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Legal Perspectives on the Interstate Incidence and Shifting of State and Local Taxes

Walter Hellerstein
UGA School of Law, wallyh@uga.edu

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Legal Perspectives on the Interstate Incidence and Shifting of State and Local Taxes

Walter Hellerstein

School of Law
University of Georgia
Athens, Georgia 30602 USA

ABSTRACT Lawyers, especially constitutional lawyers, have long been concerned with the problems associated with the interstate incidence and shifting of state and local taxes. The Constitution has frequently been invoked as a restraint on the states' power to levy taxes on persons, property, or activities outside their borders. Yet the lawyer's view of tax incidence embodied in these constitutional disputes often bears little resemblance to the economist's. In recent years, however, lawyers have sought to import economic concepts of shifting and incidence into the legal analysis of the constitutional limitations on the states' power to export tax burdens to residents of other states. Despite the Supreme Court's refusal to constitutionalize the concept of excessive state tax exportation, lawyers' increased sensitivity to the economic issues associated with interstate incidence of state and local taxes may well have an impact on future court decisions and legislation in this domain.

I. INTRODUCTION

In hundreds of decisions handed down over the past two centuries, the Supreme Court of the United States has delineated the restraints that the broad commands of the Federal Constitution impose on the exercise of state tax power. Perhaps the most significant of these restraints are those that circumscribe the territorial reach of the states' tax power and those that limit the states' power to tax interstate commerce. The former restraint derives principally from the Due Process Clause. Although the language of the Due Process Clause simply provides that no state "shall . . . deprive any person of life, liberty, or property without due process of law,"[1] the Court has construed this genéral mandate as prohibiting the states from imposing taxes on persons, property, or activities outside their borders. The latter restraint derives principally from the Commerce Clause.

In the interests of full disclosure, it should be noted that I consulted with the State of Montana in connection with Commonwealth Edison v. Montana, 453 U.S. 609 (1981), which is discussed in detail in the paper. The views expressed here, of course, are entirely my own and do not necessarily represent those of Montana.

[1] U.S. Const. amend. XIV, §1.

Although the Commerce Clause by its terms is no more than an affirmative grant of power to Congress "to regulate Commerce . . . among the several States,"[2] the Court has construed it as forbidding the states, even in the absence of congressional action, from imposing taxes that discriminate against or otherwise burden interstate commerce.

In shaping the contours of its doctrine proscribing taxes on extraterritorial values and taxes burdening interstate commerce, the Court has frequently focused on the incidence of the levy in question. Sometimes it has focused on a levy's legal incidence, while ignoring its economic incidence; sometimes it has focused on a levy's economic incidence, while disregarding its legal incidence; and sometimes it has taken both legal and economic incidence into account in adjudicating the issues before it.

This paper explores the cluster of issues associated with the incidence and shifting of state and local taxes in the context of the federal constitutional limitations on the states' authority to impose extraterritorial taxes or taxes burdening interstate commerce. Its perspective is legal. It treats incidence issues as a lawyer sees them within the framework of disputes over the constitutional limits on state tax power. Sometimes this perspective will seem formal and short-sighted to those unfamiliar with the governing constitutional principles. Indeed, it often appears that way even to those steeped in constitutional learning. The primary purpose of this paper, however, is not to replicate efforts undertaken elsewhere to expose flaws in Supreme Court doctrine through critical legal analysis.[3] The purpose is rather to identify in terms comprehensible to the lawyer and nonlawyer alike some of the fundamental precepts and problems underlying judicial decisions dealing explicitly or implicitly with interstate incidence analysis in the hope that the discussion may lay the foundation for an interdisciplinary dialog over the issues these cases raise.

II. SUBSTANCE VERSUS FORM IN INTERSTATE INCIDENCE ANALYSIS

THE SUBJECT-MEASURE DISTINCTION

The subject of a tax is its legal incidence. It is the thing or event upon which the levy is formally imposed and upon which the power to tax is predicated. The measure of a tax is the yardstick to which the tax rate is applied. Sometimes the subject and measure of a tax differ from each other and sometimes they are the same. For example, subject and measure are distinct in a franchise tax where the subject

[2] U.S. Const. art. I, §8, cl. 3.

[3] A number of these efforts are listed as references to this paper (see Hellerstein 1974, 1976, 1977, 1978, 1980, 1982a, 1982b, and 1982c; and Hellerstein and Hellerstein 1978).

is the privilege of doing business in the state and the measure is gross receipts, net income, or capital stock. On the other hand, subject and measure coincide in a direct net income tax where income is both the subject upon which the tax is levied and the measure to which the rate is applied. The subject-measure distinction has been at the heart of a number of constitutional controversies involving interstate incidence analysis.

TAXABLE SUBJECT/NONTAXABLE MEASURE

It is settled constitutional doctrine that a state may not impose a tax on an extraterritorial subject. If Georgia attempted to impose an ad valorem property tax on real property owned by a taxpayer doing business in Georgia but located in Alabama, the Due Process Clause would plainly forbid such an effort to impose a levy on a subject (property) permanently located outside the state's borders. The Due Process Clause thus keeps the legal incidence of a state's taxes at home. Instead suppose Georgia imposed a tax on the privilege of doing business in the state measured by all property owned by any person exercising the taxable privilege regardless of the location of such property. Could Georgia successfully include the value of the Alabama property in its tax base? The answer is no, but the reasoning is not nearly as straightforward as in the first case. Georgia, after all, has power to tax the local privilege of doing business in the state. It also enjoys considerable leeway in measuring the value of that privilege. The Due Process Clause requires, however, that the measure of a tax fairly reflect the taxpayer's activities in the state. It would therefore preclude Georgia from including Alabama property in the measure of a Georgia privilege tax.

