

Constitutional Restrictions on State Taxation

The Prohibition on Discriminating Against Interstate Commerce

Legislators often seek to favor Minnesota businesses in setting state tax policy. They may propose limiting tax preferences to Minnesota-based businesses and activities or suggest imposing taxes that fall exclusively or more heavily on out-of-state businesses. These proposals may violate the Commerce Clause of the United States Constitution because they discriminate against interstate commerce. This short subject describes the constitutional prohibition on discriminating against interstate commerce. This is a complicated legal topic; in many cases the applicable rules are unclear. An expert needs to carefully analyze the constitutionality of any legislative proposal.

General Rule. The Commerce Clause grants Congress the power “to regulate commerce * * * among the several states * * *.” [U.S. Const. art. II, § 8](#). The Supreme Court has long held that one implication of this grant of power is that states may not adopt regulations or taxes that place an “undue burden” on interstate commerce, even if Congress has taken no action. This is referred to as the “dormant or negative” Commerce Clause doctrine. The Commerce Clause is a principal reason for the federal constitution: i.e., to join the states in a national economy and to prevent the fragmentation that resulted from individual states imposing tariffs and laws favoring local merchants.

In *Complete Auto Transit v. Brady*, [430 U.S. 274](#) (1977), the Court set out a four-part test for testing state taxes under the Commerce Clause. Under the *Complete Auto* test, a state tax must:

- Be applied to an activity that has substantial nexus (or connection or contact) with the state
- Be fairly apportioned to activities in the state
- Not discriminate against interstate commerce

- Be fairly related to services provided by the state

The most frequently litigated and arguably the most important of these four rules is the prohibition on discriminating against interstate commerce. It is a longstanding rule, dating to the late 19th century. The Court has described the rule as follows:

[N]o State, consistent with the Commerce Clause, may “impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to a local business.” This antidiscrimination principle “follows inexorably from the basic purpose of the Clause” to prohibit the multiplication of preferential trade areas destructive of the free commerce anticipated by the Constitution. *Maryland v. Louisiana*, [451 U.S. 725, 754](#) (1981) (citations omitted).

The Court has held that state tax provisions may not favor local business firms, local products, or local activities. However, some provisions favoring local businesses may be valid, if they are properly structured and designed.

Specific Principles and Examples. The Court has invalidated many state taxes on the grounds they discriminate against interstate commerce. Some general principles from these cases include:

- **“Facial” discrimination almost always will invalidate a tax.** If a tax explicitly (“on its face”) favors local businesses, local transactions, or products, it will almost always be held to discriminate against interstate commerce. For example, the Court held invalid:

- Exempting ethanol or alcoholic beverages produced only within the state, *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988);
 - Exempting dividends paid by in-state corporations, *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); and
 - Limiting charitable contribution deductions to in-state charities. *Chapman v. Commissioner of Revenue*, 651 N.W.2d 825 (Minn. 2002).
- **Discrimination is determined by economic effect.** It is not necessary that the state or the legislature intend to discriminate, if its economic effect is to discriminate. However, showing intent to discriminate is relevant; a legislative intent to discriminate is nearly conclusive of the tax’s unconstitutionality.
 - **Minor or seemingly inconsequential discrimination is enough.** The Court has rejected arguments that the effect of the discrimination is so minor or *de minimus* to not matter.
 - **Incentives to encourage local investment or activity may be invalid.** Tax incentives for in-state activity (e.g., investment) may be invalid, if the net effect is to raise tax on out-of-state businesses. For example, the Court struck down an income tax credit to encourage businesses to export through in-state corporations. *Westinghouse Electric v. Tully*, 466 U.S. 388 (1984). However, incentives provided through the sales tax (e.g., capital equipment exemptions) or property tax (abatements or tax increment financing) are likely valid, because the underlying taxes apply only to in-state property or transactions. Incentives may be validly provided through direct spending programs (e.g., grants), unless they are linked

to a discriminatory tax or other funding source. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994).

- **Taxes must be “internally consistent.”** This test requires determining whether the state tax, if imposed by all states, would impose higher tax on out-of-state businesses or investors than comparable local ones. If it does, it is unconstitutional. *Comptroller v. Wynne*, 135 S.Ct. 1787 (2015) (invalidating individual income tax imposing higher burdens on residents with out-of-state income).

Discriminatory taxes may be valid as complementary taxes or because they favor government enterprises or activity. Otherwise discriminatory taxes may be valid “complementary” taxes, which offset a specific tax that only a local business or transaction bears. The classic case is the use tax, which complements the sales tax. Sales taxes apply to in-state purchases, but not to purchases made outside the state, such as by phone, mail order, or the Internet. To prevent disadvantaging local merchants, however, the Court upheld a “complementary” use tax, a tax on “using” a product or service in the state. This tax, in effect, only applies to items purchased from out-of-state businesses. But the Court upheld it as a complementary tax. *Hennford v. Silas Mason Co.*, 300 U.S. 577 (1937). It has construed this exception very narrowly, refusing to uphold discriminatory taxes where the argument was made that they offset general local tax burdens.

The Court has upheld provisions that discriminate against interstate commerce where the government is acting as a “market participant.” For example, the Court has held this allows discriminatory taxation favoring interest on bonds issued by in-state governments. *Dept. of Revenue v. Davis*, 553 U.S. 328 (2008).

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