Before the New Mexico Legislature
Revenue Stabilization and Tax Policy Committee

Federal Limitations on State Tax Authority

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August 11, 2022, Santa Fe, New Mexico

Focus - Types Federal Limitations

- Constitutional – including:
  - Due Process
  - Dormant Commerce Clause
- Statutory – including:
  - P.L. 86-272
  - Permanent Internet Tax Freedom Act

Constitutional Limitations - Generally

- Courts, including the U.S. Supreme Court, tell us exactly where the limits are.
- Those limits are generally on the government's power to do certain things – including the power of state governments.
- The limits are defined through litigation of specific issues in particular cases.
- Lower courts may disagree as to the extent of the limits and the Supreme Court may not always resolve those differences.
- The Supreme Court's views have changed over time.

Due Process

- Jurisdiction –
  - When does the government have power over a person or property
  - How and to what extent can the government exercise its power
- Fundamental rights –
  - Notice
  - Right to be heard
- Critical to taxing authority generally

Dormant Commerce Clause

- Limits the power of state governments over cross-border commerce (interstate or international)
- Called "dormant" or "negative" because the clause grants authority to Congress, which implicitly limits the states' authority
- Over time, the U.S. Supreme Court's interpretation of the dormant commerce clause has changed from one that severely restricted state taxing authority, to the modern interpretation which allows state taxation provided:
  - The person or thing being taxed has sufficient "nexus" with the state
  - The tax is "fairly apportioned"
  - The tax does not discriminate against cross-border commerce

Dormant Commerce Clause

- The last major dormant commerce clause case was *South Dakota v. Wayfair*, which overruled two prior cases and allowed states to impose sales tax on out-of-state sellers.
- That case solidified the reasoning of a line of cases, starting in the early 20th Century, that moved from the very restrictive view of the limits on state taxing authority to the more modern, less restrictive view.

Dormant Commerce Clause

- What is a tax that discriminates against cross-border commerce?
  - A higher tax on an activity coming into or going out of the state than on that same activity conducted entirely within the state.
  - A tax that, if every state imposed it in the same way, would result in duplicative taxes on cross-border commerce.
  - Possibly—a tax that imposes too great a compliance burden on cross-border commerce.
  - Possibly—a tax on foreign commerce that is inconsistent with the expressed policy of the federal government.

Statutory Limitations - Generally

- Congress has the authority under the Commerce Clause, and under other provisions of the U.S. Constitution, to limit state taxation.
- The full extent of this authority is not entirely clear and has been subject to debate.
- Over the years, Congress has used its authority to limit state taxation fairly sparingly – focusing mainly on the essential instruments of commerce—such as transportation and communications.
- The term generally used for federal laws that restrict state authority is "preemption." Preemption can be implicit or explicit.

P.L. 86-272 – Restriction on State Income Tax

- 1959 federal law codified at 15 U.S.C. §§381-84.
- Prohibits imposition of a state or local income tax on a person's income if the only "business activities within such State by or on behalf of such person" are "solicitation" of sales of "tangible personal property" the orders for which are filled from outside the state.
- The problem with federal preemption statutes is that there is often no clear authority for issuance of federal regulations or other guidance by any administrative agency.
- So the only way to get an answer as to how the law applies is to litigate. Different lower courts (both federal and state) may come up with different answers.

P.L. 86-272 – Restriction on State Income Tax

- The Multistate Tax Commission has long had a statement of position on the interpretation and application of P.L. 86-272 which was updated recently to address sales over the Internet.
- This statement is not binding. So why is it important? – Due process notice.
- The statement was revised in 2021.
- The essence of the revisions are that interactive activities conducted through the Internet may be "business activities performed within such State."
- So far California and New York have officially adopted that statement and other states are considering it.

Permanent Internet Tax Freedom Act

- First enacted a moratorium on taxation of Internet access (temporarily) in 1998. 47 U.S. Code § 151 (Note).
- Existing statutes in certain states, including New Mexico, were grandfathered.
- The law was made permanent in 2016. Grandfather provision ended in 2020.
- Applies to state and local transaction-type taxes.
- "Internet access" – broadly defined – may not be taxed.
- Also contains an anti-discrimination provision for "electronic commerce," which means sales over the Internet.

Permanent Internet Tax Freedom Act

- Anti-discrimination provision:
  - What are "transactions involving *similar* property, goods, services, or information" is the question not answered by the statutory language.
  - Implicates not only imposition of tax but the application of exemptions, deductions, and credits.
- Current litigation –
  - Maryland – over the state's recently adopted digital advertising tax
  - Texas – over sales tax on data processing and storage

The End.