COMMONWEALTH OF MASSACHUSETTS
SUPREME JUDICIAL COURT

Suffolk, ss: No. SJC - 10105

CAPITAL ONE BANK and
CAPITAL ONE F.S.B.,

Plaintiffs - Appellants

v.

COMMISSIONER OF REVENUE,

Defendant - Appellee

On Appeal from a Decision
Of the Appellate Tax Board

Brief for the Amicus Curiae,
Multistate Tax Commission

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BRIEF OF MULTISTATE TAX COMMISSION as *AMICUS CURIAE* IN SUPPORT OF APPELLEE - COMMISSIONER OF REVENUE OF THE COMMONWEALTH OF MASSACHUSETTS

INTEREST OF *AMICUS CURIAE*

Amicus Curiae Multistate Tax Commission (Commission) files this brief in support of the Commissioner of Revenue of the Commonwealth of Massachusetts (Commissioner of Revenue or Commissioner). The Commission agrees with the Commissioner of Revenue that the decision below is correct and should be affirmed; a State's jurisdiction to levy a net income-based tax on the share of a taxpayer's income attributable to the State is not limited by the dormant commerce clause to only those taxpayers with a physical presence in the State.

The Commission is the administrative agency for the Multistate Tax Compact (Compact), which became effective in 1967. *See* RIA All States Tax Guide ¶ 701 *et seq.*, (2005). Today, forty-seven States and the

District of Columbia are members.[1] The purposes of the Compact are to: (1) facilitate proper determination of State and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of tax systems, (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration, and (4) avoid duplicative taxation. *See* Compact, Art. I.

These purposes are central to the very existence of the Compact, which was the States' answer to an urgent need for reform in state taxation of interstate commerce. *See e.g.,* H.R. Rep. No. 952, 89th Cong. 1st Sess., Pt. VI, at 1143 (1965). By the mid-1960's, substantial lack of uniformity had resulted in

[1] Compact Member States are: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members are: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate Members are: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin. The U.S. Supreme Court upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978)

burdensome complexity and uncertainty, and an elevated risk of duplicate taxation or less than full apportionment of income. If the States failed to act, Congress stood ready to impose reform itself through federal legislation that would preempt and regulate state taxation.[2]

The promise of increased uniformity established by the States' adoption of the Compact was critical to reducing the risk of duplicative taxation and preserving the recognized sovereignty the states enjoyed, and continue to enjoy, with respect to taxation of interstate commerce. Preserving state tax sovereignty under our vibrant federalism remains a key purpose of the Commission.

The importance the Commission attaches to the present case, and our motivation for filing this brief today, lies in this goal of preserving States' sovereignty and protecting it from an erroneously expansive interpretation of federal limitations. The

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[2] The Willis Committee, a congressional study of state taxation mandated by TITLE II OF PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. *See generally Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966).

interpretation of the dormant Commerce Clause suggested by the banks in this case would result in harmful and unfounded limitation on the Commonwealth's authority to levy a tax on the banks' share of interstate income properly attributed to the Commonwealth.

In furtherance of the goals of the Compact, the Commission seeks a correct and uniform understanding of the constitutional nexus standard for income-based taxes. A correct nexus standard is important because it ensures interstate businesses pay their share of state taxes on the income they've earned from activities in the State. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995). It is important for interstate businesses to pay their share to avoid creating a tax advantage, and thus a competitive advantage, relative to local commerce. A uniform nexus standard is desirable because it facilitates taxpayer convenience and compliance.

Longstanding U.S. Supreme Court precedent does not limit States' jurisdiction to impose income-based tax on just those taxpayers that are physically present in the State. The appropriate nexus standard is that reiterated by the U.S. Supreme Court in

numerous corporate income tax cases: "nexus is established if the corporation 'avails itself of the "substantial privilege of carrying on business" within the State.'" *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 220 (1980).

SUMMARY OF THE ARGUMENT

The Supreme Court has never applied a physical presence nexus test outside of the context of use tax collection. To the contrary, Supreme Court income tax nexus jurisprudence demonstrates that the Court, for over a century, has applied an economic presence nexus standard under the due process clause to state taxation of intangibles or the income derived therefrom (pp 10 - 15). Nothing in the Court's decision in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), reaffirming a physical presence nexus standard for use tax collection first enunciated twenty-five years previously in *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753 (1967), can be construed as creating a physical presence nexus test for income tax under the

Commerce Clause (pp 15 - 19).[3] An examination of the material differences in the burdens imposed on commerce by the use tax and the income tax show that the use tax collection burdens that so concerned the Court in *Quill* simply do not apply to an income tax (pp 19 - 24).

Furthermore, the Court's dormant Commerce Clause decision in *Quill* was substantially informed by principles of *stare decisis* based upon the mail order industry's quarter century reliance on the *Bellas Hess* physical presence use tax collection rule. *Quill Corp. v. North Dakota,* 504 U.S. 298 at 317 (1992). The banking industry can point to no similar reliance interests justifying a physical presence income tax nexus rule, in the absence of Supreme Court precedent comparable to *Bellas Hess.* (pp 24 - 25).

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[3] It is worth noting that a corporation, being a legal fiction, can never be said to be "physically present" anywhere. *See* Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (determining that when used with reference to a corporation "the terms 'present' or 'presence' are used merely to symbolize those activities of the [corporation] within the state . . . ."). In all cases a corporation can only be said to be present in a state to the extent it has representatives or engages in economic activities in that state. The Court's "physical presence" rule in *Quill* cannot therefore be interpreted literally. It can only be understood to be a shorthand term for the result of the case; that an out-of-state seller whose only connections with the taxing state are advertising and delivery via common carrier lacks the requisite nexus with the state to require it to collect use tax.

In addition, quite apart from any considerations of the dormant Commerce Clause, Congress has twice considered imposing a physical presence nexus test for the income-based taxation of banks and has twice rejected such a test (pp 26 - 36). Finally, the Commerce Clause requires only that multistate banks compete on a level playing field, not that they be favored over local banks by means of a physical presence nexus test that in fact would be harmful to interstate commerce and the competitive national marketplace the commerce clause is intendeded to protect (pp 36 - 44).

ARGUMENT

The taxpayers in this case, Capital One Bank and Capital One F.S.B., are wholly-owned subsidiaries of Capital One Financial Corporation, a Delaware corporation. Capital One Bank is chartered and domiciled in Virginia and offers Visa and MasterCard credit card services to its customers. Capital One F.S.B. is a federally chartered savings bank and offers secured and unsecured Visa and MasterCard credit cards to its customers. Neither bank has any offices, employees or tangible property located within

Massachusetts.

