

## The Dormant Commerce Clause

Commerce Clause, U.S. Const. art. 1 §8, cl.3

*[Congress shall have the power to] regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.*

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## What is Interstate Commerce?

All commercial intercourse that concerns more than one state.

2

Congress can legislate in 4 broad categories:

- Channels of Interstate Commerce
- Instrumentalities of Interstate Commerce
- Articles Moving in Interstate Commerce
- Activities Substantially Affecting Interstate Commerce

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States can legislate on public health, safety, morals, and for the general welfare—e.g., education, family law, criminal law—as long as the regulations do not unduly burden interstate commerce.

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## When Congress Has Not Legislated: The Dormant Commerce Clause

### What does “dormant” mean?

marked by a suspension of activity: as (a) temporarily devoid of external activity <a *dormant* volcano> (b) temporarily in abeyance yet capable of being activated

-Merriam-Webster Dictionary

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## As the Supreme Court itself put it:

“Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.”

H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525 665 (1949).

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## Reasons for the Dormant Commerce Clause Doctrine

- Union
- Economic Efficiency
- Political Accountability

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## Congressional Preemption and Consent

Congress' power to regulate interstate commerce is supreme and, if it chooses, complete.

- 1) Congress can consent to state regulation that is inconsistent with the Commerce Clause.
- 2) Congress can preempt state regulation that is consistent with the Commerce Clause.

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## The New Jersey Garbage Case

*City of Philadelphia v. N.J.*, 437 U.S. 617 (1978)

NJ passed a law prohibiting the importation of garbage into the state. The purpose of the statute was to stem the flow of out-of-state garbage into New Jersey, particularly from the large surrounding cities such as New York and Philadelphia. The goals were (1) to conserve landfill space for domestic garbage and (2) to protect the health and safety of NJ residents from pollution that results from landfills.



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## The New Jersey Garbage Case

This law was facially discriminatory, and such laws almost never survive the Court's strict scrutiny.

The Supreme Court said that the crucial question in Commerce Clause cases involving facially discriminatory legislation is whether the measure was an "economic protectionist measure, and thus virtually *per se* invalid, or a law directed at legitimate local concerns that has only incidental effect on interstate commerce."

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## The New Jersey Garbage Case

The Dissent



(New York takes its trash to New Jersey by garbage barge.)

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## Commerce Clause Exceptions

By Congress:  
Consent

By the State:  
Market Participation

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## Standards for Review under the Commerce Clause

State economic regulations are constitutional unless they excessively burden interstate commerce:

- 1) The regulation must pursue a legitimate state end
  - If the purpose of the regulation is economic protectionism, then the Court uses a standard close to strict scrutiny—so discriminatory legislation is almost always invalidated.
- 2) The regulation must be rationally related to that end
- 3) The state's policy objective must outweigh the burden imposed on interstate commerce

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## What is a Legitimate State End?

- Permissible end: Health, safety, welfare
- Impermissible end: economic protectionism or favoritism

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## When is a Regulation Rationally Related to the State End?

This is not a difficult standard to satisfy. It is satisfied if the legislature could have reasonably believed the regulation would achieve its legitimate state end.

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## When Does the State End Outweigh the Burden on Commerce?

The Court just asks whether, in light of the goal, the regulation *excessively* burdens interstate commerce.

South Carolina State Highway Dept. v. Barnwell, 303 U.S. 177 (1938). SC banned trucks wider than 90 inches or weighing more than 20,000 pounds. The motivation for the regulation was safety, but it imposed a burden on interstate regulation because trucks had to comply.

Upheld.

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## When Does the State End Outweigh the Burden on Commerce?



Bibb v. Navajo Freight Lines, Inc.  
359 U.S. 520 (1959)

Illinois required trucks to be equipped with contoured rear-fender mudguards. But at least 45 other states permitted a straight, rather than a contoured mudguard, and at least one state, Arkansas, required a straight mudguard. Trucks could not operate in both Illinois and Arkansas without welding on different mudguards.

- Struck down for lack of conformity.