This analytical framework begins to show strains when nontaxable extraterritorial values are employed to determine the rate of a tax imposed on a local subject with a nominally local measure. The Supreme Court first had occasion to rule on the constitutionality of such a levy in 1919 when it considered whether New Jersey could determine the rate of its graduated inheritance tax by reference to the value of all of a nonresident decedent's property, including property beyond New Jersey's taxing power.[4] The subject of the tax was the right of an executor or administrator of a nonresident decedent's property to succeed to property having its tax situs in New Jersey. The measure of the tax was the value of such property. The rate of the tax was graduated according to the value of the property transferred. In order to determine the tax due on the New Jersey portion of the property transferred, however, the rate schedule was not applied directly to the property with a tax situs in New Jersey. Instead, the tax was calculated as if all the decedent's property

[4] Maxwell v. Bugbee, 250 U.S. 525 (1919).

had been located and transferred in New Jersey, and the resulting figure was multiplied by the ratio of the value of property located in New Jersey to the value of all the decedent's property wherever located. Because the tax was graduated according to the value of the decedent's entire estate, the effective tax rate on the transfer of New Jersey property was higher than it would have been if only New Jersey property had been considered in fixing the tax.

The taxpayer contended that the effect of the New Jersey taxing scheme was to tax property beyond the state's jurisdiction in violation of the Due Process Clause. After acknowledging the established rule that a state may not tax property outside its territorial jurisdiction, the Court first noted that "the subject-matter here regulated is a privilege to succeed to property which is within the jurisdiction of the State."[5] It then addressed the objection that the levy in substance imposed a tax on out-of-state property:

> In the present case the State imposes a privilege tax, clearly within its authority, and it has adopted as a measure of that tax the proportion which the specified local property bears to the entire estate of the decedent. . . . [I]t may do so within limitations which do not really make the tax one upon property beyond its jurisdiction. . . . The transfer of certain property within the State is taxed by a rule which considers the entire estate in arriving at the amount of the tax. It is in no just sense a tax upon the foreign property, real or personal. It is only in instances where the State exceeds its authority in imposing a tax upon a subject-matter within its jurisdiction in such a way as to really amount to taxing that which is beyond its authority, that such exercise of power by the State is held void.[6]

The court provided no analytically defensible criterion for distinguishing cases in which a state "really" was taxing property beyond its borders from those in which it was not. Nor did it have any response to Justice Oliver Wendell Holmes' observation in dissent that "when property outside the State is taken into account for the purpose of increasing the tax upon property within it, the property outside is taxed in effect no matter what form of words may be used."[7] Yet the Court reaffirmed the basic holding of the New Jersey case on two subsequent occasions. In 1937, it sustained over Due Process Clause objections a Louisiana chain store tax graduated according to the total number of stores in the chain, including stores located outside Louisiana.[8] The rate applied to Louisiana stores was

[5] 250 U.S. at 539.

[6] 250 U.S. at 539-40.

[7] 250 U.S. at 544.

[8] Great Atlantic & Pacific Tea Co. v. Grosjean, 301 U.S. 412 (1937). The formal subject of the tax was the privilege of engaging in the business of operating two or

higher than it would have been if only stores in Louisiana had been taken into account in determining the rate. Later, in 1969, it dismissed an appeal from the Vermont Supreme Court, which had sustained Vermont's consideration of a nonresident's income that was earned outside Vermont — and thus was not taxable by Vermont — for purposes of determining the tax rate applicable to the nonresident's Vermont income.[9] Because Vermont's tax rate was progressive, the nonresident paid a higher tax on his Vermont income than he would have paid if only income earned in Vermont had been taken into account in determining the rate.

The essential question underlying each of these cases is the constitutionality of a state's consideration of nontaxable values in determining the progressive tax rate applicable to the tax measure in question.[10] In each case, it was indisputable that the tax bill owed to the taxing state increased as a result of the consideration of nontaxable extraterritorial elements in determining the tax rate. From this one might reasonably draw the inference that the taxing state is taxing extraterritorial values in violation of the Due Process Clause. Yet the judicial answer in each case was fundamentally the same. The tax was imposed upon an in-state subject — the privilege of succeeding to in-state property, the privilege of conducting an in-state chain store business, and the earning of in-state income. The tax was measured by in-state values or elements — in-state property, stores in the state, and in-state income. The tax rate, while plainly increased by consideration of nontaxable out-of-state values, was nevertheless applied only to the taxable in-state measure of the taxable in-state subject. This was enough to satisfy the courts that what was "really" happening was "merely" the taxation of in-state elements at an increased rate and that this "therefore" did not offend the Due Process Clause. (Such reasoning might well elicit the classic demurrer: "I understand everything but the 'therefore.' ")

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more stores in the state. The measure of the tax was the number of stores in the state. The rate, which was stated on a per store basis, was determined by the total number of stores in the chain, wherever located.

[9] Wheeler v. State, 127 Vt. 361, 249 A.2d 887, appeal dismissed, 396 U.S. 4 (1969). The Vermont statute required the nonresident to determine his Vermont tax liability, which was a fixed percentage of the taxpayer's federal tax liability, as if he were a resident and thus taxable on all of his income wherever earned. The nonresident was then entitled to reduce this to a percentage reflecting the portion of his total income that was earned in Vermont. In his calculation, the nonresident would never actually apply the federal rate schedule to his Vermont-derived income. However, the result was the same as if he had directly applied the federal rate schedule to his Vermont-derived income at effective rates reflecting his total income.

[10] Because of the special relationship that a state enjoys to its residents, a state may, under some conditions, tax all of the personal property or income of its resident taxpayers without regard to the physical location of the property or the source of the income. See Hellerstein (1974). For purposes of the discussion in the text, it is assumed, as was in fact the case in the cited decisions, that the individuals or corporations were not residents of the taxing state.

