

## State and Local Taxation Outline (page limit)

- 1) Commerce clause limitations on state taxation **look to what the tax is actually on (selling, shipping, or doing business)**
  - a) A state tax is not invalid under the commerce clause merely because it is imposed directly on the privilege of conducting business.
    - i) In the absence of legislation, SC holds that some activities are unconstitutional restrictions on interstate commerce.
      - (1) Complete Auto Transit Prongs
        - (a) Substantial nexus: substantial connection with the state
          - (i) Lease can be a sale. Itel
          - (ii) Intangibles can create Nexus. Geoffrey (cert. denied)
          - (iii) There is always nexus if it is a domiciliary corporation, but have to prove that there is nexus for due process reasons with the domiciliary state
          - (iv) Setting up other companies for tax avoidance may be respected, but SJC hasn't rendered final decision on that matter, yet.
        - (b) Provide for fair apportionment between the states
          - (i) If statute provides a credit for taxes legally due in other jurisdictions, it meets the requirements
          - (ii) Can be based on different apportionment formulas
            1. Mass relies on a three factor formula (but double-weights sales): The state's percentage of property, payroll, and sales – can ask for an alternative apportionment
              - a. Some states limit it to property and tangible property
              - b. There is a question if there is intangible property where there is a sale
            2. taxpayer can ask for separate accounting
        - (c) Must not discriminate against interstate commerce:
          - (i) must treat locals and people engaged in interstate commerce the same
          - (ii) Chemical Waste: can't use tax as a barrier to hazardous waste
          - (iii) interstate commerce taxed so as to carry burdens comparable to local commerce
            1. imposition of sales tax on lease of containers within the state for use exclusively in international shipping did not violate Customs Conventions or foreign commerce clause
          - (iv) note: must be actual movement, not contemplated movement.
        - (d) Fairly related to services provided by the state: easy to meet
          - (i) Could be fire and police – maybe even a port
      - (2) Japan Lines Prongs
        - (a) Is there an enhanced risk of multiple taxation
          - (i) If a transaction occurs solely within the state there is little risk
          - (ii) Doesn't need to be actual taxation
          - (iii) Doesn't need to be mathematical certitude.
          - (iv) imposition of sales tax on lease of containers within the state for use exclusively in international shipping did not violate Customs Conventions or foreign commerce clause (convention was on ACT of importation, not on importation itself)
        - (b) Does the tax interfere with the federal government's ability to speak with once voice in dealing with foreign powers and businesses
          - (i) Can look to see whether the taxed thing is a local person or a foreign person
          - (ii) Domestic people might have no standing to claim that something is unconstitutional
        - (c) Note: in Itel, a tax could still violate federal policy under the supremacy clause, if the Federal government exclusively regulates in that area
    - ii) Public Law 86-272
  - 2) Note: if it is a fee, it might not be a tax

