DEFINING THE RULES OF THE GAME: WALTER HELLERSTEIN AND THE LAW OF STATE AND LOCAL TAXATION

Charles E. McLure, Jr.; Hoover Institution; Stanford University

INTRODUCTION

I FIRST MET WALLY HELLERSTEIN 30 YEARS AGO AT an NTA symposium on energy taxation. We immediately formed a bond that has become closer over time. We have worked on many of the same issues, we comment on each other's papers, and we have written a few things together. Hardly a week passes without e-mail communication, usually because I need help with state and local tax law. It would be hard to overstate my affection for, and my admiration of, Wally. Thus, when Jim Poterba told me that Wally would receive the Holland Medal, I was almost as delighted, but not nearly as surprised, as when Tom Neubig told me several years ago that I would receive it. As David Brunori (2008) said earlier this year in declaring Wally "the most influential academic" in state tax, Wally "has long been regarded as a giant in the field." (p. 404)

In my tribute to Richard Bird, recipient of the 2006 Holland Medal, I used the analogy of one of the basic rules of golf, "You must play the ball as it lies. You may not move it to a better spot." I meant that a tax adviser must conform the advice to conditions on the ground, not try to assume them away. Using a similar analogy to describe Wally, I would say that he has been *writing* the rules of golf. By that I mean that, for more than 30 years, Wally has been writing – or at least elucidating – the state and local tax rules under which the game of business is played.

Wally has done this in several ways. Law students use the Hellerstein and Hellerstein casebook (2005), but practicing attorneys probably think of the two-volume treatise (Hellerstein and Hellerstein, 1998) that also bears the name of Wally's late father Jerome, in his time another giant in "the study and practice of public finance." Willson (2007) has said, "The Hellerstein treatise is the 'bible' for me." I find it invaluable. When I read part of the treatise or one of Wally's myriad law review articles, I am amazed and awed by both the breadth and depth of his knowledge of the law and his ability to connect seemingly disparate strands of analysis.

Many decisions of the U.S. Supreme Court, not to mention countless state court decisions and administrative rulings, have referred to the treatise, to the casebook, or to Wally's articles as authoritative. And, of course, his writings have underpinned many arguments lawyers have made before courts and administrative bodies. Wally has not only influenced the judiciary indirectly, through his writings; he participated in the preparation of briefs in several landmark cases, and he successfully argued two important cases, *Allied Signal v. Director of Taxation* (1992) and *Hunt Wesson, Inc. v. Franchise Tax Board of California* (2000), before the Supreme Court, both decided by unanimous 9-0 votes of the Justices.

I will discuss five Supreme Court decisions that bear Wally's fingerprints, his analysis of the constitutionality of state and local tax incentives for economic development, and some of our recent joint work, conscious that I am presenting only a small fraction of the evidence that could be marshaled to document that Wally is the pre-eminent authority on state and local tax law.[1]

THE TWO UNANIMOUS SUPREME COURT DECISIONS

Allied Signal v. Director of Taxation (1992)

The first case that Wally argued successfully before the U.S. Supreme Court involved two fundamental issues: whether the Court's maxim that "the linchpin of apportionability ... is the unitary-business principle," remained good law and the characteristics of income that is part of the apportionable income of a unitary business.[2]

Full apportionment

Before oral arguments in *Allied Signal v. Director of Taxation* (1992), virtually all authorities on state and local tax law probably believed that it was settled legal doctrine that "the linchpin of apportionability ... is the unitary-business principle." Yet, in *Allied Signal v. Director of Taxation* (1992), the state of New Jersey asserted that the unitary business concept is unworkable and that a state should be able to tax all the income of a nondomiciliary corporation doing business in the state – in this case gains on the sale of stock representing a 20.6 percent interest in *ASARCO*. While this argument for "full apportionment" may have seemed prima facie absurd, especially in the light of the Court's decisions in *ASARCO* and *Woolworth*, the Court asked for supplemental briefs addressing, inter alia, whether the Court should overrule those two cases.

