A "*Complete*" Look at the Interstate Commerce Clause and Ad Valorem Taxation

Robert S. Goldman, CMI, Esq., Partner
Madsen Goldman & Holcomb, LLP
Tallahassee, FL
(850) 523-0400
rgoldman@mgh-law.com

David M. Hugin, Esq, General Counsel
Popp, Gray & Hutcheson, LLP
Austin, TX
(512).473-2661
david.hugin@property-tax.com

I. Scope and objectives

This session is intended to provide a basic understanding of the general nature of the Interstate Commerce Clause as it applies to the property taxes imposed by state and local jurisdictions. The objectives are to help session participants:

- Understand the purpose of the Interstate Commerce Clause
- Distinguish affirmative action of Congress under the Clause from the "Dormant" Clause
- Identify the factors used in evaluating state and local taxes under the Commerce Clause
- Recognize that property taxes are subject to the same Commerce Clause test as other taxes
- Understand selected applications of the Clause in the property tax context

II. Text, history of the "Interstate Commerce Clause"

A. Article I, Section 8, Clause 3 of the Constitution of the United States provides:

> Congress shall have the power … to regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes.

Notice that the Clause does not literally prohibit any state action, nor does it mention taxation.

Rather, it is a grant of regulatory authority to Congress. More precisely, it can be viewed as three separate grants of authority, one related to interstate commerce, one to foreign commerce, and the third to commerce with the Indian tribes. This leads to occasional use of terminology that incorrectly implies that there are multiple "clauses." The thrust of this session is the Clause as it relates to interstate commerce, often called the "Interstate Commerce Clause." This provision is of greatest practical interest to businesses with multistate operations or property, and businesses that engage in transactions across state lines.

B. The Commerce Clause was a critical element in the founding of the American Republic. After the Revolutionary War, a weak national government was established under the Articles of Confederation. The states began to squabble, and there was no central authority to prevent or resolve disputes. The states argued over boundaries, enacted protective tariff laws against one another, established their own customs services, and printed their own currencies that had value only within their boundaries. With regard to shipping, the smaller states were at the mercy of the larger states. These conditions ultimately became intolerable, leading to pressure for revision of the Articles of Confederation. Eventually, a convention of the states was assembled for this purpose, and in 1787 it proposed adoption of the Constitution, ratification of which by the minimum nine states was completed in 1788.

C. To eliminate the problems of the past, the founders included in the Constitution a strong central power over commerce. In the view of early and current Supreme Court justices, the desire for such a feature was the primary catalyst leading to adoption of the Constitution. This central power is the grant of regulatory authority to Congress that appears in the Commerce Clause.

D. Why the history is useful: the Commerce Clause has been difficult to interpret and apply. Consideration of the evils it was intended to cure is often helpful in deciding how to apply it to a specific situation. This is what courts do, and therefore tax professionals must also do it.

III. Twofold nature of the Commerce Clause

A. As written, the Commerce Clause is an affirmative *grant* of power to Congress. Although Congress has exercised this power in many contexts, it has done so only rarely in the context of state and local taxation. One example related to the property tax is the Railroad Revitalization and Regulatory Reform Act ("4R Act").

B. As an affirmative grant of power, the Clause does not expressly prohibit state and local governments from enacting measures, including tax laws, that create burdens on commerce. Despite this lack of an express prohibition, the United States Supreme Court determined early in the nation's history that when such measures are at odds with the purpose of the Commerce Clause, they cannot stand. This negative restriction on state power, known as the "dormant" or "negative" Commerce Clause, forbids the states from enacting laws that interfere with the objective of assuring that business within the scope of the Clause is transacted without the obstacles that prompted the adoption of the Constitution. Most of the tax cases under the "dormant" or "negative" Commerce Clause involve taxation of interstate commerce.

C. The negative Commerce Clause has proved extremely difficult to implement. Without any guidance in the text of the Clause, the Court has struggled to develop principles that advance the purposes

of the Clause while respecting the needs of the states for revenue. The many variations in state tax measures and fact patterns have frustrated the Court's efforts to establish a formulation that permits easy determination whether a particular taxing measure is or is not consistent with the dormant Commerce Clause. The Court has referred to its own decisions under the Clause as a "quagmire."

