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Walter Hellerstein

ROLES OF STATES/ PROVINCES IN TAXATION IN THE CANADA/ U.S. CONTEXT

*Walter Hellerstein**

Thank you for those kind words. It is a great honor to be here. At the outset, in the interest of truth- in- advertising, I should make it clear that my knowledge of the topic I am addressing is very one-sided. I know about state taxation in the United States, but I know considerably less about the Canadian side. The exposure I have had to what Canada has been doing has primarily been in connection with my participation in the work of the Organization for Economic Cooperation and Development (OECD) with regard to consumption taxation of electronic commerce. The U.S. has consumption sub-national taxes, i.e., our retail sales tax, and that is the only broad-based consumption tax we have. Most of rest of the world, including Canada, has a national Value Added Tax (VAT) or consumption tax. One of the very interesting aspects of the relation between sub-national jurisdictions and taxes is that suddenly, with the growth of electronic commerce and the pressure on governments around the world to try and figure out how to try to administer taxes in a digital world, sub-national jurisdictions understand that these problems are truly global. The problems we have in Ohio, Georgia, or Michigan, are precisely the same problems that the OECD countries have.

While my focus will be on U.S. specifics, I believe that what I have to say is relevant to the Canadian situation because I will focus on what happens when we start to have cross border transactions in the international context and the sources of friction created by sub-national governments in the tax arena.

I believe there are three structural sources of friction that arise out of sub-national taxing power in a federal system.

The first source of friction is the existence of different rules at the national and sub-national level. For example, if you have a different substantive rule as to what creates a sufficient establishment or nexus in order to tax, you are going to have a problem with the administration of inconsistent jurisdictional rules.

The second source of friction is different restraints on sub-national and national behavior. Now, these first two points overlap, but they are different.

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* Hellerstein bio.

Let me explain. You can have different sub-national and national rules, which may well be an irritant, but they may not offend any norm of international behavior. You can also have the same rule nationally and sub-nationally, for example, a rule that allegedly discriminates against cross-border transactions for e-commerce, but you might have a restraint at the international level, e.g., a restraint involving national treatment that does not apply at the sub-national level. These are two analytically different sources of friction, although they do overlap.

The third source of friction is that there tend to be more sub-national governments than national governments. The mere existence of a multiplicity of rules itself causes friction.

Those are three sources of friction on which I want to focus.

At the outset I wish to make a few general points that will inform the balance of my discussion. Some of these points were certainly implicit, if not explicit, in the previous presentations.

First, the states have broad autonomy in the tax area, at least with respect to general revenue- raising measures that are not directed at specific substantive policies. Assuming that a tax is relatively neutral, states are generally allowed to go in their own direction even if they choose a different means of raising revenue than those adopted by the federal government. There is more deference given to fiscal legislation than any other under the U.S. system.

Second, when you consider the states vis- a- vis cross-border transactions in the U.S. context, it really makes no difference whether the out-of-state enterprise is from another state or from another country. From the state standpoint, these are all out-of-state enterprises. It is clear under the U.S. Constitution that if a state were to accord different treatment, either less favorable or more favorable, to the foreign cross-border transaction than to the internal, cross-border or interstate transaction, the state would run into constitutional trouble. Certainly, if a state were to disfavor a transaction involving a sale by a Canadian company into the state as distinguished from a sale by an American company into the state, that would violate the Foreign Commerce Clause. By the same token, if the state were to favor foreign over domestic cross-border commerce, there are decisions out of California courts saying that favoring foreign over interstate commerce violates the Interstate Commerce Clause.

One thing I should say at this point is that when I talk about the Commerce Clause, I am not talking about it the way Professor Farber and others have talked about it. They have been focusing on what Congress can do. I am focusing to a large extent on the so-called negative restraints that exist on what sub-national governments can do simply because the

Commerce Clause exists. In other words, the general doctrine in the U.S. is that the affirmative grant of power to Congress to regulate interstate commerce carries with it certain negative implications. Even though there is no broad-based congressional statute that says states may not disfavor foreign or out-of-state commerce, states may not discriminate against foreign commerce or, indeed, against interstate commerce under the negative Commerce Clause restraints on state taxing power. These are entirely based on judicial doctrine. There are some federal statutes that do limit state tax power, but they are relatively few and far between.

Let me then identify several of what I call substantive areas in which we have friction because of the problems I mentioned; the different national and sub-national rules; the different restraints on national, as distinguished from sub-national, rules; and the multiplicity of rules. Then I would like to talk about a few areas where there has been friction and how we resolved those frictions. The recurring question is whether national or international norms trump sub-national norms or whether sub-national autonomy prevails.

Let us start with the question of jurisdiction of tax. The question is whether there is sufficient presence in a jurisdiction in order to allow that jurisdiction to exercise its tax power.

