REPLY OF SANDRA B. MCCRAY
TO THE WRITTEN AND VERBAL TESTIMONY OF PROFESSOR WALTER HELLERSTEIN
BEFORE HOUSE SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS.
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In his written and verbal testimony before the House Subcommittee on Economic Stabilization, Professor Walter Hellerstein takes issue with my contention that a repeal of the McPadden Act and the Douglas Amendment would eliminate the ability of nondomiciliary states to tax the income from federal securities. Professor Hellerstein argues that under current law state power to tax federal obligations is limited only by the commerce clause: "[T]he Court's modern decisions permit states to tax out-of-state corporations so long as the tax is applied to an activity that has a substantial nexus with the state, is fairly apportioned, is nondiscriminatory, and is fairly related to services provided by the state. State tax power does not depend ... on the states' power to exclude." Professor Hellerstein is correct that state taxation of federal obligations is limited by the commerce clause and that general state tax power does not depend on the states' power to exclude. When Professor Hellerstein's argument is applied to the specific state power to tax the income from federal obligations, however, it fails.

Despite the vehemence of Professor Hellerstein's written and verbal statements before the subcommittee, our areas of disagreement are narrow. The purpose of this reply to Hellerstein's statements is to clarify our areas of disagreement in order to help the Subcommittee to understand and come to a conclusion on the very important issue of state taxation of federal securities.

My response is divided into three parts. First I begin with a summary of my argument. Second, I clarify the existing law with respect to state foreign (nondomiciliary) corporation filing requirements and show that states have the right to grant and deny the special privilege of entry and access to state courts under these laws. Third, I examine the legal consequences of Professor Hellerstein's position that states are limited only by the commerce clause in their ability to tax the income from federal obligations and show that such a position is simply untenable in light of the decision of the Supreme Court in Weston v. Charleston and section 3124(a).
1. **A Repeal of the McFadden Act and the Douglas Amendment Will Eliminate the Ability of Nondomiciliary States to Tax the Income from Federal Obligations: Summary**

(a) The Necessary and Proper and the Supremacy clauses of the U.S. Constitution prohibit states from taxing national banks, except on such terms as Congress may dictate (*McCulloch v. Maryland*);

(b) The borrowing clause of the U.S. Constitution prohibits states from taxing stocks, bonds, and other securities of the federal government (*Weston v. Charleston*);

(c) The Supreme Court removed the **per se** prohibition against state taxation of federal obligations in 1867 when it upheld a state franchise tax on the federal obligations held by a state-chartered bank. The rationale for the court's decision was that a state may tax the franchise and privileges of a private corporation created by the state legislature. Later, the Supreme Court struck down a state franchise tax on the federal obligations held by a national bank;

(d) In 1926, Congress amended the National Bank Act to give states the power to levy a franchise tax on national banks. The legislative history to this amendment shows unequivocally that Congress amended the law in order to create tax parity between the federal obligations held by state banks and those held by national banks;

(e) In 1959 Congress amended the law (now found in 12 U.S.C. 3124a) governing state taxation of federal obligations to provide that stocks and obligations of the U.S. government are exempt from state taxation except a nondiscriminatory state franchise tax. This amendment codified existing case law with respect to franchise taxes, which limited state franchise taxes to domiciliary states or to those states that granted a special privilege to foreign corporations;

(f) In 1976, Congress amended the law governing state taxation of national banks to remove prior restrictions. The new law authorized states to impose any nondiscriminatory tax on national banks. Because states do not give a franchise to national banks, Congress included language permitting certain states to treat national banks as if they were chartered (or given a franchise) by the state. The new law established the state in which a national bank has its principal office as the state of its domicile for purposes of the state franchise tax.
(g) Case history, legislative history, and section 3124(a) limit state taxation of federal obligations to state franchise taxes on domiciliary corporations or on those nondomiciliary (foreign) corporations to whom states grant a special privilege that they have the right to withhold.

2. State Foreign Corporation (non bank) Filing Laws.

In his attempted refutation of my legal analysis, Professor Hellerstein argues that states currently tax the income from federal securities held by nondomiciliary corporations even though "the typical out-of-state corporation is granted no ... privilege [of conducting business in the state] because the Commerce Clause guarantees its right to conduct an interstate business without asking the state's permission."

In this assertion, Professor Hellerstein fails to distinguish between two very different categories of foreign corporations.