This dramatic turn of events converted a routine state tax case into one that questioned "the premises ... underlying the entire constitutional edifice governing state taxation of corporate income from multistate business." The Court might pull the linchpin of apportionability selectively, only for income from intangibles, or it might abandon the unitary business principle altogether. Because of the fundamental and far-reaching implications of a decision condoning full apportionment, long sought by the states and vehemently opposed by business, 14 amicus briefs were filed on behalf of a broad section of the business community and virtually all the states.

Wally has noted that the Court's request for supplemental briefs "read more like a law school examination question than a judicial mandate." Who better to reargue the case than Professor Hellerstein, who "wrote the book" on constitutional limitations on state taxation? Noting that "New Jersey's sweeping theory cannot be reconciled with the concept that the constitution places limits on s State's power to tax value earned outside of its borders," the Court unanimously rejected full apportionment and reaffirmed that the unitary business principle is the linchpin of apportionability. Only the income of a unitary business can be apportioned.

The "Operational-Functional" Test

The taxpayer did not just argue that New Jersey could not tax an apportioned part of *all* the corporation's income. It contended that the state could not tax *any* of the gain on the sale of the *ASARCO* stock. Wally argued for the taxpayer that the gain on ASARCO stock was not subject to apportionment, because the stock investment was not part of the taxpayer's unitary business.

The U.S. Supreme Court rejected the state's view that "there is no logical distinction between short-term investment of working capital, which all concede is apportionable, and all other investments." It ruled that, "What is required ... is that the capital transaction serve an operational rather than an investment function." It elaborated "[T]he mere fact that an intangible asset was acquired pursuant to a long-run corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one."

A minority of four Justices disputed the majority's conclusion that the taxpayer had demonstrated that the investment in ASARCO was not operationally related to its business. But of more fundamental importance, it agreed with the majority on both the continued viability of the unitary business concept and the importance of determining whether an investment serves an operational function. In other words, Wally won a unanimous Supreme Court decision on the two fundamental issues at stake. Willson (2007), who served with Wally on the taxpayer's legal team, has said, "*Allied Signal* was, in my view, a case where the lawyering (by Wally) made the difference between winning and losing."

Interest Offset: *Hunt-Wesson*

Before the decision in *Hunt-Wesson, Inc. v. Franchise Tax Board of California* (2000), which Wally also argued successfully before the U.S. Supreme Court, California's limited the amount of interest expense that could be deducted in calculating apportionable income to the amount by which interest expense exceeded interest income and dividends not subject to apportionment by formula. In other words, interest expense would be offset first against nonbusiness interest and dividend income allocable to the taxpayer's commercial domicile, with only the excess allowed as a deduction in calculating apportionable income. If California prevailed and other states followed suit, a significant step would be taken toward full apportionment by the back door.

The Court had little difficulty in deciding unanimously for the taxpayer. It stated, "California's rule measures the amount of additional unitary income that becomes subject to its taxation (through reduction in the deduction) by precisely the amount of nonunitary income that the taxpayer has received. And for that reason, that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax."

THE NATURAL RESOURCE CASES

In 1981 the U.S. Supreme Court decided two important cases involving the constitutionality of state taxes on natural resources. In the first, invalidating the tax in question, the Court relied heavily and explicitly on Wally's analysis. In the second case, upholding the state tax, Wally was counsel for the state.

