The L in SALT: Limits on Local Jurisdiction to Tax

by Martin I. Eisenstein and Jamie Szal

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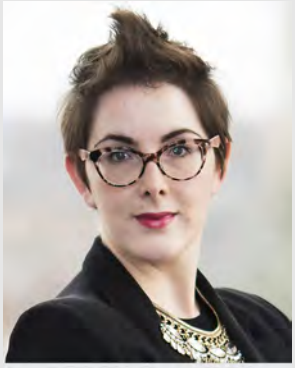

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In this edition of Eyes on E-Commerce, Eisenstein and Szal write about localities' recent attempts to impose transaction taxes on interstate commerce, highlighting via case law analysis the limitations on local jurisdictions' taxation powers.

Until recently, the SALT community paid little attention to local jurisdictions' taxing powers. Indeed, the name of this publication is a good example of this phenomenon. The number of articles (and reported court and administrative decisions) about limitations on local taxes pales compared with state tax literature and court decisions. The trend may be turning, with Walter Hellerstein's *State Tax Notes* article on the subject[1] and the well-publicized recent efforts by Chicago and other municipalities to impose transaction taxes on interstate commerce.

This article highlights — from the practitioner's standpoint — the limitations on a local jurisdiction's powers to impose a sales, transaction, or privilege tax. Each local tax must be analyzed against the background of factors such as whether the locality has exceeded the powers delegated by the state, and whether the tax is prohibited by a state or federal statute or constitutional provision. The focus here is on the commerce clause, and particularly satisfying the four-prong test of *Complete Auto Transit Inc. v. Brady*.[2] Is the evaluation of these four factors based on the taxpayer's relationship to the local tax jurisdiction or to the state? If a company has nexus with the state, does it automatically have nexus with each local jurisdiction for purposes of a local sales tax, transaction tax, or privilege tax?

We think not. In our opinion, review of the *Complete Auto* factors must be done in the context of the source of the locality's power to tax. A locality's status as a home rule jurisdiction with sovereign powers to tax affects the analysis of the tax under the substantial nexus, fair apportionment, and fair relationship prongs of the *Complete Auto* test, although discrimination is determined on a local basis regardless of whether the local tax at issue is adopted under home rule authority.[3]

[1] Walter Hellerstein, "Are State and Local Taxes Constitutionally Distinguishable?" *State Tax Notes*, Mar. 27, 2017, p. 1091.

[2] 430 U.S. 274, 279 (1977).

[3] *Associated Industries of Missouri v. Lohman*, 511 U.S. 641, 651 (1994).

Local Tax Authority

Localities' recent efforts to impose sales and excise taxes on businesses operating in interstate commerce — even though there are no comparable state taxes — sparked our interest in the issue. On June 9, 2015, the City of Chicago Department of Finance surprised the SALT community with two rulings interpreting the amusement tax and personal property lease transaction tax. Under Amusement Tax Ruling #5, the amusement tax applies to "charges paid for the privilege to witness, view or participate in amusements that are delivered electronically."[4] The city made clear that it intended to tax the delivery of Netflix and other similar streaming services, though no state tax statutes taxed those services, nor did the underlying ordinance authorize taxation of those services. Similarly, in Personal Property Lease Transaction Tax Ruling #12, the department held that the personal property lease transaction tax applied to the cloud service, software as a service (SaaS), accessed in Chicago.[5] Taxation of SaaS was neither within the contemplation of the city council when adopting the ordinance nor authorized under the state sales tax statute.[6]

On a related note, Denver[7] and Phoenix[8] have imposed sales taxes on prewritten software delivered electronically or accessed remotely, and internet advertising, respectively, although these services are not subject to the state sales and use taxes.

Chicago, Denver, and Phoenix are all home rule jurisdictions; that is, a jurisdiction that the state has granted the exclusive authority to administer taxes separately from the state and that can determine its tax rates, taxable items, and exemptions.[9] The state's grant of authority delegates to the municipality a measure of autonomy in matters of local concern.[10]

In contrast, a second category of local jurisdictions administer a state tax statute enacted based on "Dillon's Rule." Under Dillon's Rule, an enabling state statute allows the local government to act within a defined scope; these localities may exercise only powers that are legislatively granted, along with those necessarily implied to effectuate the express powers.[11] As we discuss later, the difference between the types of jurisdictions affects the commerce clause analysis.