The Commissioner levied an assessment against the banks for unpaid financial institutions excise tax ("FIET") on the apportioned share of the banks credit card fees and interest income attributable to the State.[4] The Commissioner assessed $1,758,456 in FIET against Capital One Bank for the years 1995 through 1998 and $159,075.25 against Capital One F.S.B. for the years 1996 through 1998.

To determine the apportioned share of the banks credit card fees and interest income attributable to the Commonwealth, Massachusetts, like most States, uses an apportionment percentage derived from an average of the property, payroll and receipts factors in the state.[5] The Supreme Court has affirmed that apportioning a tax base using these factors meets due process requirements that the state tax be fairly related to benefits provided and also meets commerce clause requirements that income of multistate businesses be fairly apportioned. *Butler Bros. v. McColgan*, 315 U.S. 501, 506 (1942) ("We read the

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[4] The Massachusetts FIET is an excise tax imposed on any financial institution "engaged in business in the commonwealth." MASS. GEN. LAWS c. 63, §2.
[5] MASS. GEN. LAWS c. 63, §2A(b).

statute [California's three factor apportionment formula] as calling for a method of allocation which is 'fairly calculated' to assign to California that portion of the net income 'reasonably attributable' to the business done there"). Forty years later, the Court noted "not only has the three-factor formula met our approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged." *Container Corp v. Franchise Tax Board*, 463 U.S. 159, 170, 183 (1983) ("The three factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated.")

The banks do not dispute that they are liable for the tax on their fairly apportioned share of income attributable to Massachusetts under this statutory formula. The only issue is whether the dormant Commerce Clause precludes the Commonwealth from levying its FIET on that share of the banks income because they lack a physical presence in

Massachusetts.[6]

As we point out, the dormant commerce clause does not prohibit a state from levying an income based tax on the income properly attributed to that state merely because the taxpayer does not have a physical presence in the state. Interpreting the dormant commerce clause to do so would not only be incorrect, it would be detrimental to interstate commerce and the proper functioning of national markets.

I. The Dormant Commerce Clause Does Not Prohibit A State from Levying a Fairly Apportioned Income Based Tax on the Income Attributable to Activity in the State Merely Because the Taxpayer Does Not Have a Physical Presence in the State.

A. Historical Development of the Economic Presence Nexus Rule

Whether a state may impose a tax on an out-of-state taxpayer lacking physical presence in the taxing state is not a recent question. Indeed, the Supreme Court has, for more than a century, consistently held that

[6] Seven states - Alabama, Indiana, Kentucky, Massachusetts, Minnesota, Tennessee and West Virginia - have enacted statutes establishing economic nexus as the jurisdictional rule for imposing franchise, excise, or corporate net income tax on a financial institution. ALA. CODE §40-16-4 (2008), IND. CODE §§6-5.5-3-1, 6-5.5-3-4 (2008); KY. REV. STAT. ANN. §136.520 (2008); MASS. GEN. LAWS ch. 63, §1 (2008); MINN. STAT. §290.015 (2007); TENN. CODE ANN. §67-4-2004 (2008); W. VA. CODE §11-24-7B (2007).

the economic presence nexus rule satisfies federal constitutional requirements for state taxation of intangibles, precisely because intangibles cannot be said to have a physical presence anywhere.

In *Louisville & Jeffersonville Ferry Company v. Kentucky*, 188 U.S. 385 (1903), the Court held that a franchise tax levied by Kentucky on a Kentucky corporation for the operation of a ferry across the Ohio River from Kentucky to Indiana violated the Due Process Clause[7] to the extent the state included, within the assessed value of the Kentucky franchise, the value of a separate franchise granted by Indiana to operate a ferry across the Ohio from Indiana to Kentucky. The Court noted that "beyond all question, the ferry franchise derived from Indiana is an incorporeal hereditament derived from and having its legal situs in that state. It is not within the jurisdiction of Kentucky." 188 U.S. at 398.

In *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936), the Court held that West Virginia's ad valorem property tax did not violate the Due Process Clause when applied to a foreign corporation's accounts

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[7] "[N]or shall any State deprive any person of life, liberty or property, without due process of law". U.S. CONST. amend. XIV, §1.

receivable and bank deposits having an economic presence in West Virginia. The Court observed that "[w]hen we deal with intangible property, such as credits and choses in action generally, we encounter the difficulty that by reason of the absence of physical characteristics they have no situs in the physical sense, but have the situs attributable to them in legal conception." 298 U.S. at 209.

The Court concluded that its due process nexus jurisprudence "recognize[s] the principle that choses in action may acquire a situs for taxation other than at the domicile of their owner, if they have become integral parts of some local business." 298 U.S. at 210, citation omitted.

In *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937), the Court sustained the constitutionality of New York's tax on the income realized by a Massachusetts resident as the result of his sale of a seat on the New York Stock Exchange, notwithstanding that the nonresident taxpayer maintained no place of business in New York and never executed any trades on the floor of the Exchange.

And, in *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234 (1937), the Supreme Court ruled that the Due

Process Clause did not prevent Minnesota from imposing its ad valorem property tax on a Delaware corporation based on the value of stock the corporation owned in state banks chartered in Montana and North Dakota notwithstanding that the banks were located outside of Minnesota.

The Court noted that Minnesota provided legal protection to the corporation and was therefore entitled under the Due Process Clause to be reimbursed its share of the cost of providing governmental services because it was in Minnesota "that the owner [of the stock] in every practical sense invokes and enjoys the protection of the laws, and in consequence realizes the economic advantages of his ownership". 299 U.S. at 241.

In *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940), the Supreme Court ruled that the Wisconsin Privilege Dividend Tax did not violate the Due Process Clause as applied to dividends declared and paid by a Delaware corporation doing business in Wisconsin.

In sustaining the constitutionality of the tax, the Supreme Court rejected the contention that there was no nexus between the dividends and Wisconsin because the dividends were declared and paid outside the

state:

> The substantial privilege of carrying on business in Wisconsin . . . clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. 311 U.S. at 444 - 445.

International Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435 (1944) was a later iteration of *J.C. Penney.* Following the Supreme Court's decision in *J.C. Penney,* the Wisconsin Supreme Court ruled that the legal incidence of the Wisconsin Privilege Dividend Tax fell on the stockholders receiving the dividends, not upon the corporation declaring them.

The Supreme Court once again ruled that the tax did not violate the Due Process Clause, notwithstanding that the burden of the tax fell on out-of-state stockholders with no physical presence in the State. In so doing, the Court declared the stockholders' lack of physical presence in Wisconsin to be immaterial:

> Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part

> of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. 322 U.S. at 444 - 445.