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- 3) Import-export clause: states can't lay imposts or duties, except inspection fees **look to what the tax is actually on (selling, shipping, or doing business)**
  - a) Michelin: court has held that the import-export clause was not intended to bar nondiscriminatory property taxes or exports (so no longer necessary to determine whether or not it retains the character of an import or an export)
    - i) Is the tax in question really an impost or duty
    - ii) If not, are the goods still in transit
  - b) Current applicability
    - i) Things already in the stream of commerce ("original package" may be evidence of being in the stream of commerce) *Brown v. MD*
    - ii) Discriminatory taxes only goods that are imported or exported (*Stevedoring*) – (nondiscriminatory ad valorem taxes are not prohibited)
    - iii) If a tax compensates the state for providing a service, then it is probably valid.
    - iv) See if it is somehow protectionist
- 4) Due Process: analytical touchstone of a state's ability to tax is fairness (must be rational relationship between the value in state, and tax – that is not "out of all proportion" – **real property and tangible personal property (not the sale of) are only subject to tax where they are located.**)
  - a) Initial test
    - i) Nexus (minimal contact)
    - ii) Rational relationship between income and interest value of business
  - b) State's dominion over objects
  - c) Benefits and protections afforded – has the state given any benefit (*JC Penny*)
    - i) Instate office or employees
    - ii) Property in the state
      - (1) Intangibles under due process clause: state has a right to tax intangibles if it provides protection to the people holding the rights
      - (2) Split between 9<sup>th</sup> and Federal Circuits as to whether or not an interest in an LLC is tangible property or not
        - (a) 9<sup>th</sup> argues that the partner is deemed to be engaged in a trade or business in the partnership
        - (b) there is a theory that one can convert real estate into intangible property
        - (c) in MA everyone is taxable in every state in which they are a partner
      - (3) death taxes can result in taxation in two states, because the decedent might have two relationships
      - (4) can tax grantor trusts
    - iii) Access to the courts to collect debts is not enough
    - iv) Intent
      - (1) Question is "did they know that it would 'exploit local markets'" *American Refrigerator car*
      - (2) Purposefully directed: *Quill*
        - (a) 3 times a year is enough
    - v) valuation
      - (1) might be able to reduce value of property with encumbrances (MA takes the minority view)
  - d) Cost to the state of the business or activities taxed\
  - e) Retroactivity
    - i) Transfers made prior to the enactment of a law can't be subject to tax, but increases in the rates may apply retroactively.
- 5) Commerce clause: Power of a state to tax based on a corporation's nexus. A state might have the authority under the due process clause, but it is still liable under the commerce clause
  - a) General Principles: Under the so-called negative or dormant commerce clause, state regulation which unduly burdens interstate commerce may be held invalid as inconsistent with the exclusive grant of regulatory authority to Congress.
    - i) *Quill*: when is there sufficient contacts to tax (substantial presence)
    - ii) Allied signal: **What** can be taxed (in terms of intangibles) if it is not related to the state

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- (1) Unitary business principal: A state may apply a formula based on **in-state sales, property or payroll compared to total sales, property or payroll, to determine the portion of income** which is deemed to be attributable to in-state activities and therefore subject to tax. However, the other side of the coin is that if a state taxes the income derived from many jurisdictions, then the corporations can offset losses from wherever they want. Must first identify the in-state and out of state activities.
- (a) Determining what is a unitary business
- (i) functional integration (see other forms of taxation)
    1. need not be a flow of goods, but a flow of "value" (Container Corporation)
      - a. can be horizontal or vertical intergration
    2. transactions not undertaken at arm's length
    3. income from long-term investments which serve an operational function is, like income from working capital, unitary income.
  - (ii) centralization of management: are the same people managing the foreign subs
  - (iii) economies of scale: are they using subs to take advantage of economies of scale for the whole operation
- (b) For example, if state A employs a single factor apportionment formula based on property, and 40% of the taxpayer's total property used in the unitary business is located within state A, then state A may tax 40% of the income generated by the taxpayer's unitary business partly conducted within state A.
- (c) Alternatives to unitary business principal
- (i) Single-entity
  - (ii) Unitary (Old California): This was done on the basis that the entire global activity was one "unitary" business. California's claims generated fierce opposition from foreign multinationals, supported by their governments, as it could have led to a dramatic increase in taxes and major complexities: the issues were hotly debated but Congress was reluctant to intervene
    1. Worldwide Unitary (Colgate): worldwide combined reporting does not violate due process or commerce clause
  - (iii) Michigan rule: tax is an unusual one since it is based in theory on a business's total returns to labour, capital and profit. It was based on taxable income for US federal purposes, but adding back wages, interest and depreciation.
  - (iv) Waters edge unitary: "**water's edge**" approach which taxes only an allocation of US source incomes
- (2) Challenging a state's apportionment of income or capital gains (treated the same under Allied Signal):
- (a) First, the taxpayer must convince the state court by "clear and cogent evidence" that extraterritorial values are being taxed, that is, that the apportioned income is derived from out-of-state activities unrelated to the unitary business conducted within the state.
    - (i) Mobile Oil: must show that the income was earned in the course of activities unrelated to the sale of petroleum products in Vermont. (really a negative implicaton)
    - (ii) Woolworth: since the taxpayer's activities within the taxing state were unrelated to the business activities of the dividend paying corporations, and the taxpayer was not domiciled within the taxing state, there was no sufficient connection between the taxing state and the dividends it sought to tax. As explained by the Court in Allied-Signal,
  - (b) Second, on review, the federal courts will "if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a unitary business."
  - (c) If the taxpayer carries this burden of showing that the apportioned item was derived from an activity unrelated to the unitary business, then the item (such as gain realized by Bendix on sale of the ASARCO stock) cannot be linked to the taxing state by the unitary business principle.
    - (i) Unless some other link is demonstrated, the tax will fall.

