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Federal Limitations on State and Local Taxation

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BOOK REVIEW

FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION. By Paul J. Hartman. Rochester, N.Y. and San Francisco, Cal.: The Lawyers Co-operative Publishing Co. and Bancroft-Whitney Co., 1981. Pp. xii, 743.

*Reviewed by William R. Andersen**

The extent of the states' power to tax interstate business has been hotly disputed since the beginning of the Republic, and the role of the courts in resolving the question has been central. Chief Justice Marshall, arguing in 1819 for limited state taxing power, wrote, "[T]he power to tax involves the power to destroy."[1] More than 100 years later, Justice Holmes, advocating a more expansive state taxing power, countered Marshall's position, saying, "The power to tax is not the power to destroy while this Court sits."[2] Today, judicial extension of state taxing power is accelerating. Indeed, one leading scholar has called the current movement in state and local taxation of interstate business "potentially revolutionary."[3] Amid the "revolution," lawyers and judges need a work that carefully traces the historical path of this movement and serves as a reliable guide for its future. *Federal Limitations on State and Local Taxation* by Paul J. Hartman is such a work.

In addition, serious students of government will find in this work a richly documented history of one of the major battlefields in the growth of American federalism. Hartman's work begins with a discussion of the early "free trade" notion adopted by federalist judges such as Chief Justice Marshall who feared destruction of interstate activity by strong state governments. The doctrine developed by these judges greatly restricted state power to tax interstate activities. The story proceeds to the nineteenth century when

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1. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

2. Panhandle Oil Co. v. Mississippi *ex rel.* Knox, 277 U.S. 218, 223 (1928) (Holmes, J., dissenting).

3. Lockhart, *A Revolution in State Taxation of Commmerce?*, 65 MINN. L. REV. 1025, 1025 (1981).

the courts recognized the importance of growing interstate commerce and the legitimacy of state revenue needs. The shift in the courts' view expanded the reach of state taxing power, a movement that continues today. Although this trend has not been without irregularities and reversals, it has continued unmistakably—even within the last two to three years.

In discussing these developments, Hartman uses an unusual organizational structure. The first chapters of the book are organized around legal doctrine—in this field that means discussion of constitutional clauses and their judicial interpretation. Beginning with chapter seven, the organizational focus shifts from legal doctrine to types of taxes. The reader, therefore, gets a sort of cross-grained organization in which he sees the most fundamental issues twice, first in a doctrinal discussion and later in a setting that focuses on the peculiarities of the tax instrument involved. While this approach inevitably results in some duplication, it is not repetitious. Hartman uses the changing organizational focus to highlight different aspects of the subject.

The analysis begins with a consideration of the commerce clause and due process doctrines.[4] Hartman discusses the Marshall court's "free trade" doctrine and its struggle to protect infant enterprise from powerful states. By the mid-nineteenth century, the Court permitted some expansion of state tax power by adopting the "direct-indirect" test: the Court upheld state taxes which had only "indirect" effects on interstate commerce.[5] This doctrine's emphasis on the taxing statute's language and drafting created what Hartman calls "decades of distinctions based upon insubstantial and pointless formalism."[6] This highly formalistic view prevailed with a minor digression between 1937 and 1945[7]—until the 1970's when substantial erosion began.

In *Complete Auto Transit, Inc. v. Brady*,[8] a 1977 opinion, the Court seems to have entered an era in which decisions turn on the practical economic effects of the tax rather than its formal statutory phrasing. The test—for both commerce and due process doc-

4. While these two doctrines protect somewhat different values—the commerce clause seeks to protect interstate activity and the due process clause seeks fairness to taxpayers—Hartman treats them here together because the Court commonly does so.

5. P. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION § 2:13 (1981).

6. *Id.* at 88.

7. Essentially the period between Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938) and Freeman v. Hewit, 329 U.S. 249 (1946).