Clearly, the banks receipt of income as a result of creating a market for the use of their credit cards by Massachusetts cardholders is an event or transaction occurring in Massachusetts in the same sense as is the out-of-state declaration of a dividend paid to a nonresident stockholder by a nonresident corporation doing business in the taxing state. Equally clearly, the banks are entitled to all the protections Massachusetts affords to resident creditors in collecting on delinquent accounts. The state is therefore as entitled to recover the costs of its services to non-resident banks through its FIET as it is to recover those costs from domestic banks.

B. The More Recent Decision in *Quill* Did Not Establish a Physical Presence Income Tax Nexus Rule

The foregoing cases were all decided in an era when the Supreme Court drew no distinction between the jurisprudential justification for the nexus rule under the due process clause and that required under the

Commerce Clause.[8] In *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), the Court ruled for the first time that the theoretical underpinnings supporting nexus under the two clauses are distinct. "Due process centrally concerns the fundamental fairness of governmental activity. … In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy." 504 U.S. at 312.

That *Quill* declared the jurisprudential rationales for nexus to be different under the two clauses does not mean that the Commerce Clause requires physical presence nexus in all cases.

First, nothing in *Quill* can fairly be read as overruling the Court's economic presence jurisprudence for the taxation of intangibles. Indeed, the opinion never mentions this jurisprudence at all. It is hornbook law that the Supreme Court does not normally overturn earlier authority *sub silentio*. *Shalala v.*

[8] "The Congress shall have power … to regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST. art. I, §8, cl. 3.

Ill. Council on Long Term Care, Inc., 529 U.S. 1, 18 (2000).

Second, notwithstanding that a number of the Supreme Court's due process nexus cases involved taxpayers who had real estate and/or tangible property in the taxing state, the Court has explicitly declared that the presence of real estate and/or tangible property is of no constitutional significance: "Nor are we able to perceive any sound reason for holding that the owner must have real estate or tangible property within the state in order to subject its intangible property within the state to taxation." *Virginia v. Imperial Coal Sales Co.*, 293 U.S. 15, 20 (1934), quoted in *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 213 (1936).

Third, although the Supreme Court's economic presence jurisprudence is grounded in the Due Process Clause, it is noteworthy that the Supreme Court located its comments regarding the lack of a physical presence requirement for taxes other than use tax collection in the Commerce Clause portion of the Quill opinion. *Quill*, 504 U.S. at 314, 317 (1992). Consequently, the Court's Commerce Clause physical presence nexus rule for use tax collection was

consciously informed — and limited — by its reference to a contrary economic presence rule for other taxes.

Fourth, there is nothing in *Quill* that requires, or even suggests, that the Commerce Clause nexus test must be identical for all taxes. A "one size fits all" physical presence test does not reflect material differences in the nature of each tax and the characteristics of the asset or income being taxed. Such differences render a physical presence Commerce Clause nexus test entirely unworkable as applied to an excise tax imposed on the multistate credit card operations of a financial institution. In 2003, approximately 70% of credit card debt in the United States was held by lenders based in states with 4% of the population. Mark Furletti, Comment, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards,* 77 Temp. L. Rev. 425, 443 (2004). To require physical presence before a state could impose an income-based tax on credit card operations would mean that most of the income from card card operations would escape state taxation entirely.

There is nothing remarkable about applying the same constitutional provision differently in varying

contexts. For example, under the Supreme Court's Equal Protection Clause jurisprudence, the Court will analyze most state statutes under a rational basis standard of review and the statute will be sustained if there is any set of facts that rationally furthers the legislative objective. *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 527-29 (1959). But if the statute trenches on a fundamental right, such as interstate travel, or discriminates on the basis of a suspect classification, such as race, the statutory scheme will be subject to a heightened, or strict, standard of review. Such statutes will be sustained only if the state can demonstrate a compelling interest that justifies the discrimination. *Johnson v. California*, 543 U.S. 499, 505 (2005) (race); *Shapiro v. Thompson*, 394 U.S. 618, 638 (1969) (interstate travel). Viewed in this light, the *Quill* nexus test can be viewed as a form of strict Commerce Clause scrutiny that is justified because of the unique burdens of use tax collection – burdens that are inapplicable to a direct tax on one's own income.

C. The Unique Burdens of Use Tax Collection

The burdens of which the Supreme Court spoke, both in *Bellas Hess* and in *Quill* were specifically

identified as "use tax burdens", not the general burden of paying taxes and filing returns. *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753 at 759 (1967); *Quill,* 504 U.S. at 313 n. 6. The Court was very clear in *Bellas Hess* precisely which use tax burdens informed its holding: "The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'" *Bellas Hess,* 386 U.S. at 759-60 (internal footnotes omitted).

In addition, the Court noted that the prevailing system of use tax collection required a remote seller to administer rules that varied from one state to another and which required the remote seller in each taxing jurisdiction to interpret facts that were often too remote and uncertain for the level of accuracy mandated by the system. 386 U.S. at 760 n.14.

In *Quill,* the Supreme Court demonstrated the same concern for the unique burdens of use tax collection that informed the Court's decision in *Bellas Hess.*

The Court noted that North Dakota required any seller who advertised in the state three times per year to collect use tax and that similar obligations might be imposed by any of the more than 6,000 taxing jurisdictions that imposed a use tax as of 1992. *Quill*, 504 U.S. at 313 n.6.

The Court's concerns regarding the burdens of use tax collection are simply irrelevant in the income tax context. Instead of more than 6,000 jurisdictions that imposed a use tax in 1992, only 46 states, including the District of Columbia, impose a corporate income or franchise tax. Howell E. Jackson & Stacy A. Anderson, *Can States Tax National Banks to Educate Consumers About Predatory Lending Practices?*, 30 Harv. J.L. & Pub. Pol'y 831, 868 (Summmer 2007). In addition to the District of Columbia, only one other locality — New York City — imposes a general corporate income tax. 4 U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, 2002 CONSENSUS OF GOVERNMENTS: COMPENDIUM OF GOVERNMENT FINANCES, tbl.45, 92, 101, 125 (2005).

The burdens of filing annual income tax returns reporting one's own income to no more than 47 taxing authorities are simply not of the nature or magnitude of reporting use tax collected from hundreds of

thousands, if not millions, of purchasers in thousands of taxing jurisdictions, on a quarterly or even monthly basis. Presumably, a bank is aware of where it earns its income and how. But a remote seller is often not in a position to know whether its customer is subject to sales and use tax or not. Even if the seller were in a position to make this determination, it would require highly refined tax collection software to determine whether the purchaser is subject to use tax. Similar problems exist in determining whether the purchase is for a tax-exempt purpose and, as applied to a local sales and use tax, sourcing the sale to the proper taxing jurisdiction.