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- (ii) On the other hand, if it is found that the gain was derived from unitary business activities partly conducted within the taxing state, the link is established and the tax will be upheld.
  - (iii) Really a two-part test
    - 1. is it unitary
    - 2. if it is not unitary does the payor serve a current operational function?
  - (d) Could argue that because an industry is highly regulated there is an explicit allowance to tax
- b) 86-272: sales or taxes on income based on sales<sup>1</sup> (use taxes don't count, and service taxes don't count)
- i) for the immunity to apply
    - (1) characterizations of corporation
      - (a) not incorporated in the state (state of incorporation always gets to tax it)
      - (b) no offices in the state
        - (i) perhaps attending three trade shows establishes nexus
      - (c) taxation of intangibles (Allied Signal)
      - (d) must be tangible personal property
      - (e) law doesn't apply to corporations who use truly independent contractors to solicit
      - (f) company cars are ancillary to solicitation, and therefore protected
      - (g) Registration or qualification is not enough to do business for PL86-272 purposes
      - (h) Two rules about conglomerates
        - (i) Joyce Rule: attribution of sales of corporate unitary group even if protected by PL (activity of each member is to be separately measured) -- recommended
        - (ii) Finnigan/Airborne for determining extent of protection under PL: considered to be one person
    - (2) characteristics of orders (Wrigley v. Kennemetal)
      - (a) must be actual orders
        - (i) not "drumming", solicitation, or being nice is not an order
        - (ii) replacing stale candy is not an order
        - (iii) checking credit probably is not
        - (iv) auditing inventory might be
        - (v) Kenemetal: helping clients pick out right tool went beyond solicitation
      - (b) orders must be sent outside the state
      - (c) orders must be approved outside the state (have to be set outside the state for approval of rejection)
      - (d) orders must be shipped from a point outside the state
        - (i) caselaw unclear on whether own trucks can be used to fill orders
      - (e) solicitation: appears to be split between Wrigley and Kennemetal
        - (i) can hold in-state sales meetings
        - (ii) can recruit people inside the state
        - (iii) can hold activities that are ancillary (ie replace stale gum)
    - (3) Characteristics of taxing state
    - (4) Characteristics of tpp

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<sup>1</sup> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

- (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
- (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

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- (a) Licenses are intangible (but software seems to be a little of both)
- (b) Can structure a lease to be a service contract or a rental of a boat or car
- c) Throwback rule: Under these rules, if a vendor makes a sale of tangible personal property to a customer in a state in which the vendor is not subject to tax, the vendor will often be required to "throwback" the income to the vendor's state of domicile. However, sales of intangible personal property and services are not subject to these rules.
- 6) Valuation
  - a) Market: comparable properties (usually residential)
    - i) Have to be comparable in place and time
    - ii) Have to actually be sellable (some things might have floors that are too high or too low)
    - iii) Have to figure out what the highest and best uses are
  - b) Income-capitalization (best): income stream – always the best
    - i) Value it at the "highest and best use" and then multiply by a multiplier
    - ii) Use the "highest and best use" of the property

Gross rent	
Vacancy rate (rate * rent)	-
Expenses	-
<ul style="list-style-type: none"> <li>• look at tax returns, loan documents, etc.</li> <li>• some states allow for reduction by cost to clean up hazardous waste (because other parties may be liable)</li> </ul>	
Net operating income	=
by capitalization rate. The higher the risk, the higher the capitalization rate	*
Stigma will increase a capitalization rate, because there is a higher risk	