Louisiana's First Use Tax on Natural Gas

In 1978, Louisiana enacted a tax on the "fist use" of natural gas in the state. The practical effect of the "First Use Tax" – and its intended objective – was to tax gas produced on the Outer Continental Shelf when such gas was sold, transported, or transferred in Louisiana. The First Use Tax provided that the tax must be considered a "cost" and that any contract specifying that the tax would be reimbursed by any party other than a purchaser was unenforceable. The intent was that pipeline companies would either absorb the tax or pass it on to their customers. Pipeline companies challenged the tax in state court, the federal government claimed that, under the Supremacy Clause of the U.S. Constitution, the tax was preempted by federal legislation, and a number of market states filed an original action against Louisiana in the U.S. Supreme Court.[3]

Wally offered his perspectives on the First Use Tax in November 1980, just before its legality was argued before the U.S. Supreme Court. Noting that the many complex legal and evidentiary issues involved in the case made a detailed evaluation of the merits of the challenges premature, he said that he wanted merely "to suggest an appropriate framework for resolving some of the issues it [the case] raises." In fact, that framework might well have been the brief for those challenging the First Use Tax.

Restricting his discussion to three issues – whether the tax was fairly related to benefits provided by the state, whether it discriminated against interstate commerce, and whether it was preempted by federal legislation – Wally concluded (1) that the Constitutional requirement that a tax be fairly related to benefits provided by the state does not require a factual inquiry into the relationship between the amount of a tax and the value of benefits provided by the state, (2) that the First Use Tax could not be justified as a "complementary tax" intended to "compensate" for other taxes, as a use tax on sales from out-of-state is complementary to the sales tax applied to in-state sales, and (3) that the attempt to force pipelines to absorb the tax or pass it on to their customers "should ... be scrutinized carefully," because it "smacks of price regulation."

The Supreme Court's decision that the First Use Tax was unconstitutional was consistent with much of what Wally had said regarding the second two issues. Indeed, in analyzing the discrimination issue, the Court relied explicitly on his analysis. Although the Court did not address the required relation of taxes to benefits in this case, it did so six weeks later in *Commonwealth Edison*, reaching conclusions similar to those Wally had advanced.

Commonwealth Edison Co. v. Montana (1981): The Montana Severance Tax

In 1975 Montana raised the rate of its severance tax on coal to 30 percent of the tax-exclusive value of coal. Four coal companies and 11 out-of-state electric utilities challenged the tax, arguing that it violated the Supremacy and Commerce Clauses of the U.S. Constitution.[4]

The Montana Supreme Court ruled that the tax was not subject to scrutiny under the Commerce Clause, as it was imposed on the wholly intrastate activity of severance of coal. It held, alternatively, that the tax survived scrutiny under the 4-part test of *Compete Auto Transit*. Taking favorable notice of the article Wally presented at the NTA symposium where we first met (Hellerstein, 1978), the U.S. Supreme Court rejected the claim that the severance tax is immune from scrutiny under the Commerce Clause.

The tax survived scrutiny under the first two prongs of *Compete Auto Transit* – nexus and fair apportionment. The only Commerce Clause issues were whether it satisfied the other two prongs – that it "did not discriminate against interstate commerce" and was "fairly related to services provided by the State." Since the rate of tax did not depend on the destination of coal, the tax was facially nondiscriminatory. The argument that the tax discriminated against interstate commerce rested on the assertion that 90 percent of Montana coal was shipped to other states under contracts containing "passthrough" provisions, and thus exported to residents of other states. The state's brief, which Wally wrote, emphasized the difficulty of quantifying tax exporting. The Court apparently agreed, but inexplicably relegated to a footnote a point that it has stressed repeatedly since then, that "...whether the tax burden is shifted out-of-state rather than borne by in-state producers would require complex factual inquiries."

The Court rejected the notion that a detailed analysis of the relationship between the tax and the benefits provided to taxpayers is required. While the Court made no reference to Wally's work in reaching this conclusion, the Justices were almost certainly influenced by the comments Wally had made on this issue in the context of the First Use Tax. Moreover, Wally drafted substantial portions of the state's briefs.

COMPLEMENTARY TAXES: *FULTON CORP. V. FAULKNER* (1996)

States often claim that taxes that, on their face, apply only to interstate commerce do not discriminate against interstate commerce, because they "complement" taxes levied on purely intrastate commerce. The U.S. Supreme Court has placed its imprimatur on use taxes on sales made into a state by out-of-state vendors but few other taxes claimed to complement taxes on intrastate activity have survived judicial scrutiny.

