The Commerce Clause and Municipal Taxation

Article I of the United States Constitution provides that: "Congress shall have the power to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."

Interstate commerce embodies any business which operates between two or more states. Individual states may not impede the flow of commerce from other states. The Commerce Clause prevents states from blocking channels of free trade, and, thus, impairing the national market. However, does state or local taxation of interstate commerce block free trade?

The U.S. Supreme Court has been asked to rule on this question several times, with various results. The Court has called its own decisions on state taxation of interstate commerce a "quagmire," and Justice Scalia has declared that in the years since the Commerce Clause was first applied in this area, the Court's applications of the doctrine have "made no sense."

Thus, this is a very confusing area of law, one in which even the courts often reach conflicting conclusions. Therefore, the League urges municipal officials and employees to proceed carefully in areas that involve interstate commerce questions.

This article explores the development of the Commerce Clause in the area of state taxation and examines the future ramifications of recent court decisions on the tax revenues of local governments.

History

In interpreting state taxation of interstate trade, the U.S. Supreme Court has expressed concerns in two areas: first, the Commerce Clause, which mandates that states not interfere with interstate commerce; and second, restrictions on personal jurisdiction imposed by the Due Process Clause.

The Court's decisions have tended to follow trade developments. In the early history of our country, only rare products were not produced locally. Markets were local and state regulations had little impact on commerce between the states.

In the 1800's, though, the market shifted. People began congregating more in cities and towns than in widespread rural areas. Transportation improved, and more goods were produced for a national market. During this time, the Court struck down many state regulations on Commerce Clause grounds to protect the fledgling economy and to encourage growth. These rulings placed the power to regulate this national commerce solely in the hands of Congress. Justice Harlan Stone has said that the Court's interpretation of the Commerce Clause, more than perhaps any other single element, bound the states into a nation.

Commerce Clause opinions during the 19th century illustrate some of the central concerns that the justices had in trying to establish the proper role of the state and federal governments. The Court sought to preserve the territorial integrity of the states, while simultaneously acknowledging Congress' power under the Constitution to regulate interstate commerce. Industries challenged many state laws during this period and succeeded in establishing a federal right that only Congress can regulate interstate trade.

One of the results was a ban on local taxation of interstate businesses. Thus, in the early 1800's, the Court felt that states should not tax interstate commerce.

The late 1800's, though, witnessed a shift. The Court continued to prohibit direct taxation but allowed indirect taxation. The Court held that each sovereign is supreme within its sphere of influence. A state can exercise its police power, leaving Congress to regulate the commercial aspects of interstate commerce. If a state law operated extraterritorially or unreasonably and burdened the introduction of non-domestic products into a state, the court treated the law as a direct regulation of interstate commerce and a violation of the commerce clause. When the state's exercise of police power was not aimed at interstate commerce but was instead a police power action and the means of regulation merely affected interstate commerce, the state was free to regulate unless preempted by Congress.

Over time, courts began to feel that interstate commerce merchants, who took advantage of changing technology in both delivery of goods and marketing to reach a broader audience for their products, should share in the costs of providing local services, provided that the tax in question did not constitute a burden on interstate commerce.

What is a "Burden?"

A tax on an interstate business cannot amount to a **"burden on interstate commerce."** Each situation must be examined on its own circumstances to determine if a tax or license on any particular business constitutes such a burden. Further, each situation must be looked at in light of recent legislative action. Some cities have most of their license fees set on a gross receipts basis while others charge flat amounts for their license each year. Some cases indicate that flat-rate license taxes run the risk of burdening interstate commerce. *See*, i.e, *West Point Wholesale Grocery Co. v. City of Opelika, Ala.,* 354 U.S. 390 (1957).

For instance, representatives of door-to-door firms regularly solicit business within municipalities and then deliver the products. These companies sometimes refuse to buy a license claiming immunity from the license because they are engaged in interstate commerce. Can a municipality levy and collect a license on this type of activity?

If this city has based its license on a percentage of the gross business, then case law seems to hold that the company would be liable for the license. In *Armstrong v. Tampa*, 118 So.2d 195 (Fla. 1960), a representative of the Avon Company refused to pay the license tax. The court upheld the graduated license on the representative but held that the flat sum license would be invalid as applied to this interstate business activity.

Bellas Hess

Fifty years ago, in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), the United States Supreme Court examined whether states may impose collection duties on remote mail order retailers, and held that this would violate both the Due Process and Commerce Clauses of the U.S. Constitution. *Bellas Hess* was the first major salvo in what has become a multi-pronged and lengthy battle over what constitutes nexus between remote sellers and state and local governments.

In *Bellas Hess*, Bellas Hess, a mail-order company incorporated in Delaware and headquartered in Missouri, was required by the state of Illinois to collect and remit use taxes. The company had no stores, agents, property or telephone numbers in Illinois. Its contacts with Illinois residents consisted of mailing two catalogues each year to past and potential customers, supplemented by occasional flyers. Bellas Hess accepted orders by mail and shipped goods by mail or common carrier. Bellas Hess challenged the use tax requirement on both Commerce Clause and Due Process grounds.