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## Express Discrimination

Discriminatory regulation—laws that discriminate (directly or indirectly) are unconstitutional unless there is no less restrictive means to achieve the legitimate state end. Economic protectionism is not a legitimate state end.

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### Dean Milk Co. v. Madison 340 U.S. 349 (1941)

The city of Madison, Wisconsin made it illegal to sell milk that had been processed or bottled more than 5 miles outside the city limits as "pasteurized" and forbade completely the selling of any milk that did not have an inspection certificate from the city of Madison. Madison inspectors did not inspect dairies more than 25 miles outside the city.

The reason for the regulation was to allow Madison officials to inspect milk producers so as to prevent the selling of adulterated milk to Madison residents. Madison did not want to send its inspectors to distant dairies to make inspections. The rule was challenged by a milk producer in another state.

Struck down.



Distance from Madison to Chicago is 122 miles, about 200km.

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## Latent Discrimination

As with the ECJ, the U.S. Supreme Court takes a dim view of intentionally discriminatory measures.

### The Washington Apple Case 432 U.S. 333 (1977)

North Carolina required that all containers of apples shipped within or into North Carolina bear the U.S. quality grade *or no grade at all*. The Legislation read:

"All apples sold, offered for sale, or shipped into this State in closed containers shall bear on the container, bag or other receptacle, no grade other than the applicable U.S. grade or standard or the marking 'unclassified,' 'not graded' or 'grade not determined'."

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## The Washington Apple Case

Notice that the law is facially neutral.

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## The Washington Apple Case

The Washington State Advertising Commission argued that the rule discriminated against interstate commerce by

- raising the cost of business for WA growers, but not NC growers
- denying Washington growers the benefits of the superior Washington inspection system, which the state invested in considerably and which had become a widely accepted standard
- forcing Washington growers to downgrade their best apples to the highest USDA level, which was lower than the highest Washington grade. Such downgrading would allow North Carolinian apples to compete more effectively with Washington apples

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## The Washington Apple Case

Notwithstanding the neutral language of the statute, it was discriminatory in effect.

Struck down.

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## Introduction: Tax Cases under the Dormant Commerce Clause

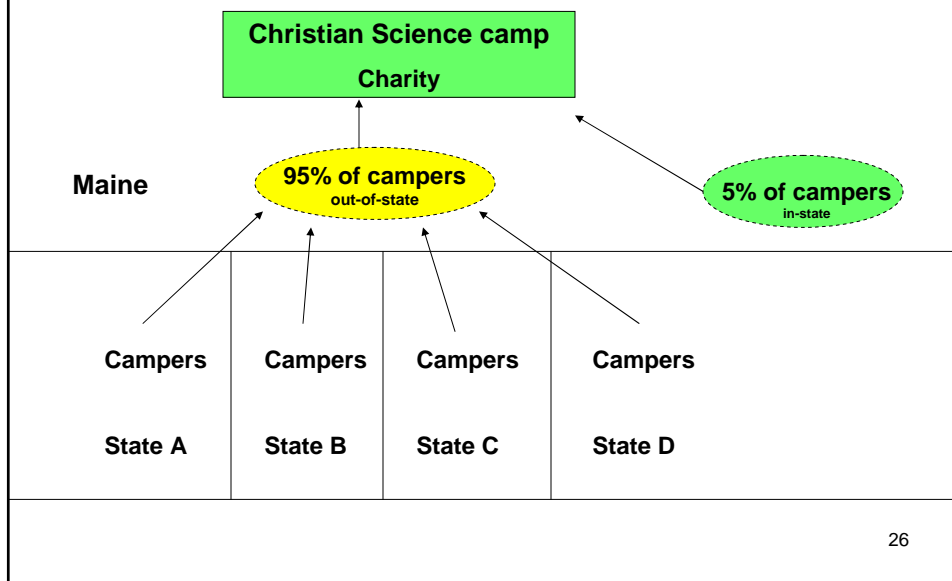
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## Applicability of the Commerce Clause

- Applies to tax
- Need Interstate Commerce

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Camps Newfound/Owatonna, Inc. v. Town of Harrison, Me.  
520 U.S. 564 (1997)



26

## Camps Newfound

The Court held that the camp was engaged in interstate commerce.

