ohio Department of Agriculture*, 806 N.E.2d 533 (Ohio 2004). In that case, the plaintiff, a manufacturer of evaporated milk, challenged the imposition of an inspection fee based upon the amount of its milk purchases. Because its out-of-state suppliers were subject to another fee that funded the same service in their state, the manufacturer complained that out-of-state product was subject to multiple fees, thereby increasing its price, while Ohio milk was subject to only one inspection fee. Nonetheless, the court rejected arguments that the fee should be viewed as discriminating against interstate commerce. While the conflict between the differing systems for collecting inspection fees resulted in a disadvantage to producers operating in states that collected the fees prior to the manufacturing process, such a conflict does not constitute discrimination under the Commerce Clause because the two fees were imposed upon different events, *i.e.*, producing milk versus manufacturing a milk product.

A FLAWED APPORTIONMENT SYSTEM MAY CREATE DISCRIMINATION

Since its decision in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the Court has employed two distinct inquiries to determine whether an apportionment system satisfies the Commerce Clause, *i.e.*, the internal and external consistency tests. Under the internal consistency test, a tax is considered a violation of the Commerce Clause

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Colorado Court Side-Steps Commerce Clause

By Thomas H. Steele & Andres Vallejo

On April 7, 2006, McLane Western, Inc. filed its petition for certiorari in the United States Supreme Court challenging the constitutionality of a Colorado excise tax imposed on the distribution of certain tobacco products in the State. As the Petition makes clear, and the Colorado Court of Appeals effectively conceded, there is little doubt that the tax imposes a higher burden on, and therefore discriminates against, interstate commerce. The question, of course, is whether the Court will take the case.

The workings of the tax are readily described: The tax is imposed on the initial distribution activity occurring within the State, on a tax base equal to the price paid by the first instate distributor. Because the price of the product increases as it moves through the distribution network, the tax base (and therefore the tax) is always at its lowest when all distribution activity occurs *within the State* and at its highest when the upstream distribution network is located *outside the State* (because the price paid by the distributor that first receives the product in Colorado now includes the mark-up of the distributor(s) outside the State). The Colorado court acknowledged this result and further conceded that the mechanics for setting the tax base could place McLane "at a competitive disadvantage in the market place" because the higher tax is added to the price of the product. However, the Colorado court then concluded that the tax did not discriminate against interstate commerce because, in its view, the statute treated all taxpayers alike and no United States Supreme Court case "involves a determination that a state tax violates the Commerce Clause based on the inequities of a shifting tax base."

McLane's petition stresses that the Colorado court's decision has widespread implications by effectively authorizing a discriminatory tax as long as that discrimination arises from a tax that appears to be neutral on the face of the statute and is implemented through the base, rather than through disparate exemptions or deductions. In this regard, McLane points out that the court's decision is also directly contrary to the Supreme Court's decision in *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963), which struck down a shifting tax base that increased the tax where fabrication or manufacturing occurred outside the state prior to the product's entry into Louisiana but not where that activity occurred after the product entered the state. McLane also maintains that the Colorado court's decision violates bedrock Commerce Clause principles that look to the practical effect of the tax, not its form, in deciding whether discrimination exists.

Because of the potentially far-reaching impact of the case, various national organizations filed or joined amicus briefs supporting McLane's Petition, *i.e.*, the Council on State Taxation, the National Association of Manufacturers, the National Association of Wholesaler Distributors, the American Trucking Association, the Chamber of Commerce of the United States of America, the Colorado Association of Distributors, the Institute for Professionals in Taxation, and the Washington Legal Foundation.

The Court is expected to rule on the Petition in late September. ■

Morrison & Foerster lawyers who represented McLane in this effort included: Thomas H. Steele, Drew S. Days, Beth S. Brinkman, Andres Vallejo, and Mark E. Medina. Professor Walter Hellerstein of the University of Georgia also assisted in drafting the petition.

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if the tax would result in the income being taxed more than once, assuming the tested tax were enacted in its identical form by other states. In contrast, the external consistency test looks not to multiple taxation but rather to whether the state's system for locating income or values actually reflects a reasonable sense of how the income or value is generated.[12]

Over the last twenty years, the internal consistency test has become something of a workhorse, particularly in the state courts, for determining whether a tax should be struck down as a violation of the Commerce Clause.

INTERNAL CONSISTENCY

Over the last twenty years, the internal consistency test has become something of a workhorse, particularly in the state courts, for determining whether a tax should be struck down as a violation of the Commerce Clause. For example, in *American Trucking Ass'ns v. New Jersey*, 852 A.2d 142 (N.J. 2004), the New Jersey Supreme Court struck down an (unapportioned) flat fee collected from transporters of hazardous waste because, if that fee were replicated by other states, interstate carriers would be subjected to multiple fees while instate carriers would pay but one fee. *See also Am. Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987).[13] In *Home Interiors & Gifts, Inc. v. Strayhorn*, 175 S.W.3d 856 (Tex. App. 2005), *petition for review filed*, No. 05-0939 (Jan. 6, 2006), a Texas Court of Appeal relied upon internal consistency to strike down the State's earned surplus throwback provision of the franchise tax because the throwback of the receipts was keyed to whether the taxpayer's operation in another state would enjoy the protection of P.L. 86-272. Because P.L. 86-272 would not protect the taxpayer from the State's alternative franchise tax base, *i.e.*, the net worth tax, were the Texas franchise tax to be replicated in other states, an interstate taxpayer would be exposed to a double franchise tax (one imposed upon earned surplus and the other upon net worth). As a consequence, the court found the provision violated the Commerce Clause.

And, in *Fluor Enterprises Inc. v. Department of Treasury*, 697 N.W.2d 539 (Mich. Ct. App. 2005), *appeal granted*, 711 N.W.2d 74 (Mich. 2006), the Michigan Appellate Court relied upon the internal consistency test to prohibit Michigan from attributing to the State receipts from out-of-state services on Michigan construction projects because the State also attributed to Michigan receipts from in-state services on out-of-state projects.