The Court stated that state taxation on interstate businesses is justified only where the tax is necessary to make the commerce bear its fair share of the cost of the government whose protection it enjoys. The Court said that due process requires that the state demonstrate that it has given benefits to the business which justify the tax. The Court found that retailers with stores, solicitors or property within a state received protection and services from the state, while retailers relying solely on mail-order business did not. The Court felt that if the use tax was upheld, every other state would impose similar requirements on mail-order businesses, which would unjustifiably entangle mail-order businesses in an administrative nightmare.

In this case, the Court ignored the nature and depth of the retailer's contacts with the taxing state. Instead, the Court conditioned nexus upon a finding that the retailer was physically present in the state. This bright-line rule, first articulated in this case, continues as the rule today, although there have been many, many re-interpretations by courts, legislative bodies, and regulators.

Post *Bellas-Hess* Cases

In *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), California sought to impose use tax collection duties on the National Geographic Society. The society sold items to California residents from its offices in Washington, D.C. It had no retail outlets in California. However, the society maintained two offices in California to solicit advertising for its magazine. The Court held that these offices constituted a physical presence in the state which justified imposing the use tax on the mail order business. This decision means that a retailer's physical presence does not have to relate to the portion of business which the state seeks to tax.

In 1977, the Court issued its ruling in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). In this case, a transportation services dealer sued over a Mississippi requirement that he collect taxes from his customers. The Court overturned its previous decisions and allowed the state tax to stand. The Court established a four-part test to determine when a state tax is permissible. A state tax will be sustained if:

a. the tax is applied to an activity with a substantial nexus with the taxing state;

b. the tax is fairly apportioned;

c. the tax does not discriminate against interstate commerce; and

d. the tax is fairly related to some service the state provides.

This test was applied in *T-Mobile South, LLC v. Bonet*, 85 So.3d 963 (Ala.2011), where the Court found that an Emergency 911 service charge applies to prepaid wireless telephone services. The fee did not violate any of the elements of this test. The Court stated that:

> "The charge is based upon activity that has a substantial nexus to the State of Alabama in that the customers to whom this charge applies have a primary use in the state. [T-Mobile] has the capacity to ascertain the place of primary use of [its] prepaid wireless customers, and [its] intentional failure to obtain this information cannot relieve [it] of [its] obligation to determine those addresses. The Charge is fairly apportioned because it applies across the board to the beneficiaries of the services which the Charge funds. By limiting its application to customers with a primary use address in Alabama, the Act does not discriminate against interstate commerce and fairly relates to the benefits provided the customer."

The *Complete Auto* test remains the standard today. Courts continue to find that interstate commerce must pay a fair share of local taxes. However, taxes and licenses applied to interstate businesses must not constitute a burden. In determining whether a tax meets this test, it is important to understand each of these four elements.

***Complete Auto* Element One: What is Nexus?**

Webster defines "nexus" as a connection, a tie or a link. For taxation purposes, legally speaking, nexus is some activity, relationship or connection which is necessary to subject a person, business or corporation to a jurisdiction's taxing powers. In other words, there must be a sufficient connection between the business involved and the taxing jurisdiction for a tax to be applied. Physical presence is generally necessary to satisfy nexus requirements under the Interstate Commerce Clause. (Note that nexus for "intrastate" transactions (those that occur completely in Alabama) is treated differently. This concept is discussed further in the article on sales and use taxation in the *Selected Readings for the Municipal Official*.). Case law and legislative efforts to statutorily define nexus have made this a frequent topic of discussion among local revenue administrators.

Interstate commerce cases generally arise from two types of taxes: true sales and use taxes and license taxes.

Business licenses are imposed on businesses of the privilege of selling their goods to local citizens. Section 11-51-90 authorizes all municipalities to collect license taxes on business that is transacted within the municipality and police jurisdiction. These fees are collected from the business itself for the privilege of doing business within the municipality. License fees are generally based on either a flat rate or on the gross receipts of the company. In Alabama, licenses may be assessed on businesses which operate in interstate commerce only to the extent of the business which is transacted within the limits of the state and where the business has an office or transacts business in the city or town imposing the license.

The true sales and use tax is a consumer tax; that is, although the seller collects this tax, he or she serves only as an agent for the taxing jurisdiction. The purchaser is the ultimate taxpayer. The use tax is on tangible personal property which was purchased outside the jurisdiction for use or consumption within the jurisdiction. Interstate Commerce Clause cases frequently challenge whether a jurisdiction can require an out-of-state seller to collect a use tax.

In the sales and use tax context, pursuant to state law, whether a sales tax is due on a transaction depends upon the passing of title between the buyer and seller. *Hamm v. Continental Gin Co.*, 276 Ala. 611, 165 So.2d 392 (Ala. 1964). Section 40-23-1(5) states that "a transaction shall not be closed or a sale completed until the time and place when and where title is transferred by the seller or seller's agent to the purchaser or purchaser's agent."