- c) Depreciation (specialized properties)
  - i) Figure out cost to build
  - ii) Subtract physical depreciation
  - iii) Subtract functional depreciation
  - iv) Subtract economic depreciation
- 7) Equal Protection: State constitutional limitations (all states have them except for CY and NY). Usually, the uniformity requirement only applies to property taxes, but some apply it to income taxes
  - a) Checklist
    - i) Even if the statute doesn't implement things in increments, a tax board is free to do so
      - (1) Can discriminate, so long as it is not *invidious discrimination* (Lake shore auto parts)
        - (a) Invidious is defined as "palpably arbitrary"
        - (b) Presumption of constitutionality is only overcome by tax that is 1) hostile; 2) oppressive; 3) discrimination; 4) against particular classes and persons
      - (2) Examples of discrimination that surpasses rational basis
        - (a) Common carrier v. commercial truck
      - (3) Since the booze exception was passed after the 14<sup>th</sup> amendment, it is not bound by the 14<sup>th</sup>.
    - ii) State equal protection
      - (1) In most states property taxes have to be levied at FMV
        - (a) Usually must be proportionate, and not a "fractional assessment"
        - (b) Might be a problem with assessment at last selling price
      - (2) If it is a fee, it might not be subject to the tax
  - b) Nature of the tax
    - i) If it is a fee, it is generally not subject to state equal protection limitations
      - (1) Special assessments are considered to be fees Newman-IA, Heavens-WA

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- (2) Volume-based changes for haulers considered to be a fee. Barnhill Sanitaization-NC
- ii) Tax credits (which have the effect of taxing people differently)
  - (1) Westvaco-SC: an equality provision does not impose uniformity on the distribution of taxes. But, other states have applied a "substance over form" approach if a tax credit has the effect of changing the tax burden. Torphy-WI
  - iii) Excise and privilege taxes v. property taxes Douglas Aircraft-CA
    - (1) Function of a property tax is to raise revenue, and does not place any conditions on the property to be taxed. Riley-Ca. This is to be distinguished from a tax that is imposed on the ownership of property.
      - (a) But, a tax on the right to remove something, where its entire value is dependant on its removal is a property tax Dawson-KY (removal of whiskey from bond)
        - (i) Examples
          - 1. Property transfer tax is not a property tax, but rather a privilege tax, because it is only imposed on one incident of ownership. Huntington Beach-CA
          - 2. Extracting turpentine from standing trees was an excise tax – Thompson v. McLeod-MS
      - (2) Function of a privilege tax tax use, storage, or withdrawal, not ownership. Gregg Dyeing Co-US
        - (a) The more that the value of the property depends on the exercise of the right, the more likely it is to be a property tax.
  - iv) Property Tax
    - (1) Defining tax
      - (a) If it isn't levied for any specific improvements, it is a tax. Covell-WA
      - (b) Fire service fee found to be a tax Pitrolo-WV
    - v) Income taxes are not property taxes as per Featherstone-WV, and the clear trend has followed this, since Pollock was abrogated.
  - c) Nature of the taxpayer
    - i) If a tax causes discriminates between business because they could chose to compensate one individual more or less, it will run afoul of an apportionment statute. Opinion of Justices-NH (NH saw that discrimination between businesses was unconstitutional)
      - (1) A **minimum tax** could also violate equal protection, because the minimum is not apportioned . Johnson and Porter-NH
    - ii) Exemptions
      - (1) in favor of charitable organizations can run afoul of state equal protection clauses. Armstrong-UT
      - (2) However, an exemption for equipment to be shipped out of the state was considered reasonable Opinion of Justices-NH
      - (3) Homeowner exemptions were also violative Opinion of Justices-NH
      - (4) Exemptions between landowners violated equal protection. Topeka Cemetery Assn.-KS (between individual cemetery-owners and

