Constitution Issues in Local Taxation

ABA SALT

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Introduction

The number of local taxes is as wide and diverse as the number of states, cities and counties in the United States.

Under the federal system, states have taxing powers that are unique to each state. Along with the taxing authority that each state enjoys, each state and its respective constitution passes specific taxing authority to the lower level jurisdiction.

Each constitution provides for not only the types of taxes that the lower jurisdiction can enact, but sets out the guidelines and, more importantly, the restrictions on how and when the lower level jurisdictions can enact those taxes.
The bottom line is that each lower level jurisdiction must not only comply or be in sync with the U.S. Constitution, but also the state level constitutions. One consideration that needs to be discussed the fact that most of the local level jurisdictions are administered by citizen office holders that do not necessarily hold law degrees or tax designations. The result is that the enactment of the ordinances and laws may sometimes be an adventure in legal sufficiency and may be open to constitutional – both federal and state - challenge.
Constitutional Test

A local (or state) tax violates the U.S. Constitution if:

1. there is not a substantial nexus between the taxing jurisdiction and the activity taxed;

2. the tax discriminates against interstate commerce;

3. the tax is unfairly apportioned; or

4. the tax is unrelated to services provided by the State

Discrimination

Internal Consistency Test


The test “looks to the structure of the tax at issue to see whether its *identical application by every State* in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.” *Wynne*, 135 S. Ct. at 1803 (emphasis added).
Discrimination | Internal Consistency Example

“All persons engaging in business activities shall include the total gross receipts from work performed within the City; in addition, if such person owns, leases or otherwise maintains within the City a place or premises from which such person engages in business activities outside the City, such person shall include 30% of gross receipts from work performed outside the City in the measure of the tax.”

City of Oakland, Director of Finance Ruling No. 9 (emphasis added).
Fair Apportionment

Internal Consistency

“[T]he formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business’ income being taxed.” Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

External Consistency

“[T]he factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.” Container Corp., 463 U.S. at 169.
Fair Apportionment | External Consistency Example

A number of San Francisco Gross Receipts Tax business classifications provide for **payroll apportionment**

- Repair and maintenance services, personal and laundry services, and religious, grantmaking, civic, professional and similar organizations\(^1\)
- Arts, entertainment and recreation\(^2\)
- Private education and health services, and administrative and support services\(^3\)
- Financial services, insurance, and professional, scientific and technical services\(^4\)

Notes: \(^1\) San Francisco Business and Tax Regulations Code ("Code") § 953.1.  
\(^2\) Code § 953.3.  
\(^3\) Code § 953.4.  
\(^4\) Code § 953.6.
Fair Apportionment | External Consistency Example

San Francisco Payroll Apportionment

“[G]ross receipts of the person [are] multiplied by a fraction, the numerator of which is payroll in the City and the denominator of which is combined payroll.”[1]

“Payroll in the City is the total amount paid for compensation in the City”[2] and “[c]ombined payroll is the total worldwide compensation ...”[3]

“Compensation” means “wages, salaries, commissions and any other form of remuneration paid to employees for services. In the case of any person who has no employees, compensation shall also include all taxable income for federal income tax purposes of the owners or proprietors of such person who are individuals.”[4]

Fair Apportionment | External Consistency Example

Issues that may arise in the context of San Francisco’s payroll apportionment:

• Owner/proprietor’s contribution disregarded if business has employees

• Payroll % in the current year may not reflect activities at the time the receipts are earned.\(^1\)

• Receipts from non-water’s edge group member?

See FTB Legal Ruling 2019-01 for a recent discussion of distortion, which is based on the external consistency requirement.

The burden is high – the tax only need be “fairly attributable to economic activity” within the City\(^2\) and not “out of all appropriate proportions to the business transacted” in the City.\(^3\)

Notes: \(^1\) See Appeal of Donald M. Drake Company, State Bd. of Equalization, March 2, 1977.
Fair Apportionment | External Consistency Example

Request Alternative Apportionment

“The Tax Collector may, in his or her reasonable discretion, independently establish a person’s gross receipts within the City and establish or reallocate gross receipts among related entities so as to fairly reflect the gross receipts within the City of all persons.” Code § 957.
Substantial Nexus | Local Economic Nexus

A person is “engaging in business” in San Francisco if that person meets one or more of the following conditions:

(a) The person maintains a fixed place of business within the City; or

... 
(k) The person has more than $500,000 in total gross receipts, as the term “gross receipts” is used in Article 12-A-1 of the Business and Tax Regulations Code, in the City during the tax year, **using the rules for assigning gross receipts under Section 956.1** of Article 12-A-1.

Code § 6.2-12.
Substantial Nexus | Local Economic Nexus

Market-based sourcing under Code § 956.1

- Gross receipts from sales of tangible personal property are in the City if the property is delivered or shipped to a purchaser within the City ...

- Gross receipts from the rental, lease or licensing of tangible personal property are in the City if the property is located in the City.

- Gross receipts from services are in the City to the extent the purchaser of the services received the benefit of the services in the City.