The superficiality of the judicial treatment of the problem, however, does not mean that there is no problem to resolve. If one looks beyond the distinctions between subject, measure, and rate, which — despite their constitutional significance — tend to confine analysis within artificial parameters, one must inquire on broader principles whether the overall taxpaying "ability" of the taxpayer is properly taken into account by states, which are powerless to tax much of the property or income upon which taxpaying ability resides.

The determination that a taxpayer should shoulder a proportionately greater tax burden as his or her tax base rises reflects a basic political judgment about the manner in which the costs of government are to be shared. See Blum and Kalren (1953). This concept seeks to distinguish taxpayers by reference, for example, to the value of their estates, the number of stores in their chains, or the amount of their incomes, and it demands increasing portions of their tax base on the basis of the distinction. This is not a determination that has any necessary relationship to state lines. If a state resolves that it is appropriate for an estate valued at $100,000 to bear a tax burden of $0.25 on the dollar, it would appear to make no difference whether the entire $100,000 estate is located in a single jurisdiction or is distributed evenly among fifty states with $2,000 of property in each. By the same token, if a state resolves that it is appropriate for a chain store with 100 stores to bear a tax burden of $25 per store or for an individual who earns $100,000 to bear a tax burden of $0.25 on the dollar, it would appear to make no difference whether the chain store has 100 stores in one state or two stores in each of 50 states, or whether the individual accumulated his income by earning $100,000 in one state or $2,000 in fifty states. The argument for permitting a state to look to a taxpayer's total tax base wherever located in order to apply its progressive rate structure would therefore seem a logical corollary of the rationale for developing such a rate structure, a rationale that has essentially nothing to do with the territorial limits of the taxing state.

Since the justification for a progressive rate structure is rooted in fundamentally jurisdictionless concepts regarding the appropriate distribution of the tax burden, one confronts an analytic impasse. If the determination by a taxing state that different taxpayers with different tax bases should pay taxes at different rates is a value judgment that does not depend on the location of a taxpayer's tax base, it makes no sense, at least insofar as that value judgment is concerned, to inquire into the jurisdictional nexus between the taxing state and the tax base. By alternative reasoning, if a state's right to tax is roughly delimited by the notion of territorial dominion or of benefit provided to the taxpayer, it is difficult to defend a tax that is determined in part by factors outside the critical jurisdictional relationship.

The clash of concepts is unavoidable and one must ultimately face the central question head on: If a state has no business increasing a taxpayer's tax bill by taxing property or income outside its borders, what business does it have increasing that bill by considering such property or income in its rate structure? The honest answer seems to be that there is a "logical antagonism"[11] between the principles underlying a state's power to tax and the principles underlying a progressive rate structure predicated on ability to pay. Perhaps it is possible to make intellectual peace with the coexistence of these conflicting theories of taxation by acknowledging the conflict and learning to live with it. A lurking sense of discomfort cannot be easily dismissed, however, when one contemplates that it is on the basis of what an Alabaman owns or does in Alabama that his or her Georgia tax will be calculated. The progressive principle, however, proves at least as compelling as the continuing sense of discomfort. We cannot rationally and fairly implement the concept that those who possess or earn more should pay taxes at an increasingly higher rate unless we determine how much a taxpayer has or earns independently of the political entity in which the property is located or the income is earned. However formalistic the judicial incidence analysis advanced in support of state taxing schemes that have freed the progressive rate structure from traditional restraints on extraterritorial taxation, it is far from clear that the courts have erred in their resolution of the issue.

NONTAXABLE SUBJECT/TAXABLE MEASURE

A state legislature's choice of a taxable subject has sometimes precluded the state from imposing a levy on an otherwise taxable measure. Historically, the most significant example of this problem involved the efforts of states to impose privilege taxes on interstate enterprises. For nearly a century, one of the central tenets of the Court's Commerce Clause doctrine was the principle that the states lacked the power to tax the privilege of doing interstate business. The principle grew out of a logical — but not necessary — inference that the Court drew from the proposition that the Commerce Clause precludes a state from preventing an out-of-state corporation from engaging in interstate commerce within its borders. After concluding that a state was barred from imposing a tax upon an out-of-state corporation as a condition to commencing business in the state, the Court extended the principle to forbid a tax on the privilege of doing business, as applied to an out-of-state corporation doing exclusively interstate business in the taxing state, even though the tax was not levied as a condition of commencing business. Nor did it make any difference that both out-of-state and domestic corporations, and both interstate and intrastate businesses, were taxed on a nondiscriminatory

[11] Lowndes (1936), p. 768.

basis. Over the years, the Court invalidated numerous state taxes, regardless of their measure, because they were found to rest upon the tax-immune privilege of doing interstate business.

The year 1959 marked a watershed in the Court's approach to state taxation under the Commerce Clause. In that year, the Court handed down its landmark decision in *Northwestern States Portland Cement Co. v. Minnesota*,[12] holding that a state could constitutionally impose a nondiscriminatory, fairly apportioned net income tax on an out-of-state corporation engaged exclusively in interstate commerce in the taxing state. For the first time outside the context of property taxation, the Court explicitly recognized that an exclusively interstate business could be subjected to the states' taxing powers. At the same time, however, the Court reaffirmed its decision in *Spector Motor Service, Inc. v. O'Connor*,[13] where it had invalidated a tax similar in virtually every respect to the tax at issue in *Northwestern* except that it was levied on the privilege of doing business in the state. The distinction the Court perceived between the two cases was that the formal subject of the tax in *Northwestern* was the corporation's net income, whereas in *Spector* it was the privilege of doing business. Since the measure of the levies at issue in both *Spector* and *Northwestern* was the net corporate income fairly apportioned to the state, the immunity that exclusively interstate commerce enjoyed from state taxation depended on whether the legislative draftsmen called the tax by the right name.

