2007

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Recommended Citation
Avi-Yonah, Reuven S. "Federalism and the Commerce Clause: A Comparative Perspective." St. & Loc. Tax. Law. (2007): 3-8.

Federalism and the Commerce Clause: A Comparative Perspective

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The U.S. Supreme Court has on numerous occasions addressed the constitutionality of state taxes under the U.S. Constitution (most often under the Commerce Clause, but sometimes under the Equal Protection and Due Process Clauses). In general, the Supreme Court has granted wide leeway to the states to adopt any tax system they wish, only striking down the most egregious cases of discrimination against out-of-state residents. Thus, for example, the Court has generally refused to intervene against state tax competition to attract business into the state.[1] It has twice upheld a method of calculating how much income of a multinational enterprise can be taxed by a state that is widely seen as both incompatible with the methods used by the Federal government and other countries, and as potentially producing double taxation.[2] And it has allowed states to impose higher income taxes on importers than on exporters through the use of so-called "single factor sales formulas," under which a business pays tax to the state only if it makes sales to residents of the state, but not if it makes sales outside the state.[3] Most recently, the Supreme Court has refused to intervene in two cases in which states imposed income taxes on an "economic nexus" theory on taxpayers with no physical presence in the taxing state.[4]

When these line of cases are compared to the European Court of Justice's (ECJ) treatment of Member State taxes under the Treaty of Rome (the "Constitution" of the EU), the difference is striking. In the last twenty years, with

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[1]*See, e.g.*, DaimlerChrysler Corp. v. Cuno, 572 U.S. 332, 549-54 (2006) (refusing to grant the taxpayers standing to challenge the franchise tax credit). *See generally* Philip M. Tatarowicz, *Federalism, the Commerce Clause, and Discriminatory Business Tax Incentives Limited to In-State Activities of the Taxpayer*, 60 TAX LAW. 835, 899–922 (2007) (arguing that unconditional business tax incentives limited to instate activities of the taxpayer are acceptable under the Court's precedents).

[2]*See* Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298, 311–14 (1994); Container Corp. of Am. v. Franchise Tax Bd., 462 U.S. 159, 184 (1983); *cf.* Brian D. Lepard, *Is the United States Obligated To Drive on the Right?* 10 DUKE J. COMP. & INT'L L. 43 (1999).

[3]*See* Moorman Mfg. Co. v. Bair, 437 US 267, 276 (1978); Charles E. McLure, Jr. & Walter Hellerstein, *Does Sales-Only Apportionment of Corporate Income Violate International Trade Rules*, 25 ST. TAX NOTES 779 (2002).

[4]*See* MBNA v. Tax Commissioner of W. Va., 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied*, FIA Card Services, N.A. v. Tax Commissioner of W. Va., 127 S. Ct. 2997 (2007); Lanco v. Dir., Div. of Taxation, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 127 S. Ct. 2973 (2007).

increasing frequency in the last five, the ECJ has interpreted the Treaty of Rome aggressively to strike down numerous Member State income tax rules on the ground that they were discriminatory.[5] For example, the ECJ has ruled that Finland cannot grant tax credits for corporate tax paid to Finnish shareholders but refuse them to foreign shareholders.[6] In another case, the ECJ struck down Germany's rules that restricted the deductibility of interest to foreign lenders, even though the rules also applied to tax-exempt domestic lenders.[7] Other examples of provisions struck down by the ECJ are:

> a dividend tax credit granted to resident companies but refused to the branch of a company having its seat in another Member State;[8]
>
> a refund of overpaid income tax granted to permanent residents but refused to taxpayers moving to another Member State during the tax year;[9]
>
> personal reliefs granted to residents but refused to non-residents even where they could not benefit from such reliefs in their Member State of residence;[10]
>
> a business relief (a tax deduction for transfers of funds to a pension reserve) granted to residents but refused to non-residents.[11]

On the face of it, this contrast is surprising. After all, the ECJ is dealing with fully sovereign countries, and taxation is one of the primary attributes of sovereignty. Moreover, the authority of the ECJ to strike down Member State direct taxes is unclear. The Treaty of Rome generally reserves competence in direct taxation to the Member States, and all EU-wide changes in direct taxation have to be approved unanimously by all 25 Member States. Nevertheless, the ECJ has since the 1980s interpreted the "four freedoms" embodied in the Treaty of Rome (free movement of goods, services, persons, and capital) to give it the authority to strike down direct tax measures that it views as incompatible with the freedoms.