Denying the deduction because the charity primarily serviced out-of-state residents was discriminatory and violated the Commerce Clause.

27

## Supreme Court's State Tax Jurisprudence

The court itself described its state tax jurisprudence as a "quagmire" of decisions that "have 'not always [been] clear... consistent or reconcilable."

*Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

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## The Early Cases: Free Trade Era

It was held, during this period, that states were prohibited from assessing taxes on income from interstate commerce. This marked the broadest interpretive scope of the Commerce Clause.

States' powers to tax interstate commerce are much broader now.

29

## "Multiple Taxation" or "Internal & External Consistency" Doctrines

States have a duty under the Commerce Clause not to place redundant or multiple tax burdens on the same income.

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## Internal Consistency Requirement

The threshold question is this:

If every state imposed the contested tax, would interstate commerce be subjected to multiple tax burdens?

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## Internal Consistency Requirement As Applied to Apportionment Formulas

A state's apportionment rule, if adopted by all the states in the union, should not burden inter-state commerce more than it burdens intra-state commerce. As the Court put it, the state cannot seek to "take more than its fair share of taxes from the interstate transaction."

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## Apportionment

Many states use a 3 factor formula to determine how much income should be allocated to each state. This three factor formula, which takes into account the ratio of the in-state sales to overall sales, in-state property to overall property and in-state payroll to overall payroll has been upheld because if every state had it, there would be no multiple tax. *Container Corp*

33

## UDITPA: Uniform Division of Income for Tax Purposes Act

23 of the 46 states with corporate income taxes have adopted the Uniform Division of Income for Tax Purposes Act, which provides an equally-weighted three-factor formula of property, payroll and sales.

This eliminates some of the risk of multiple taxation. Most of the states adopting UDITPA have an elective alternative formula, and the taxpayer can choose whichever is best.

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## UDITPA Apportionment Formula:

$$\text{3 (Percentage of income apportionable to State A)} = \frac{\text{Property in State A}}{\text{Total Property}} + \frac{\text{Payroll in State A}}{\text{Total Payroll}} + \frac{\text{Sales in State A}}{\text{Total Receipts}}$$

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## Apportionment

But single factor formulas have been upheld.

Congress has not acted to standardize the formulas, though it has the power.

Congress is itself very reluctant to trample upon the tax sovereignty of the states.

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### As Applied to “Local Non-Discriminatory Fees”

- Unapportioned flat taxes, such as professional licensing fees and so on, seem to violate the internal consistency principle, although many states have them and they have not been successfully challenged.
- Local fees assessed in a non-discriminatory way will probably be upheld.
  - e.g., organizational fees, fees to qualify to do business.
  - annual license fees for particular trades (which are unapportioned flat taxes).
  - professional and similar licensing fees.

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### Risk versus Certainty of Double Tax

The Court has said that a risk of duplicative tax is enough—the taxpayer need not show that it is subject to actual double tax.

But see Moorman.

38

### Cure by Credit

Internal inconsistency can be cured by the state if it offers a credit for like taxes paid to other states.

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### Underprotective: Risk vs. Reality of Double Tax

But note that because states can adopt disparate formulas as long as they meet the “internal consistency” requirement, taxpayers may still suffer multiple taxation in fact.

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### External Consistency Requirement

This part of the test evaluates the fairness of the factors used by the state to apportion income to it in terms of the degree of connection between the business activity or the income and the state.

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### Modern Era: *Northwestern & Complete Auto*

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## Modern Era

In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), it was finally held that the Commerce Clause does not bar states from taxing non-resident companies on income from purely interstate activities, as long as the income is fairly apportioned to the state.

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## Modern Era *Complete Auto*: Four Part Test

A state tax will be sustained against a Commerce Clause attack when the tax is:

- 1) Applied to an activity with a substantial nexus with the taxing state,
- 2) Fairly apportioned,
- 3) Not discriminatory against interstate commerce, and
- 4) Fairly related to the services provided by the state

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## Tax Discrimination & the Commerce Clause

### Standard of Review

A tax that imposes greater burdens on out-of-state goods, activities, or enterprise than competing in-state goods, activities, or enterprises will generally be struck down as unconstitutional, whether or not the discrimination was intentional.

