

CONSTITUTIONAL RESTRICTIONS ON STATE TAXATION

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The Roadmap

- Primary Constitutional Restrictions
 - A focus on the Commerce Clause
 - Due process is back
- Current Texas Positions
 - Key statutes and regulations
 - Discussion of nexus-creating activities



The U.S. Constitution

An Affirmative Grant with Negative Implications

- The Commerce Clause
 - “The Congress shall have the power ... *[t]o regulate commerce* with foreign nations, and *among the several states*, and with the Indian tribes.”
- The Dormant Commerce Clause

14th Amendment Due Process

“No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, *without due process of law*; nor deny to any person within its jurisdiction the equal protection of the laws.



How'd We Get Here?
Commerce Clause Cases

Interstate Commerce: Duty Free?

- **Case of the State Freight Tax**, 82 U.S. (15 Wall.) 232 (1872)
 - Pennsylvania tax per ton on freight transported within state
 - Railroad company refused to pay portion of tax assessed on coal transported for delivery outside of Pennsylvania
 - Intrastate and interstate companies paid at same rate
 - Court held mandatory tax is regulation of commerce
 - No maximum rate could so burden interstate commerce as to make it impractical or impossible
 - Including intrastate transactions does not protect a tax
 - Tax on freight (not franchises or property of company using services) is not compensation for state services
 - National subject requires Congressional action
 - Additional examples:
 - **Almy v. State of California** – tax on gold or silver transported out of state substantially on transportation and therefore unconstitutional
 - **Crandall v. State of Nevada** – tax on vehicles per person leaving state actually on privilege of transport and therefore unconstitutional

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Direct v. Indirect: A Meaningful Difference?

- **State Tax on Railway Gross Receipts**, 82 U.S. (15 Wall.) 232 (1872)
 - Tax imposed on gross receipts of transportation companies
 - Railroad company refused to pay portion of tax assessed on gross receipts from coal transported for ultimate delivery outside of Pennsylvania
 - Court concluded:
 - Not everything that affects interstate commerce is a regulation
 - States permitted to tax real and personal estates of corporations
 - Taxes may be in proportion to privileges granted by states
 - Gross receipts tax not directly imposed on interstate commerce
 - Income no longer freight once incorporated into company's general property and taxed – state could also tax imported goods once packages opened and contents intermingled with other items
 - Additional example:
 - **Brown v. Maryland** – per-package tax on importers unconstitutional

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Cover Charge

- ***Western Union Tel. Co. v. Kansas***, 216 U.S. 1 (1910)
 - Statute required application and fee for foreign corporations seeking to do business in Kansas
 - Included tax on capital stock of all such foreign corporations, along with savings clause relating to interstate commerce
 - Company received certificate, refused to pay, but continued operating
 - State sued and company raised numerous arguments, including that tax directly burdens or embarrasses interstate commerce
 - Court concluded:
 - Court must look through form of savings clause to substance of law
 - Tax is not apportioned, and therefore is imposed not on local capital stock, but on all in-state and out-of-state capital
 - Tax distinct from license and privilege fees in other cases relating only to business carried on or property used within taxing states
 - Intent of tax to support Kansas schools invalid because state cannot tax outside property and business to support in-state services

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Ad Valorem

- ***Pittsburgh, etc. Railway v. Board of Public Works***, 172 U.S. 32 (1898)
 - Tax imposed on value of rail in state and proportional in-state value of rolling stock and other property used both in and outside of state
 - Company sought injunction against assessment and collection of tax
 - Court held that tax did not interfere with company's ownership or operation of rail, and therefore no constitutional infirmity

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Apportioned Approval

Beginning in the 1930s, the Supreme Court expanded the list of permissible state taxes to include nondiscriminatory, fairly apportioned taxes if there was a reasonable nexus with the property, receipts, or income taxed:

- ***Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938)**
 - Tax on gross receipts from advertising of newspaper and magazine businesses valid even though advertisers and subscribers were located in multiple states
 - Producing and distributing magazine is local by nature
 - Purpose of Commerce Clause to prevent cumulative burdens in multiple states that would affect only interstate businesses
 - Here, tax on advertising receipts could not be repeated elsewhere

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Apportioned Approval

- ***Central Greyhound Lines Inc. v. Mealey*, 334 U.S. 653 (1948)**
 - New York tax imposed on gross receipts from entire mileage of trips originating and terminating in New York but passing through New Jersey and Pennsylvania
 - State argued that no other state taxes same gross receipts
 - Court held tax invalid to extent unapportioned, but noted that applying a mileage-based apportionment factor would preserve it
- ***Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959)**
 - Net income taxes providing for apportionment by sales, property, and payroll factors cannot possibly create cumulative, unfair burden on interstate commerce
 - Net income taxes also not by their nature imposed on privilege of engaging in interstate commerce