8. 430 U.S. 274 (1977).

trines—now turns in a real sense on matters such as whether the connection between the taxed activity and the state is sufficient to make the imposition of the tax fair, whether the benefits received by the taxpayer are fairly related to the tax, whether the tax in effect discriminates against the interstate business, and whether the tax is apportioned fairly.[9] Several later opinions of the Court have reinforced this new practical view of the validity of state taxes levied on both interstate[10] and foreign[11] commerce. For almost thirty years, Hartman has argued for this pragmatic, nonformal approach.[12] One guesses that this chapter was a pleasure for him to write.

The equal protection clause which Hartman discusses next, has not significantly limited states' power to tax interstate activities. The Court adopted early the notion that the clause did not require an "iron rule of equal taxation."[13] Since that time, heavy presumptions in favor of classification schemes have doomed most taxpayer equal protection claims. A court is simply not likely to respond favorably to these complaints when it is willing to presume that the classification "though discriminatory, is not . . . violative of the Equal Protection Clause . . . *if any state of facts reasonably can be conceived that would sustain it.*"[14]

Hartman also sees expansion of the state taxing power in recent decisions under the privileges and immunities clauses. The book focuses on the article IV clause, which allows a state to discriminate against nonresidents only when valid independent state objectives are rationally related to the statutory scheme. The Court judges the validity of these objectives and the adequacy of their relation to the challenged statutory scheme "with due regard for the principle that the States should have considerable leeway in analyzing local evils and in prescribing appropriate cures."[15] Again, the latter day movement in the direction of expanding state taxing power is evident. Recent decisions under the clause have sought to limit its protection to privileges and immunities that are "fundamental" in the sense that they preserve "the vitality of the

9. P. HARTMAN, *supra* note 5, at 91.

10. Department of Revenue v. Association of Washington Stevedoring Cos., 435 U.S. 734 (1978).

11. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).

12. *See* P. HARTMAN, STATE TAXATION OF INTERSTATE COMMERCE (1953).

13. Bell's Gap R.R. Co. v. Pennsylvania, 134 U.S. 232, 237 (1890).

14. Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 528 (1959) (emphasis added).

15. Toomer v. Witsell, 334 U.S. 385, 396 (1948).

Nation."[16] Whether a doctrinal formula cast in an elusive term like "funadmental" will prove any more useful here than it has elsewhere remains to be seen. Hartman concludes that on balance the current movement is sound. He finds in the inevitable unclarity of the word "fundamental" a desirable judicial "latitude in weighing the legitimate interests of the taxing State and nonresidents in a flexible application of the . . . clause."[17]

Hartman's discussion of the export/import cases illustrates the same pattern of limiting constitutional protections and expanding state taxing power. Hartman's historical treatment shows the development of the early doctrine that limited the states' ability to tax imports still in their "original package" and the abandonment of that test in 1976[18] in favor of a simple ban on discrimination. Similarly, in the state taxation of exports, the Court introduced a doctrine that required determining when the "stream of commerce" began, permitting states to tax only prior to that point. In 1978, the Court abandoned that approach in favor of a more practical inquiry into the purposes of the clause.[19]

The final "doctrinal" section of the book examines in some detail the "implied immunity" from state taxation that federal activities have enjoyed.[20] The federal immunity expanded during the period between 1840 and 1940, but has gradually narrowed since *James v. Dravo Contracting Co.*[21] in 1937. *Dravo Contracting* articulated the "legal incidence" theory, which effectively allows the states to impose the economic burdens of a tax on federal activities so long as the legal incidence of the tax is not laid on the federal government. As Professor Powell trenchantly noted, the determinative inquiry is "not 'who is hurt, but who is hit.' "[22] Unlike the movement in other areas toward more practical and less formal tests, this doctrine still stresses legalisms rather than economic effects. While he concedes that the implied immunity will survive for

16. Baldwin v. Fish & Game Comm'n, 436 U.S. 371, 383 (1978).

17. P. HARTMAN, *supra* note 5, at 186.

18. Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976).