In 1975 the Court further eroded the tax-immune privilege of doing business in holding that a pipeline company conducting an exclusively interstate business in the taxing state was subject to a nondiscriminatory, fairly apportioned franchise tax measured by the taxpayer's capital stock.[14] The Court sustained the exaction on the ground that it was imposed on the privilege of doing business in corporate form, a legal incident the Court found distinguishable from the privilege of doing interstate business. The case demonstrated that the protection afforded by the privilege doctrine had become illusory; not only was the corporate form obviously the only form in which a corporation could conduct interstate business, but the same taxpayer had resisted the imposition of an earlier version of almost the identical levy, which had been imposed on the tax-immune privilege of doing business. With a minimum of wordsmithing, the state legislature was able to deprive the taxpayer of its constitutional immunity. The true meaning of the Court's decision lay in its remark that

> decisions of this Court, particularly during recent decades, have sustained nondiscriminatory, properly apportioned state corporate taxes upon foreign corporations doing an exclu-

[12] 358 U.S. 450 (1959).
[13] 340 U.S. 602 (1951).
[14] Colonial Pipeline Co. v. Traigle, 421 U.S. 100 (1975).

sively interstate business when the tax is related to a corporation's local activities and the State has provided benefits and protections for these activities for which it is justified in asking a fair and reasonable return.[15]

Two years later, the Court took the final step in its retreat from the position that the privilege of doing interstate business is immune from state taxation: it repudiated the doctrine altogether, along with the philosophy underlying it. In *Complete Auto Transit, Inc. v. Brady,*[16] the Court was confronted with a tax imposed on the privilege of doing business as applied to a corporation providing interstate transportation services in the taxing state. The tax was measured by the corporation's gross receipts from such services. In upholding the levy, the Court explicitly overruled the *Spector* case and abandoned the privilege concept as a limitation on state tax power because it bore "no relationship to economic realities"[17] and did "not address the problems with which the Commerce Clause is concerned."[18]

In discarding a Commerce Clause analysis based on legal incidence for one based on economic reality, the Court referred to four criteria it regards as controlling the determination whether a state tax affecting interstate commerce is valid under the Commerce Clause. First, the tax must be applied to an activity that has a substantial nexus with the state. Second, the tax must be fairly apportioned to activities carried on by the taxpayer in the state. Third, the tax must not discriminate against interstate commerce. And fourth, the tax must be fairly related to services provided by the state. In its opinions subsequent to *Complete Auto Transit,* the Court has faithfully reiterated the four-part test articulated in that opinion, a test the Court has characterized as a "consistent and rational method of inquiry" that looks to "the practical effect of a challenged" tax on interstate commerce.[19]

III. INTERSTATE INCIDENCE ANALYSIS AND "COMPENSATING" TAXES

SALES AND USE TAXES

One of the more instructive episodes bearing on the incidence of state taxes — and one that stands as a warning against any generalization in this area — involves the compensating use tax. Use taxes, ordinarily imposed on the use, storage, or consumption of tangible personal property in the state, are functionally equivalent and complementary to sales taxes. They were designed to meet two

[15] 421 U.S. at 108.
[16] 430 U.S. 274 (1977).
[17] 430 U.S. at 279.
[18] 430 U.S. at 288.
[19] Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 443 (1980).

problems raised by the sales tax: first, the loss of business by local merchants through purchases made in adjoining states without sales taxes; second, the immunity that sales of goods shipped into the purchaser's state from out-of-state vendors were generally thought to enjoy under the Commerce Clause from a sales tax imposed by the purchaser's state. The use tax dealt with both these problems by imposing a levy equal to the sales tax that would have been imposed on the transaction had it occurred within the state's taxing jurisdiction. In principle, then, the in-state consumer stood to gain nothing by making an out-of-state or interstate purchase, because he or she would ultimately be saddled with an identical use tax when the property was brought into the taxing state.

The Court's first opportunity to consider the constitutionality of a use tax scheme arose in 1937 in *Henneford v. Silas Mason Co.*[20] The State of Washington had assessed a use tax on equipment and material purchased by the taxpayer in other states for use in construction work in the taxing state. The tax was levied on the "privilege of using within this state any article of tangible personal property,"[21] a subject that clearly lay within the state's taxing power. Yet the levy's legal incidence was constitutionally suspect because, viewed in isolation, it applied only to goods purchased out-of-state, since any in-state purchase would already have been subjected to a sales tax and have therefore been exempted from a use tax. So perceived, the tax appeared to violate one of the fundamental concepts of Commerce Clause jurisprudence — that the states may not impose taxes discriminating against out-of-state products.