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The Case That Changed Everything

- ***Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977)**
 - Privilege of doing business no longer immune from taxation
 - Taxing receipts or franchise as opposed to privilege too formalistic, ignores substance in favor of good draftsmanship
 - Announced new criteria to test constitutionality of state taxes:
 - Substantial nexus
 - Fairly apportioned
 - No discrimination against interstate commerce
 - Fairly related to services provided by state

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Complete Auto: Substantial Nexus

- ***Standard Pressed Steel Co. v. Dept. of Revenue*, 419 U.S. 560 (1975)**
 - Taxpayer, located in Pennsylvania and California, had one employee located in Washington who worked out of his home to consult with Boeing, the manufacturer's principal customer
 - Taxpayer argued Washington B&O tax violated the Commerce Clause because it taxed the unapportioned receipts from sales to Boeing
 - The Supreme Court found the tax constitutional, having been "apportioned exactly to the activities taxed"
- ***National Geographic Soc. v. California Bd. Of Equalization*, 430 U.S. 551 (1977)**
 - D.C. nonprofit had two offices in California selling magazine advertising
 - The Supreme Court held that the taxpayer's continuous presence in the state was sufficient nexus with California to require collection of use tax on taxpayer's mail order sales delivered to California, notwithstanding no connection between the mail order sales and the advertising offices
 - Similar examples include: ***Scripto*** (private contractors making sales) and ***Tyler Pipe*** (independent contractors marketing products)

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Complete Auto: More Substantial Nexus

- **Quill Corp. v. North Dakota**, 112 S.Ct. 1904 (1992)
 - North Dakota required Quill, an out-of-state mail-order business, to collect and remit use tax on goods delivered by mail into the state
 - The Supreme Court distinguished its Due Process and Commerce Clause jurisprudence, finding that the N.D. tax collection obligations were not prohibited by the Due Process Clause because Quill had purposefully availed itself of N.D.'s economic market
 - Relying on the bright-line physical presence test in **National Bellas Hess v. Dep't of Revenue of Illinois**, however, the Supreme Court ruled that the tax collection obligations as applied to Quill violated the Commerce Clause

- **Rylander v. Bandag**, 18 S.W.3d 296 (Tex. App. 2000)
 - Comptroller asserted that taxpayer was subject to Texas franchise tax solely by virtue of its license to transact business in Texas
 - The Austin Court of appeals, applying the *Quill* physical presence test, found that the taxpayer did not have sufficient nexus with Texas under the Commerce Clause, and also found that a license to transact business was also insufficient under the Due Process Clause

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Complete Auto: More Substantial Nexus

- **Geoffrey Inc. v. South Carolina Tax Commission**, 437 S.E.2d 13 (S.C. 1993)
 - Geoffrey owned several valuable trademarks, including for Toys R Us, and received royalties on the licenses of these trademark, which were placed on goods sold in South Carolina
 - The South Carolina Supreme Court upheld the tax on Geoffrey, concluding that the presence of intangible property (i.e., licenses) was sufficient nexus for income tax purposes

- Other cases addressing an intangible presence:
 - **Lanco Inc. v. Director, N.J. Div. of Taxn.**
 - Deriving income from license with retailer in state
 - **West Virginia Tax. Commr. v. MBNA America Bank**
 - Deriving income from credit cards issued to residents
 - **Kmart Properties Inc. v. New Mexico Taxation and Revenue Dep't**
 - Receiving royalties on intellectual property used by parent company in state

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Complete Auto: More Substantial Nexus

- ***In re Allied Signal Inc.***, 229 A.D.2d 759 (N.Y. 1996)
 - Michigan-based Taxpayer, located in Michigan, realized gains from the purchase and sale of interests in various unrelated businesses and argued that these investment activities occurred in Michigan, not New York
 - New York law required business income to be apportioned based on payroll, property and receipts attributable to New York
 - The Court found sufficient nexus with this income by virtue of the connections between the unrelated businesses and New York

- ***Matter of Orvis, Inc.***, 654 N.E.2d 954 (1995)
 - Vermont-based company's employees traveled to New York to solicit (not accept) sales from New York stores, which annually totaled over \$1 million
 - The Court concluded that while a physical presence is required, it need not be substantial, only more than a "slightest presence," and Orvis' activities were sufficient to find nexus

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Complete Auto: Fair Apportionment