Because the internal consistency test looks to whether the state's tax regime, if replicated, would result in multiple taxation of interstate commerce, an effective credit mechanism (whereby the tested state reduces its taxes by the amount of tax previously imposed by another state on the same commerce) is considered a complete defense to a claim that a tax violates internal consistency. *See Goldberg v. Sweet*, 488 U.S. 252 (1989). A recent decision of the Minnesota Supreme Court illustrates that this defense also applies where the State grants a credit for taxes subsequently paid to another state that taxes the same commerce (*i.e.*, downstream from the initial taxes). *See Mayo Collaborative Servs. v. Comm'r of Revenue*, 698 N.W.2d 408 (Minn. 2005), *cert. denied*, 126 S. Ct. 1334 (2006). This case involved the constitutionality of an exemption from the MinnesotaCare tax on the gross revenues of a health-care provider (the in-state wholesale provider) for revenue received from another health-care provider who was also subject to the MinnesotaCare tax (the in-state retail provider). In rejecting a challenge that the tax violated the internal consistency test, the court relied on, among other things, the State's representation that the tax provided for a refund of the tax paid by the in-state wholesaler when the out-of-state retailer paid a similar tax on the gross receipts to another state and bore the burden of the Minnesota tax because the tax was passed through. Thus, while the in-state wholesaler's sales to local medical service providers were exempt because those local providers paid the tax on their sales to the ultimate patient, the credit mechanism apparently provided for a similar end result in the interstate context.

EXTERNAL CONSISTENCY

In contrast to the internal consistency test, the external consistency test looks to whether the income or values taxed by a state are fairly related to activities within the state. In theory, this test is concerned with whether the tax is excessive in light of the taxpayer's actual operations in the state.[14] In recent years, this test has been employed primarily to attack tax regimes that lack any apportionment mechanism, and the litigation has centered upon whether an apportionment mechanism is required at all for that type of tax. *See Okla. Tax Comm'r v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995) (holding that a traditional sales tax need not be apportioned even when applied to the gross proceeds of an interstate service,

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MoFo SALT Attorney News

Morrison & Foerster's State and Local Tax Group would like to welcome Michael W. McLoughlin as of counsel in the New York office. Mike has over 15 years of state and local tax experience and has written extensively in the area of state and local taxation and is a co-author of a treatise entitled *State Taxation of Pass-Through Entities and Their Owners*. Mike is also a frequent speaker on various tax topics. He has been a past Editor in Chief of the *State and Local Tax Lawyer* and currently chairs a sub-committee of the State and Local Tax Section of the American Bar Association.

Mike's practice focuses on handling state and local tax matters, including administrative and judicial appeals and business planning. Mike received both his B.A. and his J.D. from Louisiana State University. He is admitted to practice in Louisiana and New York and is a member of the American Bar Association, Section of Taxation. ■

Michael W. McLoughlin can be reached at (212) 468-8240 or mmcloughlin@mofo.com.

Morrison & Foerster's State & Local Tax Group also would like to welcome Jim Kratochvill as of counsel to the San Francisco office. As the former Chief Counsel for state & local taxes at AT&T, Jim has over 30 years of state and local tax expertise, concentrating on interstate telecommunications, information and other high technology service transactions, with extensive experience in litigating and negotiating matters at all levels of administrative and judicial forums. Jim has also written extensively in this area, and is the co-author of a BNA Multistate Tax Portfolio, entitled Sales and Use Taxes: Communications Services and Electronic Commerce (1997, 2000), and co-editor of a book, Telecommunications: Taxation of Services, Property and Providers (2002). Jim is also a frequent lecturer and instructor in the field, and has served for over 13 years on the Board of Directors for the Council on State Taxation (COST).

Jim's practice will focus on handling state and local transaction tax matters, including advocacy, advice and planning regarding all forms of high technology interstate service transactions. Jim received his JD from the Case Western Reserve School of Law and his BA from the University of Pittsburgh. He is currently admitted to practice in New Jersey and Ohio. ■

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but that gross receipts or gross income taxes do require apportionment).

Recently, at least three state courts have relied upon the external consistency test as authority for striking down local gross receipts taxes. *See City of Modesto v. Nat'l Med., Inc.*, 128 Cal. App. 4th 518 (2005) (affirming a lower court decision striking down an unapportioned business license tax on gross receipts and rejecting the City's attempt to create an apportionment mechanism retroactively); *Northwood Constr. Co. v. Twp. of Upper Moreland*, 856 A.2d 789 (Pa. 2004) (striking down an unapportioned local Pennsylvania gross receipts tax and holding that a credit for taxes paid in other jurisdictions does not satisfy the external consistency test), *cert. denied*, 544 U.S. 962 (2005); *S. Pac. Transp. Co. v. Arizona*, 44 P.3d 1006 (Ariz. Ct. App. 2002) (striking down an unapportioned state gross receipts tax on railroad operations conducted between two states).

DEFENSES TO DISCRIMINATORY TAX CLAIMS

As a general matter, in order to justify a discriminatory tax, the state must demonstrate that the scheme "'advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.'" *Camps Newfound/Owatonna, Inc.*, 520 U.S. at 581 (citation omitted). In reality, defending a tax that admittedly discriminates against interstate commerce is an almost impossible task since the Court has indicated such defenses will be subject to a strict scrutiny standard. Moreover, there is almost always a nondiscriminatory alternative to a discriminatory tax, namely, a nondiscriminatory tax. Thus, alleviating administrative burdens, while a legitimate local purpose, provides no defense to discrimination against interstate commerce at least where those administrative burdens could be resolved by extending the favorable treatment to interstate commerce. *See Halliburton Oil Well Cementing Co.*, 373 U.S. 64; *Ex parte Hoover, Inc.*, No. 1040969, 2006 Ala. LEXIS 82 (Ala. Apr. 28, 2006) (striking down a sales tax exemption for sales to the Alabama government but not to governments of other states, based upon a finding that any administrative burden of collecting tax from what would be the recipient of those same tax revenues could be equally resolved by extending the exemption to other states that purchase goods within Alabama).