The Court nevertheless upheld the tax. Viewing it in conjunction with the sales tax, the Court found that the "practical effect"[22] of the overall tax structure imposed a burden on the out-of-state purchase of goods identical to that imposed on an equivalent in-state purchase. The Court's firm conviction that the scheme's design and effect were to produce equality led it to reject objections that were raised under the Commerce Clause. The Court observed that one of the system's "effects must be that retail sellers in Washington will be helped to compete upon terms of *equality* with retail sellers in other states who are exempt from a sales tax or any corresponding tax burden";[23] it declared that "*[e]quality* is the theme that runs through all sections of the statute"[24] and further remarked:

> when the account is made up, the stranger from afar is subject to no greater burdens as a consequence of ownership than the dweller within the gates. The one pays upon one

[20] 300 U.S. 577 (1937).
[21] 300 U.S. at 580.
[22] 300 U.S. at 581.
[23] 300 U.S. at 581 (emphasis supplied).
[24] 300 U.S. at 583 (emphasis supplied).

activity or incident, and the other upon another, but the sum is the same when the reckoning is closed. *Equality* exists when the chattel subjected to the use tax is bought in another state and then carried into Washington. It exists when the imported chattel is shipped from the state of origin under an order received directly from the state of destination. In each situation the burden borne by the owner is balanced by an *equal burden* where the sale is strictly local.[25]

In refusing to strike down the use tax as a discrimination against out-of-state products, the Court ignored the legal incidence of the tax and focused instead on the substantial economic equality the overall sales/use tax structure created between intrastate and out-of-state or interstate purchases. Finding that the whole statutory scheme merely put out-of-state and local sales on an equal footing, the Court saw no reason to characterize the use tax for what it formally was — a tax imposed only on products purchased out-of-state. In so concluding, the Court rejected the characterization of the tax as a protective tariff, dismissing it as a "catch word" and "label" to be disregarded "[w]hen equality not preference is the end to be achieved."[26]

The issue of protectionism, however, cannot fairly be disposed of so casually. As Brown inquired a number of years ago: "Should one state in a federal system be able to raise its price levels, isolate itself and protect markets from the outside price competition thereby stimulated? Or does the federal system demand at least that degree of economic unity which would require that consumers and buyers within the state have some measure of access to a free market outside?"[27] The Court in *Silas Mason* simply did not address these issues. Its attempt to distinguish the *Silas Mason* case from *Baldwin v. Seelig*,[28] the leading case that did consider these questions, has never been regarded as satisfactory. In *Silas Mason*, the Court characterized the minimum milk price legislation it had struck down in *Baldwin*, which barred the resale in the state of milk purchased more cheaply out-of-state, as an attempt by a state "to project its legislation within the borders of another state."[29] Precisely the same point may be made with respect to the use tax. Yet, in the context of state taxation, the Court has never confronted the fundamental question posed by Brown: "whether a single state should be allowed to alter its domestic price level in isolation unaffected by its neighbors."[30] Despite its possession of ample doctrinal authority to condemn the use tax as

[25] 300 U.S. at 584 (emphasis supplied).
[26] 300 U.S. at 586.
[27] Brown (1957), p. 234.
[28] 294 U.S. 511 (1935).
[29] 300 U.S. at 585.
[30] Brown (1957), p. 235.

discriminatory and to hold that the Commerce Clause forbids states from attempting to insulate themselves from the competitive and fiscal consequences of diversity in state tax structures, the Court has instead buried the issue under an exclusive preoccupation with preferential treatment.

OTHER ALLEGEDLY "COMPENSATING" TAXES

When the legal incidence of a state tax falls exclusively on interstate commerce, states often try to justify the apparent discrimination by pointing to other allegedly equivalent levies that fall exclusively on intrastate commerce. In determining whether such allegedly equivalent levies save the evidently discriminatory tax from condemnation under the Commerce Clause, the Court has considered both the legal and economic incidence of the allegedly equivalent levy in resolving the constitutional issue. While constraints of time and space preclude a full explication of these decisions here, a brief catalog of the results may nevertheless provide a broad overview of the Court's decisions in this domain.

The Court has rejected the claim that an Alaskan tax on freezer ships, imposed at the rate of 4 percent of the value of the fish processed, discriminated against interstate commerce because no tax was imposed on fish caught and frozen in Alaska.[51] The Court pointed out that local canners were subject to a 6 percent tax on the value of fish obtained for canning and concluded that there was therefore no discrimination in favor of local commerce. The Court has also found that a 1 cent per mile tax on interstate busses was nondiscriminatory in light of a 3 percent gross income tax on local busses,[52] and it has sustained a 50 cent per gallon tax on introducing liquor into the state when a tax of equal amount was imposed on liquor manufactured in the state.[53]

More often than not, however, the Court has rejected the contention that a tax whose legal incidence falls exclusively on interstate commerce is unobjectionable due to the existence of a formally distinct but economically equivalent levy imposed on local commerce. Just last term, the Court rebuffed such an argument in invalidating West Virginia's business and occupation tax applied to out-of-state manufacturers who sell property at wholesale in West Virginia.[54] Local manufacturers who sold property at wholesale in the state were exempt from the tax on wholesaling but were subject to a higher tax on manufacturing. The state claimed that the discrimination against out-of-state manufacturer-wholesalers was more apparent than real when one took account of the higher manufac-

[51] Alaska v. Arctic Maid, 366 U.S. 1 (1961).
[52] Interstate Busses Corp. v. Blodgett, 276 U.S. 245 (1928).
[53] Hinson v. Lott, 75 U.S. (8 Wall.) 148 (1868).
[54] Armco, Inc. v. Hardesty, 104 S.Ct. 2620 (1984).

turing tax imposed on local manufacture-wholesalers to which their out-of-state competitors were not subjected. The Court disagreed:

> The gross sales tax imposed on the [out-of-state manufacturer-wholesaler] cannot be deemed a "compensating tax" for the manufacturing tax imposed on its West Virginia competitors. . . . [M]anufacturing and wholesaling are not "substantially equivalent events" such that the heavy tax on in-state manufactures can be said to compensate for the admittedly lighter burden placed on wholesalers from out of state. Manufacturing frequently entails selling in the State, but we cannot say which portion of the manufacturing tax is attributable to manufacturing and which portion to sales. The fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of state, and that it is reduced when part of the manufacturing takes place out of state, makes clear that the manufacturing tax is just that, and not in part a proxy for the gross receipts tax imposed on [the taxpayer] and other sellers from other States."[35]

For similar reasons, the Court refused to consider a tax on the first use of natural gas in Louisiana brought in from out of state as a complement to a severance tax of the same amount on gas produced within the state.[36] The Court observed that severance and first use or processing were not "substantially equivalent event[s]"[37] on which compensating taxes might be imposed.