These are the unique burdens of use tax *collection* that concerned the Court in *Bellas Hess* and *Quill.* The burdens identified by Appellants on pages 32 - 36 of their Brief are the routine burdens all taxpayers, whether local or out-of-state, have in computing, reporting and remitting tax on their income. The Court has long made clear that "[i]t was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing the business." *W. Live Stock v. Bureau*

of Revenue, 303 U.S. 250, 254 (1938); *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 108 (1975); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623-24 (1981); *Quill*, 504 U.S. at 310, n.5.

Creating a safe harbor from use tax collection for sellers whose only connection with the taxing state is delivery by U.S. mail or common carrier was an understandable response to the burdens imposed on interstate commerce by requiring a remote seller to collect use tax on the purchases made by its customers in the taxing state. In contrast, a physical presence test for taxing income from credit card operations would be entirely inappropriate. The Supreme Court has made clear that courts are to be mindful of the realities of the modern business world. "[C]ourts must not be blind to what all others can see and understand." *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 486 (1985).

In affirming the constitutionality of the economic presence due process nexus rule for the taxation of intangibles, the Supreme Court has similarly not been "blind to what all others can see and understand." Indeed, in acknowledging that a taxpayer need not have any real and/or tangible property in a state and still

be liable for tax on the income realized from activities in that state, the Court has explicitly seen and understood the unique nature of the modern economy that justify economic presence as the appropriate Commerce Clause nexus standard in this case—the realization of income from credit card operations requires no physical presence upon which to base nexus. The economic presence nexus rule therefore satisfies the dormant Commerce Clause nexus test as applied to the income received by a bank from its credit card users who reside in the taxing state.

D. *Quill* Was Largely Decided on *Stare Decisis* Principles That Have No Relevance To the Determination of A Proper Income Tax Nexus Rule Under the Dormant Commerce Clause

In considering the relevance of the *Bellas Hess/Quill* use tax nexus rule in the context of an income tax, it is significant that a quarter century had elapsed between the two cases; a quarter century in which the mail order industry in reliance on *Bellas Hess,* had matured with the expectation that it was not required to collect state use tax if its only connection with the taxing state was delivery by US mail or common carrier. In *Quill,* the Court acknowledged that "contemporary Commerce Clause

jurisprudence might not dictate the same result were the issue to arise for the first time today." *Quill,* 504 U.S. at 311. Nevertheless, the Court was reluctant to overturn the earlier case precisely because it recognized that *Bellas Hess* had engendered substantial reliance on the use tax physical presence nexus rule by the mail order industry. 504 U.S. at 317. Therefore, "the continuing value of a bright-line rule *in this area* and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law." 504 U.S. at 317, emphasis added.[9]

No such reliance interests apply in the income tax area. As the cases in Part IA make clear, the Court has long ruled that economic presence is sufficient to establish due process income tax nexus and there are no income tax Commerce Clause nexus decisions comparable to *Bellas Hess* in the sales and use tax context. Much of the jurisprudential rationale for *Quill* is simply immaterial as applied to the income taxation of banks.

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[9] The sentence immediately prior to the quote makes clear that the phrase "this area", refers to "the area of sales and use taxes."

E. Congress Has Twice Indicated Its Approval of An Economic Nexus Rule for the State Taxation of Income Derived From Interstate Banking

Finally, the Court's decision in this case should be informed by the fact that Congress has twice considered and rejected recommendations to impose a physical presence nexus rule for the state taxation of income derived from interstate banking.

1. The Federal Reserve Report

In 1969, Congress enacted legislation to remove certain restrictions on state taxation of national banks.[10] Act of December 24, 1969, Pub. L. No. 91-156, 83 Stat. 434 (§2(a) of which is codified at 12 U.S.C. § 548). P.L. 91-156, §2(a) provides that "[f]or the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which

[10] Prior to December 24, 1969, Congress had allowed state taxation of national banks in any one of four specified ways in addition to taxes on their real property. States could tax national banks on their shares, on dividends derived from the shares, on net income, or according to or measured by net income. *Crocker National Bank v. State Board of Equalization,* 639 F.2d 458 at 460 (9th Cir. 1980), *cert. denied,* 451 U.S. 1028 (1981).

its principal office is located." Section 2(b) provided that the statute would take effect on January 1, 1972.[11] In the interim, Section 1(a)5.(a) allowed states to continue to tax a national bank whose principal office was in the taxing state, provided the State taxed national banks "in the same manner and to the same extent as such tax is imposed on a bank organized and existing under the laws of such State."[12] Section 3(a) prohibited a State, prior to January 1, 1972 (later extended to January 1, 1973), from imposing a tax on any class of banks, unless the tax was imposed on that class of banks prior to the enactment of P.L. 91-156 or the State legislature affirmatively authorized the imposition of the tax subsequent to the enactment of P.L. 91-156.[13] Finally, Section 4 directed the Board of Governors of the Federal Reserve System to study "the probable impact on the banking systems and other economic effects of

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[11] The effective date was later extended to January 1, 1973. Act of December 22, 1971, Pub. L. No. 92-213, §4(b), 85 Stat. 775.

[12] Section 1(a)5.(b) temporarily authorized states to impose certain taxes on a national bank whose principal office was not located in the taxing State. These authorized taxes did not include a tax imposed on or measured by net income.

[13] Section 3(b) provided for certain exclusions from the moratorium imposed by Section 3(a), none of which are material in this case.

the changes in existing law to be made by section 2", including specifically the effects of changes in income taxes or "doing business" taxes.

The Board of Governors presented its report to Congress in June 1972. BD. OF GOVERNORS OF THE FED. RESERVE SYS., 92d CONG., 2d SESSION, STATE AND LOCAL TAXATION OF BANKS, REPORT OF A STUDY UNDER PUBLIC LAWS 91-156 AND 92-213, REPORT FOR THE S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS (Comm. Print 1972) (hereinafter, "Federal Reserve Report").[14] The Federal Reserve Report recommended that Congress "limit the circumstances in which national banks, State banks, and other depository institutions may be subject to State or local government taxes on or measured by net income, gross receipts, or capital stock, or to other "doing business" taxes in a State other than the State of the principal office." Federal Reserve Report, Recommendation 2, at 4.[15] Specifically, the Board of Governors recommended that Congress impose restrictions on state authority to tax

[14] A copy of the Federal Reserve Report is available at http://lawlibrary.rutgers.edu/cgi-bin/lib/hearing.cgi?file=72602451%20page=0001, (last visited on April 7, 2008).