To date, the only workable defense to a discriminatory tax is technically not a defense at all, but rather a framework for establishing that the tax ultimately is not discriminatory when other taxes imposed by the state are considered. This framework, known as the compensatory tax defense, involves three distinct elements. First, the state must identify the intrastate tax burden for which it is attempting to compensate. Second, the tax on interstate commerce must be shown to approximate – but not exceed – the amount of the tax on intrastate commerce. Finally, the events on which interstate and intrastate taxes are imposed must be "substantially equivalent"; that is, they must be sufficiently similar in substance to serve as mutually exclusive "proxies" for each other. *See Fulton Corp.*, 516 U.S. 325.

The Court has expressed considerable skepticism concerning the compensatory tax defense and, to date, the Court has accepted the defense in only one context: use taxes on products purchased out of state when in-state purchases are subject to the state's sales tax. *See Or. Waste Sys., Inc. v. Dep't of Envtl. Quality of Or.*, 511 U.S. 93 (1994). However, at least in theory, the defense should be available in other contexts, and one state court recently relied upon the defense to uphold a tax that on its face appeared to be discriminatory. *See Tenn. Gas Pipeline v. Urbach*, 750 N.E.2d 52 (N.Y. 2001) (upholding a tax imposed on consumers of natural gas sold in interstate commerce because the tax compensated for two other New York taxes that were imposed upon in-state sellers of natural gas but that were passed through to consumers under the State Public Utility Commission tariff).

As noted, to invoke the defense, the state must identify a burden on in-state commerce for which the apparent discriminatory tax on interstate commerce is purporting to compensate. Because the defense focuses upon a particular state's tax system, the question arises as to whether taxes imposed by other jurisdictions may be considered in determining whether the discriminatory tax merely levels the playing field. A related question is whether the state's tax system may be used to affect a benefit provided by another jurisdiction. At least where the benefit is afforded by the federal government, the answer to the latter question appears to be no. *See Hutchinson Tech., Inc. v. Comm'r of Revenue*, 698 N.W.2d 1 (Minn. 2005) (concluding, based upon *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 76 (1992), that benefits provided to the disfavored foreign commerce by the federal government could not be relied upon as compensating taxes that leveled the playing field when considering favorable state tax benefits that were extended only to local commerce). And while there appears to be no authority concerning whether another state's tax may be used to justify discrimination, given the Court's apparent hostility to the compensatory tax defense, it seems unlikely that the Court would permit such a multi-state formulation.[15]

RE-EVALUATING THE DORMANT COMMERCE CLAUSE

As should be evident from the foregoing discussion, when considered in broad strokes, the decisional framework followed by the Court in its Dormant Commerce Clause jurisprudence has internal logic and generally appears to make sense. Moreover, judging by the results, the Court's efforts in this field have worked. In general, commerce between the states appears to flow without noticeable impediments. And, for the most part, when discriminatory taxes have arisen, either the Court or the state courts have eventually addressed the issues using this decisional framework, and in most (but not all) cases have gotten it right (in our opinion).

That the Court's efforts ultimately have proven workable, however, is not an answer to the broader question whether there may be a better way to approach these problems. The Court, itself, has frequently acknowledged its struggle to fulfill its responsibilities in this area. Indeed, the Court has long

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> At its heart, the Court's struggle appears to arise from the common law process whereby the Court is required to decide actual cases based upon particular facts as a means for establishing broad principles that necessarily are applied to a myriad of unforeseen circumstances arising in different facts.

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referred to its Dormant Commerce Clause jurisprudence as a "quagmire." *See, e.g., Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959). And Justices Scalia and Thomas have made clear that they favor scaling back the Court's Dormant Commerce Clause responsibilities to inquiries relating solely to facial discrimination. *See, e.g.*, *Camps Newfound/Owatonna, Inc.*, 520 U.S. at 610 (Thomas, J., joined by Rehnquist, C.J., and Scalia, J., dissenting) ("The negative Commerce Clause has no basis in the text of the Constitution, makes little sense, and has proved virtually unworkable in application.").[16]

At its heart, the Court's struggle appears to arise from the common law process whereby the Court is required to decide actual cases based upon particular facts as a means for establishing broad principles that necessarily are applied to a myriad of unforeseen circumstances arising in different facts. The first consequence of this limitation is that the Court is frequently called upon to reconcile to its prior decisions new cases arising with different fact patterns presented by an ever-changing economy. The second consequence is that the Court simply may not have the resources, particularly the economic data and analysis, to draw a distinction between taxes that are actually antithetical to our free market and taxes that provide incentives which ultimately will improve the health of the economy at little or no cost to free trade between the states.

CUNO AND *AMERICAN TRUCKING ASS'NS*

Two cases from the Court's recent docket illustrate the Court's continuing struggle with these limitations. The first, of course, is *DaimlerChrysler Corp. v. Cuno*, 126 S. Ct. 1854 (2006). In that case, the Court was called upon to consider a decision of the United States Court of Appeals for the Sixth Circuit that had struck down Ohio investment tax credits granted to DaimlerChrysler for "'purchas[ing] new manufacturing machinery and equipment during the qualifying period, provided that the new manufacturing machinery and equipment are installed in [Ohio].'" *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, 741 (6th Cir. 2004) (citation omitted). In invalidating the tax credit, the Sixth Circuit relied upon United States Supreme Court decisions striking down taxes that discriminated against interstate commerce by coercing taxpayers to locate business operations or conduct transactions within the taxing state.[17] In this regard, the court rejected any distinction between taxes that penalize out-of-state activity and those that provide a tax incentive (lower taxes) for operating within the state. The court noted that "'virtually every discriminatory statute allocates benefits and burdens unequally; each can be viewed as conferring a benefit on one party and a detriment on the other, in either an absolute or relative sense.'" *Id.* at 745 (quoting *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 273 (1984)). The court also found that the Supreme Court had at least hinted at a distinction between direct subsidies and tax credits because the latter implicate the state's power to regulate interstate commerce, which must be even-handed. Finally, the court rejected a challenge to a 10-year personal property tax exemption that was also granted to DaimlerChrysler as an incentive to locate the facility in the state. Here the court found that the exemption did not impose any requirement not directly connected to the use of the exempted property. For example, the statute did not impose specific monetary requirements, require the creation of new jobs, or encourage a beneficiary to engage in an additional form of commerce independent of the newly acquired property.