- Gross receipts from intangible property are in the City to the extent the property is used in the City. ...
Substantial Nexus | Local Economic Nexus

• Compare Cal. Rev. & Tax. Code 25136:

  Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state.

  Sales from intangible property are in this state to the extent the property is used in this state.

• Cal. Code Regs., tit. 18, § 25136-2 interprets this language at the California state level.

• Commenters have raised constitutional issues with using the proposed § 25136-2 sourcing rules for establishing nexus, which appears equally a concern for San Francisco.
Substantial Nexus | Old Codes and New Interpretations

The Modesto municipal code requires a business license to “carry on any business, trade, profession, calling or occupation in the City of Modesto.”[1]

“Every person having a license issued under the provisions of this chapter, and carrying on a trade, calling, profession, or occupation at a fixed place of business, shall keep such license posted and exhibited while in force in some conspicuous part of said place of business.”[2]

And persons “not having a fixed place of business shall carry such license with him/her at all times while carrying on the trade, calling, profession or occupation for which the same was granted.”[3]

Application of Local Business Privilege Tax (BPT) Violated Commerce Clause

In *Upper Moreland Township v. 7 Eleven, Inc.*, 160 A.3d 921 (Pa. Commw. Ct. 2017), a local *business privilege tax (BPT)* imposed on fees paid by Pennsylvania 7-Eleven franchisees to 7-Eleven’s regional office in the Township held unconstitutional because not fairly apportioned.

7-Eleven filed BPT returns reporting gross receipts generated by the corporate store in the Township, but did not include the 7-Eleven charges it collected from franchise stores in the Northeast Division. The Township assessed tax on all of the 7-Eleven Charges from franchise stores in Pennsylvania, even though the activity that generated the Pennsylvania 7-Eleven Charges resulted from economic activity from both inside and outside Pennsylvania.
Application of Local Business Privilege Tax (BPT) Violated Commerce Clause, Cont.

To establish that a tax is not externally consistent, the taxpayer must prove that the income attributable to the taxing municipality is disproportionate to the business transacted in the municipality, has led to a grossly distorted result, or is inherently arbitrary or produced an unreasonable result.

The Commonwealth Court affirmed the lower court’s holding that based upon the application of the test set forth in Complete Auto Transit, supra, the tax on interstate commerce was not fairly apportioned, in violation of Commerce Clause and remanded for a recalculation of tax due by 7-Eleven.
Other Challenges to Local Expansions of Tax Law

States derive their powers to impose taxes from the 10th Amendment to the U.S. Constitution, which provides, “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people.”

Local governments obtain their authority to impose tax from the states, by constitutional grants, by statute, or both.

When confronted by an expansion of a local tax or fee as applied to businesses operating in multiple jurisdictions, taxpayers should first determine whether the local tax collector is authorized to levy such tax or fee.
Alcohol Excise Tax Disguised as License Tax Found Constitutional

Despite its holding in *Radiofone, Inc. v. The City of New Orleans*, 630 So.2d 694 (La. 1994), striking down a city tax on the privilege of engaging in the telecommunications business which exceeded the limitations on occupational license taxes established in the La. Constitution, the La. Supreme Court more recently, in *Beer Industry League of Louisiana v. City of New Orleans*, No. 2018-0289, 251 So.3d 380 (La. 2018), upheld the City of New Orleans’ efforts to sidestep restrictions on its power to tax by finding that the City’s ‘excise or license tax’ on dealers of alcoholic beverages of both high and low alcoholic content was an occupational license tax that did not exceed that imposed under the state statute.
Alcohol Excise Tax Disguised as License Tax, Cont.

• The Louisiana Supreme Court in *Beer League*, *supra*, reversed the trial court’s decision that the ordinance imposing the gallonage tax was unconstitutional.

• The court said that to determine what type of tax is being levied, a court must look to the operational effect of the tax, as opposed to the descriptive language in the assessment.
Alcohol Excise Tax Disguised as License Tax, Cont.

• The court ignored the fact that the statute authorizing the state’s gallonage tax provided that it was levying a tax on high alcoholic beverages and that under the ordinance the liability for the tax followed the alcohol, and maintained that although the tax was levied pursuant to the statute imposing the state excise/gallonage tax, the tax was really an occupational license tax.

• But then, the court said that the prohibition against any occupational license taxes applicable to the wholesale trade of alcoholic beverages in La. R.S. 47:360(D) did not apply because this “occupational license tax” had been imposed under the state’s gallonage/excise tax contained in a Title 36 of the La. Revised Statutes rather than Title 47.
Supremacy Clause – Preemption

The U.S. Constitution’s Supremacy Clause prevents states from enforcing laws that circumvent federal restrictions and frustrate Congress’ intent. Article VI, Cl. 2 of the United States Constitution.
Public Law 86-272, Imposition of Net Income Tax

• P.L. 86-272 was enacted by Congress in response to the Supreme Court’s decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), as stopgap legislation to limit state taxing power on remote sellers until it could look at the issue more closely.

• This federal law prohibits states and localities from imposing net income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state. 15 USC §381.
Does P.L. 86-272 provide any relief?