19. *See, e.g.*, Department of Revenue v. Association of Washington Stevedoring Cos., 435 U.S. 734 (1978).

20. Hartman traces the history of both elements of the doctrine—the implied immunity of federal activities and the constitutional power of Congress to regulate commerce. *See* P. HARTMAN, *supra* note 5, ch. 6.

21. 302 U.S. 134 (1937).

22. T. POWELL, VAGARIES AND VARIETIES IN CONSTITUTIONAL INTERPRETATION 141 (1956).

some time,[23] Hartman perceives little logical necessity for it. Congress, he suggests, can provide for those few situations in which conflicting local taxes would place burdens on interstate activities.

At this point in the book, the organizational focus shifts to types of taxes. Chapter seven deals with state property taxes on goods and vehicles moving in interstate and foreign commerce. The chapter includes a discussion of apportionment and valuation problems. Chapter eight discusses the development of the gross receipts tax from *Western Live Stock v. Bureau of Revenue*[24] through *Moorman Manufacturing Co. v. Bair.*[25] The Court's decisions relating to both of these taxes illustrate again the current expansion of the states' taxing power.

Chapter nine treats the net income tax, which provides such a large portion of state revenue today.[26] The special fairness claims of this tax—there is no tax if there is no net income—perhaps explain why it was one of the first taxes that the Court permitted on an exclusively interstate business.[27] Congress has tried to limit the reach of state power to tax net income of interstate business,[28] but its efforts have produced much uncertainty. Hartman's discusson of the case law here is very helpful.

Division of income remains a particularly difficult problem. The text discusses the uniform act[29] and the Multistate Tax Compact[30] as well as *Moorman Manufacturing Co. v. Bair,*[31] *Mobil Oil Corp. v. Commissioner of Taxes,*[32] and *Exxon Corp. v. Department of Revenue.*[33] The Court is moving unmistakeably in the direction of greater latitude for the states and less immunity for interstate commerce. Indeed, the sharpness of the dissents corroborates the velocity of this movement.

Discussion of the sales and use taxes in chapter ten reviews the plentiful litigation resulting from states seeking to tax interstate sales of goods. While courts have expanded state power to tax

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23. P. HARTMAN, *supra* note 5, at 339.
24. 303 U.S. 250 (1938).
25. 437 U.S. 267 (1978).
26. Hartman discusses both personal and corporate income taxes.
27. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).
28. *See, e.g.,* Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381-384 (1976)).
29. UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT, 7A U.L.A. 91 (1957).
30. MULTISTATE TAX COMPACT, *reprinted in* 1 ST. & LOC. TAX SERV. (P-H), ALL STATES UNIT ¶ 6310 (Apr. 22, 1975).
31. 437 U.S. 267 (1978).
32. 445 U.S. 425 (1980).
33. 447 U.S. 207 (1980).

these sales, significant limits still remain. The determinative issue is whether *McLeod v. J.E. Dilworth Co.*[34] is still sound law. *McLeod* held that a state could not tax an interstate sale to one of its residents, even though the goods were shipped into the taxing state and the seller's traveling salesman solicited the sale in the taxing state. Hartman believes *Dilworth* still lives and argues that even under the modern view of *Complete Auto Transit*[35] some "nexus" must exist between the taxing state and the sale—a requirement not met if the seller does nothing but send in traveling salesmen.[36]

