Constitutional Limitations on State and Local Taxation

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Many attorneys will never come across a constitutional law issue in their entire career practicing law. Indeed, many attorneys may have actively avoided any involvement with constitutional law since studying for the bar exam. However, for those attorneys who practice state and local tax law, constitutional law is a large part of every case they handle. Although it may not always feel like states have any limits beyond the political process as to how much they can tax, in reality, states are constrained by the United States Constitution when they enact taxes. This article discusses some of these restrictions.

After the close of the Revolutionary War, a fledgling United States of America adopted its first form of government, the Articles of Confederation. A prime concern for those creating the new government was how to avoid the abuses they had felt under the monarchy in England. To do this, they decided to form a government with little centralized power, giving most of the decision-making rights to the individual states. However, the new country quickly realized that some form of central government was necessary for the stability of the new nation.

And so the U.S. Constitution as we know it today was born. Ratified by the states in 1788, the Constitution created a form of government known as federalism, which divides powers between a single national government and the individual states. While certain powers are the exclusive domain of the federal government, others are reserved as the province of the states. Congress may not impede states’ rights, and states may not impinge upon the rights of the national government. When it comes to taxation, the Constitution imposes limitations on the laws states may enact and enforce.

Supremacy Clause
The Supremacy Clause of the Constitution provides that the laws of the United States are the “supreme law of the land.” In other words, states may not enact laws in direct conflict with the Constitution nor with federal laws enacted by Congress. States also may not impede the federal government’s functions.

The first application of this test in the realm of state taxation came in *McCulloch v. Maryland* (1819). In that case, the state of Maryland attempted to challenge the federal government's authority by taxing the Second Bank of the United States, a federally-created institution. The United States Supreme Court held that by taxing the national bank, the state of Maryland was impeding the function of the federal government, thus making the state superior to the United States government. This violated the Supremacy Clause, which mandates that federal law be superior to state law. The precedent in *McCulloch v. Maryland*, therefore, established that under the Supremacy Clause, states may not tax the federal government.

Due Process Clause
Another limitation on the states’ ability to tax can be found in the Due Process Clause of the 14th Amendment, which mandates that no state may “deprive any person of life, liberty, or property without due process of law.” As a deprivation of property, state taxation is subject to the constraints of the Due Process Clause.
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In Miller Bros. Co. v. Maryland (1954), the Supreme Court held that before a state may enact a tax, there must be "some minimum connection between a state and the person, property, or transaction it seeks to tax." This requirement is known as nexus. In addition to nexus, Mobil Oil Corp. v. Commissioner of Taxes of Vermont held that the tax must have "a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'

Combining the two tests, we are left with the principle that in order to exercise its taxing powers, a state must also provide benefits to the taxpayer that the taxpayer is seeking out by conducting business in that state. For in-state taxpayers, these standards are usually clearly met. Out-of-state taxpayers, however, may question how a state with whom they have seemingly no connection may tax them.

For these taxpayers, the "rational relationship" test is generally easily satisfied. The nexus test, however, is a bit more complex. There are two types of nexus: transactional and presence. In Allied-Signal, Inc. v. Director, Div. of Taxation (1992), the Supreme Court held that for a state to tax an activity, it must have a connection to the activity itself, not just the actor involved in the transaction.

In the seminal case regarding presence nexus, Quill Corp. v. North Dakota (1992), the Supreme Court held that a state need only have minimum contacts to tax an out-of-state corporation. The Quill court determined that due process requirements for state taxation purposes was similar to the standards that must be met to hale an out-of-state defendant into civil court within the state. In other words, for a state to tax an out-of-state entity, that entity must be subject to personal jurisdiction within the state.

Attorneys may recall certain personal jurisdiction buzzwords from civil procedure cases like International Shoe and its progeny: purposeful availment of a state's benefits, notions of fair play and substantial justice, stream of commerce, etc. Generally, an out-of-state person is subject to personal jurisdiction within a state if his actions are such that he may reasonably anticipate being called to court there, despite the fact that he has no continual physical presence within the state. Since the Quill decision, physical presence has not been required for a state to impose an income tax on an out-of-state corporation.

For years, Quill has weakened due process claims for out-of-state taxpayers. Under the Quill standard, if a taxpayer purposefully directs itself into a state by doing business there, it can expect to be subject to taxation. In today's global economy, many entities do business in all 50 states, meaning they could be subject to taxation in all of them. In the last several years, however, the Supreme Court has decided a number of cases that seem to have contracted the once-broad umbrella of personal jurisdiction. These cases have created a stricter standard for when a state may impose personal jurisdiction on an out-of-state defendant.

These cases, like Goodyear Dunlop Tires Operations, S.A. v. Brown (2011) and Daimler AG v. Bauman (2014) may have opened the door for out-of-state taxpayers to argue that their connections to a taxing state are too weak under these new standards and what once would have passed muster under Quill has now changed. Savvy state and local tax practitioners should keep abreast of these types of cases as they develop.

Commerce Clause
The Commerce Clause also limits the ability of states to tax out-of-state persons. The Commerce Clause mandates that Congress shall have the power to regulate interstate commerce. Because the power to regulate interstate commerce is granted to Congress, states may not enact laws that discriminate against or substantially interfere with interstate commerce. First articulated in Gibbons v. Ogden (1824), this concept is known as the Dormant Commerce Clause, and it means that states may not favor in-state persons over out-of-state persons when enacting laws.
In *Complete Auto Transit, Inc. v. Brady*, the Supreme Court applied the Dormant Commerce Clause to state taxation. The Court held that state tax on an out-of-state entity is not, *per se*, unconstitutional and created a four-part test to determine whether such a tax violated the Commerce Clause. First, the taxed activities must have substantial nexus to the taxing state. Second, the tax must be fairly apportioned. Third, the tax must not discriminate against interstate commerce. And finally, the tax must be fairly related to the services provided by the state.

Importantly, although a taxpayer may have the minimum contacts with a taxing state to satisfy the due process standard, that same taxpayer might not have the substantial nexus with the state as required by the Commerce Clause. Therefore, Commerce Clause challenges to a state and local taxation scheme are much more frequent than Due Process Clause challenges. What constitutes "substantial nexus" is a constant source of tension between state departments of revenue and out-of-state taxpayers. It is often an incredible fact-specific question.

Conclusion
This article describes just a few of the limitations our Constitution places on state and local taxation. In addition, many states impose their own limitations on taxation through their own respective constitutions. Although lawyers often hear that those among us who practice constitutional law are few and far between, state and local tax practitioners know differently. Constitutional law is a daily concern for these attorneys, whether they work for the state or in private practice. And with technology continually expanding our reach into other states, issues of nexus and due process will be of increasing concern. It sounds strange, but it’s true: there’s never a dull moment in the world of state and local taxation.

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