D. This much is clear: interstate commerce is not constitutionally immune from state or local taxation. Rather, the ultimate question now, in the Commerce Clause analysis of a state taxing measure, is how the measure affects interstate commerce. If the effect is considered unacceptable, the tax is stricken; otherwise it is upheld.

E. The Commerce Clause does not preclude a state from enacting laws that confer an advantage on interstate commerce, such as interstate commerce exemptions. However, such measures are not constitutionally required. The states are free to require that interstate business pay a fair share of the cost of government.

IV. Putting flesh on the bones of the "dormant" Commerce Clause

A. As the dormant Commerce Clause is a judicial creation, one consults court cases to learn about its operation.

B. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) is often cited as the source of the modern test for evaluating state taxes under the Commerce Clause. In that case, Mississippi had labeled the disputed tax a "privilege tax," and a line of prior cases had said that such a characterization of a tax is fatal to its imposition on interstate business activity. In *Complete Auto* the U.S. Supreme Court abandoned those cases and announced that the focus instead would be on the practical economic *effect* of the tax on interstate commerce. To measure this effect the Court identified four factors or "prongs." A state tax (which for this purpose includes local taxes) will be upheld if it:

- is applied to an activity which has a substantial nexus with the taxing state;
- is fairly apportioned;
- does not discriminate against interstate commerce; and
- is fairly related to the services provided by the taxing state.

Conversely, if a tax fails to satisfy one or more of the prongs, it will be held unconstitutional. The test does not depend on the type of tax involved. Therefore, cases that entail consideration of income taxes, sales taxes, and other taxes are all potentially relevant to the examination of a property tax, and vice versa. Further, the four "prongs" overlap. An apportionment analysis, for example, may resemble a discrimination analysis or a nexus analysis. Finally, *Complete Auto* did not overrule *all* prior Commerce

Clause cases. Many survive, even if they did not expressly apply the modern test. Some examples of court cases involving the property tax are mentioned below.

C. Nexus. This prong relates to the nature and extent of the connection between the activity taxed and the taxing state and is often related to the Due Process Clause as well as the Commerce Clause. Historically most nexus issues have involved taxes other than the property tax. However, an early line of decisions involved objections to a property tax that had the elements of what would currently be considered a nexus argument. *See Pullman Co. v. Richardson,* 261 U.S.330 (1923) (rejecting argument that taxation of an average number of railcars within the state, owned by a company that had no place of business or contracts within the state, was invalid as reaching property outside the state); *Braniff Airways v. Nebraska State Board of Equalization*, 347 U.S. 590 (1954) (similar result in airline context). Generally, the states do not attempt to tax property that has no presence, or only a minimal presence, within their borders.

D. Apportionment. This prong generally relates to the way a tax is measured. Using another railcar property tax example, the courts would not sustain a tax on more than the average number of cars habitually present within the taxing state. *Union Tank Line v. Wright*, 39 U.S. 276 (1919) rejected such a tax. However, this is an unusual result. States have considerable leeway in devising apportionment formulas; the Court has commented that mathematical perfection is unattainable and not required. Unless an apportionment is clearly arbitrary, it will survive a Commerce Clause challenge.

E. Discrimination. This prong is generally the easiest to apply and has probably been the most effective in contesting state taxes under the Commerce Clause. Two property tax cases of note are *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564 (1997) and *Fulton Corporation v. Faulkner*, 516 U.S. 325 (1996). In *Camps Newfound/Owatonna* the Court struck down a Maine property tax exemption for summer camps primarily serving residents of the taxing state as discriminatory against interstate commerce. In *Fulton Corporation*, the Court invalidated a North Carolina intangible personal property tax on shares of stock that was inversely proportional to the exposure of the corporate issuer of the stock to the state's income tax. That is, to the extent the corporate issuer of the stock conducted business in North Carolina, the measure of the tax on its stock was reduced. The tax violated the discrimination prong because it discouraged investment in companies conducting interstate business in favor of purely domestic enterprises, and discouraged domestic companies from conducting business outside the state.

