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TO: Joint Subcommittee on the Changing Economy and Impacts to the Long-Term Viability of Montana's Tax Structure

FROM: Jaret Coles, Staff Attorney

RE: Federal Constitutional Provisions

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This memorandum provides a ***very*** brief overview of four provisions of the United States Constitution that limit a state's power to tax. Further information is available from staff if the joint subcommittee desires more detail.

Commerce Clause:

Article I, section 8, of the United States Constitution (the Commerce Clause) grants Congress the power "to regulate commerce . . . among the several states." Examples of express congressional action include:

- the Interstate Income Act of 1959 (Public Law 86-272), codified at 15 U.S.C. §§ 381-383, regarding a prohibition on the taxation of income related to the solicitation of goods of an interstate business that does not have physical presence;
- the Internet Tax Freedom Act, regarding taxes on electronic commerce;
- the Railroad Revitalization and Regulatory Act of 1975, regarding discriminatory taxation of railroad transportation property;
- 49 USC § 14502, regarding discriminatory taxation of motor carrier transportation property;
- 49 USC § 14505, regarding discriminatory taxation of transportation of passengers by motor carriers; and
- 49 USC § 40116, regarding taxation of air commerce.

The United States Supreme Court has also held that a negative implication of this grant of power is that states may not adopt regulations or taxes that place an "undue burden" on interstate commerce, even if Congress has taken no action. This is referred to as the "dormant or negative" Commerce Clause doctrine. In *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), the Court set out a four-part test for testing state taxes under the Commerce Clause. Under the *Complete Auto* test, a state tax must:

1. be applied to an activity that has substantial nexus with the state:
    a. In *Quill v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court held that an out-of-state mail order vendor with over 3,000 North Dakota customers was not responsible for collecting a state sales tax, as none of

its employees worked or resided in North Dakota, its ownership of tangible property in that state was either insignificant or nonexistent, and all of its merchandise to its North Dakota customers was by mail or common carrier from out-of-state locations.

b. On January 12, 2018, the United States Supreme Court agreed to hear *South Dakota v. Wayfair*, which is a direct challenge to *Quill.* At issue is whether the U.S. Supreme Court should overturn *Quill* and allow a recently enacted South Dakota law that requires $100,000 in sales or 200 separate transactions to trigger a collection requirement.

2. be fairly apportioned to activities in the state;
3. not discriminate against interstate commerce; and
4. be fairly related to services provided by the state.

Examples of relevant cases include:

- *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalid Hawaii tax that exempted ethanol or alcoholic beverages produced only within Hawaii); and
- *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (invalid North Carolina tax that exempted dividends paid by in-state corporations).

Privileges and Immunities Clause

Article IV, section 2, of the United States Constitution provides: "The citizens of each state shall be entitled to all privileges and immunities of citizens in the several states." This clause, which is referred to as the "Privilege and Immunities Clause," generally prohibits a state from imposing higher tax rates or taxes on nonresidents than it imposes on residents.

The United States Supreme Court reasons that when a state is "confronted with a challenge under the Privileges and Immunities Clause to a law distinguishing between residents and nonresidents, a State may defend its position by demonstrating that '(i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State's objective.'" *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287, 298 (1998) (quoting *Supreme Court of N. H. v. Piper*, 470 U.S. 274, 284 (1985) (emphasis added).

Examples of relevant cases include:

- *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920) (invalid denial of personal exemptions and deductions to nonresidents under the New York individual income tax);
- *Austin v. New Hampshire,* 420 U.S. 656 (1975) (invalid commuter income tax for nonresidents working in New Hampshire); and
- *Borden v. Selden,* 146 N.W.2d 306 (Iowa 1966) (invalid property tax credit that was limited to farms owned by residents).

Equal Protection Clause

The Fourteenth Amendment to the United States Constitution provides: "nor shall any state . . . deny to any person within its jurisdiction the equal protection of the laws." State tax laws that treat nonresidents differentially from residents must be rationally related to the state's objective.

Examples of relevant cases include:
- *Zobel v. Williams*, 457 U.S. 55 (1982) (invalid Alaska law that paid rebates to residents based on how many years they had lived in Alaska);
- *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985) (invalid Alabama law that taxed out-of-state insurance companies at a higher rate than instate companies); and
- *WHYY, Inc. v. Borough of Glassboro*, 393 U.S. 117 (1968) (invalid New Jersey law denying a property tax exemption to an out-of-state charity).

Due Process Clause

The Fourteenth Amendment to the United States Constitution provides: "No state shall . . . deprive any person of . . . property, without due process of law." There is procedural due process, which pertains to assessment and collection of taxes, including a right to a hearing, and substantive due process, which pertains to whether a state has jurisdiction to impose a tax. To comply with due process, the U.S. Supreme Court in *Allied-Signal, Inc. v. Director*, 504 U.S. 768, 778 (1992), held there must be a:
- minimal connection between the interstate activities and the taxing state; and
- rational relation between the income attributed to the taxing state and the intrastate value of the corporate business.