Thus, delivery is a pivotal issue for determining where title transfers, but it is not conclusive. The determining factor is the intent of the parties, in whatever means it is revealed.

Sales and use taxes comprise a large portion of most state and local revenues. Most economists feel these taxes will increase as states are forced to assume responsibility for more federal programs. Budget shortfalls have made state and local governments increasingly aggressive in enforcement of these taxes.

State laws require retailers to collect sales and use taxes from consumers and remit these amounts to the government. Retailers remain liable for any uncollected taxes. State collection requirements have resulted in challenges based on the interstate Commerce Clause.

In the case of both sales and use taxes and license taxes, courts have focused on the nature of contacts the retailer has with the state. Clearly, physical presence is enough to enable the state to require collection of the taxes. Closer questions arise where the contact is more limited.

In the interstate commerce area, "the 'substantial–nexus' requirement . . . limit[s] the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." *See*, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Nexus can only be determined by examining all possible connections the taxpayer has with the taxing jurisdiction. This can only be determined on a case-by-case basis because these factors vary in each individual situation. However, generally speaking for interstate commerce purposes, only a minimal contact is necessary.

Factors Indicating Nexus

Cases have indicated a number of factors relevant to the issue of nexus. For instance, maintaining a legal domicile or principle place of business generally subjects the business to tax liability. Other factors include making deliveries into the jurisdiction, advertising, employing local individuals, maintaining or using a facility, rendering services, taking advantage of the economic benefits of locating near the jurisdiction, and soliciting orders. However, in the case of soliciting orders, 15 U.S.C. Section 381 et seq., prohibits a state or local government from assessing any net income-based tax on an interstate business if the only contact between the business and the taxing jurisdiction is the employment of a representative to solicit orders which are filled and shipped from a point outside the state. Even in this situation, though, every decision about accepting or rejecting the order must be made outside the state in order to defeat a finding of nexus.

An example might help clarify the issue of nexus. In *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987), the State of Washington imposed a business and occupational tax on businesses which operated within the state. The measure of this tax, a wholesale tax, was based upon the gross proceeds of the company's sales within Washington. The U.S. Supreme Court found that sufficient nexus existed to justify imposing the tax against Tyler Pipe, even though the only connection between Tyler Pipe and Washington was hiring an independent contractor to solicit orders within the state. Tyler Pipe maintained no offices in Washington, owned no property, and had no employees within the state, even though it sold large amounts of cast iron and other products within the state. The Court pointed out that the sales representative Tyler Pipe hired acted daily on behalf of the company, calling on customers and soliciting orders. In addition to the goodwill established by the representative, he also kept the company informed on all aspects of their business within Washington, and kept Tyler Pipe up-to-date about the market for its products within the state. Because of the substantial activities of the representative, the Court found sufficient nexus to uphold imposing the tax.

In attempting to define nexus legislatively, in 2003 the Alabama legislature adopted Section 40-23-190, Code of Alabama 1975. The purpose of this legislation is to establish the conditions under which an affiliation between an out-of-state business and an in-state business creates remote entity nexus with Alabama to require the business to collect and remit state and local use tax. Remote entity nexus is established and an out-of-state business to collect and remit state and local use tax if the out-of-state business and the in-state business maintaining one or more locations within Alabama are related parties; and one or more of the following conditions is met:

- The out-of-state business and the in-state business use an identical or substantially similar name, trade name, trademark, or goodwill, to develop, promote, or maintain sales, or
- The out-of-state business and the in-state business pay for each other's services in whole or in part contingent upon the volume or value of sales, or
- The out-of-state business and the in-state business share a common business plan or substantially coordinate their business plans, or
- The in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market.
- An out-of-state business and an in-state business are related parties if one of the entities meets at least one of the following tests with respect to the other entity:
- One or both entities is a corporation, and one entity and any party related to that entity in a manner that would require an attribution of stock from the corporation under the attribution rules of Section 3l8 of the IRC owns directly, indirectly, beneficially, or constructively at least 50 percent of the value of the corporation's outstanding stock; or
- One or both entities is a limited liability company, partnership, estate, or trust and any member, partner or beneficiary, and the limited liability company, partnership, estate, or trust and its members, partners or beneficiaries own directly, indirectly, beneficially, or constructively, in the aggregate, at least 50 percent of the profits, or capital, or stock, or value of the other entity or both entities; or
- An individual stockholder and the members of the stockholder's family, as defined in Section 318 of the IRC, owns directly, indirectly, beneficially, or constructively, in the aggregate, at least 50 percent of the value of both entities' outstanding stock.

***Complete Auto* Element Two: Fair Apportionment**

The apportionment element of the *Complete Auto* test is concerned with the avoidance of applying multiple taxes to a single interstate transaction. State and local governments cannot exact from interstate commerce more than a fair share of the tax associated with the transaction. This part of the test looks to the structure of the tax to see whether its identical application

by every State would place interstate commerce at a disadvantage as compared with intrastate commerce.