[15] The cited references to the Federal Reserve Report are attached in the Appendix, pages A1 - A3.

the income of banks that were similar to the restrictions of Public Law 86-272.[16]

> [T]he law relating to depositary institutions might provide that certain common occurrences do not, by themselves, constitute a sufficient connection with the State to establish jurisdiction to tax (e.g., mere solicitation or (sic) prospective borrowers by a depositary institution or its representatives, the loans being approved or rejected outside the State; the holding of security interests in property located in a State; or enforcement of obligations in the courts of a State).

Federal Reserve Report, at 6.

2. The Advisory Commission on Intergovernmental Relations Report

Congress did not adopt any of the Federal Reserve's state tax recommendations. Instead, Congress enacted the State Taxation of Depositories Act of 1973, Act of August 16, 1973, Pub. L. No. 93-100, 87 Stat. 342, §7. Section 7(c) of the Act provided that "no State … may impose any tax measured by income or receipts or any other "doing business" tax on any insured depository not having its principal office within such State." Section 7(c) was in

[16] Public Law 86-272 prohibits a state from imposing a tax on or measured by net income on a non-domiciliary corporation whose only activities in the taxing state are limited to the solicitation of orders for tangible personal property, provided that the orders are accepted and filled from a point outside the state.

effect from the enactment of the statute until it sunset on January 1, 1976.[17] In the interim, Section 7(e)(1) directed the Advisory Commission on Intergovernmental Relations (ACIR) to study "all pertinent matters relating to the application of State "doing business" taxes on out-of-State commercial banks, mutual savings banks, and savings and loan associations."[18] The study was to "include recommendations for legislation which will provide equitable State taxation of out-of-State commercial banks, mutual savings banks and savings and loan associations."

The ACIR delivered its report to Congress in 1975. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, 94th CONG., 1st SESSION, STATE AND LOCAL

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[17] Section 7(d) defined an "insured depository" to include all banks whose accounts are insured under the Federal Deposit Insurance Act, any institution whose accounts are insured by the Federal Savings and Loan Insurance Corporation or a member of a Federal home loan bank. Unlike 12 U.S.C. §548, the State Taxation of Depositories Act is not limited to federally chartered banks.

[18] The ACIR was a federal commission created by Congress for the purpose of conducting a continual study of federal, state and local governmental problems. The commission was composed of congressmen, governors, state legislators, county officials, city officials and public members. *Germano v. Kerner,* 220 F. Supp. 230, 242 (ND Ill 1963) (Austin, J., dissenting), *rev'd* 378 U.S. 560 (1964). The ACIR was disbanded in September 1996.

"DOING BUSINESS" TAXES ON OUT-OF-STATE FINANCIAL DEPOSITORIES, REPORT FOR THE S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS (Comm. Print 1975) (hereinafter, "ACIR Report").[19] The ACIR recommended that a state should have jurisdiction to tax out-of-state depositories only if they had a "substantial physical presence" within the taxing state. ACIR

[19] The cited references to the ACIR report are attached in the Appendix, pages A4 - A6.

Report, at 48 - 49.[20]

Congress did not adopt the ACIR's 1975 recommendations. Instead, Congress allowed the restrictions on state taxation of out-of-state banks imposed by the State Taxation of Depositories Act to sunset. Since January 1, 1976, the states have been free to impose a tax on or measured by the net income

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[20] Pursuant to its congressional charter to continually study governmental problems, in 1989 the ACIR issued an additional report of the state taxation of banks, reversing its 1975 nexus recommendation. Instead, the 1989 report concluded that physical presence nexus rules "appear obsolete in an era in which loans are made and deposits solicited interstate by mail, telephone, and other electronic means." Advisory Commission on Intergovernmental Relations, *State Taxation of Banks: Issues and Options* (hereinafter, "1989 ACIR Report"), at 27 (December 1989) The 1989 ACIR Report is available at http://www.library.unt.edu/gpo/acir/Reports/information/M-168.pdf, (last visited on April 1, 2008). The 1989 ACIR Report, drawing on the history of congressional restrictions on state taxation of national banks, cautioned against congressional intervention in state taxing powers, pointing out that such intervention often leads to years of litigation that "are unlikely to bring either order or clarity to state tax systems." 1989 ACIR Report, at 5. Furthermore, the ACIR recognized that federal laws that contain specific directives and limitations on state taxation often have unintended consequences brought about by changing judicial interpretations and by new business practices. *Id.* The report concluded that "[i]n an area of law like tax jurisdiction, which must respond to technological advances, and in a business like banking, which is currently highly innovative, such unintended consequences are inevitable." *Id.* Cited references to the 1989 ACIR Report are attached in the Appendix at pages A7 - A9.

of out-of-state banks, the only restriction being the non-discrimination requirement of 12 U.S.C. §548 that requires state and nationally chartered banks to be taxed the same.

The foregoing history unequivocally demonstrates congressional acceptance of an economic nexus rule for state taxation of the income of out-of-state banks. Twice within a three year period, Congress considered and declined to adopt the recommendation of congressionally mandated studies that a physical presence nexus test be imposed for state taxation. Furthermore, in allowing the State Taxation of Depositories Act to expire in 1976, Congress chose to let a statute lapse that had gone beyond merely requiring physical presence but instead required an in-state principal office before a state could tax an out-of-state bank.

Typically, when Congress chooses to limit state action under the Commerce Clause it does so by enacting laws that affirmatively restrict the states ability to engage in activities that affect commerce. For example, P.L. 86-272, 15 U.S.C. §§381-384, prohibits a state from imposing an income tax on an out-of-state seller of tangible personal property if

its only activity in the taxing state is the solicitation of orders. Similarly, for the period it was in effect, the State Taxation of Depositories Act prohibited the states from imposing an income tax on an out-of-state bank that did not have its principal office in the taxing state.