F. Fairly related to services provided by the taxing state. Although included in the four prong test, this element has not generally been useful for taxpayers since it was substantially diluted in *Commonwealth Edison v. Montana*, 453 U.S. 609 (1981). There, the Court essentially reformulated this prong as focused not on the measure of services received from the state, but on whether the tax was in proportion to the activity taxed.

G. Two additional observations about the Commerce Clause

1. There is disagreement among the justices of the United States Supreme Court as to whether the *Complete Auto* test should be retained. They also often disagree on how the test should be applied. Many Commerce Clause decisions are rendered by a divided Court. The justices seem to agree that discrimination against interstate commerce is bad, but on very little else.

2. Most tax cases do not reach the United States Supreme Court. Therefore, a great deal of the application of the *Complete Auto* test, which remains binding on all the courts as long as the U.S. Supreme Court does not abandon it, is found in state court decisions. The state courts also have difficulty applying the test, with the result that different courts reach different results on similar facts.

V. Current hot Commerce Clause topics involving the property tax

A. Gas and oil "storage" cases. Three recent cases present interesting applications of the *Complete Auto* test. The first two reach different results on nearly identical facts, while the third could be considered confined to its facts.

In re Assessment of Personal Property Taxes Against Missouri Gas Energy, ___P.3d___, No.103,355, 2008 WL 4648330 (Okla. October 21, 2008), petition for cert. filed, 77 USLW 3670 (May 22, 2009) (08-1458).[1] In *Missouri Gas*, the property at issue was natural gas. The trial court found that the property tax levied against the gas was improper and ordered it refunded together with all accrued interest. The Oklahoma Supreme Court reversed the trial court and upheld the tax.

First some background facts. Missouri Gas Energy ("MGE") is a gas distribution or shipper company whose principal place of business is in Kansas City, Missouri. MGE purchased natural gas from suppliers in Texas, Kansas and Oklahoma and contracted with Panhandle Eastern Pipeline Company ("Panhandle"), an interstate common carrier of natural gas, for transportation of the gas to the state of Missouri. MGE sold *no gas whatsoever* in Oklahoma.

Multiple shippers such as MGE used Panhandle's pipeline system at the same time and their gas was commingled. In addition to transportation services, Panhandle also offered storage services with one such facility located in Woods County, Oklahoma. But like transportation in the pipeline, all gas in storage was commingled and incapable of being traced to a particular shipper. While Panhandle took possession of gas placed into its pipeline and controlled its movement, including the determination of which facility would receive storage gas, Panhandle never acquired title to the gas – which at all times remained with the shipper.

After resolution of some state-law issues, primarily that MGE did own some portion of gas and not merely an intangible right, the Oklahoma Supreme Court addressed the question of whether any natural gas acquired a situs in Oklahoma, specifically Woods County. MGE argued that because the gas was in interstate commerce it did not have any tax situs in Oklahoma under federal law.

Whether property has a tax situs in a particular state is a question of due process and is separate from the question of whether a tax discriminates as to interstate commerce. While the Due Process Clause and the Commerce Clause operate in tandem to maintain and advance the idea of a national and international economy, the analytical framework for determining conformity to the two provisions is not identical.

[1]On October 5, 2009, the Supreme Court issued an Order requesting the Solicitor General of the United States to file a brief regarding Missouri Gas' petition.

Both provisions require that there be a nexus between the property to be taxed and the taxing state – but under the Due Process Clause that requirement is minimal; under the Commerce Clause it is substantial.

The Oklahoma Supreme Court found that despite the parties' intention that MGE's stored natural gas would ultimately be delivered to Missouri, its "sojourn in storage" in Oklahoma gave it at least a minimal nexus to Oklahoma sufficient to establish situs and survive a due process attack. The Court pointed out that the stored volumes of gas received the continuous protection, benefits and opportunities afforded by the state and county throughout the tax year and even if the gas was "in transit" in interstate commerce for federal regulatory purposes, it had a presence in Oklahoma sufficient to satisfy due process.