M & Associates v. City of Irondale, 723 So.2d 592 (Ala. 1998), provides an Alabama example of the application of the "fairly apportioned" standard. In this case, M & Associates was an Alabama corporation, headquartered in Irondale. The company sold electrical supplies from its Irondale facility as well as from facilities in Mobile, Georgia, Tennessee, Mississippi and Louisiana. The company used a central billing system in Irondale; all gross receipts were transmitted to its headquarters in Irondale. The city sought to assess a gross receipts license against M & Associates' entire interstate business; that is, the city based the business's gross receipts upon its total sales, even where those sales had no connection to Alabama other than the bookkeeping.

The Alabama Supreme Court evaluated this taxing scheme using the four part test set out by the U.S. Supreme Court in *Complete Auto Transit, Inc. v. Brady*, discussed above.

In *M & Associates*, the court was particularly concerned with whether the local tax was fairly apportioned. The court quoted the U.S. Supreme Court, stating that:

> "[W]e are mindful that the central purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction. But 'we have long held that the Constitution imposes no single [apportionment] formula on the States,' and therefore have declined to undertake the essentially legislative task of establishing a 'single constitutionally mandated method of taxation.' Instead, we determine whether a tax is fairly apportioned by examining whether it is internally and externally consistent. . . .To be internally consistent, a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result." *Goldberg v. Sweet*, 488 U.S. 252 (1989). (Citations omitted.)

To be externally consistent, the local government must demonstrate that it has taxed only that portion of the revenues from the interstate activity which reasonably reflects the local component of the activity that is being taxed. *Goldberg v. Sweet*, 488 U.S. 252 (1989).

The court also cited *Gwin, White & Prince v. Henneford*, 305 U.S. 434 (1939), where the U.S. Supreme Court struck down a Washington state statute that assessed a gross receipts privilege tax against a business which marketed fruit shipped from Washington to different places around the country and the world. The State of Washington included in gross receipts even transactions where the fruit was shipped to a location outside Washington, then sold outside the state. The U.S. Supreme Court held that imposition of the state tax violated the federal commerce clause.

Similarly, the Alabama Supreme Court held that the ordinance in *M & Associates* was not internally consistent. The court stated that "if local governments in other states in which M & Associates does business . . . were to impose license taxes based on gross receipts from sales made within their respective jurisdictions, then multiple state taxation of interstate commerce would result. . . .[I]f M & Associates were to sell a certain piece of electrical equipment from its facility in Marietta, Georgia, that one sale would be subject to taxation in both Georgia and Alabama." Thus, the court held that the ordinance was not fairly apportioned because a single transaction could result in two taxes by separate jurisdictions. It is irrelevant whether other jurisdictions actually apply a tax—the only question is whether the transaction may be reasonably subject to application of a gross receipts tax by another jurisdiction.

The court did, however, specifically uphold its decision in *City of Tuscaloosa v. Tuscaloosa Vending Co*., 545 So.2d 13 (Ala. 1989), where the court stated that a city can impose on businesses located inside the corporate limits or police jurisdiction a gross receipts fee that includes transactions from that facility, whether the sale was inside the corporate limits or beyond. Thus, it would be permissible for a municipality to include in the license fee of a business located in the municipality or police jurisdiction any intrastate sales from that location. The court declined to address whether Irondale could include the receipts from M & Associates' Mobile location when computing the company's license fee. The question remains, though, can a municipality include the gross receipts from interstate sales by businesses located in the police jurisdiction or corporate limits? In the League's opinion, the answer is a qualified yes.

Once the court determined that municipalities have the right to include in the license fee the gross receipts of transactions which occur beyond the municipal corporate limits, the issue returns to the court's earlier analysis; that is, does the imposition of the tax satisfy the four-prong test of *Complete Auto*? Simply stating that the sale occurs in interstate commerce isn't enough to exempt the sale from municipal gross receipts taxation. Remember that a tax is not fairly apportioned only if another state could impose the same type tax on the same transaction. In many cases, this can't happen because the other state cannot obtain sufficient nexus to assess the gross receipts tax.

Perhaps an example would help illustrate this point. Look again at the situation in *Tuscaloosa Vending*: a business physically located within a municipality's taxing jurisdiction ships goods throughout the country. It receives orders at the Tuscaloosa site and ships from that location. In this situation, it is clear that Tuscaloosa is the only jurisdiction so closely aligned with the transaction that it can levy a license tax. If the goods are shipped to Atlanta, Georgia, Atlanta's only connection to the

transaction is the delivery. It would not have sufficient nexus with the business to assess a gross receipts tax against it.

M & Associates is frequently cited for the proposition that it requires municipalities to exclude gross receipts of interstate transactions from the computation of a local business's license fee. In the League's opinion, this is not the case. Only where the gross receipts of the same transaction can be taxed both by an Alabama municipality and a municipality in another state does *M & Associates* prohibit including the gross receipts of interstate sales. In other words, each jurisdiction may only tax the taxable portion of the transaction that occurs in its jurisdiction.