45

## Protects Commerce, not Persons

The Supreme Court has never required an empirical link between discrimination against an out-of-state person—such as a foreign corporation or a corporation established in another state—and discrimination against interstate commerce.

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## “Completeness” of Discrimination

Discriminating against a sub-set of in-state producers is no justification for discriminating against all out-of state producers.

### Compare

Dean Milk Co. v. Madison

### With

Case C-156/98 Commission v. Germany

47

## Dean Milk Co. v. Madison 340 U.S. 349 (1941)

The city of Madison, Wisconsin made it illegal to sell milk that had been processed or bottled more than 5 miles outside the city limits as “pasteurized” and forbade completely the selling of any milk that did not have an inspection certificate from the city of Madison. Madison inspectors did not inspect dairies more than 25 miles outside the city.

The reason for the regulation was to allow Madison officials to inspect milk producers so as to prevent the selling of adulterated milk to Madison residents. Madison did not want to send its inspectors to distant dairies to make inspections. The rule was challenged by a milk producer in another state.

Struck down.



Distance from Madison to Chicago is 122 miles, about 200km.

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## No *De Minimis* Exception

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## Compare Case Case C-156/98 Commission v. Germany

Germany discriminated in administering state aid by excluding all companies not established in Germany. It did not matter that some German companies were also not eligible for the aid.

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## Complementary Tax Doctrine

A facially discriminatory tax can be justified if an equivalent tax is levied against in-state interests.

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## Application Against the Home State

Dictum “It is not the purpose of the Commerce Clause to protect state residents from their own state taxes.”

We will see how true that is in practice when we come to the *Bacchus* case in a minute.

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## Some Litigated Cases

- “Drummer’s Fees”
- Natural Resources
- Corporate Consolidation

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# Corporate Consolidation

The Supreme Court has never considered the issue, but two state Supreme Courts, in Florida and Missouri, have held that residence-based restrictions on the ability of corporate groups to file consolidated returns violate the Commerce Clause.

Compare

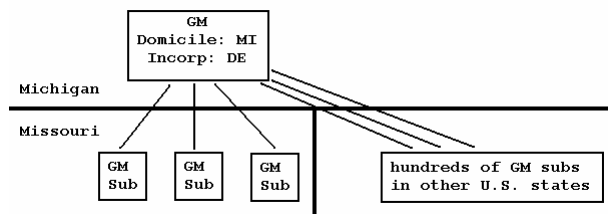
The Missouri Case [General Motors] & the Florida Case [Amrep]

With

The EC Case: Metallgesellschaft & Hoechst

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## The Missouri Consolidation Case: General Motors, 981 S.W.2d 561 (Mo. 1998)



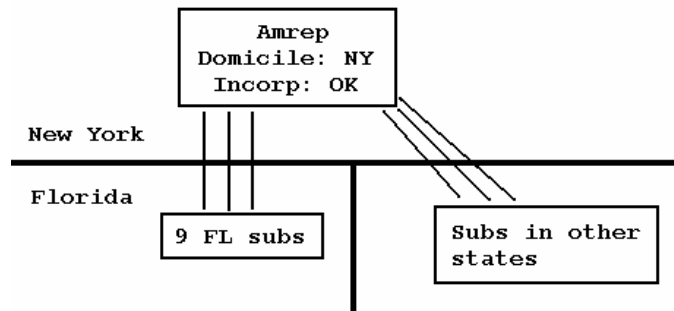
Less than 2% of the GM Group's income was Missouri-sourced, but Missouri required at least 50% of a group's income to be sourced within the state for it to file a consolidated return.

GM claims that this requirement discriminates against interstate commerce.

Struck down by Missouri Supreme Court.