The *Associated Industries* Test

The U.S. Supreme Court's formulation of the modern dormant commerce clause test in *Complete Auto* was based on a state tax — in that case, an excise tax imposed by Mississippi.[12] Nevertheless, the dormant commerce clause has always been

[4] City of Chicago Department of Finance Amusement Tax Ruling. Chi. Dept. Finance Amusement Tax Ruling #5 (June 9, 2015). *See also* Chi. Mun. Code sections 4-156-010, 020(A), 030(A).

[5] Transaction Tax Ruling. Although the personal property lease tax was designed to tax rental equipment in the city, department rulings have expanded the ordinance's scope to include data storage on a server in Chicago and data processing services from outside Chicago if the access terminals were located in the city.

[6] The Chicago City Council later made clear that the personal property lease transaction tax covered SaaS and other cloud services, although it reduced the rate for these services from 9 percent to 5.25 percent. The rate remains 9 percent for receipts from all other leases.

[7] *See, e.g.*, Denver Mun. Code sections 53-25(7), 53-96(6); Denver Tax Guide Topic No. 18, "Data Processing" (Oct. 2014); and Colo. Rev. Stat. section 39-26-102(15)(c)(l) (software taxable effective June 1, 2012).

[8] *See, e.g.*, Phoenix City Code section 14-405; and City of Phoenix Tax Bulletin — Advertising (Apr. 2014).

[9] All county, municipal, and local jurisdictions are political subdivisions of a state that are created by the state and obtain their source of power — including powers to tax — from a state constitutional or statutory provision. *Hunter v. City of Pittsburgh*, 207 U.S. 161, 178-79 (1907).

[10] *See City and County of Denver v. State*, 788 P.2d 764, 767 (Col. 1990) (home rule jurisdictions granted "every power theretofore possessed by the [state] legislature to authorize municipalities to function in local and municipal affairs"); *see also Black's Law Dictionary* 802 (9th Ed.).

Home rule authority was adopted first in Missouri before spreading to other states. *See* David J. Barron, *Reclaiming Home Rule*, 116 Harv. L. Rev. 2255, 2290 (2003). In an early challenge to St. Louis's home-rule authority, the U.S. Supreme Court described the city's authority as *imperium in imperio* — its powers were self-appointed, not derived from grant by legislature, but through its own home rule charter adopted under constitutional authority. *City of St. Louis v. Western Union Telegraph Co.*, 149 U.S. 435, 467 (1893).

[11] Dillon's Rule was derived from the decisions of Iowa Supreme Court justice John Dillon. *See, e.g., Merriam v. Moody's Executors*, 25 Iowa 163, 170 (1868); *City of Clinton v. Cedar Rapids and the Missouri River Rail Road Co.*, 24 Iowa 455, 475 (1868); and *Clark v. City of Des Moines*, 19 Iowa 199, 212 (1865); *see also City of St. Louis supra* note 10, at 467 (generally, the Legislature delegates to municipal corporations a measure of control over local matters); and *Black's Law Dictionary* 523 (9th ed.) (a locality "may exercise only those powers that the state expressly grants to it, the powers necessarily and fairly implied from that grant, and the powers that are indispensable to the existence of the unity of local government").

[12] A tax passes muster under the commerce clause if it 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 the services provided by the State." 430 U.S. at 279. That is because the commerce clause relates to the congressional power "to regulate Commerce . . . among the several states." U.S. Const., Art. I, section 8.

thought to operate as a restriction on a local jurisdiction's power to tax.[13] As Chief Justice John Marshall stated long ago in *Gibbons v. Ogden*:

> The commerce of the United States . . . is that of the whole United States. Every district has a right to participate in it. The deep streams which penetrate our country in every direction pass through the interior of almost every State in the Union, and furnish the means of exercising this right.[14]

Thus, the Supreme Court recognized in *Associated Industries of Missouri v. Lohman* that if a state is barred from assessing a tax under the commerce clause, it cannot circumvent that bar by delegating power to a local jurisdiction.[15]