Putting aside the question of whether the court's distinction between the property tax exemption and the income tax credit makes any economic sense, the central dilemma presented by the case was how, and perhaps whether, a tax incentive freely and openly offered by a state to a willing taxpayer for locating operations in the state can be distinguished on a principled basis from a broadly applicable tax benefit or detriment that may be viewed as effectively forcing a re-location of operations to within the state. The dilemma may be illustrated by considering two hypothetical tax provisions. In the first hypothetical, suppose, as a means of attracting local business, California offered a deduction against income based upon the amount of investment made in California manufacturing facilities. In the second hypothetical, suppose California instead offered an alternative deduction designed to promote capital investment in companies that built and operated such facilities: *i.e.*, the state offered a dividends received deduction ("DRD") for investment in the stock of companies that built and operated such manufacturing facilities, and the DRD was limited to dividends paid from the investee's California income.

The first hypothetical, of course, closely resembles the tax benefit at issue in *Cuno*, albeit in *Cuno*, the benefit was in the form of a tax credit, rather than a tax deduction. Hypothetical two is essentially the deduction struck down by both the California Court of Appeal and the North Dakota Supreme Court as a violation of the Dormant Commerce Clause. *See Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976 (2003), *cert. denied*, 540 U.S. 1178 (2004); *D.D.I., Inc. v. North Dakota*, 657 N.W.2d 228 (N.D. 2003). While there are certainly factual differences between these two hypotheticals, as a matter of economics it is difficult to see why one would be permissible and the other would not.[18]

The second case illustrating the Court's continuing struggle with its Dormant Commerce Clause doctrine is its most recent decision in this area, *i.e.*, *American Trucking Ass'ns v. Michigan Public Service Commission*, 545 U.S. 429 (2005). In that case, the Court upheld a flat fee ($100) imposed on intrastate trucking activities that was also applicable to carriers that "top off" with local loads in making deliveries. To its credit, the Court acknowledged that the flat fee could not be reconciled with the mathematics of internal consistency. Plainly, interstate carriers that make such deliveries in more than one state will pay multiple fees, while an intrastate operation would pay but a single fee. Indeed, the Court seemed to have resolved this basic issue in its earlier decision, *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987), where it struck down a Pennsylvania flat tax imposed upon interstate carriers. To avoid that implication, however, the Court reasoned that the Michigan fee applied only to local commerce and that carriers should expect to pay fees for conducting intrastate commerce in each of the states.

Plainly, interstate carriers that make such deliveries in more than one state will pay multiple fees, while an intrastate operation would pay but a single fee.

By basing its approval of the flat fee in *American Trucking Ass'ns* on the theory that the fee in that case simply involved local as opposed to interstate commerce, the Court appears to be retreating from the *Complete Auto Transit* analytical construct for evaluating taxes, into a prior, largely discredited approach in which

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formalistic distinctions drive the results. Plainly, from the carrier's point of view, the carriage at issue was simply two stops on a route that probably crossed a number of state boundaries. Economically, it is difficult to see why, for example, a delivery between New York City and Philadelphia should be treated differently from a delivery between New York City and Buffalo. Moreover, even if the carrier was operating entirely within one state, the goods being delivered were almost certainly en route from another state or country, and thus the interstate commerce ultimately would bear the burden of the fee.

Ultimately, the Court's difficulty with *American Trucking Ass'ns* arises from the same source as the dilemma of separating acceptable tax incentives from unacceptable discriminatory taxes: essentially the Court lacks the economic tools and perhaps the record to determine whether these impositions are damaging to the free flow of interstate commerce. For example, one might well conclude that flat fees which are modest in amount are acceptable even if, in theory, approval might result in multiple impositions for interstate carriers. It simply may be that the benefits of state regulation of local roadways outweigh the administrative difficulties of trying to apportion such modest fees based on, say, the miles traveled within the state compared to total miles. Unfortunately, the Court is simply not equipped to complete such an analysis and, thus, its decisions tend to rest upon factors that often are less than fully satisfying.

CONGRESS TO THE RESCUE?

In the wake of the outcry that followed the Sixth Circuit's decision in *Cuno* striking down the Ohio investment tax credit, the business community and the states joined forces to sponsor legislation to circumscribe the Court's Dormant Commerce Clause doctrine and provide broad congressional authorization of business incentives. *See* Economic Development Act of 2005, S. 1066, H.R. 2471, 109th Cong. (2005).[19] To limit that authorization to "beneficial" tax incentives while retaining protection against "harmful" discriminatory tax provisions, the legislation essentially carves out of the authorization certain impositions that resemble impositions the Court has previously branded as discriminatory.