Oklahoma Tax Com'n v. Jefferson Lines, Inc., 514 U.S. 175 (1995), is another case that involved the internal/external consistency prong of the *Complete Auto* test. Jefferson Lines, Inc., a common carrier, did not collect or remit to Oklahoma the state sales tax on bus tickets sold in Oklahoma for interstate travel originating there, although it did so for tickets sold for intrastate travel. The Court found no failure of consistency in this case, because if every state imposed a tax identical to Oklahoma's—that is, a tax on ticket sales within the state for travel originating there—no sale would be subject to more than one state's tax. Additionally, since Jefferson offered no convincing reasons why the tax failed the external consistency test, the Court found that Oklahoma's sales tax on full price of ticket for bus travel from Oklahoma to another state did not violate dormant commerce clause.

In *Goldberg v. Sweet*, 488 U.S. 252 (1989), Illinois passed an Telecommunications Excise Tax Act which imposed a 5% tax on the gross charges of interstate telecommunications originated or terminated in the State and charged to an Illinois service address, regardless of where the call was billed or paid. The Act also provided a credit to any taxpayer upon proof that another State has taxed the same call and required telecommunications retailers to collect the tax from consumers.

The U.S. Supreme Court found that this tax was fairly apportioned. The Court stated that the tax was internally consistent, since it was structured so that if every state imposed an identical tax on only those interstate phone calls which are charged to an in-state service address, only one State would tax each call. Thus, no multiple taxation would result.

The Court also found that the tax was externally consistent even though the tax was assessed on the gross charges of an interstate activity, since the tax was reasonably limited to the in-state business activity which triggered the taxable event in light of its practical or economic effects on interstate activity. Because it was assessed on the individual consumer, collected by the retailer, and accompanied the retail purchase of an interstate call, the tax's economic effect was like that of a sales tax, and reasonably reflected the way consumers purchased interstate calls, even though the retail purchase simultaneously triggered activity in several States, and was not a purely local event.

Further, the Court found that the risk of multiple taxation was low, since only two types of States—a State like Illinois which taxed interstate calls billed to an in-state address and a State which taxed calls billed or paid in state-have a substantial enough nexus to tax an interstate call. Even though this opened the door to possible multiple taxation, actual multiple taxation was precluded by the Act's credit provision.

And, in *American Trucking Associations, Inc. v. Michigan Public Service Com'n*, 545 U.S. 429 (2005), the U.S. Supreme Court refused to invalidate on Commerce Clause grounds Michigan's flat $100 annual fee imposed on trucks engaged in intrastate commercial hauling. The Court held that the law applied even-handedly to all carriers engaged in intrastate transactions, not just those involved in interstate commerce. Further, the Court seems to have been influenced by the fact that Michigan used this fee to regulate commerce to protect the public, rather than to raise revenue. The Court noted that although this tax did apply to carriers engaged in hauling interstate commerce, and could be subject to numerous taxes by several states, it would be subject to the tax only if it picked up local goods and hauled them within the state, the same as intrastate carriers. *But see*, for comparison purposes, *Boyd Bros. Transp., Inc. v. State Dept. of Revenue,* 976 So.2d 471 (Ala. Civ. App. 2007), where the Alabama Court of Civil Appeals held that a flat-rate two percent use tax on truck tractors that were originally purchased outside Alabama, but later used in Alabama, was not properly apportioned since the tax was not "based upon actual miles traveled in the performance of a contract in Alabama."

***Complete Auto* Element Three: Discrimination**

The third element of the Complete Auto test is that the tax must not discriminate against interstate commerce. This test is designed to prevent taxes which are imposed which provide a commercial advantage to intrastate business. The Court has described the rule as follows:

> "[N]o State, consistent with the Commerce Clause, may "impose a tax which discriminates against interstate commerce . . .by providing a direct commercial advantage to a local business." This antidiscrimination principle "follows inexorably from the basic purpose of the Clause" to prohibit the multiplication of preferential trade areas destructive of the free commerce anticipated by the Constitution. *Maryland v. Louisiana*, 451 U.S. 725 (1981)."

For example, a state excise tax on wholesale liquor sales, which exempted sales of specified local products, was held to violate the Commerce Clause in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984). And, a state statute that granted a

tax credit for ethanol fuel if the ethanol was produced in the State was found discriminatory in *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988).

In *American Trucking Associations v. Scheiner*, 483 U.S. 266 (1987), two Pennsylvania statutes which imposed lump-sum annual taxes on the operation of trucks on Pennsylvania's highways were challenged. One statute required that an identification marker be affixed to every truck over a specified weight, and imposed an annual flat fee ($25) for the marker. The statute exempted trucks registered in Pennsylvania by providing that the marker fee was part of the vehicle registration fee. The second statute imposed a $36 annual axle tax on all trucks over a specified weight using Pennsylvania highways. Again, Pennsylvania vehicles registration fees were reduced to offset the axle tax.