In *Associated Industries*, a trade association representing businesses selling to customers in Missouri challenged the state's multitiered system of state and local sales and use taxes. Missouri imposed a 4 percent state sales tax and a parallel use tax at the same rate; the state also imposed an additional use tax at a flat 1.5 percent rate to compensate and equalize state-authorized taxes on sales in the state. Local taxes were imposed by counties and other local authorities at rates ranging from 0.5 percent to 3.5 percent.[16] The combined state and local use tax rate for items used in some counties exceeded the aggregate state and local sales tax rate for sales in those counties, although the combined state and local use tax rate was no higher than the average of the aggregate state and local sales tax rates.[17]

The Court held that the proper framework for determining discrimination is whether the use tax exceeded the sales tax for any locality. The fact that the average use tax rate for all jurisdictions did not exceed the average sales tax rate did not save the constitutionality of the tax, because "discrimination is appropriately assessed with reference to the specific subdivision in which applicable laws reveal differential treatment."[18] The Court rejected the approach of "aggregating the burdens on commerce across an entire State to determine the constitutionality of a burden on interstate trade imposed by a particular subdivision of the State," since that approach would frustrate the commerce clause's central objective of securing a national area of free trade among the several states.[19]

Associated Industries requires analysis of commerce clause discrimination at the local level. However, it does not necessarily follow that resolution of the other *Complete Auto* factors is based on review at the local — rather than state — level. Just as a state "may not avoid the strictures of the Commerce Clause by curtailing the movement of articles of commerce through subdivisions of the State, rather than through the State itself," the state statute must be considered.[20] Nevertheless, cases applying the *Complete Auto* factors in home rule jurisdictions suggest that other factors may likewise be analyzed at the local level, depending on the nature of the state's grant of authority.

Substantial Nexus Analysis

Three 1980 cases support the proposition that the nature of the state grant of authority to the municipality drives the commerce clause substantial nexus analysis. In *Sea-Land Services Inc. v. Municipality of San Juan*, the U.S. District Court rejected the defendant municipalities' argument that nexus and the other *Complete Auto* factors must be analyzed from the standpoint of the entire commonwealth of Puerto Rico, rather than on the basis of the connections to the municipalities themselves.[21] Each municipality had an ordinance imposing taxes on various ocean transportation companies. The ordinances were based on the commonwealth's statutory delegation of the power to levy and collect taxes for the privilege of doing business within the municipality. Under this broad

[13] *See Comptroller of the Treasury v. Wynne*, 64 A.3d 435 (Md. 2013), *aff'd on other grounds*, 135 S. Ct. 1781 (2015) ("under the dormant Commerce Clause . . . a state may not unreasonably burden interstate commerce through its subdivisions any more than it may at the state level").

[14] 22 U.S. (9 Wheat.) 1, 195 (1824).

[15] 511 U.S. at 651.

[16] *Id.* at 643-44.

[17] *Id.* at 645.

[18] *Id.* at 650 (internal quotations omitted).

[19] *Id.*

[20] *Fort Gratiot Sanitary Landfill Inc. v. Michigan Department of Natural Resources*, 504 U.S. 353, 361 (1992).

[21] 505 F. Supp. 533, 546 (1980).

delegation of the commonwealth's power to levy and impose the tax, the court ruled that "when it is a city's regulatory burden which is questioned under the Commerce Clause, it is the city's relationship with the given plaintiff which must be examined."[22] Accordingly, the court rejected the municipalities' argument that nexus for the companies must be determined based on their presence in the commonwealth as a whole, but required nexus with the municipalities themselves.

In contrast, in *Aldens Inc. v. Tully* the New York Court of Appeals decided the taxpayer's nexus challenge to a state-imposed local use tax assessment based on its connection to New York state, even though the taxpayer lacked nexus with the localities.[23] A New York statute authorized cities and counties to adopt a sales and use tax identical — but for rate — to the preexisting state sales and use taxes; the local taxes were administered, collected, and distributed by the state.[24] In holding that nexus should be evaluated at the state level, the court found that "a significant, indeed decisive, fact" was that "the obligation for petitioner's collection of local use taxes has been imposed by State, not local, action."[25] According to the court, "in the adoption and imposition of local use taxes, cities and counties exercise a power vested in the State, only to the extent and within the limits the State has seen fit to delegate such authority to them."[26]

In *Allegro Services Ltd. v. Metropolitan Pier and Exposition Authority*,[27] the Illinois Supreme Court distinguished between:

- a municipality's imposition of tax under home rule authority granting the municipality the power to decide the subjects of taxation; and
- a local jurisdiction's assessment based on state statutory authorization to impose the tax on the item assessed by the municipality.