The Supreme Court, on the other hand, has clear authority under the Supremacy Clause to strike down state laws that are incompatible with the Constitution. As Justice Oliver Wendell Holmes observed, the United States will not be hurt if the power to review federal laws were taken away from the

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[5] *See generally* Ruth Mason, *A Theory of Tax Discrimination* (The Jean Monnet Program, Working Paper 09/06), *available at* http://ssrn.com/abstract=978880 (2006); REUVEN AVI-YONAH, JAMES HINES & MICHAEL LANG, COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN COURT OF JUSTICE AND THE U.S. SUPREME COURT'S TAX JURISPRUDENCE (2007).

[6] Case C-319/02, Proceedings brought by Manninen, 2004 E.C.R. I-7477.

[7] Case C-324/00, Lankhorts-Hohorst Gmbh v. Finanzamt Steinfurt, 2002 E.C.R. I -11779.

[8] Case C-270/83, Commission v. French Republic, 1986 E.C.R. 273.

[9] Case C-484/93, Svensson v. Ministre du Logement et de l'Urbanisme, 1995 E.C.R. I-3955.

[10] Case C-279/93, Finanzamt Koln-Altstadt v. Schumaker, 1995 E.C.R. I-225.

[11] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493.

Court, but it could not survive if the Court lost its power over state legislation. More-over, the states are not fully sovereign, and are not even directly represented in Congress. Therefore, the Court could strike down their laws without (in most cases) expecting an outcry from the other branches of the federal government.

What is the explanation for the contrast? Part of the reason is that Member State taxes in the EU are more important than state taxes in the United States because most taxes in the United States are paid to the federal government, whereas all taxes in the EU are paid to Member States. Thus, even high-tax states like New York or California have income tax rates in the low double digits, whereas Member State tax rates can reach 39% (for corporations) and 56% (for individuals).[12]

However, this cannot be the whole answer because the U.S. Supreme Court adopted its lenient attitude to state taxation before there were federal taxes (the federal corporate tax only began in 1909, and the federal income tax in 1913, long after the states began taxing income). Instead, the answer lies in different conceptions of federalism.

In the United States, the country began as a loose confederation of sovereign states. The issue of state sovereignty loomed large in the formation of the Constitution and, thereafter, through the civil war, and the concept of state rights still resonates strongly today. As a result, in the United States, federalism means that the federal government should respect the sovereignty of the states as much as is compatible with the need to have a unified country. Taxes are essential to sovereignty, and therefore, the Supreme Court has always maintained a deferential attitude to state choices in matters of taxation, even if it resulted in some level of discrimination against out-of-state taxpayers. The Supreme Court intervenes only when the tax is blatantly discriminatory, such as New Hampshire's attempt to adopt an income tax only for nonresidents who commute into the state.[13]

In the EU, on the other hand, there is no unified central government, but there is a background of bitter wars between sovereign states. As a result, there is a wish among some for the creation of a "United States of Europe." That goal has so far proven elusive, but the focus of the federalists has been to advance it by enhancing the economic union that underlay the formation of the EU. Thus, the ECJ has taken the lead in trying to create a meaningful single market. It, and the EU Commission (which brings many of the tax cases before the ECJ), see discrimination in direct tax matters as a major obstacle to the achievement of this goal. Ultimately, many observers feel that the ECJ is trying to force Member States to abandon the unanimity rule for direct tax matters and even to achieve direct tax harmonization, such as the harmoni-

[12]OECD in Figures, 58–59 (2008) (Germany and Hungary).
[13]Austin v. New Hampshire, 420 U.S. 656, 665 (1975).

zation already used for indirect taxes (consumption taxes, such as VAT, are harmonized in the EU by the Sixth Directive, adopted by unanimous consent when the EU was much smaller).

Given this divergence of political context, can the ECJ and the Supreme Court learn something from each other's tax jurisprudence? I believe the answer is yes.[14]

In regards to the U.S. Supreme Court, I believe the EU experience shows that it is sometimes too lenient in state tax matters. In particular, permitting states to compete for the location of investment by multinationals by granting tax incentives has proven to be very costly for the states, while not bringing any benefit to the United States as a whole (since the multinational typically has decided to invest somewhere in the United States already). Such tax competition creates a "race to the bottom," in which states only grant incentives to prevent the multinational from going elsewhere, not because they believe the benefits of the investment truly justify the cost in foregone tax revenue. In Europe, such incentives are banned by the State Aid provisions of the Treaty of Rome, which are strictly interpreted by the Commission and the ECJ to prohibit all tax incentives that are targeted at particular taxpayers.