The U.S. Supreme Court found that these taxes violated the Commerce Clause. The Court noted that the Clause prohibits a State from imposing a tax that places a much heavier burden on out-of-state businesses that compete in an interstate market than it imposed on its own residents who also engaged in interstate commerce. The challenged taxes do not pass the "internal consistency" test under which a state tax must be of a kind that, if applied by every jurisdiction, there would be no impermissible interference with free trade because the challenged taxes' inevitable effect is to threaten the free movement of commerce by placing a financial barrier around Pennsylvania. The Court noted that "though 'interstate business must pay its way,' a State, consistently with the Commerce Clause, cannot put a barrier around its borders to bar out trade from other States and thus bring to naught the great constitutional purpose of the fathers in giving to Congress the power 'To regulate Commerce with foreign Nations, and among the several States ... [.]' Nor may the prohibition be accomplished in the guise of taxation which produces the excluding or discriminatory effect."

A similar Alabama tax was found to violate the Commerce Clause in *Sizemore v. Owner-Operator Independent Drivers Ass'n, Inc*., 671 So.2d 674 (Ala. Civ. App. 1995).

A Florida municipality's policy of automatically denying permits for new applicants and automatically renewing permits for existing permit holders discriminated against interstate commerce and violated the dormant Commerce Clause. *Florida Transp. Services, Inc. v. Miami-Dade County*, 703 F.3d 1230 (11th Cir. 2012).

A September, 2002, report of the Research Department of the Minnesota House of Representatives notes several important aspects of the discrimination part of the *Complete Auto* test:

- **"Discrimination is determined by economic effect.** It is not necessary that the state or the legislature intend to discriminate, if the provision has the economic effect of discriminating. However, showing intent to discriminate is relevant; a legislative intent to discriminate is nearly conclusive of the tax's unconstitutionality."
- **"The tax will be invalidated, even if discrimination is minor or seemingly inconsequential.** The Court has rejected arguments that the effect of the discrimination is so minor or *de minimus* that it is not of constitutional stature."
- **"Incentives to encourage local investment or activity may be invalid.** Tax incentives for in-state activity (e.g., investment or exporting) may be invalid, if the net effect is to raise the underlying tax on out-of-state businesses."

See, *Constitutional Restrictions on State Taxation The Prohibition on Discriminating Against Interstate Commerce*, Joel Michael, (http://www.house.leg.state.mn.us/hrd/issinfo/clssintc.pdf - NOTE: This page has been removed and is no longer available on-line.)

***Complete Auto* Element Four: Relation to State Services**

Finally, in order to be valid under the Commerce Clause, a tax must be "fairly related to some service the state provides." This element seems to be fairly easily satisfied, provided that there is sufficient nexus to uphold the tax. The test appears to be whether the business has the requisite nexus with the State or local government. If so, the tax probably meets the fourth element simply because the business has enjoyed the opportunities and protections that the government has provided.

Quill

Twenty-five years after *Bellas Hess*, the Court had the opportunity to reexamine the physical presence requirement in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

In this case, North Dakota required its residents to pay a use tax on personal property brought into the state for storage, use or consumption. All retailers maintaining a place of business in North Dakota were required to collect the tax when the property was sold. For purposes of the North Dakota statutes, distribution of catalogues or advertisement in the state on a regular or systematic basis constituted maintaining a place of business. Regular or systematic solicitation was defined as three or more separate transmissions of any ad during a twelve-month period.

In 1989, North Dakotas' tax commissioner filed suit in North Dakota district court requesting that the Quill Corporation be ordered to pay use taxes, interest and penalties on all sales in North Dakota since July 1, 1987. Quill, a Delaware corporation

with property in Illinois, California, and Georgia, sold office supplies and equipment to North Dakota residents. Quill mailed catalogues and flyers into the state 62 times a year and supplemented these efforts with telephone solicitation. At the time of the lawsuit, Quill was the sixth largest retailer of office supplies in North Dakota. However, its presence in the state was almost purely economic. It owned no real property and very little personal property. It had no representatives, facilities, in-state telephone numbers or bank accounts in North Dakota.

The district court, relying on *Bellas Hess*, rejected the commissioner's request. On appeal, the North Dakota Supreme Court reversed, holding that changes in the mass marketing business and in the legal landscape had reduced *Bellas Hess* to an "obsolescent precedent."

The state supreme court stated that the test applied in personal jurisdiction cases should apply in mail-order taxation cases as well. That is, out-of-state retailers are subject to use tax collection duties if they purposefully direct their activities at a state's residents. The court held that a seller's nexus with a taxing state should be evaluated by analyzing the economic realities present in each case. Thus, the court found a substantial nexus in Quill's intentional solicitation and exploitation of North Dakota residents. The court determined that the company's economic presence was substantial, given its market share, level of advertising and annual gross revenues in North Dakota. The court noted that North Dakota regulated financial institutions Quill utilized to verify customer credit. The state also supplied Quill with a benefit the court deemed extremely important: disposal of Quill's advertising. The court reasoned that Quill profited from advertising and benefited from the annual disposal of an estimated 24 tons of discarded advertisements.

