How Not to Read International Harvester: A Response

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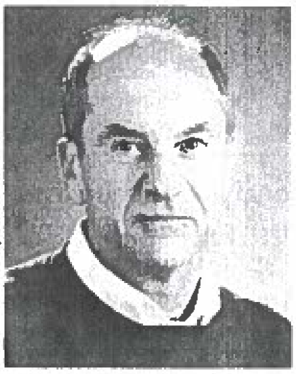

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In this article, Hellerstein examines a recent article by Alysse McLoughlin and Kathleen Quinn and seeks to clear up the confusion surrounding *International Harvester*.

In a recent article in *State Tax Notes*,[1] Alysse McLoughlin and Kathleen Quinn address the alleged "confusion" created by the U.S. Supreme Court's decision in *International Harvester Co. v. Wisconsin Department of Revenue*,[2] "which has been interpreted by some to support the ability of a jurisdiction to impose tax on a nonresident merely because of the ownership of stock in a corporation doing business in the jurisdiction."[3] They go on to say:

> In *International Harvester*, the Supreme Court upheld a Wisconsin tax on dividends paid to nonresident shareholders with no connection to Wisconsin other than the ownership of stock in the payer corporation that was doing business in the state. In upholding the tax, the Court held that the tax was actually imposed *on the corporation's earnings and not the shareholder's income*. . . .
>
> Interpreting *International Harvester* to mean that the owner of an interest in an entity can be subject to tax in all jurisdictions where the entity does business would create absurd results. That would mean that if a person owned one share of stock in a publicly traded corporation operating in all 50 states, he or she could be required to pay income tax in all 50 states. Requiring a shareholder to file a complex income tax return in all 50 states based on its ownership of one share of stock would place an undue burden on interstate commerce and violate the commerce clause.[4]

In point of fact, *International Harvester* creates no such confusion, and the alleged confusion identified by the authors is confusion of their own making. This article seeks to clear up this confusion so that it does not erroneously influence further analysis in this context.[5]

I. The Distinction Between Personal Jurisdiction And Subject Matter Jurisdiction

The collection of rules that fall under the rubric of "jurisdiction to tax" has aptly been described as "a body of law in search of a theory."[6] That body of law encompasses two discrete but related concepts that generally are regarded as

[1] Alysse McLoughlin and Kathleen M. Quinn, "The Tables Turn: A State Asserts Unconstitutionality of a Tax on Passthrough Owners," *State Tax Notes*, May 6, 2019, p. 497.

[2] 322 U.S. 435 (1944).

[3] McLoughlin and Quinn, *supra* note 1, at 497-498.

[4] *Id.* at 498 (emphasis in original, footnote omitted).

[5] This article draws freely from my earlier work on this topic. *See* Jerome R. Hellerstein, Walter Hellerstein, and John Swain, *State Taxation*, paras. 6.01, 6.04 (2019 rev.); and Walter Hellerstein, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective," 38 *Ga. L. Rev.* 1 (2003).

[6] *Kulick v. Department of Revenue*, 624 P.2d 93, 96 (Or. 1981).

involving questions of jurisdiction to tax. Failure to distinguish clearly and carefully between these two aspects of taxing jurisdiction can confuse the proper understanding and analysis of jurisdiction-to-tax questions.

A. Personal Jurisdiction Over the Taxpayer or Tax Collection Agent

Jurisdiction-to-tax questions frequently involve the issue of whether a state has a sufficient connection or "nexus" with the taxpayer or a tax collection agent to permit the state to compel the taxpayer or tax collection agent to comply with the state's tax obligations. These are essentially questions of personal or in personam jurisdiction that the U.S. Supreme Court first articulated in the context of judicial jurisdiction but subsequently incorporated into its jurisprudence addressed to jurisdiction to tax.[7]

B. Subject Matter Jurisdiction Over the Tax

Wholly apart from the questions of personal jurisdiction over the taxpayer or the tax collection agent,[8] "jurisdiction to tax" may involve questions as to whether a state has power over the subject matter of the tax. As the U.S. Supreme Court declared in a case raising the question whether a state could tax income earned by a taxpayer over which the state indisputably had personal jurisdiction, "in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax."[9]

C. The Relationship Between Personal Jurisdiction and Subject Matter Jurisdiction

There are four possible relationships between personal jurisdiction and subject matter jurisdiction, which may be visualized as follows:

• Personal Jurisdiction • Subject Matter Jurisdiction	• No Personal Jurisdiction • Subject Matter Jurisdiction
• Personal Jurisdiction • No Subject Matter Jurisdiction	• No Personal Jurisdiction • No Subject Matter Jurisdiction