- ***Oklahoma Tax Commission v. Jefferson Lines***, 514 U.S. 175 (1995)
 - Oklahoma attempted to apply sales tax to entire price of bus tickets for interstate rides originating in state
 - Jefferson Lines argued that the tax was unapportioned and therefore unconstitutional
 - Court concluded:
 - Tax was internally consistent – identical imposition by every state would not yield multiple taxation
 - Tax externally consistent – Oklahoma's claim to tax value of transaction economically justified because agreement, payment, and at least partial delivery all occurred in state

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Complete Auto: Interstate Discrimination

- ***Maryland v. Louisiana***, 451 U.S. 725 (1981)
 - Louisiana imposed a gas tax and provided exemptions and credits for gas used for certain purposes within Louisiana
 - In looking at the practical effect of the tax scheme, the Supreme Court found that Louisiana consumers had protections from the tax while gas moving outside of the state was generally burdened by the tax, and therefore the tax scheme discriminated against interstate commerce

- ***Bacchus Imports, Ltd. v. Dias***, 468 U.S. 263 (1984)
 - Hawaii imposed an excise tax on sales of liquor and provided an exemption for certain locally produced alcohol
 - The Supreme Court found that legislature's purpose and effect of exemption was to help Hawaii businesses and therefore impermissibly discriminated against interstate commerce in favor of local products

- ***Tyler Pipe Industries Inc. v. Washington State Dept. of Revenue***
 - Exemptions that worked to effectively tax only products sold to out-of-state customers was facially unconstitutional

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Complete Auto: Fair Relation to State Services

- ***Commonwealth Edison Co. v. Montana***, 453 U.S. 609 (1981)
 - The Supreme Court noted that the fair relation prong is closely associated with substantial nexus prong "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'"
 - The Court upheld a coal severance tax measured by the value of coal mined in Montana

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Recent Supreme Court Commerce Clause Cases

- ***Direct Marketing Association v. Brohl***, No. 13–1032, 2015 WL 867663 (U.S. Mar. 3, 2015)
 - Colorado statute required retailers that do not collect Colorado sales or use tax to notify Colorado purchasers of use tax liability and report tax information to DOR
 - Plaintiff argued requested injunction, and state argued under Tax Injunction Act that federal district courts are prohibited from enjoining assessment, levy or collection of tax where remedy may be had in the state courts
 - Court held notice requirements not levy, assessment, or collection, and Tax Injunction Act therefore does not bar the federal jurisdiction over this dispute
 - Kennedy concurrence questions *Quill* holding, noting that it works an unfairness to states, and invites the legal system to find an appropriate case for the Court to reexamine the physical presence requirement

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Recent Supreme Court Commerce Clause Cases

- ***Comptroller of the Treasury of Maryland v. Wynne***, No. 13–485, 2015 WL 2340843 (U.S. May 18, 2015)
 - Maryland imposed two state-level personal income taxes (a “state” tax and a “county” tax) on income of individual residents earned both in-state and out-of-state but did not provide a credit against the “county” tax for taxes paid to other states
 - Taxpayers claimed credit against both taxes, and state assessed deficiency with respect to “county” tax
 - Court found no Due Process infirmity
 - Court held that tax scheme violated Dormant Commerce Clause prohibition on discriminating between transactions on the basis of some interstate element
 - Tax scheme failed internal consistency text because it would result in double-taxation of portion of out-of-state income subject to “county” tax, and thereby favored intrastate activities

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The Return of Due Process

Due Process

- ***International Shoe Co. v. State of Washington, et al***, 66 S. Ct. 154 (1945)
 - Manufacturer and seller of shoes had no office and no merchandise in Washington and made no contracts or deliveries there, though sales men occasionally set up sample sales rooms, solicited sales, and took orders to forward to company
 - State assessed company for unemployment taxes
 - Court held that company's activities in state were neither irregular nor casual, but instead systematic and continuous, resulting in large volume of interstate business

- ***Burger King Corp. v. Rudzewicz***, 105 S. Ct. 2174
 - Franchisor sued Michigan franchisee in Florida under agreement for failure to make payments and for continuing to operate after termination
 - Agreement establishes relationship and payments in Miami
 - Court held franchisee had minimum contacts in Florida by purposefully directing activities giving rise to litigation at Florida-resident Burger King
 - Contract alone not enough, but course of dealing supports holding

Due Process

- ***J. McIntyre Machinery v. Nicastro***, 131 S.Ct. 2780 (2011)
 - Plaintiff injured by machine manufactured by English defendant sued in New Jersey where accident occurred
 - US distributor sold machines in US, manufacturer officials attended US trade shows, and few machines wound up in Jersey
 - Court held no explicit or implicit (e.g., incorporation or domicile) consent to NJ jurisdiction, no purposeful availment of privilege of conducting business in NJ, no targeting forum, and therefore jurisdiction would violate due process clause
- ***Goodyear Dunlop Tires Operations, S.A. v. Brown***, 131 S. Ct. 2846 (2011)
 - Parents of boys killed in bus accident in France sued Goodyear US as well as European subs in NC over defective tires
 - European companies manufactured tires, but not registered, no place of business, employees, or assets, and no sales in NC
 - Court held no general jurisdiction because stream of commerce not continuous and systematic affiliation with NC, and no specific jurisdiction because no connection between controversy and state

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What About Texas?