The U.S. Supreme Court reversed, holding that *Bellas Hess* was still good law for the proposition that a retailer must have a physical presence in a state in order to establish a substantial nexus under the Commerce Clause. However, the Court removed one barrier to future taxation of direct marketers: The Court held that a physical presence is not necessary to establish nexus under the Due Process Clause. Under a due process analysis, the Court held that a retailer satisfies the nexus requirement when its connections with a state provide fair warning that it may be subject to the state's jurisdiction.

The Court pointed out that the central concern of due process is the fundamental fairness of governmental activity. The Court stated that developments in the law of due process since *Bellas Hess* had rendered the physical presence requirement unnecessary. Thus, as long as an out-of-state retailer purposefully directs its solicitation toward residents of a taxing state, it doesn't matter whether the solicitation is by catalogue or retail stores.

However, the Court held that the Commerce Clause still requires that a retailer have a physical presence in a state before he or she can be required to collect a state tax. The Commerce Clause is primarily concerned with issues of national unity, the Court said, and only a physical presence can satisfy problems of state regulation on the national economy. This requirement, according to the Court, sets boundaries on the states' authority to impose collection duties, reduces litigation over such imposition and encourages settled expectations and promotes business investment based on those expectations.

In the direct marketing context, though, the Court's decision to remove the due process barrier was important because it opens the door to regulation of the direct marketing business by Congress. The Commerce Clause says that only Congress can regulate interstate commerce. Therefore, Congress has the power to pass a law that less than physical presence will satisfy the Commerce Clause.

Changes in Direct Marketing Since 1967

In the years since *Bellas Hess* and *Quill*, retailers have developed the ability to target customers by lifestyles, life-events, demographics and geographic and previous purchasing characteristics. Orders are no longer taken just through the mail. Retailers now use telemarketers, toll-free numbers, computers, the Internet, FAX machines, interactive television, electronic bulletin boards and e-mail. Technology continues to evolve at a breath-taking pace, leaving courts and legislators scrambling to keep up with developments.

Revenues have grown as well. In 1967, mail order sales totaled $2.4 billion annually. Worldwide, ecommerce sales topped $1 trillion in 2012, according to a 2013 on-line report from eMarketer (http://www.emarketer.com/Article/Ecommerce-Sales-Topped-1-Trillion-First-Time-2012/1009649).

In the United States, ecommerce sales were projected at 349.06 billion dollars in 2015, and are projected to surpass 600 billion dollars in 2019. Some estimates indicate that on-line retail sales account for up to 20 percent or all retail sales in the U.S. If not for the present interpretations of the Commerce Clause, these sales would be subject to taxation, just like intrastate sales. Several bills are currently before Congress that would close this loophole e-retailers currently enjoy, allowing states and localities to require remote sellers to collect the use that is due on these transactions. In 2012, the Alabama Legislature passed Section 40-23-174, Code of Alabama 1975, which requires remote sellers to collect this tax should Congress authorize the collection of a use tax by these remote retailers on these otherwise taxable sales.

Substantial Nexus – Major change in 2018

As previously discussed, physical presence is generally necessary to satisfy nexus requirements under the Interstate Commerce Clause. Case law and legislative efforts to statutorily define nexus have made this a frequent topic of discussion among local revenue administrators. Interstate commerce cases generally arise from two types of taxes: true sales and use taxes and license taxes.

Business licenses are imposed on businesses of the privilege of selling their goods to local citizens. Section 11-51-90 authorizes all municipalities to collect license taxes on business that is transacted within the municipality and police jurisdiction. These fees are collected from the business itself for the privilege of doing business within the municipality. License fees are generally based on either a flat rate or on the gross receipts of the company. In Alabama, licenses may be assessed on businesses which operate in interstate commerce only to the extent of the business which is transacted within the limits of the state and where the business has an office or transacts business in the city or town imposing the license.

The true sales and use tax is a consumer tax; that is, although the seller collects this tax, he or she serves only as an agent for the taxing jurisdiction. The purchaser is the ultimate taxpayer. The use tax is on tangible personal property which was purchased outside the jurisdiction for use or consumption within the jurisdiction. Interstate Commerce Clause cases frequently challenge whether a jurisdiction can require an out-of-state seller to collect a use tax.

In the sales and use tax context, pursuant to state law, whether a sales tax is due on a transaction depends upon the passing of title between the buyer and seller. Hamm v. Continental Gin Co., 276 Ala. 611, 165 So.2d 392 (Ala. 1964). Section 40-23-1(5) states that "a transaction shall not be closed, or a sale completed until the time and place when and where title is transferred by the seller or seller's agent to the purchaser or purchaser's agent."

Thus, delivery is a pivotal issue for determining where title transfers, but it is not conclusive. The determining factor is the intent of the parties, in whatever means it is revealed. Sales and use taxes comprise a large portion of most state and local revenues. Most economists feel these taxes will increase as states are forced to assume responsibility for more federal programs. Budget shortfalls have made state and local governments increasingly aggressive in enforcement of these taxes.