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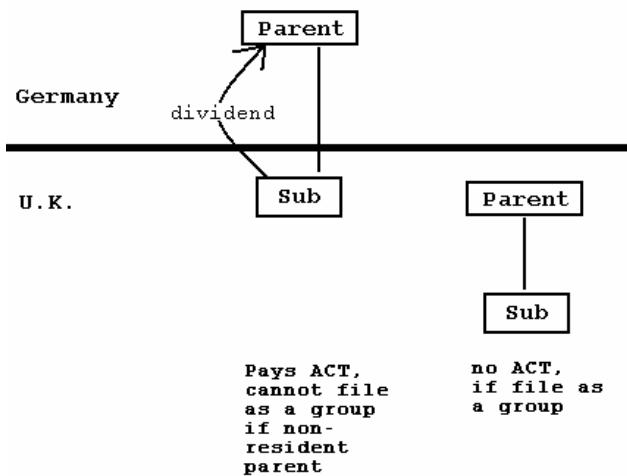
## The Florida Consolidation Case: Amrep Corp, 358 So.2d 1343 (Fla. 1987)



Florida limited consolidation to groups whose parent company was either incorporated or domiciled in Florida. Amrep challenged the rule under the Equal Protection clause, and won.

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## EC Consolidation Case: Metallgesellschaft, 2001 E.C.R. 1721.



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## Comparing European State Aids with U.S. Subsidies

There is no explicit prohibition on State Aids in the U.S., and almost every state and locality employs tax incentives and outright subsidies.

58

## Comparing European State Aids with U.S. Subsidies

Commerce Clause, U.S. Const. art. 1 §8, cl.3  
*[Congress shall have the power to] regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes*

### Article 87(1) EC

*Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.*

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## Basic scheme for tax incentives

- Discriminatory taxation – virtually always invalid
- Tax incentives favoring in-state interests – mix of rulings
- Direct subsidies – perhaps permitted, unless paired with discriminatory taxes

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## Tax Reduction for Domestic Sales

*Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977)

New York statute imposed transfer taxes on securities transactions occurring wholly or partially in New York, regardless of where the sale of the securities took place. Although New York imposed this tax, neighboring states with competing stock exchanges—such as Massachusetts—did not. To prevent the New York exchange from suffering from competition with the tax-free exchanges, New York permitted a 50% tax reduction when the transfer of securities involved an in-state sale.



The Supreme Court held that the tax was invalid because it violated the Commerce Clause by discriminating against interstate commerce.

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## Tax Exemption for Domestic Products

*Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984)

Hawaii exempted from its 20% wholesale liquor excise tax certain locally produced products, such as pineapple wine. The goal was to stimulate nascent domestic industry. Liquor wholesalers sued because they did not want to have to charge the tax.



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*Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984)

The Court held that the discriminatory tax violated the Commerce Clause. It held that:

"The Commerce Clause limits the manner in which a State may legitimately compete for interstate trade, for in the process of competition no State may discriminatorily tax products manufactured in any other State. Here, it cannot properly be concluded that there was no improper discrimination against interstate commerce merely because the burden of the tax was borne by consumers in Hawaii. Nor does the propriety of economic protectionism hinge upon characterizing the industry in question as 'thriving' or 'struggling.' And it is irrelevant to the Commerce Clause inquiry that the legislature's motivation was the desire to aid the makers of the locally produced beverages rather than to harm out-of-state producers."

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## Tax Credits

- Domestic Shipping
- Domestic Products
- Domestic Investments

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## Tax Credit for Domestic Shipping

Westinghouse Electric Corp v. Tully, 466 U.S. 388 (1984)

USSC invalidated a credit against NY State tax for exporters who shipped from New York.

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## Tax Credit for Use of Domestic Products

New Energy Co. of Indiana v. Limbach  
486 U.S. 269 (1988)



USSC invalidated a credit against Ohio's motor fuel tax for each gallon of gasohol sold that contained ethanol produced in Ohio, or in a state other than Ohio that granted like credits for ethanol produced in Ohio. An out-of-state ethanol producer brought the case.

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## Tax Credit for Domestic Investment: The *Cuno* Case

Cuno v. DaimlerChrysler, 386 F.3d 738 (6th Cir. 2004)

DaimlerChrysler agreed to build a new plant in Toledo, Ohio at a cost of \$1.2 billion, for which Ohio gave it \$280 million in tax incentives.