Gross Receipts Tax

In *Stanislaus Food Products Co. v. Director, Division of Taxation*, No. 011050-2017 (N.J.T.C, June 28, 2019), the New Jersey Tax Court, in an unpublished decision, recently held that a California company was protected from New Jersey’s *corporation business tax* (CBT) by P.L. 86-272.

As part of the Business Tax Reform Act of 2002, New Jersey required corporations to pay the higher of the regularly computed corporate income tax or the then-new *alternative minimum assessment* (AMA).

Beginning in 2006, the AMA was effectively eliminated for most corporations but stayed in place for corporations protected from income tax by P.L. 86-272 (The AMA’s base was gross receipts/profits and the tax only applied to entities protected by P.L. 86-272).

It was determined that New Jersey, by having a tax imposed exclusively on P.L. 86-272-protected companies, which could not be taxed under the general corporate income tax, made an end-run around the federal prohibition, violating the Supremacy Clause.
Does P.L. 86-272 provide any relief?

Income Tax

Is P.L. 86-272 still relevant in a modern, intangibles driven world? Maybe, to sellers of digital goods if classified as tangible personal property under state or local law.
First Amendment

• A tax that is “content-based,” i.e., directed to the suppression of free expression, is subject to strict scrutiny under the First Amendment. *Leathers v. Medlock*, 499 U.S. 439, 447 (1991). In determining tax classifications, the legislature may not create categories that suppress the expression of particular ideas or viewpoints. If the tax classification raises free speech concerns by threatening to suppress the expression of particular ideas or viewpoints, the tax is constitutionally suspect and becomes subject to strict scrutiny, thus requiring the state to offer a compelling justification for the tax. *Arkansas Writer’s Project*, 481 U.S. at 231. If the fundamental right of free speech is not infringed, then equal protection analysis requires that the classification be rationally related to a legitimate state interest.

• A tax that is not content-based is evaluated under four-part test set forth in *United States v. O’Brien*, 391 U.S. 367 (1968), for evaluating content-neutral restrictions on symbolic speech. Under that test, a government regulation is sufficiently justified if (1) it is within the constitutional power of the government; (2) it furthers an important or substantial governmental interest; (3) the governmental interest is unrelated to the suppression of free expression; and (4) the incidental restriction on alleged First Amendment freedoms is no greater than is essential to the furtherance of that interest. *O’Brien, supra*; *Combs v. Texas Entertainment Ass’n, Inc.*, 347 S.W.3d 277 (Tex. 2011).

• Watch out for ordinances that contain exemptions that are content-based.
Chicago

From our friends at Horwood Marcus – While Illinois has an economic nexus standard in statute – Chicago does not.

Does the Wayfair “economic standard” apply without a statute or ordinance defining nexus? Does jurisdiction apply?

Chicago auditors are using Wayfair thresholds in Personal Property Lease Transaction audits

Will the Chicago “cloud computing” ordinance rely on Wayfair?
Philadelphia

From our friends at Chamberlain Hrdlicka


• Violation of Pennsylvania’s Uniformity Clause

• Prohibition against discriminatory assessment practices that favored one class of taxpayers over another – residential over commercial.

• “Where there is conflict between maximizing revenue and ensuring that the taxing system is implemented in a non-discriminatory way, the Uniformity Clause requires that the latter goal must be given primacy.” Valley Forge.

• Discrimination against non-residential properties in favor of residential owners.
RESULT:

July 17, 2019 decision Philadelphia Court of Common Pleas Order: City Council pressured Office of Property Assessment to raise revenue. Only commercial reassessment or 2018 Striking 2018 Assessments Applied only to appellants before the Court but left open possible refunds for other commercial property owners

TAKE HOME: Look not only to the federal Constitution but to the state one as well. States constitutions may address the issue of property tax and other taxes with a deeper dive than the federal. The state ones’ address property tax and other local level taxes.
Credits and refunds for overpayments of Business Privilege Tax (BPT)/ statutes of limitations / credits and refunds are not the same thing.

But see the Dissent” “However, there is simply no salient requirement for equilibrium as between constraints upon the government (which represents the interests of the citizenry at large) and those affecting individual taxpayers.”

Does Discrimination come into play when dealing with credits and or refunds? Can the city be treated one way and the individual taxpayer be treated another?
Virginia BPOL


Apportionment and allocation principles of the federal Constitution applies to local level taxes as well.

Taxpayer cited to Complete Auto Transit but the circuit court rejected that argument in determining that “the income attributed to the Richmond Branch was not “out of all appropriate proportion” to the business transacted in the locality” …
VA S. Ct. not citing *Complete Auto* directly – cited *City of Winchester v. American Woodmark* which did rely on Commerce Clause language.

Looked specifically to statutory language that provided deduction ‘[a]ny receipts attributable to business conducted in another state or foreign county in which the taxpayer (or its shareholders, partners or members in lieu of the taxpayer) is liable for income or other tax based upon income” shall be deducted from gross receipts that would otherwise be taxable.”
QUESTIONS?  THANK YOU!