The Court next turned to the Commerce Clause question and started by setting out *Complete Auto*'s four-part test: a tax survives a Commerce Clause challenge if it (1) is applied to an activity with a substantial nexus with the taxing state; (2) it is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to services provided by the state. The Court also noted that the United States Supreme Court has never addressed whether the *Complete Auto* test applies to an ad valorem tax on goods in the process of being transported in interstate commerce.[2]

Reasoning that some amount of gas is always in storage in Oklahoma, the Court found the nexus substantial enough to meet the first test. MGE argued that a Federal Energy Regulatory Commission ("FERC") regulation defining transportation as necessarily requiring storage means that constructively there is no storage. The Court summarily rejected the argument and merely set out the text of the regulation. The second and third tests were held met without much analysis. Finally, as to the fourth test, MGE argued that it had no offices or employees in Oklahoma and moreover the risk of loss of the gas from a catastrophic event is on the pipeline, not the stored gas, thus MGE receives no benefit from fire or police protection. The Court dismissed the argument and found the test met by simply stating that the property receives the "advantages of a civilized society," without explanation as to what those advantages are.

Peoples Gas, Light & Coke Co. v. Harrison Central Appraisal Dist., 270 S.W.2d 208 (Tex. App. – Texarkana 2009, pet. filed January 21, 2009). In *Peoples*, the property was, again, natural gas. The trial court upheld the tax. The court of appeals reversed the trial court and found the tax did not satisfy the first and fourth tests of *Complete Auto*. The case is now pending at the Texas Supreme Court.

The pipeline involved in *Peoples* was operated by Natural Gas Pipeline Company of America ("NGPCA"). Like MGE, Peoples is a distribution company. And like the pipeline in *Missouri Gas*, the *Peoples* pipeline is FERC regulated. Importantly, NGPCA paid ad valorem taxes on "cushion gas," the amount of gas that must remain in the storage facility to provide necessary pressure and balance to facilitate the safe, efficient operation of the pipeline.[3] The remaining facts addressed as to *Missouri Gas* are nearly identical to those in *Peoples*.

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[2] With the Court's recent request for briefing from the Solicitor General, it looks increasingly likely it will now. *See supra* note 1.

[3] It is not clear from the opinion in *Missouri Gas* if Pipeline paid taxes on cushion gas. Counsel for MGE informed an author of this paper that in fact Pipeline did pay on cushion gas.

Peoples like *Missouri Gas* holds that its respective state law requires a finding that Peoples does in fact own an allocation of the natural gas "for tax purposes."

Peoples, however, finds the tax impermissibly discriminates on interstate commerce and thus violates the Commerce Clause. The Court first discussed at length whether the gas was actually in interstate commerce and concluded that gas in the pipeline was without question in interstate commerce. The "critical question" was whether gas in storage was also in interstate commerce.

The Court looked at both Texas state and federal case law to determine what type of breaks in the continuity of transport of a good cause it to be deemed no longer in transit and thus not in interstate commerce. Declaring that if the stoppage is necessary for the safety and convenience of the goods (rather than some business purpose of the owner) that continuity of transit is not broken, the Court found that Peoples gas' storage was an integral and necessary part of its transportation and thus even the stored gas was in interstate commerce.

The Court next analyzed the *Complete Auto* test and found the first and fourth tests lacking. As to the first or nexus test, like MGE, Peoples maintained no office in the state, had no employees in the state, and owned no facilities in the state. Further, there was no evidence that any of the natural gas Peoples purchased was delivered to any customer in the state. Thus, the Court found there was an "insufficient nexus between Texas and the entity, property, or transaction to be taxed."

Without discussing *Commonwealth Edison*, the Court also found the fourth test was failed. As to the fourth test, Peoples made essentially the same argument as MGE, yet the *Peoples* Court agreed and found that the measure of the tax was insufficiently related to Peoples' presence in Texas as well services provided in Texas.