To finance the expansion of the McCormick Place Convention Center, an Illinois statute authorized the Metropolitan Pier and Exposition Authority to issue bonds and impose an occupation tax on anyone providing ground transportation for hire, collected from commercial vehicles departing from O'Hare International Airport and Chicago Midway International Airport.[28] A class of cab service companies challenged the tax on grounds that they did not have substantial nexus with the authority itself.[29] The state supreme court disagreed, holding that the tax — though formally imposed by the authority — was in substance "a manifestation of the legislative policy formed at the State level."[30] Thus, the court determined that "the appropriate nexus to be examined is that between the taxed activity and the state."[31] The court noted, however, that an analysis of substantial nexus focused on the local tax jurisdiction may be suitable for municipal taxes that were the recipients of broad taxing powers to be exercised at the municipality's option, as was the case in *Sea-Land*.[32]

Although there have been no published court decisions addressing the scope of the commerce clause nexus inquiry regarding taxes imposed under Chicago's home rule authority, the city finance department recognizes the limits of its taxing authority. An information bulletin made clear that only companies with substantial nexus in the city are required to collect the controversial personal property lease transaction tax on cloud services.[33] Similarly, while the Illinois Supreme Court ruled that Chicago's attempt to impose the car rental tax on companies doing business outside the city limits violated the Illinois Constitution, the court did not reach the substantial nexus prong of the commerce clause test.[34]

[22] *Id.* at n.37.

[23] 49 N.Y.2d 525 (1980).

[24] *Id.* at 530-531.

[25] *Id.* at 535.

[26] *Id.*

[27] 172 Ill.2d 243, 247 (1996).

[28] *Id.*

[29] *Id.* at 261.

[30] *Id.* at 263.

[31] *Id.*

[32] *Id. at 262.*

[33] *See* Chi. Personal Property Lease Transaction Tax. Information Bulletin, Nonpossessory Computer Leases, at p. 7 (Nov. 2015).

[34] *The Hertz Corp. v. City of Chicago*, No. 2017 IL 119945, 119960 (slip op. filed Jan. 20, 2017) (citing *City of Carbondale v. Van Natta*, 61 Ill. 2d 483, 485 (1975)). Similarly, the June 9, 2015, Personal Property Lease Transaction Tax Ruling and Amusement Tax Ruling stated the city's position that nexus will be triggered only on the basis of "activity that takes place within Chicago." Personal Property Lease Transaction Tax Ruling #12, para. 20; and Amusement Tax Ruling #5, para. 14.

The Colorado Supreme Court has agreed that nexus is determined based on a connection only to the home rule jurisdiction imposing the tax.[35] Called on to determine whether a use tax imposed by Denver under its home rule authority satisfied the commerce clause substantial nexus standard, the supreme court required that the substantial nexus be with Denver.[36] The court applied *Quill Corp. v. North Dakota*[37] and *National Bellas Hess Inc. v. Department of Revenue*[38] to test the sufficiency of the taxpayer's nexus with Denver.[39] Likewise, in determining whether Arvada constitutionally could impose a use tax collection obligation, the court held that the standard for determining nexus in Colorado home rule jurisdictions "is that the taxpayer must be engaged in a business having a fixed or transitory situs in the taxing jurisdiction (the city of Arvada)."[40]

Similarly, the Arizona Court of Appeals, facing a challenge to Phoenix's business privilege tax, adopted under the city's home rule authority, focused on "the nature and quantity of [the taxpayer's] activity in the city of Phoenix."[41] Because the taxpayer corporation had only one sales representative soliciting orders (which were forwarded to Minnesota for acceptance and processing), but no office or inventory within the city limits, the court concluded "the nexus between West and the City [was] insubstantial and insufficient to justify the imposition of the privilege license tax in question."[42]

In sum, state courts addressing substantial nexus for a local tax determine the scope of their inquiry on the nature of the grant of authority to tax. If the municipality has the power to impose the tax under home rule authority, then it is treated as its own sovereign and courts base nexus on connections with the municipality. But if the local tax is authorized by a state statute, with the municipality's only discretion in the setting of the tax rates, the courts have determined nexus based on the taxpayer's connection to the state.