Congress ultimately chose not to restrict the states ability to tax banks without a physical presence in the taxing state. And it did so twice, subsequent to the Supreme Court ruling in *Bellas Hess* that the dormant Commerce Clause required physical presence before a state could require a seller to collect use tax. In declining to adopt a physical presence nexus rule, Congress has not merely been silent on the issue. Given the history of federal banking legislation from 1969 to 1976, it is clear that Congress implicitly approved an economic nexus test. And when Congress *approves* of a Commerce Clause standard for the states, there is no necessity for Congress to pass any legislation. By twice rejecting a physical presence nexus test after receiving congressionally mandated studies of the issue, and by allowing the State Taxation of Depositories Act to

lapse, Congress has expressed its acceptance of an economic nexus test.[21]

The Commerce Clause is a grant to Congress of plenary and supreme authority over interstate commerce. *Prudential Insurance Co. v. Benjamin,* 328 U.S. 408, 423 (1946). Congress has the ultimate power to resolve any Commerce Clause issue if it disagrees with a judicial ruling under the dormant Commerce Clause. *Quill Corp. v. North Dakota,* 504 U.S. 298, 318 (1992); 49 U.S.C. §14505 (superseding *Oklahoma Tax Commission v. Jefferson Lines, Inc.,* 514 U.S. 175 (1995) and prohibiting a State from levying a tax on the interstate transportation of passengers by motor carriers or on the gross receipts derived therefrom). In the instant case, it is clear that the dormant Commerce Clause does not prohibit the State from imposing its FIET on an out-of-state bank with economic nexus to the State. Even if the courts were to rule otherwise under the dormant Commerce Clause, Congress has the final authority to interpret the

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[21] At least one commentator has opined that the history of 12 U.S.C. §548 supports the view that Congress has approved an economic nexus test for the state income taxation of banks. Jackson & Anderson, 30 Harv. J.L. & Pub. Pol'y 831 at 877 ("§548 is not a typical case of congressional silence").

requirements of the Commerce Clause. The history of congressional studies and legislation pertaining to the state taxation of banks demonstrates that Congress has exercised its Commerce Clause powers by twice considering and rejecting a physical presence nexus test for banks.

II. An Overly Expansive Interpretation of the Dormant Commerce Clause Prohibitions Would Harm Interstate Commerce by Creating A Tax Advantage, and thus a Competitive Economic Advantage, for Interstate Businesses at the Expense of Local Businesses

The Commerce Clause, unlike the Due Process Clause, is not a restriction on state power. Rather it is one of Congress's enumerated powers under Art. 1, §8: "To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." This grant of Congressional authority has long been held to contain a negative inference, restricting State authority even in the absence of an explicit federal regulation if the state action would improperly discriminate against interstate commerce.

The purposes of the Commerce Clause, from which the purposes of the dormant Commerce Clause flow, were explained by this Court in *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525 (1949):

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.

336 U.S. 525, 539

Thus, the dormant Commerce Clause has been held to prohibit state taxes that discriminate against interstate commerce; where "discrimination" involves differential treatment of the private business interests competing in a national market place. See, e.g., *Reeves, Inc. v. Stake*, 447 U.S 429, 437 (1980) (prohibiting a differential treatment that discriminates against interstate commerce thereby "imped[ing] free private trade in the national market place"); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273-274 (1988) ("[The] 'negative' aspect of the Commerce Clause prohibits economic protectionism - that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors" (citations omitted); *General Motors v.*

Roger W. Tracy, Tax Commissioner of Ohio, 519 U.S. 278, 299 (1997) (referring to "…the dormant Commerce Clause's fundamental objective of preserving national markets for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors"); *In re Trade-Mark Cases*, 100 U.S. 82, 96 (1879) (For Commerce Clause purposes, "…commerce among the States means commerce between the individual citizens of different States…").

In its first decision invalidating a state tax expressly on dormant commerce clause grounds, the Court turned the purpose of the clause on its head to bar the States from taxing anything that Congress could regulate, thus creating an advantage for interstate commerce at the expense of in-state competitors. The Court held "whenever the subjects over which a power to regulate commerce is asserted are in their nature national . . . they may justly be said to be of such a nature as to require exclusive legislation by Congress." *Case of the State Freight Tax*, 82 U.S. 232, 279 (1872). Congress had not acted, but it could, and therefore the States could not. The Court initially treated interstate commerce as a tax - free zone. "No state has the right to lay a tax on

interstate commerce in any form." *Leloup v. Port of Mobile*, 127 U.S.640 (1888).

The Court soon realized that barring state taxation of all aspects of interstate commerce ended up precluding considerably more state taxes than were justified. The Court proceeded over the next 70 years to create a series of formal and sometimes artificial distinctions between "direct" and "indirect" taxation of interstate commerce, between taxing transactions that were still in "the stream of commerce" or had "come to rest," between taxes imposed on a "local activity" or on goods destined for "delivery to out of state customers."[22] As more and more commerce became interstate in nature, the unfairness of excluding interstate commerce from state taxation became palpable.

Finally, in 1938, the Court began to articulate its modern dormant commerce clause jurisprudence with its decision in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). It was crafting a theory

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[22] *Hope Natural Gas Co. v. Hall*, 274 U.S. 284 (1927); *American Mfg. Co. v. St.* Louis, 250 U.S.459 (1919); *Adams Express Co. v. Ohio*, 165 U.S. 194 (1897); *Coe v. Errol*, 116 U.S. 517 (1886).

that in the absence of congressional regulation, the Commerce Clause did not bar States from taxing interstate commerce, but rather prohibited states from using taxation to discrimate against interstate commerce. The Commerce Clause required a level playing field between interstate and intrastate commerce. The Court recognized "the double demand that interstate business shall pay its way, and that at the same time, it shall not be burdened with cumulative exactions which are not similarly laid on local business." *Western Live* Stock, 303 U.S. at 258. Gone was the notion of treating interstate commerce as a tax-free zone to the detriment of in-state competitors.

After some backsliding toward the tax-free zone concept of the dormant commerce clause during the 1940s and 1950s, *see Freeman v. Hewitt*, 329 U.S. 249 (1946), and *Spector Motor Services Inc. v. O'Connor*, 340 U.S. 602 (1951), the Court continued its modern commerce clause analysis in *Northwestern States Portland Cement*, 358 U.S. 450 (1959). It held that "net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is

properly apportioned to local activities within the taxing State forming sufficient nexus to support the same." *Id.* at 452. The Court accepted that interstate commerce should not be disadvantaged as compared to local commerce, but it should not be advantaged, either.

Ultimately, with *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), the Court completely abandoned formalistic distinctions of "direct" and "indirect" taxes and enunciated its authoritative and oft-quoted four-pronged test of the validity of state taxes imposed on multistate business activity. The state tax is permitted "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by the State." *Id.* at 279.

Following *Complete Auto*, the Court proceeded in a series of cases to confirm the utility of its modern dormant commerce clause doctrine by cogently identifying how States can disadvantage interstate commerce. The States gave the Court ample fodder to test its dormant commerce clause analysis by enacting a number of state taxes that managed in a variety of

ways to discriminate against multistate businesses. *See Armco Inc. v. Hardesty*, 467 U.S. 638 (1984) (exemption from gross receipts tax on wholesale sales granted to local manufacturers who pay a manufacturing tax discriminates against interstate commerce because exemption is not available to out of state manufacturers who may be subject to a manufacturing tax in their State); *Bacchus Imports Ltd. v. Dias*, 468 U.S. 263 (1984) (tax exemption for locally produced wine discriminates against interstate commerce); *Tyler Pipe Indus. Inc. v. Washington DOR*, 483 U.S. 232 (1987) (business and occupations tax exemption granted on in-state wholesale sales to local manufacturers paying tax on manufacturing discriminates against out-of-state manufacturers selling into Washington); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (gasoline tax credit granted for ethanol manufactured in Ohio or a State granting a reciprocal credit).