Here I have to make a distinction with which U.S. observers sometimes are unfamiliar, namely the distinction between direct taxes and indirect taxes. The U.S. income tax is a direct tax. U.S. sales and use taxes are indirect taxes corresponding to the Canadian Goods and Services Tax (GST).

At the direct tax level there is an international jurisdictional standard because most of the developed world has tax treaties. Those tax treaties generally say that an out-of-state enterprise is not subject to the jurisdiction of the taxing authority unless it has a permanent establishment. A permanent establishment is a store, a warehouse, or something physical. Right now, one of the burning debates in the area of e-commerce is whether a server constitutes a permanent establishment. If you have a permanent establishment in a state, then you are subject to income tax jurisdiction there. That is the international norm that applies in both the U.S. and Canada. Direct tax treaties do not govern sub-national governments.

In the U.S., the question whether an enterprise is subject to tax at the sub-national level does not depend on whether it has a permanent establishment in that state- the international norm. Rather, it depends on whether there is nexus under the negative implications of the Commerce Clause and under the Due Process Clause, which has also been read as imposing a jurisdictional or territorial limitation on state taxing authority. The basic notion is that if you do not have a sufficient connection with someone, then you cannot exercise your fiscal power over that someone. These are very vague terms and have been interpreted in many different ways in many different states. For example, right now there is an ongoing debate as to whether one needs to have physical presence in a state in order for a state to impose a direct tax. This is a no-brainer from the standpoint of national rules. The state cannot impose a direct tax because you do not have a permanent establishment. However, the Supreme Court of South Carolina has held intangible presence is sufficient to establish jurisdiction to impose a direct tax, because, under the Due Process Clause and Commerce Clause, it is enough.

There is some friction with respect to jurisdictional issues between Canada and the U.S. I have two Canada/ U.S. examples.

The first example is the single business tax. The single business tax is odd. It is supposedly a VAT, a value added tax, but it is imposed on business activity, like a direct business income tax. It has nothing to do with consumption, and should not be confused with a VAT that we have in OECD and most other countries in the world. The U.S. is the only major country without a national VAT.

Michigan has a single business tax. What is the standard for determining whether Michigan can impose a tax on Canadian truckers? The truckers do not have a permanent establishment in Michigan, but they do have nexus because they are physically present in Michigan. That is enough under our constitutional system, although not under international treaties. This has created friction. In the end, the friction was resolved through an informal process whereby Michigan was persuaded to conform to the national norm and to say, in effect, "If truckers do not have a permanent establishment in Michigan, then we will not assert our taxing power." In short, Michigan has the power, under our Constitution, to impose a direct tax on in state trucking activity, but assertion of that power would not be consistent with the international norm. In this instance, at least, the international norm prevailed.

Let me turn next to jurisdiction-to-tax issues regarding indirect taxes. What is interesting about indirect taxes is that, in contrast to direct taxes, there is no treaty system where the world generally agrees that you have to have a permanent establishment to be subject to tax obligations. While there is no treaty system, there are, nevertheless, international norms. These norms generally require some kind of presence or fixed establishment, but the standards are not identical from country to country. With regard to this issue on the U.S. side, the U.S. Supreme Court has weighed in. The U.S. Supreme Court has told the states, in effect, that unless the remote vendor has a physical presence within the state, it cannot be required to collect the indirect tax. As a practical matter, the only way to collect indirect taxes is if someone collects them other than the ultimate consumer, when that consumer is a private person. The problem is simply multiplicity of rules. What is the rule for sufficient jurisdiction? Someone may say three visits is enough; someone else might say three visits is not enough. There the source of the irritant is not so much the difference between national and sub-national rules as the idea that every state decides for itself until the U.S. Supreme Court says, "Well, here is one safe harbor." That is just one case. It does not resolve this issue for many other contexts.

Let me turn to another issue where the same sources of friction arise. That area is discrimination. Again, we have a national norm for discrimination in the sense that our treaties have a norm of non-discrimination; and, in the indirect tax area, as well as the direct tax area, some of our trade agreements also have a national treatment norm.

I think here I need to refer to Mr. Farber who has written an excellent article, A GATT's Eye View Of The Dormant Commerce Clause, which really goes through the relationship between these worlds, between the trade agreements and the Dormant Commerce Clause.[1] Let me say that when you look at the differences here from the state standpoint, the kind of discrimination in which they think they can engage, notwithstanding the Commerce Clause, there is a real conflict. Take, for example, the beer cases, where we have all kinds of exemptions for small brewers who are using in-state products. That would be regarded, I think, as perfectly acceptable under U.S. sub-national law, but not acceptable under a national treatment standard. The question is whether or not those national treatment standards can be imposed sub-nationally, unlike tax treaties. The question is whether those standards do, in fact, apply to the states. Here is one example of a situation where the national norm should trump the different sub-national approach.