This distinction is supported in the underlying basis for the substantial nexus test. The substantial nexus test of *Complete Auto* serves as "a means for limiting state burdens on interstate commerce."[43] As stated by the U.S. Supreme Court, the risk of varying tax obligations imposed across multiple jurisdictions "illustrates well how a state tax might unduly burden interstate commerce."[44] Thus, in establishing their own tax measures and exemptions, home rule local jurisdictions could — together with the states themselves — create the kind of multiple burdens about which the *Quill* Court was concerned.[45]

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[35] Colorado home rule municipalities have extremely broad authority. By the plain terms of the Colorado Constitution, home rule charters and ordinances enacted under those charters supersede all other state or local laws that stand in direct conflict. Colo. Const., Art. XX, section 6. Colorado home rule jurisdictions explicitly are authorized to levy and collect taxes. *Id*. Municipal tax authority over the same field as that also taxed by the state of Colorado is coexistent. The two taxes are entirely distinct. State constitutional provisions and legislation dealing exclusively with state levies has "no application on taxes levied by home rule cities." *Berman v. City and County of Denver*, 156 Colo. 538, 544-45 (1965).

[36] *General Motors Corp v. City and County of Denver*, 990 P.2d 59, 68 (1999).

[37] 504 U.S. 298 (1992).

[38] 386 U.S. 753 (1967).

[39] *General Motors*, 990 P.2d at 68.

[40] *Associated Dry Goods Corp. v. City of Arvada,* 197 Colo. 491 (citing *Englewood v. Wright*, 147 Colo. 537 (1961), in turn citing *Jackson v. City of Glenwood Springs*, 122 Colo. 323 (1950) (emphasis added) (decided in part on commerce clause grounds)). We note that while the court in *Associated Dry Goods* stated that its ruling that the lack of nexus with Arvada was based on the due process clause, the court grounded its conclusion of lack of nexus on commerce clause cases. 197 Colo. at 494-95 (citing *National Geographic Society v. California*, 430 U.S. 551 (1977); and *Scripto v. Carson*, 362 U.S. 207 (1960)). These Supreme Court decisions applied the same standard for nexus under both the commerce clause and due process clause. It was only later, after the *City of Arvada* case was decided, that the Supreme Court in *Quill* determined that these constitutional clauses have different requirements. Therefore, the *Associated Dry Goods* court's determination that nexus for a tax imposed by a home rule authority is based on physical presence within the limits of the jurisdiction remains good law, and continues to be cited at the state level. *See* State of Colorado Letter Ruling dated Apr. 28, 2014, note 4. ("Nevertheless, the Department continues to believe that a retailer must have something more than a de minimis contact with a local jurisdiction before a local jurisdiction can require the retailer to collect that jurisdiction's tax.")

[41] *City of Phoenix v. West Publishing Co.*, 712 P.2d 944, 947 (Ariz. App. 1985).

[42] *Id.* at 949.

[43] *Quill,* 504 U.S. at 313.

[44] *Quill,* 504 U.S. at 313 n.6 (citing *National Bellas Hess*, 386 U.S. at 759-60) (noting that the "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a remote seller] in a virtual welter of complicated obligations" if state use tax obligations were imposed on interstate businesses).

[45] A KPMG study on local tax administration recently described the substantial burdens companies faced from the approximately 700 home rule local tax jurisdictions. KPMG LLP, *Locally Administered Sales and Use Taxes* at 13-14 (Institute for Professionals in Taxation, Study 2016), *available at* http://www.ipt.org/iptdocs//Files/MiscForms/CompleteStudy.pdf. The study, commissioned by the Institute for Professionals in Taxation, noted the added degree of complexity posed to taxpayers by sales and use taxes administered locally by home rule jurisdictions. *Id*. The complexity arises from such areas as the degree to which the home rule jurisdiction deviates from its state sales tax in determining items subject to tax, the sales tax base, and the tax rate, in addition to the separate administrative procedures governing the tax and the ease (or lack thereof) of obtaining information about the local taxes. *Id*.