As the Court outlined the limits on state cleverness in each of these decisions, it became reassuringly clear that the modern dormant commerce clause doctrine worked. It treated interstate commerce on a level playing field with intrastate commerce. Interstate commerce was no longer a protected tax-free

zone that did not pay its fair share of tax, but it was protected from shouldering a greater burden of state tax than local commerce.

These concerns are relevant to the circumstances in this case. Given current banking practices, a physical presence nexus test for state taxation of banks would preclude such taxation in all but a handful of states having a minuscule share of the national population.

> Over the last quarter century, banking markets in the United States have undergone a dramatic transformation. Although banking markets were traditionally served through local institutions and segmented by legal restrictions on interstate branching and even interstate bank holding companies, the American banking industry has become increasingly national in scope. The trend is most pronounced in the credit card industry, where a substantial proportion of credit cards are now issued by a handful of major firms located principally in South Dakota and Delaware.[23]

The Supreme Court has recognized that "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted." *Burger King*

[23] Jackson & Anderson, 30 Harv. J.L. & Pub. Pol'y at 835 - 836.

Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985).[24]

A physical presence rule would allow the segment of interstate commerce that has no investment or jobs in a state to have a clear competitive advantage over other segments of interstate commerce and local business that do have investment and jobs in the state. This result, far from required by the dormant commerce clause, would work against the purpose of the dormant commerce clause - which is to preserve fair competition in competitive national markets. The point of the dormant commerce clause is to ensure all economic interests are on the same footing with respect to state taxation, and thus to preserve competitive national markets.

CONCLUSION

The dormant Commerce Clause does not require a physical presence nexus test for the state income taxation of banks and Congress, acting under the

[24] *Burger King* was a due process challenge to a suit filed in Florida against a Michigan resident for breach of an agreement to operate a Michigan Burger King franchise. Although the case was not decided under the dormant Commerce Clause, the commercial reality recognized in that case - that modern business does not require physical presence in order to conduct substantial interstate commerce - should as well inform the courts when considering cases under the dormant Commerce Clause.

affirmative Commerce Clause, has twice considered and rejected a physical presence test for such taxation. Accordingly, this Court should affirm the decision of the Appellate Tax Board and sustain the assessments levied by the Commissioner of Revenue.

Respectfully submitted,

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STATE AND LOCAL TAXATION OF BANKS
PARTS I, II, III, AND IV

Report of a Study Under Public Laws 91–156 and 92–213

PREPARED BY THE
BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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area of application raises difficult problems in the setting of boundaries and the definition of the institutions to be covered. In any event, since depositary institutions account for the bulk of all intangibles held by the financial sector, and a large part of the remainder—namely, pension funds—would undoubtedly be exempt from tax in any event, a prohibition limited only to depositary institutions probably would serve effectively to protect the entire financial sector. If the Congress wished to broaden the prohibition, it could do so, for example, by extending it to cover all institutions that derive 50 percent or more of their income from interest or dividends on loans and investments.

Recommendation 2. Taxation by States other than the State of the principal office: Limit the circumstances in which national banks, State banks, and other depositary institutions may be subject to State or local government taxes on or measured by net income, gross receipts, or capital stock, or to other "doing business" taxes in a State other than the State of the principal office, and prescribe rules for such taxation.

As to the application of net income and "doing business" taxes in States other than the home-office State of a bank of other depositary institution, the central problem relates not to the aggregate sum of State and local taxes that may be collected from these institutions but rather to the methods for determining which States have a legal basis for imposing taxes and for dividing any given tax base between the home State and other States that have such claims. With the possible interstate division of the net income or other tax base of national banks that is permitted under section 2 of Public Law 91–156 and which would also be permitted under the above recommendation, the home State may be required to divide the tax base of its domiciliary banks with other States. On the other hand, it may acquire jurisdiction over part of the tax base of non-domiciliary banks.

With interstate division of the tax base, assurances are needed that the sum of the taxable base on which two or more States levy taxes will not exceed 100 percent of the actual base. But even where this limit is not exceeded, serious burdens may result when two or more States claiming jurisdiction to tax, for example, the same net income, use different rules for interstate division of the tax base and require different kinds of records and reports.

If interstate division of the taxable net income of banks were to conform closely to procedures currently applied to other businesses by most States, there would be—with present lending practices—comparatively little allocation or apportionment of the tax base to States other than the home State of the banks. However, if all restrictions on taxing out-of-State institutions were removed, States could be expected to modify their allocation procedures so as to apply their levies to an increasing proportion of the tax base of out-of-State banks. This could involve the introduction of new division-of-base measures tailored particularly to financial intermediaries.

The aggregate of taxes paid by any individual bank or other depositary institution probably would be reduced by multiple State taxation as compared with taxation confined to the headquarters State because applicable tax rates in the home State (especially in the major banking center States) may be higher than in other States, and some

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erty). But the circumstances in which these taxes would be applied to out-of-State institutions would be clearly defined and circumscribed and certain State procedures for applying taxes to out-of-State institutions would be standardized throughout the Nation.

The Federal statute should establish uniform criteria for determining when a State or its subdivisions may exercise jurisdiction to tax a bank or other depositary institution which has its principal office or is chartered in another State; principles and procedures that will govern the interstate division of each type of applicable tax base in circumstances where the jurisdictional tests are met; and rules that will guide the States in their administrative procedures, such as the application of a unitary business concept, requirements of consolidated or combined tax returns from related or affiliated corporations, audits of out-of-State corporations, and other procedures. It may be desirable in such legislation to designate a Federal administrative agency to provide interpretations and regulations.

Like the present Federal statute that applies to net income taxes on business involving interstate sales of tangible personal property (Public Law 86-272), the law relating to depositary institutions might provide that certain common occurrences do not, by themselves, constitute a sufficient connection with the State to establish jurisdiction to tax (e.g., mere solicitation or prospective borrowers by a depositary institution or its representatives, the loans being approved or rejected outside the State; the holding of security interests in property located in a State; or enforcement of obligations in the courts of a State). In establishing such criteria, the overriding objectives should be to avoid creation of tax impediments to the continued free flow of credit across State lines and uneconomic changes in the procedures that now govern the overwhelming bulk of interstate lending by depositary institutions.