Midland Central Appraisal Dist. v. BP America Production Co., 282 S.W.3d 215 (Tex. App. – Eastland, pet. filed May 20, 2009). In *BP America*, the product was crude oil. The trial court found the tax invalid, as did the court of appeals. The case, along with *Peoples*, is now pending at the Texas Supreme Court.

The issue in this case was whether an ad valorem tax could be imposed on crude oil located in Midland County, Texas, in a tank farm.

The oil at issue in the case was produced mostly in west Texas and a small amount in eastern New Mexico and was injected into the Midland Pipeline System, a configuration of interconnecting pipelines covering more than two dozen counties in west Texas and eastern New Mexico. The Midland Pipeline System is an interstate common carrier pipeline regulated by FERC.

The oil in the tank farm arrived and exited via the Midland Pipeline system and the time from entry into a tank to exit from a tank was only six to seventy-two hours. A certain amount of cushion oil was required for safety reasons and to meet emission standards.[4]

The Court described the tanks as essentially part of the pipeline itself and that a tank should be considered simply "as a pipe of larger size."

Distinguishing the *Missouri Gas* case the Court held: "We find at least one crucial fact of the *Missouri Gas* to be distinguishable from the facts of the present case. The crude oil in the present case was not in storage but, rather, was in transit in the stream of interstate commerce. For this same reason, the case at hand presents an even stronger case for a Commerce Clause violation than did the circumstances in *Peoples*."

So persuaded that the oil was never stored but merely in transit, the Court proceeds to a summary analysis of the *Complete Auto* test and finds the first test lacking: "Although the oil itself had a substantial nexus with this state and some of it was destined for an in-state refinery, the 'activity' being taxed had no such nexus."

B. Tax incentives. Another issue concerning taxes and the Commerce Clause is tax incentives. Perhaps indicating a desire to not revisit established jurisprudence, several years ago the United States Supreme Court refused to consider the merits of an alleged Commerce Clause violation as to franchise and property tax incentives granted to DaimlerChrysler Corporation by the state of Ohio and the city of Toledo. *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332 (2006). City and state taxpayers brought an action in Ohio state court challenging local property tax abatements and investment tax credits granted to DaimlerChrysler. The case was removed to federal court, and the district court dismissed the case for failure to state a claim. The United States Court of Appeals for the Sixth Circuit reversed and held on the merits that the state franchise tax credit violated the Commerce Clause. The United States Supreme Court in a near-unanimous opinion (seven Justices joined Chief Justice Roberts' opinion; Justice Ginsburg concurred, in part) refused to reach the merits of the Commerce Clause violation, holding that the plaintiffs lacked standing.

Rejecting the argument that as taxpayers the plaintiffs have an interest and hypothetical injury as to the funds available to the state and thus the burdens on plaintiffs as taxpayers, the Court held that state taxpayers have no standing under Article III of the Constitution (the Judiciary Article) to challenge state tax or spending decisions simply by virtue of their status as taxpayers.

Plaintiffs additionally argued that an exception to the general prohibition on taxpayer standing should exist for Commerce Clause challenges to state tax or spending decisions. The Court rejected the plaintiffs' attempt to shoe-horn an alleged Commerce Clause violation into an exception granted for First Amendment Establishment Clause violations, noting that "such a broad application of [the Establishment Clause violation] exception to the general prohibition on taxpayer standing would be quite at odds with its

[4] The *BP America* case is silent on whether taxes are paid on this cushion. One of the authors, however, has confirmed with a former employee of the District's appraisal firm that in fact such taxes are paid.

narrow application in our precedent and [the exception's] own promise that it would not transform federal courts into forums for taxpayers' 'generalized grievances.'"