There can be both personal jurisdiction over the taxpayer and subject matter jurisdiction over the tax (for example, when an individual or corporation with a constitutional presence[10] in a state earns income from sources within the state); there can be personal jurisdiction over the taxpayer, but no subject matter jurisdiction over the tax (for example, when a nonresident individual or non-domiciliary corporation with a constitutional presence in a state earns income from activity outside the state wholly unrelated to its activity within the state); there can be no personal jurisdiction over the taxpayer, but subject matter jurisdiction over the tax (for example, when a nonresident individual or non-domiciliary corporation with no constitutional presence in the state earns income from sources within the state[11]); and there can be no personal or subject matter jurisdiction, a situation that needs no parenthetical explanation.

II. Source-Based Taxation of Income of Nonresidents Over Whom the State Lacks Personal Jurisdiction Through Withholding Mechanism

To anyone familiar with the rules governing international income taxation, the imposition of a

[7] *See, e.g., South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

[8] By "wholly apart from," I mean to indicate only that questions of personal jurisdiction and subject matter jurisdiction are analytically distinct. The criteria for determining the existence of personal jurisdiction and subject matter jurisdiction may well — and often do — overlap.

[9] *Allied-Signal Inc. v. Director, Divisionof Taxation*, 504 U.S. 768, 778 (1992). In *Wayfair*, the Court made it clear that there was ample subject matter jurisdiction and the only question before the Court was personal jurisdiction over the out-of-state vendors. Thus, the Court noted that "[a]ll concede that taxing the sales in question here is lawful." *Wayfair*, 138 S. Ct. at 2087. The Court reiterated the point later in the opinion, observing that "[a]ll agree that South Dakota has the authority to tax these transactions." *Id.* at 2092.

[10] I use the term "constitutional presence" in a conclusory sense to mean simply that the individual or corporation exceeds the due process and commerce clause thresholds to establish its constitutional nexus with the state.

[11] Even in this case it may be possible to enforce the tax over which the state has subject matter jurisdiction if there is personal jurisdiction over a person in a position to withhold the tax from the nonresident taxpayer over whom the state lacks personal jurisdiction, the point I address in Section II *infra*.

tax on a nonresident's income from sources within the state, even though the state lacks personal jurisdiction over the nonresident, is hardly problematic. Indeed, this is precisely what the U.S. international tax regime does regarding nonresidents' U.S.-source income that is not "effectively connected with the conduct of a trade or business in the United States."[12] Thus, the United States imposes a tax of "30 percent of the amount received from sources within the United States" by nonresident alien individuals and foreign corporations "as . . . interest . . . dividends, rents and other fixed or determinable annual or periodical gains, profits and income"[13] (FDAP income) regardless of whether there is personal jurisdiction over the nonresident individual or foreign corporation, as there typically is not.

There is nothing problematic about this assertion of income tax jurisdiction because it is based on the established source principle. The problem, of course, is how to enforce collection of a tax on FDAP income over which the United States plainly has "subject matter" jurisdiction when it has no personal jurisdiction over the taxpayer.[14] The answer, in the U.S. international tax context, is the imposition of a withholding obligation on those in control of the payments of the specified items of income. Thus, "all persons, in whatever capacity . . . having the control, receipt, custody, disposal, or payment of any of the items of [FDAP] income . . . (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual" or foreign corporation must "deduct and withhold from such items a tax equal to 30 percent thereof."[15] In fact, California has adopted a similar regime, mirroring the federal regime, requiring withholding of tax on taxable FDAP income earned by nonresidents from sources within the state.[16]

A. Withholding Regime Applied to Dividends Earned by Nonresident Shareholders

In *International Harvester*, the U.S. Supreme Court sustained the constitutionality of a withholding regime as applied to Wisconsin-source dividends paid to nonresident shareholders over whom the state had no personal jurisdiction. Wisconsin had imposed a tax "[f]or the privilege of declaring and receiving dividends, out of income derived from property located and business transacted in this state."[17] The tax was measured by the proportion of the corporation's dividends attributable to Wisconsin, determined by applying the corporation's income tax apportionment percentage to the dividends. The dividend payers were required to deduct the tax from the dividends payable to both resident and nonresident shareholders.