Unfortunately, the Supreme Court has recently declined to address this very issue. In 1998, the City of Toledo granted DaimlerChrysler $280 million in tax incentives to expand its factory there, rather than move it to Michigan or elsewhere in the United States. The Sixth Circuit Court of Appeals in *Cuno v. DaimlerChrysler, Inc.* held that such targeted tax incentives violate the Commerce Clause of the U.S. Constitution.[15] However, the Supreme Court reversed on the ground that the plaintiffs lacked standing to raise the issue.[16] It is likely that this question will arise again with better plaintiffs, and if so, the Supreme Court should learn from the ECJ and affirm on the merits.

What about the ECJ learning from the Supreme Court? Here as well, a recent decision illustrates a learning opportunity. In *Marks & Spencer v. Halsey*, the issue was whether the United Kingdom (U.K.) was obligated to allow losses incurred by Marks & Spencer's foreign subsidiaries to offset income earned by the U.K. parent because under U.K. rules it can use losses by domestic subsidiaries to offset income of the parent. The big difference, of course, is that the domestic subsidiaries are subject to tax at the same rate as the parent, while the foreign subsidiaries can be in Estonia, where there is no corporate tax, or in Ireland, where the tax rate is only 12.5%. The ECJ ruled that the U.K. must allow the loss offsets even though it cannot tax the foreign subsidiaries.[17]

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[14]*See* Mason, *supra* note 5, at 7 (proposing that the ECJ develop the "internal consistency" test as developed by the Court).

[15]386 F.3d 738, 746 (6th Cir. 2004).

[16]DaimlerChrysler Corp. v. Cuno, 547 U.S. 332, 344–46 (2006).

[17]Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837.

It is widely believed that the ECJ ruled the way it did in order to force the political branches of the EU to move toward corporate tax rate harmonization, as the Commission has advocated (to no avail) for many years. But here the ECJ can learn a lesson from the U.S. Supreme Court: deciding cases in order to force action by the legislature can be dangerous.

This rule can be illustrated by the *Quill* case, decided by the Supreme Court in 1992.[18] The case involved a question that had confronted the Court before: under what circumstances can a state force retailers that sell into the state by remote means, such as catalogues (nowadays via the Internet), to collect the sales tax due on the purchases? The tax is clearly due, but relying on the buyers to pay it voluntarily is hopeless, so collection by the remote vendor is the only practical way to enforce the tax.

In 1967, the Court held that a vendor cannot be forced to collect the tax unless it has a physical presence (like a warehouse) in the state, relying on both the Due Process and Commerce Clauses of the U.S. Constitution.[19] Most observers expected when the Court accepted the *Quill* case that it would overturn that decision, given the phenomenal growth of the remote sales industry between 1967 and 1992. Instead, the Court held that the physical presence test still applies, but only under the Commerce Clause, not the Due Process Clause.

The reason the Court adopted this approach is clear: Commerce Clause decisions can be changed by Congress through simple legislation, since the Constitution gives Congress the power to regulate commerce among the states, but Congress is powerless to overcome decisions under the Due Process Clause. The Court thus expected Congress to intervene and set rules under which states can force remote vendors to collect sales taxes.

Fifteen years have passed, and Congress has not acted. The reason is simple: The states are not represented in Congress, so Congress cares more about the remote sales industry with its powerful lobby than about state tax revenues. In the meantime, the Internet has sprung into existence, remote sales now top $100 billion per year, and state sales tax revenues are rapidly shrinking.[20]

The lesson for the ECJ is thus not to decide cases in the expectation that the political branches will act. Many Member States are vehemently opposed to direct tax harmonization. The U.K., for example, is more likely to react to losing *Marks and Spencer* by abolishing its domestic loss offset rules than by giving up on the unanimity requirement in direct taxes. Thus, the lesson for the ECJ is that it should be more careful about dismantling Member States

[18]Quill Corp. v. North Dakota, 504 U.S. 298, 311–12 (1992).

[19]Nat'l Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753, 758 (1967).

[20]Billy Hamilton, *Internet Sales Tax: What if There's No There There?*, 2008 St. Tax Today 171-3 (Sep. 3, 2008).

income taxes, because such decisions can have unexpected consequences.

More broadly, I believe comparing the U.S. and EU experiences shows that there is more than one way of constructing a single market without tax distortions, and that some level of distortion can be accepted. Thus, the U.S. Supreme Court can afford to be a bit more harsh without trampling down on state sovereignty on tax matters, and the ECJ can afford to be more lenient without creating unacceptable barriers to trade and investment within the EU.