Wally has long been interested in this topic. He had little difficulty disposing of arguments that the First Use Tax was a complementary tax. In a subsequent article in *The Tax Lawyer* (Hellerstein, 1986) he presented a systematic analysis of Supreme Court doctrine that included a "deconstruction" (as well as a "reconstruction") of that doctrine, paying particular attention to the "economic equivalence and economic incidence" of the challenged tax and the tax it is alleged to complement. In concluding that use taxes may be the only taxes that can stand constitutional scrutiny as complementary taxes, he reemphasized what the Court had said in *Commonwealth Edison Co. v. Montana* (1981) regarding the "complex factual inquiries" required to determine the incidence of taxes.

Prior to the U.S. Supreme Court decision in *Fulton Corp. v. Faulkner* (1996), North Carolina imposed an "intangibles tax" on a fraction of the value of corporate stock owned by residents of the state that was inversely proportionate to the corporation's exposure to the state's income tax.

The Court had noted previously that for a levy to pass muster as a complementary tax, the interstate and intrastate events on which tax is imposed must be substantially equivalent, that is, that they must be sufficiently similar in substance to serve as mutually exclusive proxies for each other.[5] The state argued that the intangibles tax and the state corporate income tax were substantially equivalent. The Court noted , however, that when two taxes "fall ... on taxpayers who are differently described, as, for example, resident shareholders and corporations doing business out of state," a state "has the burden of showing that the actual incidences of the two tax burdens are different enough from their nominal incidences so that taxpayers are within the same class, and that therefore a finding of combined neutrality on interstate competition would at least be possible." In deciding for the taxpayer, the Court cited Wally's 1986 paper as well as the footnote in its own decision in *Commonwealth Edison* mentioned earlier, and again refused to undertake the complex analysis required to assess the economic incidence of the two taxes.

CUNO V DAIMLERCHRYSLER, INC. (2004): THE CONSTITUTIONALITY OF STATE AND LOCAL TAX INCENTIVES

Like import duties, which the U.S. Constitution prohibits, state and local tax incentives and subsidies can be used to encourage economic development. This raises a perplexing question, whether subsidies and tax incentives should also be outlawed, either by the courts, because they contravene the Commerce Clause, or by the Congress, as a matter of public policy.

The U.S. Supreme Court has interpreted the positive grant of power to the Congress "to regulate commerce with foreign nations, and among the several states ..." to have the dormant or negative implication that the states cannot impose restrictions, including taxes, that burden interstate or foreign commerce. Judicial limitations on the use of subsidies and tax incentives to encourage economic development must be based on this interpretation.

In a 1996 article Wally and Dan Coenen examined "Commerce Clause Restraints on State Business Development Incentives." The authors noted both that "The prohibition against state taxes that discriminate against interstate commerce has been a fundamental tenet of the Court's Commerce Clause jurisprudence from the beginning" and that "The concept of discrimination, however, is not self-defining." They concluded that tax incentives that are constitutionally suspect exhibit two characteristics: they single out activities that occur in the taxing state for favorable treatment and they involve "the coercive machinery of the state." On this basis the authors concluded that tax credits, which involve reductions in pre-existing tax liability, generally will not pass muster, but property tax exemptions, which involve failure to collect a tax otherwise due, will. They concluded that subsidies are not constitutionally prohibited, because they do not involve exercise of the coercive power of the granting state (or locality).[6]

In 2004 the U.S. Court of Appeals for the 6th Circuit decided the *Cuno v. DaimlerChrysler, Inc.* (2004) case, which involved challenges to both types of tax incentives (but not subsidies). In finding that the investment tax credit "runs afoul of the constitution," but that a property tax exemption does not, the court closely followed the Hellerstein/Coenen analysis.