Any jurisdictional standards and division-of-base rules that are applied to State taxation of out-of-State depositary institutions should be applicable to local government levies as well. In this connection, the Congress may wish to examine whether additional restrictions would be needed to avoid imposition of a variety of local levies and recordkeeping and other compliance requirements upon banks from other parts of the same State or from other States, which would tend to discourage banks and other depositary institutions from widening their service areas.

Recommendation 3. Discriminatory taxation: Proscribe the imposition of discriminatory or more onerous license, privilege, or other similar "doing business" taxes upon out-of-state depositary institutions than would be imposed upon these institutions if chartered by the taxing State. The provision might take the form of a specific limitation, under which an out-of-State corporation or association could not be required to pay a higher license, privilege, or other "doing business" tax or fee than it would pay under the same circumstances if it were domiciled or chartered in the taxing State.

Because constitutional doctrines in this field are not clear, there is at least a risk that States would have power to levy for the privilege of doing business in a State heavier taxes on out-of-State banks and other depositary institutions than they impose on those institutions

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94th Congress } 1st Session }

COMMITTEE PRINT

STATE AND LOCAL "DOING BUSINESS" TAXES ON OUT-OF-STATE FINANCIAL DEPOSITORIES

Report of a Study Under Public Law 93-100

BY THE ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 1975

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from several organizations of depositories. (The witnesses at the hearing are listed in appendix B.) In addition, a member of the senior staff of the Federal Reserve Board of Governors discussed current and prospective developments in the field of banking with the Commission. (For his prepared paper, see appendix D.)

(F) Commission Recommendations

A policy of negative Federal guidelines

Public Law 86-272, the only Federal statute outside the depository area which sets limits on State taxation of interstate commerce, imposes its restrictions in terms of negative Federal guidelines. These guidelines control the determination of State jurisdiction to tax net income derived from sales of tangible personal property in interstate commerce. As noted elsewhere in this report, the Act does not regulate interstate division of the tax base.

Under that law, a State may not apply its tax if business activities within the State during the tax year are limited to solicitation of orders by the seller or its representative in the State, which orders are sent outside the State for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the

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State. A seller is not considered to have engaged in business activities within a State merely by reason of sales or solicitation of orders on its behalf by independent contractors, whether or not the contractors maintain offices in the State, if their activities there on behalf of the seller consist solely of making sales or soliciting orders. But each independent contractor must be one who engages in selling tangible personal property for more than one principal and holds himself out as an independent contractor in the regular course of business. The term "representative" does not include an independent contractor.[1/]

On the basis of our examination of comparable questions that arise in the field of depository taxation, the Commission concludes that the precedent of P.L. 86-272 might advantageously be extended to interstate activities of banks and thrift institutions. We propose, however, that Federal legislation on this subject should establish a higher and more specific threshold for State assertions of jurisdiction to tax. That threshold should be defined in terms of a substantial physical presence within the taxing State. The jurisdictional provision should be supplemented by a congressional declaration of policy regulating interstate division of the taxable base of any depositories subject to an income, receipts, or other "doing business" tax outside the home-office State.

1/ 15 U.S.C. 381-384; P.L. 86-272, September 14, 1959; 73 Stat. 555; reproduced in appendix G of this report.

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State Taxation of Banks: Issues and Options

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Advisory Commission on
Intergovernmental Relations

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law and removed all prior conditions and limitations on state taxation of national banks and passed legislation requiring only that states tax national banks in the same manner as they tax their state-chartered banks.

The history of congressional restrictions on state taxation of national banks contains valuable lessons for proponents of federal intervention in state taxing powers.

First, congressional intervention in state taxation, which is effected through specific statutory limitations and/or directives, is subject to differing interpretations by the states. Years of litigation are unlikely to bring either order or clarity to state tax systems. Judicial opinions are, by their nature, piecemeal and narrow. Issues that are suitable for judicial resolution involve questions of whether a state has interpreted a given law reasonably or whether a certain state or federal statute violates the U.S. Constitution. The judiciary does not have the power to analyze and revamp entire state tax systems. As the Supreme Court itself has recognized on numerous occasions, spasmodic and unrelated instances of litigation cannot afford an adequate basis on which to create consistent rules in the area of state taxation.[49]

Second, laws that contain specific directives and limitations often have unintended consequences brought about by changing judicial interpretations and by new business practices. In an area of law like tax jurisdiction, which must respond to technological advances,[50] and in a business like banking, which is currently highly innovative, such unintended consequences are inevitable.

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Chapter 6

Conclusion

The 1819 decision of the Supreme Court in *McCulloch* v. *Maryland* set the stage for congressional domination of state taxation of national banks and federal obligations that continues today. States cannot tax either national banks or federal obligations without statutory permission from the Congress.

The Congress began exercising its control over state taxation of national banks with the passage of the *National Currency Act* in 1864. The act codified the *McCulloch* holding by permitting states to tax the real property and shares of national banks. One section of the act limited state taxes on national bank shares to a rate no greater than the rate assessed on "other moneyed capital." This first congressional foray into the business of regulating state taxation of national banks through specific statutory directives and limitations signaled the beginning of over a century of litigation involving mind-numbing differences in state calculations of their rates of taxation and interpretations of the phrase "other moneyed capital."

By 1969, the Congress had recognized that neither further amendments, which merely led to a new round of litigation, nor judicial mediation, which produced a large body of inconsistent and conflicting opinions, could bring order or clarity to state taxation of national banks. In a final revision of the law, the Congress removed all prior conditions and limitations on state taxation of national banks and passed legislation that directed states to tax national banks in the same manner as they tax their state banks. The new law became effective in 1976.

Given the long history of congressional control over the methods by which a state could tax national banks, it is not surprising that most states have not yet revised their laws to reflect either the changes in federal law or the changes in the business of banking. For example, some states still tax their domestic banks using pure residence-based taxation, even though that system fails to promote competitive equality between in-state and out-of-state banks and creates the potential for multiple taxation. Approximately 32 states apportion the income of multistate banks. About 11 of those states apportion the income of in-state and out-of-state banks using the UDITPA three-factor formula, which was designed for manufacturing companies. By failing to take account of intangible property, such as loans and government securities, the UDITPA formula misallocates income among the states when used for banks. There is no commonality among the apportionment rules in the remaining 21 states. Also, most states still use jurisdiction rules based on a physical presence, although such rules appear obsolete in an era in which loans are made and deposits solicited interstate by mail, telephone, and other electronic means.

It is not possible yet to describe all the contours of the "best" bank tax. States have only recently begun to amend their bank tax laws to take advantage of the lifting of prior congressional restraints; therefore, one cannot measure the relative effectiveness of the new taxes. The three states that have recently revamped their laws—Minnesota, New York, and Indiana—have adopted very different approaches to the taxation of bank income. Both Minne-

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