The second Canada/ U.S. example has to do with so-called run away film companies. The U.S. is complaining about how Hollywood is leaving the United States for Canada. Apparently, this is an issue because the Canadian provinces are trying to attract industry by tax incentives. Of course, this is what we do everyday. The last time I saw Mr. Farber, we were at a conference and we were having a conversation about this "race to the bottom," where states are fighting each other to see who can provide a bigger tax abatement to get the next sports stadium.

The last time I saw Mr. Schaefer, we were at a European conference on state aid control. State aid control is about controlling subsidies that states provide for their own business. Under the Treaty of Rome, there are

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[1] Daniel A. Farber & Robert E. Hudec, *Free Trade and the Regulatory State: A GATT's-Eye View of the Dormant Commerce Clause*, 47 VAND. L. REV. 1401 (1994).

restraints on the extent to which states can provide such subsidies.[2] The U.S. has no restraints on what can be done nationally or sub-nationally, with the exception, of course, of the fact that we are members of the OECD and have signed the World Trade Agreement. So when we do something at the national level, like a domestic international sales corporation, we get reprimanded. There are some limitations at the national level, but at the sub-national level there are virtually no limitations at all.

Let me turn now to the questions: what kinds of cases have we had, how have the conflicts been resolved, and why?

Let me turn to an example. There was an international convention on containers that the U.S. signed in which the U.S. agreed that, on the national level, it will allow only the home state, the state where the container has been registered or where the owner resides, to tax the container. California imposed a tax that would have been perfectly good under our sub-national, Dormant Commerce Clause norms. The tax was not discriminatory. The tax was fairly apportioned. It was a fair tax. However, the argument was that this sub-national tax violated international norms because the U.S. has signed a treaty with Japan. This is one of the rare instances where, in fact, the U.S. Supreme Court said, "The states cannot do this."[3] Why? It was not as if the state was preempted by explicit congressional legislation. It was the negative implication of the Dormant Commerce Clause and the thought that the federal government must speak with one voice when dealing with foreign affairs. The Court struck down the tax.

This negative Commerce Clause doctrine might have been expanded to cut a broad swath through the state tax field to get rid of all these sub-national taxes that violate international norms. Of course, that has not happened. What has happened?

Take a look at the two of the most infamous cases that relate to the same problem, but in the context of income taxes rather than property taxes. As many of you know, the states have their own way of deciding what portion of a unitary group of corporations' income the state is entitled to tax when any member of that group is engaged in activity within and without the state. The international norm is to say, "If a subsidiary of Barclay's Bank is doing business in the U.S, we will determine the subsidiary's income by figuring how much of the subsidiary- viewed as an independent enterprise- earned in the U.S. based on its own activity in the U.S."

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[2] Treaty of Rome (1957) (now Treaty Establishing the European Community) was the establishment of a single market allowing the free circulation of goods, services, capital and persons between the countries of the European Union.

[3] Japan Line Ltd. v. County of Los Angeles, 441 U.S. 939 (1979).

The states do it differently. If one member of an affiliated group is doing business in the state and that member of the affiliated group has close economic interrelationships with other members of the affiliated group, the states put all the affiliates together and create one big pie of income. The way we determine the right slice that the state can take is by a formula. It is a method of determining the right slice the state can take when one does not really know where income is earned and, given the problems of tax avoidance and limitations on jurisdiction, the states do not want to be in the business of monitoring transfer prices. This is the so-called 'unitary' method of taxation or, more accurately, world wide combined reporting. This had the world up in arms.

Nevertheless, the U.S. Supreme Court, when it first considered a case involving the question whether California could impose this world wide unitary apportionment scheme on a corporation with a state based multinational business said, "As long as there is no explicit federal directive prescribing otherwise, the mere fact that we do it one way at the federal level, does not mean that we may not do it a different way at the state level."[4]

How did the Court distinguish the property case? The Court observed that concurrent taxation of income is a well-established norm. Moreover, who knows where income is earned, that is, the Court said, "It is like slicing a shadow." By contrast, we know where the property is located. Furthermore, the container convention was a more explicit statement of federal policy than simply being a member of OECD. That point was essentially reiterated several years ago in the Barclays case in 1994.[5] In the Barclays case, the Court said the same thing in an even more sensitive context because there was a foreign multinational. Again, one can see sources of friction.

Let me just end then with one other case where Florida imposed a tax on the sale of fuel to airlines.[6] There was nothing wrong with the tax. It was a typical sales tax. The U.S. signed an agreement with Canada and many other countries in which it was agreed that that airline fuel taxes would be imposed only by the state from which the carrier originates. The Court once again held that the agreement did not preempt state regulation because the provision did not explicitly bind the states. These national agreements do not bind sub-national jurisdictions, except in very unusual circumstances. The Court said, "Look, Congress did not say anything about this. Indeed, by excluding states from this prohibition, Congress presumably approved this."

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[4] Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994).
[5] Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).
[6] Wardair Canada Inc. v. Florida Department of Revenue, 477 U.S. 1 (1986).