In structure, the bill proceeds as follows: First, the bill broadly authorizes "tax incentives" by providing that a state may "provide to any person for economic development purposes tax incentives that otherwise would be the cause or source of discrimination against interstate commerce under the Commerce Clause." Economic Development Act of 2005, S. 1066, H.R. 2471, § 2, 109th Cong. (2005). The term "tax incentive" is thereafter defined as "any provision that reduces a state tax burden or provides a tax benefit as a result of any activity by a person that is enumerated or recognized by a state tax jurisdiction as a qualified activity for economic development purposes." Economic Development Act of 2005, S. 1066, H.R. 2471, § 4(a)(9), 109th Cong. (2005). Finally, the legislation provides in sweeping terms that economic development purposes encompass "all legally permitted activities for attracting, retaining, or expanding business activity, jobs, or investment in a state." Economic Development Act of 2005, S. 1066, H.R. 2471, § 4(a)(2), 109th Cong. (2005).[20]

Thereafter the proposed legislation sets forth a list of tax provisions that are to be carved out of this authority. These provisions appear to be designed to leave undisturbed most of the Dormant Commerce Clause framework discussed above, by fashioning the carve-outs to track state tax provisions that the Court has struck down in the past under its Commerce Clause doctrine.[21] In summary, under the carve-outs, a tax incentive will not be authorized if the tax benefit:

- Is dependent upon the state or country of incorporation, commercial domicile, or residence of an individual;
- Requires the recipient to acquire or use property or to provide services to property produced in the state;
- Is reduced or eliminated as a result of an increase in out-of-state activity by the recipient of the tax incentive;
- Is reduced or eliminated as a result of an increase in out-of-state activity by a person other than the recipient or as a result of such other person not having taxable presence in the state;
- Results in loss of a compensating tax system because the tax on interstate commerce exceeds the tax on intrastate commerce;
- Requires other taxing jurisdictions to offer reciprocal benefits; or
- Requires the offset against another tax on local activities.

IS THERE A BETTER SOLUTION THAN THE ECONOMIC DEVELOPMENT ACT OF 2005?

The Court's dismissal of *Cuno* on standing grounds provides an opportunity, perhaps, to ask more fundamental questions about how discriminatory taxes should be identified and analyzed than would otherwise be possible in the heat of litigation, with millions of dollars at stake. Ultimately this question involves

We would like to suggest that it may be possible to envision a system that might offer some improvement both to the status quo and to the legislative approach currently being considered in the Economic Development Act of 2005.

the possibility of redefining the role of both the Court and the Congress, and even the Executive Branch, in resolving these issues.

In regard to the Economic Development Act of 2005, there is both the practical question of whether Congress is likely to act, now that the heat is off, and the more fundamental question whether we want Congress to act on this legislation. In particular, at least from our perspective, the question is whether the approach embodied in the legislation will prove workable in protecting interstate commerce from future forms of state discrimination. Certainly, history suggests that the pressures upon states and their localities (consciously or unconsciously) to create taxes that export the burden to out-of-state entities and that lighten the load upon their neighbors are likely to continue. Again, if history is any indication, these pressures will continue to produce new, unexpected discriminatory levies that may or may not resemble impositions previously tested by the Court. Indeed, one might well wonder whether it is even possible for Congress to delineate in a statute specific instances in which providing an advantage to local commerce should or should not be permitted, given the changing nature of the economy.

That is not to suggest that continuing the current system, whereby the courts are the principal arbiters of these disputes, is necessarily the best resolution. As suggested above, the common law process whereby broad economic policy is established by litigation, at best, places courts in a difficult position. For the most part, cases arise in the context of factual patterns that often involve transactions which are decades old. The records in those cases typically are reduced to the bare minimum and are designed to allow the courts to test the tax based upon categorical, often abstract rules: *e.g.*, will this tax result in multiple tax burdens if replicated by other states? Or, does this tax require some form of apportionment mechanism, or can

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we assume that all of the income or value the state seeks to tax is located within a single jurisdiction? And so on. Moreover, because courts have limited resources and time, the framework governing judicial decisions virtually precludes economic analysis or even evidence concerning what other state taxes might actually have been imposed upon the same commerce. As a consequence, the courts have, at best, a limited perspective for evaluating whether interstate commerce is actually disadvantaged. And yet, in spite of these limitations, the courts are expected to deliver decisions that advisers and others will reduce to bright-line principles governing fact patterns that may not even have been existent at the time the taxation question arose. Under the circumstances, it is hardly surprising that some of the Justices would apparently like to beat a fast retreat from continuing responsibility for policing this area.

IS THERE ANY ALTERNATIVE?

With heartfelt modesty, we would like to suggest that it may be possible to envision a system that might offer some improvement both to the status quo and to the legislative approach currently being considered in the Economic Development Act of 2005. While the specifics of any such system are beyond the scope of this article, in its broadest sense, the system might involve the following. First, in lieu of the list of specific transactions that are embodied in the carve-outs from the authority for tax incentives, we believe that Congress should enact legislation that articulates broad principles that are to inform decisions as to whether a state tax should be viewed as contrary to our free market, *e.g.*, that state taxes must not restrict, or impose unreasonable burdens on, the free flow of goods across state borders. Second, Congress should establish some administrative agency or special court (*e.g.*, similar to the U.S. Tax Court but with explicit jurisdiction over these disputes) that is to be charged with reviewing state tax impositions that may have some discriminatory effect upon interstate or foreign commerce. That agency or court should have access to economists to assist it in making decisions as to what taxes actually hinder free trade and under what circumstances. It should also have authority to review state taxes before they are actually adopted. By design, the agency or court could narrowly draw the scope of the decision so as to affect only the imposition at issue, much like the advance pricing agreements negotiated by the Internal Revenue Service with individual taxpayers.

> Those who would dismiss our proposed system as Pollyannaish might examine the system used by the EU before rushing to judgment on the proposal.

Such a system, of course, brings the danger that we will simply be creating another level of expensive administrative or court review that is unlikely to improve upon the problems identified above. We acknowledge this risk but believe it important to recognize that the current system may sometimes do more harm than good in adopting what, admittedly, must be a wholly inflexible approach to discriminatory taxes. For example, there might be specific circumstances in which a state should be permitted to enact what appears to be a discriminatory tax in order to stimulate growth in a long-depressed region that lags behind the rest of the national economy or in an area that has been hit by natural disaster. To take a specific example, in the aftermath of Katrina, perhaps Louisiana should be permitted to enact tax statutes that, for a period of years, stimulate local growth to speed recovery, even if those taxes may discriminate against interstate commerce. On the other hand, a state that is simply attempting to strengthen an industry with an already strong market might be prohibited from enacting that same statute. *See, e.g., Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977) (striking down a New York tax intended to protect the New York Stock Exchange).