Finally, an interesting intersection of legal and economic analysis of interstate shifting and incidence is contained in a recent decision of the Supreme Court in Washington.[38] Washington imposed a privilege tax on fish processors or dealers (denominated "original receivers") who first receive fish within the state. It also imposed a sales tax at one-half the privilege tax rates on those who sell fish to the original receivers. The original receivers were required to deduct the sales tax from the amount paid the seller and to remit it to the state. The original receivers were also permitted a credit against the privilege tax otherwise due in the amount of any fish sales tax they collected. When an original receiver collected the sales tax from a fisherman, its privilege tax was thus reduced by one-half. When it purchased fish from an out-of-state fisherman from whom it could not collect the sales tax (because the state had no jurisdiction to impose it), the original receiver would have to pay the full privilege tax.

A fish processor challenged this taxing scheme on the grounds

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[35] 104 S.Ct. at 2623.

[36] Maryland v. Louisiana, 451 U.S. 725 (1981).

[37] 451 U.S. at 759.

[38] State Department of Fisheries v. DeWatto Fish Company, 100 Wash. 2d 5 68, 676 P.2d 659 (1983), cert. denied, 104 S.Ct 2159 (1984).

that it discriminated against interstate commerce in violation of the Commerce Clause by penalizing the processor for buying fish from out-of-state fishermen. The court rejected the challenge on the ground that the taxes placed an equal economic burden on all fish sales regardless of where or from whom the fish were purchased. It declared: "That the identity of the party bearing the legal incidence of the tax shifted to reflect the fact that certain parties were not subject to state taxation is of no constitutional significance since the total tax rate remained equal and the parties had the opportunity to allocate the burden among themselves."[39] The court illustrated its thesis by the example set forth in the margin.[40] Whether or not the court's economic assumptions and analysis can withstand critical scrutiny is of only passing concern here. The significant point is that the court was explicitly relying on economic analysis for the proposition that the shifting of the legal incidence of a tax from a taxable to a nontaxable party does not make a tax unconstitutionally discriminatory if the economic impact of the overall taxing scheme is nondiscriminatory.

IV. CONSTITUTIONAL LIMITATIONS ON STATE TAX EXPORTATION

The one area in which the Supreme Court has explicitly considered the legal significance of the economic implications of interstate incidence and shifting of state taxes is in connection with the con-

[39] *Ibid.*, 676 P.2d at 662.

[40] "[A]ssume that a processor buys a Chinook salmon in Washington from a . . . fisherman for $10. The processor deducts from the price the fish sales tax of 2.5 percent, or $0.25, and therefore pays the fisherman a net price of $9.75. It then owes the State a privilege fee of 5 percent, or $0.50. But since the processor receives a credit for the $0.25 fish sales tax collected, its net privilege fee is only $0.25. It must pay the State the net privilege fee plus the sales tax collected from the fisherman, a total net tax of $0.50. The final result is that the processor pays a total of $10.25 for the fish: $9.75 to the fisherman and $0.50 to the state.

"Next assume that the processor wishes to buy an identical fish for the same price in Oregon. . . . Since it cannot collect a fish sales tax, the processor will have to pay the State the full $0.50 privilege fee. The total net tax is $0.50 in both cases, although in the first example the legal incidence is split equally between the fisherman and the processor, while in the second example the processor bears the entire legal incidence of the tax. . . .

"Moreover, depending on the economic forces operating in the fish market, the processor may pass some or all of the *actual burden* of the fish sales tax along to the nontaxable fisherman. For example, the processor who pays a total of $10.25 for a fish caught by a taxable fisherman will ordinarily be willing to buy an Oregon . . . fish only if the purchase price and privilege fee total no more than $10.25. The processor will therefore lower the price it pays to the nontaxable fishermen until the purchase price and the privilege fee together total $10.25, the price for fish caught by taxable fishermen. If the market works to shift the actual burden of the tax in this way, fish caught by taxable and nontaxable fishermen will cost the processor (and ultimately the consumer) exactly the same total price, and the fisherman will effectively pay up to half of the total tax regardless of whether he or she is technically subject to the tax." *Ibid.* (emphasis in original).

troversy over the restraints that the Commerce Clause imposes on state severance taxes. In 1978, a number of coal companies and their out-of-state utility customers filed suit in Montana, alleging that Montana's 30 percent severance tax on coal violated the Commerce Clause. The gravamen of their complaint, although couched in the language of the Court's Commerce Clause doctrine, was that Montana was unconstitutionally attempting to export its tax burden to residents of other states by singling out for excessive taxation a resource that was destined for out-of-state consumers who ultimately would bear the severance tax burden.

In its celebrated decision in *Commonwealth Edison Co. v. Montana,*[41] the Supreme Court considered these claims. The taxpayers' assertion that Montana's severance tax was being unconstitutionally exported to residents of other states was framed in part as a claim of discrimination against interstate commerce in violation of the Commerce Clause. The claim did not fit neatly within the Court's proscription against discriminatory levies, however. Severance taxes are generally nondiscriminatory on their face, applying as they do to every ton of coal, barrel of oil, or thousand cubic feet of gas extracted in the state, without regard to the residence of the producer or the consumer. Montana's tax was no exception.