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- corporation cemetery owners or "tax exemptions must be based on USE and not ownership")
- d) Classifications of types of property
    - i) While some state constitutions provide for differentiating between classes, other state constitutions do not.
  - e) Geographical distinctions
    - i) Differences in state taxes caused by differing powers between incorporated municipalities and unincorporated areas was violative of Georgia's equal protection clause. Martin v. Ellis-GA
- 8) 14<sup>th</sup> amendment equal protection. Corporations, while persons, are not considered to be "citizens" -- Western Turf Ass'n-US
- a) test for violation of the equal protection clause is whether or not the discrimination is invidious – Lake Shore Auto parts-US. Must satisfy a 1) rational basis and 2) a legitimate state goal
    - i) no equal protection problem with property classification
    - ii) deliberate undervaluation by officials: but where a state claimed (in its constitution) that every property would be treated equally, a regime which taxed only on the last sale was considered to be discriminatory. Allegheny Pittsburgh-US – this is considered *intentional undervaluation by officials*
      - (1) this could also mean that proposition 13 (which limits valuation based on what properties were sold for) could run afoul of the constitution. However, Proposition 13 was upheld because there was a rational basis, and California was not being as hypocritical as West Virginia
  - b) Gender classifications are subject to middle-tier scrutiny (Kahn v. Shevin-US: persuasive justification for tax exemption for widows)
  - c) Sales taxes that have graduated rates are violative of equal protection. Stewart Dry Goods-US
  - d) Discrimination under the 14<sup>th</sup> amendment between types of companies as construed by state courts
    - i) Some state courts have found a tax which taxed one type of company as opposed to another (different types of utilities) to be violative.
    - ii) Forcing an company to recapture a federal tax benefit in his state taxes, when they received no state benefit was violative. Oxx-VT
  - e) Discrimination between in-state and out-of-state companies
    - i) Insurance companies originally to seek protection under equal protection and not under the commerce clause, because it was originally held that insurance companies that did business out of state were not engaged in commerce. South-Eastern Underwriters-US
      - (1) Where state statute provided for higher taxes on non-domestic insurance companies (could be reduced by investing in the state), there was no legitimate purpose served in negative discrimination (as opposed to trying to encourage businesses to enter the state). In other words, an aim to enter the state is purely and completely discriminatory. Metropolitan Life v. Ward-US
        - (a) This wasn't really encouraging domestic insurance companies

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- (b) This wasn't really encouraging capital investment by negatively prodding insurance companies to invest
- ii) Non-insurance cases
  - (1) Discrimination on ad valorem property taxes okay, and a different residence of an owner of property is permissible grounds for discrimination. Allied Stores of Ohio-US
  - (2) Once a corporation is admitted to the state, a foreign corporation may not be discriminated against (argument was that it cost more to regulate foreign corporations) WHYY-NJ
- f) Discrimination against non-resident individuals
  - i) Violates equal protection to not give a tax credit for cars purchased out of state. Willaims-US
- g) Discrimination between residents
  - i) Can't discriminate between residents on basis of how long they have lived in the state – Hooper-US (discrimination between Vietnam-veterans based on how long they lived in the state)
- h) State equal protection and school financing (14<sup>th</sup> amendment allows for schools to be financed based on property taxation).
  - i) school financing which relies on property taxation violates state equal protection in some states (Rodriguez, Dusartz,), and Federal Courts won't interfere
- 9) privileges and immunities clause
  - a) interstate privileges and immunities clause
    - i) doesn't apply to corporations
    - ii) if there is no reason for it (e. g. conserve shrimp) but its real purpose is to punish non-residents, it is invalid. Toomer-US
    - iii) however, differing homestead exemptions (for primary v. non-primary residence) has been held to be constitutional, because it is only an "incidental" effect
  - b) 14<sup>th</sup> amendment privileges and immunities clause
    - i) states cannot tax foreign transactions (notes) differently, because it abridges the rights of an American citizen to transact business anyway. Colgate v. Harvey-US
      - (1) different licensing fees
      - (2) different denial of alimony deductions

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