Perhaps the availability of the use tax, however, has made litigation of the *Dilworth* point unnecessary—the taxing state can tax a resident for the privilege of using the property puchased in an interstate sale even when the state cannot reach the sale itself. For many kinds of property, therefore, the availability of the use tax makes irrelevant the inability to reach the sale directly. Of course, not all property subject to the use tax can be identified readily by the taxing state. The identification problem has led to efforts by the taxing state to require the out-of-state seller to collect the taxing state's use tax at the time of sale. The questions here involve the degree and nature of the out-of-state seller's contacts with the taxing state. *National Bellas Hess, Inc. v. Department of Revenue*[37] held that when the seller only solicits by mail-order catalog in the taxing state, the seller has insufficient contact with that state to warrant imposing on the seller the duty to collect the use tax. On the other hand, *National Geographic Society v. California Board of Equalization*[38] permitted imposition of the duty when the out-of-state seller had offices in the taxing state even though the offices had no relationship to the sale. The Court, thus does not require a "transactional" nexus, only " 'some definite link.' "[39] Clearly preferring the generosity of the *National Geographic* approach, Hartman wonders why the clear economic presence of the out-of-state seller in *Bellas Hess* should not have been recognized.[40]

After a chapter on capital stock taxes and one on exactions for

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34. 322 U.S. 327 (1944).

35. 430 U.S. 274 (1977).

36. *See* P. HARTMAN, *supra* note 5, at 597.

37. 386 U.S. 753 (1967).

38. 430 U.S. 551 (1977).

39. P. HARTMAN, *supra* note 5, at 635 (quoting National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 561 (1977)).

40. *See id.* at 631.

the use of public facilities, Hartman concludes with a chapter speculating whether recent opinions such as *National League of Cities v. Usery*[41] signal some limit on congressional power over state and local taxation. He concludes that while Justice Rehnquist's *Usery* opinion has sufficient elasticity to permit classifying state tax structures as "traditional ways in which the local governments have arranged their affairs"[42]—a classification that would immunize these activities from federal power under *Usery*—the Court nevertheless has sent more recent signals reasserting federal power.[43] Hartman believes *Usery* "will [not] appreciably change the design of the power of Congress to control state and local taxation."[44]

Federal Limitations on State and Local Taxation presents a central question about how usefully and how legitimately courts have dealt with the issues of state taxing powers. The United States Supreme Court has assumed a role as the principal architect of this component of federalism. State legislatures and tax officials have, of course, played roles, but they have always operated under the shadow of judicial doctrine. While Congress has not been wholly inactive, its role has been derivative, interstitial, and hesitant. Perhaps Congress' fact-finding role has been larger than its legislative role.[45]

Some federal role, of course, is needed to police state taxing activities, since many persons and businesses affected by these state taxes have no representation in the legislature of the taxing state. The importance of representation, however, does not explain why the judicial branch had to be so predominant in the federal role. Historical factors may explain the Court's early role in state taxation disputes. The first Chief Justice, an ardent Federalist, not surprisingly made it the business of the Court to help solidify the power of the central government. The reasons for the continuation of this pervasive judicial role are less apparent. Perhaps the Court believes that these conflicts are better decided on a case-by-case basis—a better job for courts than legislatures. Moreover, congressional attempts to regulate this conflict may encounter an inherent

41. 426 U.S. 833 (1976).

42. *Id.* at 849.

43. *See, e.g.*, Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978).

44. P. HARTMAN, *supra* note 5, at 704.

45. See the so-called Willis Report, H.R. REP. No. 1480, 88th Cong., 2d Sess. (1964); H.R. REP. No. 565, 89th Cong., 1st Sess. (1965); H.R. REP. No. 952, 89th Cong., 1st Sess. (1965).

structural difficulty: the representational structure of the Congress—especially in the Senate—may make congressional restraint of the important interests of any one state unlikely.

Whatever the reasons for the tradition of judicial intervention in this area, the recent movement of the Court in the direction of expanding state power and reducing the constitutional constraints on state taxation will have the inevitable effect of reducing the judicial involvement. Recent decisions have returned a great deal of discretion to state and federal legislatures. Whether this trend will continue remains uncertain. Professor Hartman's work provides valuable assistance in resolving the ambiguities that have arisen because of the changing views of the Court.