Key Constitutional Concepts

- **34 Tex. Admin Code § 3.286** (“engaged in business”)
 - Maintains, occupies, or uses in this state, permanently or temporarily, directly or indirectly, or through an agent, kiosk, office, distribution center, or other physical location where business is conducted
 - Has representative, agent, salesperson, canvasser, or solicitor who operates under authority of seller to conduct business in this state
 - Derives receipts from sale, lease, or rental of tangible personal property located in this state or owns or uses tangible personal property located in this state, including computer server or software to solicit orders for taxable items, unless seller uses server or software as purchaser of Internet hosting service
 - Allows franchisee or licensee to operate under trade name in this state if franchisee or licensee required to collect sales or use tax in this state
 - Formed, organized, or incorporated under laws of this state and seller's internal affairs governed by laws of this state

- ...where is trailing nexus?

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More Key Constitutional Concepts

- **Tex. Tax Code § 151.303(c)**
 - A taxpayer is entitled to a credit against the use tax imposed by Subchapter D of this chapter on a taxable item in an amount equal to the amount of any similar tax paid by the taxpayer in another state on the sale, purchase, or use of the taxable item if the state in which the tax was paid provides a similar credit for a taxpayer of this state
 - See also **Section 151.338(b)(1)**.

- **Tex. Tax Code § 321.205(c)**
 - “If a taxable item is shipped from outside this state to a customer within this state and the use of the item is consummated within a municipality that has adopted the tax authorized by this chapter, the item is subject to the municipality's use tax and not its sales tax. A use is considered to be consummated at the first point in this state where the item is stored, used, or consumed *after the interstate transit has ceased*. A taxable item delivered to a point in this state is presumed to be for storage, use, or consumption at that point until the contrary is established”

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Franchise Tax Nexus-Creating Activities?

- Physical presence generally or physical presence as a result of agent
- Trailing nexus
- Doing business
- Registering to do business, for payroll or workers' comp, or as a government contractor
- Retaining title to property to ensure payment
- Having an interest in an entity doing business in Texas: investment LLC or partnership, general partnership, limited partnership, disregarded entity, LLC (managing v. non-managing)
- Having unrelated third party provide fulfillment services
- Foreclosing on property in Texas

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More Franchise Tax Nexus-Creating Activities?

- Employees in Texas: (i) accepting or negotiating orders, (ii) checking credit or handling credit disputes, (iii) accepting deposits, (iv) attending trade shows, (v) maintaining free samples, (vi) checking customer inventories, (vii) having an in-home office, (viii) operating mobile stores, (ix) collecting delinquent accounts, (x) repossessing property, (xi) performing repair services, (xii) setting up product displays, (xiii) supervising/inspecting installation, or (xiv) training other employees
- Independent contractors working in Texas
- Receiving revenue from in-state customers
- Owning or leasing internet server or paying 3rd party for web-hosting on server in Texas

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Sales Tax Nexus-Creating Activities?

- Registering to do business, for payroll or workers' comp, or as a government contractor
- Providing reimbursement for in-home office
- Using an in-state 3rd party distributor
- Attending trade show or seminar or meeting with supplier
- Advertising in local media (and paying commission to advertiser for in-state sales)
- Having an interest in an entity doing business in Texas: investment LLC or partnership, general partnership, limited partnership, disregarded entity, LLC (managing v. non-managing)
- Affiliate sells property, accepts returns, operates store, participates in loyalty program, sells gift cards, or is part of controlled group

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More Sales Tax Nexus-Creating Activities?

- Using in-state manufacturer for fulfillment services with or without title to product
- Owning or leasing internet server or paying 3rd party for web-hosting on server in Texas
- Selling music or video downloads, canned or customized software downloads, software licenses, data, remote access to software
- Click-through nexus or otherwise advertising on in-state website
- Charging fees to access software loaded outside Texas
- Remotely performing software services from outside Texas
- Employees or independent contractors in Texas setup or provide training on remote software

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Questions?

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Please consult your tax advisor on your specific facts, as this outline (which was completed in advance of the presentation) is not intended to be a comprehensive survey of recent developments or to offer legal advice.

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