The claim that Montana's severance tax discriminated against interstate commerce, however, was predicated on two interrelated propositions that arguably brought the case within the Court's doctrine forbidding discriminatory levies. First, it was contended that the burden of the tax was in fact borne largely by out-of-state consumers, a fact that depended on whether the tax was exported along with the resource. Second, it was alleged that the amount of tax exceeded the costs imposed on and the benefits provided by the state in connection with the extraction of resource. The second contention was a necessary element of the Commerce Clause argument because states do not violate the Commerce Clause when they demand reimbursement for a fair share of such costs and benefits from those consuming their resources. It would therefore not have been enough to demonstrate merely that the tax was exported; it would also have to be shown that the amount of the tax exported exceeded the costs and benefits associated with the taxpayers' activities in the state.

The Court rejected the taxpayers' argument for reasons that go to the heart of the controversy in constitutional analysis over state tax exportation. The Court first observed that it was not confronted with the typical allegation of "differential tax treatment of interstate and intrastate commerce"[42] that had led it to find unconstitutional discrimination in other cases. Rather, "the gravaman of appellants' claim is that a state tax must be considered discriminatory for purposes

[41] 453 U.S. 609 (1981).
[42] 453 U.S. at 618.

of the Commerce Clause if the tax burden is borne primarily by out-of-state consumers."[43] The Court, however, was unwilling to characterize as a claim of discrimination the "assertion that Montana may not 'exploit' its 'monopoly' position by exporting tax burdens to other states."[44] The Court declared:

> there is no real discrimination in this case; the tax burden is borne according to the amount of coal consumed and not according to any distinction between in-state and out-of-state consumers. Rather, appellants assume that the Commerce Clause gives residents of one State a right of access at "reasonable" prices to resources located in another State that is richly endowed with such resources, without regard to whether and on what terms residents of the resource-rich State have access to the resources. We are not convinced that the Commerce Clause, of its own force, gives the residents of one state the right to control in this fashion the terms of resource development and depletion in a sister State.[45]

Furthermore, the Court expressed considerable "misgivings about judging the validity of a state tax by assessing the State's 'monopoly' position or its 'exportation' of the tax burden out of State."[46] The Court elaborated on these misgivings:

> The threshold questions whether a state enjoys a "monopoly" position and whether the tax burden is shifted out-of-state, rather than borne by in-state producers and consumers, would require complex factual inquiries about such issues as elasticity of demand for the product and other alternate sources of supply. Moreover, under this approach, the constitutionality of a state tax could well turn on whether the in-state producer is able, through sales contracts or otherwise, to shift the burden to its out-of-state customers. As the Supreme Court of Montana observed, "[i]t would be strange indeed if the legality of a tax could be made to depend on the vagaries of the terms of contracts." It has also been suggested that the "formidable evidentiary difficulties in appraising the geographical distribution of industry, with a view toward determining a state's monopolistic position, might make the Court's inquiry futile."[47]

Finally, the Court recognized that the taxpayers' discrimination theory, and the claim of unconstitutional tax exportation underlying it, "ultimately collapse[d] into the claim that the Montana tax is

[43] 453 U.S. at 618.
[44] 453 U.S. at 619.
[45] 453 U.S. at 619.
[46] 453 U.S. at 618.
[47] 453 U.S. at 619-20 note 8.

invalid under the fourth prong of the [Court's Commerce Clause] test: that the tax is not 'fairly related to services provided by the State.' "[48] The requirement that interstate commerce must pay its way had compelled the taxpayers to concede that Montana could impose and, indeed, export a coal severance tax at some unspecified level. What transformed an otherwise nondiscriminatory levy into a tax discriminating against interstate commerce was simply its amount. In substance, the taxpayers' claim that Montana's severance tax discriminated against interstate commerce was rooted in their contention that the tax was excessive and that interstate commerce was therefore being made to pay *more* than its way.

The fourth prong of the Court's Commerce Clause test — that a tax be fairly related to services provided by the state — ostensibly provided the most powerful predicate for the taxpayers' claim in *Commonwealth Edison* that Montana was unconstitutionally exporting its severance taxes. The Court's opinion, to be sure, had already made it clear that state tax exportation was not in itself a suspect practice under the Commerce Clause and that the very concept of tax exportation might be a judicially inadministrable criterion of Commerce Clause adjudication. Nevertheless, if the Court's "fairly related" test required the existence of a reasonable quantitative relationship between a state tax and the services provided by the state, the taxpayers, it might have seemed, were entitled to an opportunity to prove their allegation that the amount of Montana's tax far exceeded any services provided them by the state.

As the Court held in *Commonwealth Edison*, however, the major premise of the taxpayers' Commerce Clause syllogism was false. The "fairly related" test does not require that the *amount* of a tax bear some quantitative relationship to the value of services provided by the state to the taxpayers. It requires only that "the *measure* of the tax must be reasonably related to the extent of the [taxpayer's] contact [with the State], since it is the activities or presence of the taxpayer in the State that may properly be made to bear a 'just share of state tax burden.' "[49] In light of this reading of the "fairly related" criterion, the Court in *Commonwealth Edison* had little difficulty in concluding that the Montana severance tax satisfied it:

> The "operating incidence" of the tax is on the mining of coal within Montana. Because it is measured as a percent of the value of the coal taken, the Montana tax is in "proper proportion" to appellants' activities within the State and, therefore, to their "consequent enjoyment of the opportunities and protections which the State has afforded" in connection with those activities.[50]

[48] 453 U.S. at 620.
[49] 453 U.S. at 626 (emphasis in original).
[50] 453 U.S. at 626.

In sum, the Court's opinion in *Commonwealth Edison* made it clear that a typical state severance tax will survive Commerce Clause scrutiny regardless of the extent to which the resource or the tax is exported and regardless of the levy's rate or amount.