Those who would dismiss our proposed system as Pollyannaish might examine the system used by the EU before rushing to judgment on the proposal. In general, the EU system roughly follows this model for evaluating taxes that are considered inimical to the EU's movement towards a single market. As broad principles, the Treaty Establishing the European Community articulates five fundamental freedoms (the "Five Freedoms") that are to inform any evaluation of taxes or other impositions by the Member States:

- Free movement of goods;
- Freedom of establishment;
- Free movement of capital;
- Free movement of persons; and
- Free movement of services.

See generally Treaty Establishing the European Community, Dec. 24, 2002, 2002 O.J. (C 325) 33 (the "EC Treaty").

The protection of the Five Freedoms generally is entrusted to a dual system: In one path, a state wishing to adopt a tax that might be viewed as infringing upon the principles of the EC Treaty may (and under certain circumstances must) submit the tax for approval to the European Commission. *See, e.g.*, EC Treaty art. 87, 88, 94, 211; Council Directive 98/34, art. 2, 1998 O.J. (L 204) 37, 40 (EC). In another path, an aggrieved taxpayer may test the tax directly in its home country and eventually present the question to the European Court of Justice, which is charged with ultimately resolving such questions. *See, e.g.,* EC Treaty art. 230, 232.

By making this suggestion, we do not intend to imply that we have fully resolved, even in our own minds, that the United States should follow the same model employed by the EU. We are suggesting that, at this juncture, it makes sense to broaden our lens

In the lower court proceedings, the Colorado Court of Appeals explicitly acknowledged that the tax may place out-of-state product at a competitive disadvantage because the higher tax will be added to the price of the product.

and consider alternatives to both the current system in America, where the Court is largely left to its own devices to resolve these questions, and the specific delineation approach adopted in the Economic Development Act of 2005.

FUTURE CHALLENGES LIKELY TO REACH THE COURT

In closing, we want to offer a brief preview of a few of the more important state tax issues that are likely to call for Court attention in the future.

MCLANE WESTERN, INC. V. DEPARTMENT OF REVENUE

As we write, McLane Western, Inc., has filed with the Court a Petition for Certiorari that involves a new brand of

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state tax discrimination implemented through a "shifting tax base." *McLane Western, Inc. v. Dep't of Revenue*, 126 P.3d 211 (Colo. Ct. App. 2005), *cert. denied*, No. 05SC439 (Colo. Jan. 9, 2006), *petition for cert. filed* (U.S. Apr. 7, 2006) (No. 05-1294).[22] The Colorado tax at issue in that case is imposed once, but only once, upon the chain of the products' distribution and is based on the price of the product paid by the first distributor with a taxable presence in the state. As a consequence, product that is manufactured and distributed entirely within the state is taxed on a lower tax base than product whose upstream distribution is conducted out-of-state. Simply, the later in the distribution chain the product is taxed, the higher the price, and therefore the higher the tax borne by the product. By way of contrast, a traditional sales tax is always imposed at the same stage of distribution (the retail distribution), and the tax is the same regardless of the location (in-state or out-of-state) of the upstream distributors.

In the lower court proceedings, the Colorado Court of Appeals explicitly acknowledged that the tax may place out-of-state product at a competitive disadvantage because the higher tax will be added to the price of the product. Nonetheless, the court refused to strike down the tax because, in the court's view, the higher burden on interstate goods is the result of a "shifting tax base," not a more favorable tax rate or exemption for local commerce.

THE ADDBACK STATUTES

In our view, the recently-enacted addback statutes also are likely to present Commerce Clause questions worthy of the Court's attention.[23] In general, those statutes disallow a deduction for certain payments (*e.g.*, royalties or interest) made to affiliates. However, typically, the disallowance is overridden (the deduction is allowed) when the recipient of the payment is located in the addback state or the recipient is taxable on the income at a rate the addback state considers to be acceptably high. *See, e.g.*, Md. Code Ann., Tax Gen. § 10-306.1(c)(3)(ii); N.J. Stat. § 54:10A-4(k)(2)(I). Embedded within the details of these exceptions to the addback statutes are a variety of specific Commerce Clause issues. For example, Maryland's initial addback statute appears to discriminate against foreign commerce in effectively extending the exemption only to interstate and not foreign transactions. *See* Md. Code Ann., Tax Gen. § 10-306.1(c). But, to our minds, the overriding issue is whether a state may avoid the obvious charge that its addback statute facially discriminates against interstate commerce by conditioning a tax benefit (the deduction of the royalty or interest payment) on the presence of the recipient in the addback state (*i.e.*, upon the payment being made in intrastate commerce). While the state may point to the fact that the deduction is also permitted where the recipient pays sufficient tax in another state, it is not at all clear that such a defense would be effective under the current Commerce Clause framework. In particular, as discussed above, it is not clear that a state may use its tax system merely to level the playing field to counter some tax benefit provided by another jurisdiction. *See, e.g.*, *Hutchinson Tech., Inc. v. Comm'r of Revenue*, 698 N.W.2d 1 (Minn. 2005) (concluding, based upon *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 76 (1992), that benefits provided to the disfavored foreign commerce by the federal government could not be relied upon as compensating taxes that leveled the playing field when considering favorable tax benefits that were extended by the state only to local commerce). A variation on the question is whether a state may effectively punish taxpayers (through the denial of a deduction) for making payments to businesses located in another state that has a lower tax rate. *See Austin v. New Hampshire*, 420 U.S. 656 (1975) (discriminatory tax imposed on income of residents of other states that provide credit for New Hampshire tax not cured by fact that other states could repeal their credit).