Fair Apportionment

The fair apportionment part of the *Complete Auto test* requires that the tax jurisdiction "taxes only its fair share of an interstate transaction."[46] In turn, the tax must be both internally and externally consistent.[47]

In *Philadelphia Eagles Football Club Inc. v. City of Philadelphia*, the Pennsylvania Supreme Court considered whether Philadelphia's business privilege tax (BPT), as applied to 100 percent of the copyright royalties the Eagles received from network broadcasting of football games, satisfied the fair apportionment prong.[48] The BPT applied to 100 percent of the copyright receipts of any company domiciled in Philadelphia. The supreme court held that the tax satisfied the internal consistency test but failed the external consistency test. The Philadelphia tax on all of the receipts, according to the court, was "inherently arbitrary and had no rational relationship o the Football Club's business activity that occurred *in Philadelphia*."[49] The court explained that "imposing the BPT on 100 percent of the media receipts when only 50 percent of the receipts were generated from games played in and broadcast from Philadelphia" meant that the tax was out of proportion to the Eagles' "business activities in Philadelphia that generated the payment of media receipts."[50] The supreme court was concerned that another jurisdiction could tax the very same activity because the media receipts were partially generated by activity occurring outside Philadelphia. Thus, fair apportionment required that the tax be applied only to Philadelphia's "fair share of the receipts."[51]

In *Centric-Jones Co. v. Town of Marana*, the Arizona appellate court also recognized that fair apportionment required a determination whether the gross receipts taxes were fairly related to the taxpayer's activities in the local home rule taxing jurisdiction.[52] The court in that case found that the tax was fairly apportioned because it was assessed only on receipts from contracts in the city, and was not assessed on receipts from activities occurring outside the municipality's territorial limits.[53]

Similarly, in *Sea-Land*, the federal court held that the municipalities' taxes on gross receipts were not fairly apportioned because they were not "imposed only on those receipts from interstate transactions which [could] be ascribed to activities taking place wholly within their jurisdiction."[54]

Determining the relationship to the taxing jurisdiction is the apples-to-apples comparison called for under *Complete Auto*. Just as the decision of what to tax is the local jurisdiction's, it should also be the basis to measure the benefits for commerce clause fair apportionment purposes. If each local home rule jurisdiction could justify its tax based on the statewide benefits, then an interstate trader providing goods and services throughout the state would be subject to multiple tax burdens. The commerce clause analysis for home rule jurisdictions should be based on a comparison of the local tax's burdens to the benefits the local jurisdiction provides. ■

[46] *Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175, 184 (1995) (quoting *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989)).

[47] *Goldberg v. Swett*, 488 U.S. 252, 260-61 (1989).

[48] 573 Pa. 189, 226 (2003).

[49] *Id.* at 227 (emphasis in original).

[50] *Id.* at 228.

[51] *Id.* at 231.

[52] 188 Ariz. 464 (App. 1996) (also decided under due process). *See City of Peoria v. Brink's Home Security Inc.*, 229 P.3d 1020, 1026 (Ariz. Ct. App., 2010) (reversed and remanded on other grounds; the Arizona Supreme Court did not reach the question of commerce clause analysis).

[53] *Id.* We note that the *Centric-Jones* court also considered the company's argument that the fair relationship prong should be analyzed as a quid pro quo test — that the locality should furnish public benefits directly to the taxpayer company. *Id.* at 475. The court rejected Centric-Jones Co.'s theory, holding that the fair relationship prong "focuses on a wide range of benefits provided to the taxpayer, not just the precise activity connected to the interstate activity at issue." *Id.* at 476 (quoting *Goldberg v. Sweet*, 488 U.S. at 266-67). The town's road maintenance services — and its obligation to provide them — was available to the taxpayer and its workforce while in town, and thus were fairly related to the taxpayer's activities in the local jurisdiction. *Centric-Jones*, 188 Ariz. at 476.

[54] 505 Supp. at 552.