The Supreme Court's refusal in *Commonwealth Edison* to constitutionalize the concept of excessive tax exportation was rooted not only in its misgivings about the formidable evidentiary inquiries such an approach would entail but also in fundamental institutional considerations. Because the taxpayers had conceded that Montana's severance tax would have survived Commerce Clause scrutiny at some lower rate, their contention that the tax at its existing rate violated the Commerce Clause invited a judicial determination of the appropriate rate of a state tax. The Court flatly declined this invitation:

> the simple fact is that the appropriate level or rate of taxation is a matter for legislative, and not judicial resolution. In essence, appellants ask this Court to prescribe a test for the validity of state taxes that would require state and federal courts to calculate acceptable rates or levels of taxation of activities that are conceded to be legitimate subjects of taxation. This we decline to do.[51]

Even assuming the Court could have overcome its reluctance to perform the "legislative" function of establishing the appropriate level of a tax, it would still have been faced with the difficulty of determining the criteria by which the level would be established and of applying these criteria to the facts before it. In light of the Court's view that taxation is "not an assessment of benefits"[52] but rather "a means of distributing the burden of the cost of government,"[53] it is questionable whether the Court would have been capable of fashioning meaningful, substantive standards for enforcing a doctrine that required taxpayers to pay for their fair share of maintaining a civilized society.

While the matter is one about which reasonable persons will continue to differ, the Court's dismissal of the taxpayers' tax exportation claim in *Commonwealth Edison* was arguably warranted. The determination of the extent to which a state severance tax is exported is indeed a monumental undertaking. It would require resolution of difficult theoretical questions on which eminent economists disagree. It would require examination of complex factual issues, the analysis of which lies at the outskirts of judicial competence, if not beyond. The undertaking is also one that might be triggered with some frequency because severance taxes are exported in substantial amounts. Moreover, even if a court could deal with these matters satisfactorily,

[51] 453 U.S. at 627-28 (citations omitted).
[52] Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 522 (1937).
[53] 301 U.S. at 522.

it would then be faced with a host of additional issues bearing on the question of whether the exported portion of the tax was reasonably related to the benefits provided and the costs incurred by the state. In the context of the Montana severance tax, this would have required a court to put a dollar value on the ecological damage, the social disruption, and the loss of an economic base attributable to the extraction of coal in the state.

One could nevertheless contend that even if the inquiry into excessive tax exportation would be unusually complex, judicial intervention was nevertheless justified in *Commonwealth Edison*. The Court has often reminded us that rigorous standards of judicial review are especially appropriate when the burden of a tax "is not likely to be alleviated by those political restraints which are normally exerted on legislation where it affects adversely interests within the state."[54] As the taxpayers in Commonwealth Edison argued:

> selection of coal as the object of this extraordinary tax permitted the Montana legislature to export the practical effect of the tax to consumers in other states who are unable to vote in Montana. . . . Uninhibited by the sort of constituent pressure which typically restrains excessive taxes, the Montana legislature set the rate for the tax with an eye toward revenue-maximization.[55]

The Court's decision in *Commonwealth Edison*, however, is not insensitive to the need to protect the interests of those who are unrepresented in the state legislature. Its refusal to intervene in the Montana severance tax controversy reflects, rather, an even more compelling consideration, namely, that there are some issues so intrinsically political, such as the determination of the appropriate level of a tax, that only a politically responsible institution should resolve them. As the Court concluded in *Commonwealth Edison:*

> even apart from the difficulty of the judicial undertaking, the nature of the factfinding and judgment that would be required of the courts merely reinforces the conclusion that questions about the appropriate level of state taxes must be resolved through the political process. Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress, when particular state taxes are thought to be contrary to federal interests.[56]

Even conceding that the issue is political in nature, one might nevertheless object to its relegation to a politically responsible insti-

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[54] McGoldrick v. Berwind-White Coal Mining Co., 309 U.S. 33, 46 note 2 (1940).

[55] Brief for Appellants at 8-6, Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981).

[56] 453 U.S. at 628.

tution if there are serious barriers to that institution's resolution of the issue. To quote Brown once again:

> The mechanisms of our government to not give to Congress any regularized opportunity or duty of reviewing, to test for compatibility with the federal system, state statutes even in their skeletal form as enacted, much less as fleshed (SIC) by application, interpretation and administration. Nor has Congress been so idle that such matters could be assured a place on its agenda without competition from other business which might often be deemed more pressing; in Justice Jackson's phrase, the inertia of government would be heavily on the side of the centrifugal forces of localism.[57]

This reasoning has a false ring, however, in the context of the Montana severance tax controversy. The matter of state severance taxes has been a focus of congressional concern ever since Montana raised its severance tax rate to 30 percent. To be sure, the present configuration of political forces — resource-rich versus resource-poor, energy producer versus energy consumer, South and West versus North and East — militates against a national solution to the problem. Congress's failure to act is thus a political outcome as worthy of as much judicial respect as congressional action in this domain.

V. CONCLUSION

Lawyers have long been concerned with questions relating to the interstate incidence and shifting of state and local taxes. The analytical framework within which they have addressed these questions, however, often seems far removed from the critical economic issues that underlie them. Thus courts have decided such questions as whether a tax has extraterritorial impact or whether a tax burdens interstate commerce by focusing exclusively on the formal legal incidence of the tax without regard to its economic impact. Indeed, when given an opportunity to import economic analysis into constitutional doctrine, the Supreme Court explicitly rejected it in *Commonwealth Edison Co. v. Montana,* where it refused to constitutionalize the notion of excessive state tax exportation. Nevertheless, lawyers and courts have become increasingly sensitized to the economic issues bearing on incidence analysis, and it is likely that the economic learning in this domain will continue to inform judicial decisionmaking with regard to such questions as whether one tax can be viewed as complementary to another.

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[57] Brown (1957), p. 222.

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