C. Other differential treatment. A recent Louisiana court of appeals decision highlights the third test of *Complete Auto*. *Transcontinental Pipe Line Corp. v. Louisiana Tax Commission*, ___So.3d___, Cause Nos. 2009 CA 0628, 2009 CA 0629, 2009 WL 2461597 (LA Ct. App. August 10, 2009). In *Transcontinental Pipe*, the procedural history was complicated, so much so that the Court labeled it a "legal labyrinth." Finding two Louisiana statutory provisions related to ad valorem taxation of gas pipeline companies unconstitutional, the court of appeals reversed in part the trial court's judgment and severed those portions of the statutes it found unconstitutional.

Focusing on the third test of *Complete Auto*, the Court described United States Supreme Court precedent holding that a state tax discriminates against interstate commerce if it (1) is facially discriminatory; (2) has a discriminatory intent; or (3) has the effect of unduly burdening interstate commerce. Moreover, the Court noted that even a nondiscriminatory burden on commerce can be struck down on a showing that the burden clearly outweighs the benefits of a state or local practice.

The Court noted: "When called upon to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual states in exercising their taxing powers, the Supreme Court has advised that the result turns on the unique characteristics of the statute at issue and the particular circumstances in each case. This case-by-case approach has left 'much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'"

Finding that a statutory provision of classification for ad valorem taxation that taxed some intrastate pipelines at a lower ratio to fair market value than other interstate and intrastate pipelines, the Court determined the provisions were facially discriminatory against interstate commerce. Once such a law is found to be discriminatory, the burden falls on the state to demonstrate the statute serves a legitimate local purpose that cannot be achieved in a less discriminatory way. The burden is nearly insurmountable: "This is an extremely difficult burden placed on taxing authorities, so heavy that facial discrimination by itself may be a fatal defect. 'Once a state tax is found to discriminate against out-of-state commerce, it is typically struck down without further inquiry.'"

ROBERT S. GOLDMAN, CMI, ESQ., is a Partner with the Tallahassee, Florida law firm of Madsen Goldman & Holcomb, LLP. He has practiced in the state and local tax field since 1977, representing clients in all phases of state and local tax matters, in disciplines that include the property tax, sales tax, corporate income tax, and communications services tax. He assists clients in audits, protests, negotiation, litigation, legislation, and tax planning. In 1996, Mr. Goldman was appointed by Governor Lawton Chiles to the Florida Telecommunications Taxation Task Force. In the year 2000 he participated in the nation's first major legislative reform of state and local taxes on telecommunication services, resulting in legislation consolidating and simplifying Florida's multiple levies. In 2009 he participated in writing Florida's revision of the State's property tax remedy law. He has also chaired various tax committees of the Florida Bar. Mr. Goldman served from 1990-1993 as a member of the IPT Board of Governors, and represented IPT as a member of the Steering Committee of the NTA Communications and Electronic Commerce Tax Project. He has written and lectured extensively in the state and local tax area and has been an instructor at IPT Sales and Use Tax Schools since 1987. He has also served as Overall Chair of Sales Tax Education for IPT, and as Chair of the Institute's Professional Designation - Sales Tax Committee.

DAVID M. HUGIN, ESQ., leads the litigation and appellate practices at Popp, Gray & Hutcheson, LLP in Austin, Texas, and serves as in-house General Counsel to the firm. After law school, Mr. Hugin clerked for the Honorable John Cornyn, Justice, Supreme Court of Texas, and then joined Carrington Coleman Sloman & Blumenthal, LLP in Dallas. After Justice Cornyn became Texas Attorney General, Mr. Hugin returned to public service (1999-2000) as an Assistant Attorney General. He, then, joined Winstead Sechrest & Minick P.C. in its Austin office where he later became a Shareholder. His practice at Winstead consisted of a variety of complex administrative and commercial litigation matters, including property tax. Mr. Hugin serves as a member of the Editorial Board of the State Bar of Texas' Appellate Advocate. He is a member of the Austin and Dallas Bar Associations, as well as the American Bar Association and its litigation section. He is licensed to practice in all state and federal district courts in Texas, as well as the United States Court of Appeals for the Fifth Circuit. Mr. Hugin received his BA from the University of Texas, cum laude, in 1990 and his JD from the University of Texas School of Law in 1993, where he was an associate editor of the Texas Law Review.