THE SINGLE SALES FACTOR APPORTIONMENT SYSTEM

Finally, there is the issue of the single (or enhanced) sales factor apportionment statute. In *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), of course, the Court rejected a challenge to Iowa's adoption of a single factor apportionment formula, on the basis of a record that offered no evidence that the formula actually resulted in extraterritorial taxation in violation of the Due Process Clause. Moreover, the Court was unconvinced that the risk of multiple taxation (produced by the interplay of that system with other systems such as an equally weighted three-factor formula) should be blamed upon Iowa. In particular, the Court was unwilling to endorse any particular system for determining the income earned within the state.

The recent proliferation of state apportionment systems that rely in whole or in large part on the sales factor, along with widely publicized evidence that such systems are often patently designed to benefit in-state activity at the expense of out-of-state activity, suggests it may be time to revisit this issue. Quite simply, the purpose of these apportionment systems is to encourage local industry and to export the tax burden to those businesses which are not present within the state (or have a relatively small presence) but which sell in the state's market. While the Court generally does not require a showing that a statute was intended to produce discrimination, when the record contains explicit evidence to that effect, the Court may consider such evidence, particularly if faced with other evidence that the effect of the formula is to reduce the tax burden on profits actually earned from local industry, at the cost of out-of-state operations.

It may well be said that the Court, more than any other institution, has been responsible for the free flow of commerce between the states.

CONCLUSION

It may well be said that the Court, more than any other institution, has been responsible for the free flow of commerce between the states. At the moment, the Commerce Clause jurisprudence developed by the Court is virtually the only protection interstate business has against discriminatory impositions. Admittedly, the Court's current doctrine has unresolved internal tensions such as those framed in the *Cuno* litigation and those that were exposed in *American Trucking Ass'ns v. Michigan Public Service Commission.* The very process the Court uses to decide cases is problematic and probably makes such conflicts inevitable. Nonetheless, we need the Court to stay on duty until Congress develops a better system.

To improve the system, we believe the dialogue ought to encompass broader alternatives than the approach

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taken by the Economic Development Act of 2005, which attempts to delineate by statute what constitutes a discriminatory tax. In support of that observation, we note that it is not at all clear how the controversies identified in the preceding sections would be resolved under the statute. For example, the controversies presented by addback statutes would not appear to fit neatly within the carve-outs of impositions that will continue to be viewed as discriminatory taxes. As a consequence, under the legislation, the addback statutes would apparently be immune (or at least could be immunized by branding them as an incentive) from challenge as a discriminatory levy.

Our proposal for an alternative system for evaluating discriminatory taxes, modeled roughly on the system used by the EU, is offered simply as an attempt to begin a broader dialogue. We, ourselves, are not yet convinced that such a system would necessarily be an improvement over the current system. But, if the purpose of the Commerce Clause is to enhance the national economic health through a single market system, we do believe that the current system of litigating such cases before the Court might not provide the best approach and that we should consider an alternative system that broadens the analysis and the decisional tools beyond the abstract conceptual framework currently in use. Given the demands already placed on the Court, it is not realistic to expect the Court, itself, to shoulder the full burden of such analysis. If the current decisional framework is to be improved upon, Congress must provide the direction, and ultimately the resources, to implement a new system. ■

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[1] The Court's order reads as follows: "All the theories plaintiffs have offered to support their standing to challenge the franchise tax credit are unavailing. Because plaintiffs have no standing to challenge that credit, the lower courts erred by considering their claims against it on the merits. The judgment of the Sixth Circuit is therefore vacated in part, and the cases are remanded for dismissal of plaintiffs challenge to the franchise tax credit." *Id.* at 1868. The Court subsequently dismissed the Petition for Certiorari filed by the plaintiffs which sought to overturn the lower court's approval of the property tax exemption, discussed below. 2006 U.S. LEXIS 3964 (May 22, 2006).

[2] Similar cases filed in North Carolina and Nebraska have now been dismissed. *See, e.g.*, *DeCamp v. Nebraska*, No. CI041981 (Neb. Dist. Ct. Mar. 7, 2005); *Blinson v. North Carolina*, No. 05-CVS-8378 (N.C. Super. Ct. May 10, 2006). In *Blinson*, the North Carolina court concluded that plaintiffs lacked standing but that, in any event, the incentives in question did not violate the Commerce Clause.

[3] Economic Development Act of 2005, S. 1066, H.R. 2471, 109th Cong. (2005).

[4] *See, e.g.*, Ala. Code § 40-18-35(b); Ark. Code § 26-51-423(g)(1); Conn. Gen. Stat. § 12-218c; 2003 Conn. Pub. Acts § 78 (Spec. Sess.); Md. Code Ann. Tax Gen. § 10-306.1.

[5] Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* (3d ed. 2001 & Supp. 2005).

[6] For a more detailed treatment of the authority provided by the Commerce Clause, *see* Walter Hellerstein, *Symposium: DaimlerChrysler v. Cuno and the Constitutionality of State Tax Incentives for Economic Development: Cuno and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives*, 4 Geo. J.L. & Pub. Pol'y 73 (2006).

[7] U.S. Const., art. I, § 8, cl. 3.

[8] In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979) (citation omitted), the Court ruled that taxation of foreign commerce may call for additional inquiries, namely whether the tax creates "a substantial risk of international multiple taxation" when considered against international norms and/or whether the tax "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" The impact of this decision, however, apparently has been limited to the facts of that case by subsequent decisions. *See, e.g., Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (state apportionment of income of an international unitary business permitted despite general custom of nations endorsing separate accounting).