State laws require retailers to collect sales and use taxes from consumers and remit these amounts to the government. Retailers remain liable for any uncollected taxes. State collection requirements have resulted in challenges based on the interstate Commerce Clause. In the case of both sales and use taxes and license taxes, courts have focused on the nature of contacts the retailer has with the state. Clearly, physical presence is enough to enable the state to require collection of the taxes. Closer questions arise where the contact is more limited.

In the interstate commerce area, "the 'substantial–nexus' requirement . . . limit[s] the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." See, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Nexus can only be determined by examining all possible connections the taxpayer has with the taxing jurisdiction. This can only be determined on a case-by-case basis because these factors vary in each individual situation. However, generally speaking for interstate commerce purposes, only a minimal contact is necessary.

By giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes, *Quill 's* physical presence rule limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field.

***Wayfair* Physical Presence Is Not Necessary for Substantial Nexus**

In *South Dakota v. Wayfair, Inc.,* 138 S.Ct 2080 (2018), the United States Supreme Court overruled the longstanding rule that a state cannot require an out-of-state seller with no physical presence in the state to collect and remit sales taxes on goods the seller sells and ships to consumers in the state. The case dealt specifically with a South Dakota statute requiring internet sellers with no physical presence in the state to collect and remit sales tax applied to activities with a substantial nexus with the State, as required to satisfy the Commerce Clause. U.S.C.A. Const. Art. 1, § 8, cl. 3; SDCL § 10–64–2.

The court held that an out-of-state seller's physical presence in taxing state is not necessary for state to require seller to collect and remit its sales tax, overruling *Quill Corp. v. North Dakota By and Through Heitkamp*, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91; *National Bellas Hess, Inc. v. Department of Revenue of State of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505. The Court reasoned that although physical presence " 'frequently will enhance' " a business' connection with a State, " 'it is an inescapable fact of modern commercial life that a substantial amount of business is transacted ... [with no] need for physical presence within a State in which business is conducted.' " *Quill,* 504 U.S., at 308, 112 S.Ct. 1904.

Further, the requirement that a state tax on interstate commerce must apply to an activity with a substantial nexus with the taxing State is established when the taxpayer or collector avails itself of the substantial privilege of carrying on business in that jurisdiction. U.S.C.A. Const. Art. 1, § 8, cl. 3.

In a 5-4 decision, the Court concluded that Wayfair's "economic and virtual contacts" with South Dakota were enough to

create a "substantial nexus" with the state allowing it to require collection and remittance. Before state and local governments rush to start requiring collection of sales taxes it's important to understand that although *Wayfair* overturned long standing precedent, it is not without Commerce Clause limitations. In 1977 in *Complete Auto Transit v. Brady* the Supreme Court held that interstate taxes may only apply to an activity with a "substantial nexus" with the taxing State in order to be constitutional. So while physical presence is no longer required, the "substantial nexus" requirement remains. In *Wayfair*, the Court found a "substantial nexus" because in its view a business could not do $100,000 worth of sales or 200 separate transactions in South Dakota "unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."

The Court acknowledged that questions remain about whether other commerce clause principals might invalidate" South Dakota's law. Ideally, the Court would have said that South Dakota's law is constitutional in every respect and that if a state passes a law exactly like South Dakota's it will pass constitutional muster; But it didn't do that. Instead, the Court cited to three features of South Dakota's tax system that "appear designed to prevent discrimination against or undue burdens upon interstate commerce. First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively. Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement."

Simplified Sellers Use Tax (SSUT) Information for Local Governments

The "Simplified Sellers Use Tax Remittance Act", codified at Sections 40-23-191 to 199.3, Code of Alabama 1975, allows "eligible sellers" to participate in a program to collect, report and remit a flat 8 percent Simplified Sellers Use Tax (SSUT) on sales made into Alabama. An "eligible seller" is one that sells tangible personal property or a service into Alabama from an inventory or location outside the state and who has no physical presence and is not otherwise required by law to collect tax on sales made into the state. The term also includes "marketplace facilitators" as defined in Section 40-23-199.2(a)(3), Code of Alabama 1975, for all sales made through the marketplace facilitator's marketplace by or on behalf of a marketplace seller.

The proceeds from the SSUT 8 percent tax are distributed as follows:

- 50% is deposited to the State Treasury and allocated 75 percent to the General Fund and 25% to the Education Trust Fund.
- The remaining 50% shall be distributed 60% to each municipality in the state on the basis of the ratio of the population of each municipality to the total population of all municipalities in the state as determined in the most recent federal census prior to distribution and the remaining 40% to each county in the state on the basis of the ratio of the population of each county to the total population of all counties in the state as determined in the most recent federal census prior to distribution.

The department of revenue will provide a list of SSUT account holders on the website disclosing the start and cease date of participants in the program, as applicable. This list is provided so that the local governments are aware of the taxpayers who fall under the protection of the SSUT Act.

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