The Court had previously sustained the levy, observing that "the practical operation of the tax is to impose an additional tax on corporate earnings within Wisconsin, but to postpone the liability for payment of the tax until such earnings are paid out in dividends."[18] The Wisconsin courts, however, subsequently construed the state taxing statute as imposing the levy upon the shareholders. In *International Harvester*, the Court revisited the constitutional questions raised by the tax on the assumption "that the statute, by directing deduction of the tax from declared dividends, distributes the tax burden among the stockholders differently than if the corporation had merely paid the tax from its treasury *and that the tax is thus, in point of substance, laid upon and paid by the stockholders.*"[19]

[12] IRC section 864.

[13] IRC sections 871(a), 881.

[14] See Section I *supra* (discussing the distinction between personal jurisdiction and subject matter jurisdiction).

[15] IRC sections 1441 and 1442. This is not to suggest, however, that the imposition of such a withholding obligation can always be enforced as a practical matter. *See, e.g.*, Rev. Rul. 80-362, 1980-2 C.B. 208 (holding that royalties paid by a foreign corporation to a nonresident alien for the use of a U.S. patent were U.S.-source income subject to withholding obligations).

[16] *See* Cal. Rev. & Tax. Code section 18662; and Cal. Admin. Code tit. 18, sections 18662-1 and 18662-2 (adopting withholding regime for "interest, dividends, rent, prizes and winnings, premiums, annuities, emoluments, compensation for personal services, and other fixed or determinable annual or periodical gains, profits and income" paid to nonresidents). Other states have similar statutes either authorizing such withholding or requiring the filing of information returns regarding such income. Ark. Code Ann. sections 26-51-811 and 26-51-812; and Miss. Code Ann. section 27-7-39.

[17] Wis. Stat. section 71.60 (1941), quoted in *International Harvester*, 322 U.S. at 446 (Jackson, J., dissenting).

[18] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 442, (1940).

[19] *International Harvester*, 322 U.S. at 440 (emphasis supplied).

Thus, the Court explicitly repudiated McLoughlin and Quinn's inaccurate suggestion that "the Court held that the tax was actually imposed *on the corporation's earnings and not the shareholder's income*."[20]

International Harvester challenged the statute, claiming it violated the due process clause by taxing (1) the act of declaring dividends and (2) the act of receiving dividends, both of which activities occurred outside Wisconsin (International Harvester declared its dividends in Chicago, and 98 percent of its shareholders were nonresidents of Wisconsin). The Court rejected this claim and sustained the tax in broad terms:

> The power to tax the corporation's earnings includes the power to postpone the tax until the distribution of those earnings, and to measure it by the amounts distributed. In taxing such distributions, Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholders-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. And the privilege of receiving dividends derived from corporate activities within the state can have no greater immunity than the privilege of receiving any other income from sources located there.[21]

Wisconsin had plainly afforded "protection and benefits to appellants' corporate activities and transactions within the state."[22] Accordingly, Wisconsin was entitled to tax the dividends because "[t]hese activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities."[23] Finally, as long as the earnings actually arose in the state, the fact that "some practically effective device [may] be necessary in order to enable the state to collect the tax — here by imposing on the corporation the duty to withhold"[24] — did not deprive the state of power to impose the levy on the nonresident shareholder.

The Court's sweeping affirmation of Wisconsin's power to impose a tax on dividends earned from sources within the state by nonresident shareholders over whom the state lacks personal jurisdiction, and to enforce the tax through a withholding mechanism imposed on the jurisdictionally present corporate payer, thus puts to rest any constitutional doubts about the states' power to adopt tax regimes analogous to the federal regime applied to U.S.-source interest, dividends, rents, annuities, and other FDAP income earned by nonresident alien individuals or by foreign corporations, when such income is not effectively connected with a U.S. trade or business.[25] McLoughlin and Quinn's suggestion to the contrary is untenable as a matter of settled principles of cross-border taxation and of U.S. constitutional law. ■

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[20] See text accompanying note 4, *supra* (emphasis by McLoughlin and Quinn).

[21] *International Harvester*, 322 U.S. at 441-442 (citations omitted).

[22] *Id.* at 442.

[23] *Id.*

[24] *Id.* at 444.

[25] *See* IRC sections 871, 881, 1441, and 1442. *See also Borden Chemicals and Plastics LP v. Zehnder*, 726 N.E.2d 73, 78 (Ill. App., 1st Dist. 2000) (reaffirming *International Harvester*'s declaration that "[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them"). The enforcement issues raised by *International Harvester* are considered further in Hellerstein, "State Taxation of Corporate Income From Intangibles: *Allied-Signal* and Beyond," 48 *Tax. L. Rev.* 739, 824-826 n.446 (1993).