[9] *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), provides additional evidence of the Court's overlapping analysis of discrimination and fair apportionment. The parties to that case argued its merits in part upon discrimination grounds, yet the Court decided the case strictly on the principle against extra-territorial taxation. In particular, in answering the issue presented by the case—whether the Commerce Clause permitted California to carve out an exception to its interest expense deduction, which the State measured by the amount of nonunitary dividend and interest income that the *nondomiciliary* corporation had received—the Court responded that California's interest offset provision violates the Due Process and Commerce Clauses of the Constitution because "it constitutes impermissible taxation of income outside its jurisdictional reach." *Id.* at 468. Interestingly, in the context of remedies for unconstitutional taxes, the Court has delineated rules establishing that the underlying defect in the taxing scheme initially will drive the choice of remedy required to cure it. In *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 39 (1990), the Court stated that where a tax is invalid "either because it was beyond the State's power to impose . . . or because the taxpayers were absolutely immune from the tax," the state must "undo" the unlawful deprivation by refunding the tax previously paid under duress. Regarding discriminatory taxes, however, the Court afforded more flexibility for the proper remedy. If a tax is struck down as discriminatory, the state "may cure the invalidity . . . by refunding to petitioner the difference between the tax it paid and the tax it would have been assessed were it extended the same

rate reductions that its competitors actually received." *Id.* at 40. Alternatively, "the State may assess and collect back taxes from [the favored class] . . . calibrating the retroactive assessment to create in hindsight a nondiscriminatory scheme." *Id.* Finally, a state also may cure discrimination through "a combination of a partial refund to petitioner and a partial retroactive assessment of tax increases on favored competitors." *Id.* at 41.

[10] This is not to say that the requirement of nexus is not important to the free flow of goods between the states. It is simply an observation that since issuing its decision in *Complete Auto Transit*, the Supreme Court, for whatever reason, has, with the notable exception of *Quill Corp. v. North Dakota*, 504 U.S. 296 (1992), found few nexus controversies worthy of its attention. The requirement that a state tax be fairly related to the services provided by the state has received even less attention. Although the United States Supreme Court did reference that prong of the *Complete Auto Transit* test in *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 291 (1987), in concluding that the Pennsylvania flat tax on interstate trucking at issue in that case did not approximate fairly the cost or the value of the use of the state's roads, the authors are aware of only one court decision, from the Illinois Court of Appeals, clearly relying upon that requirement to strike down a tax. *Am. River Transp. Co. v. Bower*, 813 N.E.2d 1090 (Ill. App. Ct.), *appeal denied*, 824 N.E.2d 282 (Ill. 2004).

[11] On the other hand, proof of a discriminatory intent appropriately may weigh in favor of finding a violation of the Commerce Clause. *See Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989) ("[A] tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce.").

[12] The focus of the external consistency test might well be viewed as emanating from the Due Process Clause rather than the Commerce Clause since the underlying rationale appears designed to prevent states from overreaching. *See Allied Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-78 (1992); *Container Corp. of Am.*, 463 U.S. 159. Nonetheless, because an overreaching tax invites multiple taxation of the same income or value by the state with a legitimate claim to that income or value, it may also be viewed as serving the purpose of preventing discrimination (in the form of multiple taxation) against interstate commerce.

[13] The Court's recent decision in *American Trucking Ass'ns v. Michigan Public Service Commission*, 545 U.S. 429 (2005), apparently limits the use of the internal consistency doctrine in the context of flat fees on what might be viewed as local commerce. This implication is discussed below.

[14] In this regard, the test may simply be regarded as a new label for the distortion analysis previously applied by the Court. *See Norfolk & W. Ry. v. Mo. State Tax Comm'n*, 390 U.S. 317 (1968).

[15] As discussed below, the answer to this question may well determine the constitutionality of certain state addback statutes.

[16] The authors are unaware of any decision by the Court defining what constitutes facial discrimination, and the concept seems somewhat elusive when one begins to consider what facts (beyond the words of the statute) may be relied upon to establish the discrimination. However, Jerome R. Hellerstein and Walter Hellerstein have provided a definition that should prove workable in most cases, *i.e.*, a facially discriminatory tax statute is one that "explicitly subjects out-of-state products, out-of-state taxpayers, or interstate transactions to higher tax burdens than competing local products, taxpayers, or transactions." *See* Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, ¶ 4.13[1][a] (3d ed. 2001 & Supp. 2005), for a detailed examination of the issue.

[17] The court also relied upon a law review article written by Walter Hellerstein and Dan T. Coenen. *See* Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives,* 81 Cornell L. Rev. 789 (1996).

[18] This is not to say that the issues presented in *Cuno* are identical to those presented in the hypotheticals. In particular, the taxpayer in DaimlerChrysler essentially had a private contract with the state upon which it based a large investment decision. While some may argue that it was bad public policy for Ohio to have entered into such a contract either because (as the plaintiffs alleged) the cost of the tax incentives was effectively borne by the local citizenry or because (as the Court's Commerce Clause jurisprudence might suggest) decisions concerning the location of business facilities should not be skewed by such government tax subsidies at all, the fact of the matter is that DaimlerChrysler and Ohio had an agreement upon which the taxpayer had the right to rely.

[19] For a thorough analysis of the legislation, *see* Hellerstein, *Cuno and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives*, 4 Geo. J.L. & Pub. Pol'y 73.

[20] Because the legislation addresses only challenges under the Commerce Clause, challenges based upon other constitutional theories (*e.g.*, Equal Protection or Due Process) or other federal statutes (*e.g.,* the 4-R Act) are unaffected. Moreover, because the legislation appears to be limited to discriminatory taxes, presumably it does not affect Commerce Clause challenges based on, for example, the apportionment prong of *Complete Auto Transit.* However, as discussed above, in practice the distinction between discrimination and apportionment is not always as clear as the theory would have it. For example, originally, the Court set forth the internal consistency test as a subset of the fair apportionment requirement, but subsequently has applied internal consistency to support its discrimination analysis.

[21] Hellerstein, *Cuno and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives*, 4 Geo. J.L. & Pub. Pol'y 73.

[22] In the interest of full disclosure, the authors wish to acknowledge that they are counsel to McLane Western, Inc. in that case.

[23] For a more detailed examination of these statutes and the constitutional issues presented, *see* Thomas H. Steele & Pilar M. Sansone, *Surveying Constitutional Theories for Challenges to the Addback Statutes,* State Tax Notes, Feb. 28, 2005, at 613.