The U.S. Supreme Court found that the claimant in *Cuno v. Daimler Chrysler, Inc.* (2004) lacked standing to bring suit, and thus refused to grant certiorari. Another district court might decide a similar case differently. Moreover, even if the Court had granted certiorari, a decision in *Cuno v. Daimler Chrysler, Inc.* (2004) probably would not have settled all issues. Thus, in testimony to two subcommittees of the House Judiciary Committee, Wally has urged the Congress to codify what is and is not a permissible tax incentive, while leaving intact the Court's anti-discrimination principles. See Hellerstein (2005a) and (2006).

THE "TAX TAG TEAM"

Reflecting on the above, and comparing it with what Wally said when I received the Holland Medal (Hellerstein, 2005b), I am struck – and a bit embarrassed – by the overlap, particularly regarding the implications of tax incidence analysis of constitutional restraints on tax exporting. I suppose that this similarity is more or less inevitable, since Wally titled his comments "Travel's with Charlie" and often refers to us as a "tax tag team." I will now mention several recent tag team efforts to nudge tax policy in the right direction.[7] We have not yet redefined the "rules of the game" in these areas. But working on them with Wally has been a great pleasure and a privilege, and not only because of the great expertise he has brought to them.

Sales-only Apportionment and the GATT

The General Agreement on Tariffs and Trade (the GATT) provides that border tax adjustments – rebate of taxes on exports and collection of taxes on imports – can be provided only for indirect taxes. In 2002 Wally and I argued (McLure and Hellerstein, 2002) that sales-only apportionment of state corporate income violates the prohibition of BTAs for exports.

Nexus for BAT

In its 1992 decision in *Quill*, the U.S .Supreme Court confirmed that a state cannot require an out-of state vendor to collect its use tax, unless it has a physical presence in the state. It remains unclear whether the "physical presence" test of nexus also applies to income taxes; I believe most legal authorities think not. Both to remove this uncertainty and to provide even more protection from state income taxes than *Quill* provides from use tax collection, the business community has recently pressed for a nexus rule for business activities taxes that would require a "substantial physical presence" in the state. In 2004 Wally and I wrote a paper (Hellerstein and McLure, 2004c) arguing against adoption of this overly restrictive nexus standard.[8]

The CCCTB

The European Commission has recently been drafting a proposal for a Common Consolidated Corporate Tax Base (CCCTB) – an apportionment-based corporate tax system to replace the present approach, which is based on separate accounting and transfer pricing of transactions between affiliates. In 2004 Wally and I wrote two articles (Hellerstein and McLure, 2004a, 2004b) in which we drew on experience of the U.S. states in an effort to provide lessons that would inform the European debate.

CONCLUDING REMARKS

These remarks do not adequately convey my respect and admiration for Wally. Perhaps that is not even an attainable objective. Let me say simply that, of all those who have received the Holland Medal, none has towered over others in his field the way Wally does.

Notes

[1] The oral presentation, which appears in its entirety in McLure (2008), has been condensed. Most references to Court decisions and Hellerstein's comments thereon are suppressed.

[2] *Allied Signal v. Director of Taxation* (1992). This section draws heavily on Hellerstein (1993). To avoid confusion, I employ the term "taxpayer," rather than naming the taxpayer. Allied Signal was the successor-in-interest of the taxpayer, Bendix.

[3] *Maryland v. Louisiana* (1981). This discussion draws on Hellerstein (1981).

[4] *Commonwealth Edison Co. v. Montana* (1981).

[5] *Oregon Waste Systems, Inc. V. Department of Environmental Quality* (1994).

[6] Enrich (1996) reaches essentially the same conclusions; see Hellerstein and Coenen (1996, p. 872, n. 444).

[7] Also, at the 2000 annual meetings of the NTA, we noted (Hellerstein and McLure, 2001) that not much has been said about what needs to be done to rationalize the state sales and use taxes that John Due had not anticipated, by now about a half-century ago.

[8] We also examined the Internet Tax Freedom Act and the Streamlined Sales and Use Tax Act.

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