Two incentives were offered to DaimlerChrysler:

- 1) a property tax abatement, which was held to be consistent with the Commerce Clause, and
- 2) an investment tax credit for new property put into service in Ohio

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## Cuno v. DaimlerChrysler

The 6<sup>th</sup> Circuit invalidated the investment tax credit, but upheld that property tax exemption.

There is some reason to believe that the Supreme Court will not be sympathetic to the credit, since it said in an earlier ruling that "states can no more favor local over out-of-state interest by 'forgiving' taxes... than they can... by imposing taxes that discriminate against out-of-state enterprise in the first place."

However, outright subsidiaries tend to be treated differently.

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## Congressional Response to *Cuno*

Even though many commentators have argued that state tax subsidies are harmful tax competition, the states jealously guard their power to grant them.

After the Sixth Circuit's decisions, legislators in Ohio introduced Congressional legislation to allow tax credits.

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## Subsidies

It's not clear why the Supreme Court has drawn such a clear distinction between tax incentives and subsidies, but it is clear that the Court has done so. Without elaborating a reason, the Court in New Energy v. Limbach stated that:

"Direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does."

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## Subsidies

West Lynn Creamery v. Healy, 512 U.S. 186 (1994)

### Facts:

Massachusetts required every milk dealer in Massachusetts to make a monthly "premium payment" into the "Massachusetts Dairy Equalization Fund." The amount of the premium payment was tied to the amount of milk sold into Massachusetts, and so the premium payments were like a tax on the wholesaling of milk.

The tax was not facially discriminatory since it applied to all milk dealers, including domestic milk dealers. However, the proceeds of the tax subsidized in-state dairy farmers.

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## Subsidies

West Lynn Creamery v. Healy, 512 U.S. 186 (1994)

In arguing that two constitutional methods—a non-discriminatory tax & a direct subsidy—cannot necessarily be combined into a constitutional aggregate, the Supreme Court stated that

"Our Commerce Clause jurisprudence is not so rigid as to be controlled by the form by which a State erects barriers to commerce. Rather our cases have eschewed formalism for a sensitive, case-by-case analysis of purposes and effects."

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## Subsidies

West Lynn Creamery v. Healy, 512 U.S. 186 (1994)

### The dissents

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## Justifications

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## State Taxation of Foreign (non-U.S.) Commerce

Commerce Clause, U.S. Const. art. 1 §8, cl.3

*[Congress shall have the power to] regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes*

### **Article 56(1) EC**

Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

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## The Complete Auto Four-Part Test

A state tax will be sustained against a Commerce Clause attack when the tax is

- 1) Applied to an activity with a substantial nexus with the taxing state,
- 2) Fairly apportioned,
- 3) Not discriminatory against interstate (here, international) commerce, and
- 4) Fairly related to the services provided by the state

But there are two additional criteria for foreign commerce

- 5) It must not create a substantial risk of multiple international taxation
- 6) It must not prevent the Federal government from speaking with one voice when regulating commercial relations with foreign governments.

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## Substantial Risk of Multiple International Taxation Japan Lines

California sought to assess a fairly apportioned property tax on foreign-owned and foreign-based shipping containers that entered California ports, but that were then used exclusively in interstate commerce. The Court held that by taxing the instrumentalities of foreign commerce, CA created an enhanced risk of international (juridical) multiple taxation.

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## Substantial Risk of Multiple International Taxation Japan Lines

"Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the Commerce Clause forbids.'"

In the case, California created unconstitutional double tax because Japan had a right to tax the containers fully (and in fact did so).

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## Substantial Risk of Multiple International Taxation Japan Lines

So the U.S. constitution also forbids the states to assess discriminatory taxes on taxpayers established *outside* of the political and economic union. The states can not disadvantage international commerce as compared with (1) in-state commerce ("intrastate commerce") or (2) U.S. commerce ("interstate commerce").

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## Federal Ability to "Speak with One Voice"

- Federal Preemption
- Tax Treaties

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## Discrimination and the Water's Edge

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