Commerce Clause Issues – Jeffrey Dardick, PricewaterhouseCoopers

I have broken this down into 3 parts; 1) A major state tax credit case that was challenged under the Commerce Clause and went all the way to the U.S. Supreme Court, 2) some recent Commerce Clause cases, and 3) a major Missouri case finding an impermissible discrimination of out-of-state taxpayers under the Commerce Clause.

I. **There are many "Commerce Clause" cases out there, but the most recent case close to being on point with what Missouri legislators are trying to do is Cuno v. DaimlerChrysler, Inc. U.S. Court of Appeals for the Sixth Circuit, 2004 U.S. App. LEXIS 18550, No. Dkt. 01-3960, September 2, 2004, as amended October 19, 2004.**

Factual Background

At issue was the validity of certain state tax credits and local property tax abatements granted to DaimlerChrylser as an inducement to expand it business operations in Ohio. Specifically, Cuno asserted that the tax credit and abatement provisions discriminate against interstate commerce by granting preferential treatment to in-state investment and activity in violation of the Commerce Clause of United States Constitution and the Equal Protection Clause of the Ohio Constitution. In addition, Cuno argued that the investment tax credit encourages the development of local business through the use of Ohio's taxing power. Accordingly, the economic effect of the credit is to encourage further investment in-state at the expense of development in others states, which hinders free trade among the states. DaimlerChrysler challenged Cuno's assertions and argued that the tax credit is permissible because it does not penalize out-of-state economic activity. In addition, DaimlerChrylser asserted because the credit has the same economic impact as a subsidy, the credit is therefore permissible under the Commerce Clause.

Court of Appeals Ruling on Investment Tax Credit

The United States Constitution expressly authorizes Congress to, '"regulate commerce with foreign Nations and among the Several states," and the "negative" or "dormant" aspects of the Commerce Clause implicitly limits a state's right to tax interstate commerce, the appeals court noted. A tax provision satisfies the requirements of the Commerce Clause if: (1) the activity taxed has a substantial nexus with the taxing State; (2) the tax is fairly apportioned to reflect the degree of activity that occurs within the State; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to benefits provided by the state, the court also noted.

The court noted that the parties agreed that tax provisions at issue have a sufficient nexus with the state, are fairly apportioned, and are related to benefits provided by the state. Rather, the dispute centers on whether Ohio's method for encouraging new economic investment; i.e., conferring investment tax incentives and property tax exemptions - discriminates against interstate commerce.

In general, a challenged credit or exemption will fail Commerce Clause scrutiny, the court explained, if it discriminates on its face or if, on the basis of a sensitive, case-by-case analysis of purposes and effects, the provision will in its practical operation result in discrimination against interstate commerce by providing a direct commercial advantage to local business. "Discrimination" in such a context simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter. Accordingly, a state tax provision that discriminates against interstate commerce is invalid unless it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.

In general, subsidies do not run afoul of the Commerce Clause because they are not connected with a state's regulation of interstate commerce, the court explained. However, a subsidy is constitutionally distinct from a credit in that the latter involves state regulation through the power to tax. Despite the taxpayer's assertions that the court should allow the credit where the credit has the same economic impact as a subsidy, a credit and subsidy must be viewed separately. Accordingly, given the distinctions between the two, the Ohio investment credit provisions do not withstand a Commerce Clause challenge, the court found.

Personal Property Tax Exemption Upheld. The court dismissed Cuno's assertions with respect to the property tax exemption, and found that conditions (e.g., maintaining a specified level of employment and investment in the state) imposed on the receipt of the exemption are minor collateral requirements that are directly linked to the use of the exempted property. The statute does not impose specific monetary requirements, require the creation of new jobs, or encourage a beneficiary to engage in any additional form of commerce independent of the newly acquired property. As a consequence, the conditions on eligibility for exemption do not independently burden interstate commerce. Further, the exemption imposed no burden on out-of-state taxpayers that purchase property outside Ohio as they would not be subject to the Ohio personal property tax, the court noted

II. More recent Commerce Clause cases include:

- **CDR Systems Corporation v. Oklahoma Tax Commission, Okla. Ct. of App., Case No. 109,886, 1/17/13**

In an unpublished opinion, the Oklahoma Court of Appeals held that the Oklahoma capital gains deduction is facially discriminatory and unconstitutional in violation of the Commerce Clause of the US Constitution. The capital gains deduction is generally available when certain property is held for at least three years by an Oklahoma company or held for at least five years by a non-Oklahoma company. The court did not provide a remedy to cure the constitutional defect.

- **Nestle USA, Inc., Texas Supreme Court, No. 11-0855, 359 S.W.3d 207, February 10, 2012.**

On October 19, 2012, the Texas Supreme Court dismissed constitutional challenges to the margin tax by Nestle USA, Inc. Nestle alleged that the franchise tax bore no reasonable relationship to the value of the privilege of doing business in Texas and therefore violated the Equal and Uniform Clause of the Texas Constitution as well as the Equal Protection and Due Process clauses of the US Constitution. The court held that the structure of the franchise tax is reasonably related to the value of the privilege of doing business in Texas. For this reason, the court found no constitutional violations. In addition, the court found that the manufacturing tax rate did not discriminate against interstate commerce because the differing rate was due to the nature of business activities rather than the location of business activities.

III. Missouri Supreme Court case on U.S. Commerce Clause

General Motors Corporation and Subsidiaries v. Director of Revenue, Supreme Court of Missouri, No. 80853, 981 S.W.2d 561, December 22, 1998.

A provision that prohibited an affiliated group of corporations from filing a Missouri consolidated corporate income tax return if the affiliated group derived less than 50% of its income from sources within Missouri facially discriminated against interstate commerce in violation of the Commerce Clause of the U.S. Constitution and therefore was invalid because the provision created an advantage for businesses that conducted a majority of their business in Missouri and penalized businesses that conducted a majority of their business outside Missouri. The 50% threshold requirement to file a consolidated return was ordered severed from the other provisions of the statute and this could be done without invalidating the remainder of the statute. Thus, if an affiliated group files a federal consolidated income tax return, the group may elect to file a Missouri consolidated corporate income tax return. Sec. 143.431.3(1), Revised Statutes.

The court reached its conclusion for several reasons:

1. The statute expressly distinguishes between affiliated groups that perform the majority of their business in Missouri and groups that perform the majority of their business out of state. The fifty-percent threshold penalizes groups, such as GM Group, that perform the majority of their business out of state. Disparate tax treatment based on an affiliated group's geographic location and corporate structure, as in this case, constitutes an impermissible burden on interstate commerce.

2. Imposing a tax and granting a tax credit are not the exclusive means of discriminating against interstate commerce. The form by which a state erects barriers to commerce has no effect on the determination of whether discrimination exists. The right to elect to file a consolidated return is a tax benefit. Based on its corporate form and its geographic location, GM Group is placed at a competitive disadvantage when it is denied the tax benefits that section 143.431.3(1) confers. This impermissibly discriminates against interstate commerce.

3. Finally, the statute fails the Director's posited internal consistency test in that if every state required affiliated groups to conduct a majority of their business within the state before the groups could qualify to file consolidated income tax returns, there would be interference with free trade.

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