**Category 1.** If a foreign corporation wishes to conduct a intrastate business or a mixed intra- and interstate business within a host state, the host state has the right to control the entry of that foreign corporation and other important privileges such as access to host state courts. The leading Supreme Court case in this area of law is *Eli Lilly & Co. v. Sav-On-Drugs.* The facts were as follows. Eli Lilly was an Indiana corporation that maintained an office in New Jersey. Lilly brought an action in New Jersey courts to prevent Sav-On-Drugs from selling Lilly's products in New Jersey at prices lower than those fixed by Lilly and as required by New Jersey law. Lilly had not received a certificate of authority to do business as a foreign corporation in New Jersey. Sav-On-Drug moved to dismiss the action, citing a New Jersey statute that denied a foreign corporation transacting business in New Jersey from bringing an action in New Jersey courts unless and until the foreign corporation complied with the states filing requirements and received a certificate of authority from the state of New Jersey allowing it to transact business. Lilly opposed the motion to dismiss, stating that the commerce clause prohibited New Jersey from requiring it to file documents with and receive a certificate of authority from the state before entering and using the state's courts.

The U.S. Supreme Court upheld the New Jersey law denying Lilly access to New Jersey courts, stating that "it is ... well settled that if Lilly is engaged in intrastate as well as interstate aspects of the New Jersey drug business, the State can require it to get a certificate of authority to do business." The activities of Lilly found to be intrastate and mixed intra- and interstate were the maintenance of an office and employees in the state. The Lilly case supports the proposition that the maintenance of an office and employees by a foreign corporation within a host state
are sufficient to allow a state to control entry and access to the state's courts, including denial of access to the state's courts.

Thus, Professor Hellerstein's assertion is not valid for foreign corporations falling within category 1. Professor Hellerstein's assertion is valid only in category 2 as follows.

**Category 2.** If a foreign corporation is engaged in a wholly interstate business within a host state, the host state may not control either its entry or its access to host state courts. The Supreme Court has found a foreign corporation to be engaged in a wholly interstate business in the following circumstances: where the foreign corporation had no office in the host state and the state law exposed the foreign corporation to the general jurisdiction of the state; and where the foreign corporation had a warehouse in the host state but used the warehouse only to store goods in transit (i.e., goods that it shipped out of state).

Is category number 1 or category number 2 more "typical?" I know of no statistics that would answer this question. Although the validity of Professor Hellerstein's assertion rests on the presumption that foreign corporations falling within category number 2 are more "typical" than those falling within category number 1; in fact, the opposite is more likely to be true. Foreign corporations fall within category 1 if they are engaged in intra- or intra- and interstate commerce. Foreign corporations fall within category 2 only if they are engaged in wholly interstate activities. By judicial definition category 2 is the more narrow one.

Where do Professor Hellerstein and I disagree? I maintain that states may tax the income from federal obligations held by foreign corporations only when those foreign corporations are granted a special privilege or franchise by the host state. Examples of such a special privilege are the privilege of entry or access to courts, both of which the host state has the right to deny. Thus, under my analysis state taxation of federal obligations is limited to obligations held by foreign corporations that have "localized" (i.e., are conducting some intrastate activities in the host state). Under Professor Hellerstein's analysis, state taxation of federal obligations is not so limited — every state in which the foreign corporation does business, with or without an office, is free to tax the income from federal obligations, subject only to the general restrictions of the commerce clause. The trouble is that Professor Hellerstein's analysis directly conflicts with the Supreme Court's decision in *Weston v. Charleston*. In the next section I discuss why this is so.
3. The Conflict Between the Analysis of Professor Hellerstein and the decision of the Supreme Court in Weston v. Charleston.

Professor Hellerstein is correct in his contention that the commerce clause allows a host state to impose its tax on a foreign corporation that has no place of business in the host state if the tax is applied to an activity that has a substantial nexus with the state, is fairly apportioned, is nondiscriminatory, and is fairly related to services provided by the state. That is settled commerce clause jurisprudence. Although correct, the contention is not relevant to the issue of whether all host states can tax the income from federal securities.

The real question is: is there any constitutional doctrine that would require states to treat a foreign corporation's income from federal obligations differently than they treat its income from other sources? If the answer to this question is no, then Professor Hellerstein is correct to assert that the only limitation on state taxation of the income from federal obligations is the general commerce clause limitation. If the answer to this question is yes, then I can correctly assert that state taxation of the income of federal obligations is limited not only by the commerce clause but by another constitutional doctrine. To settle this question, which is really our only relevant area of dispute, one must look at the controlling Supreme Court case, Weston v. Charleston.

Weston arose out of the following fact situation. The city of Charleston, South Carolina imposed a tax on stock issued by the Bank of the United States and held by a private individual. The Charleston ordinance exempted from the tax all stock issued by the state of South Carolina. The "constitutional court" of South Carolina upheld the tax and Weston appealed to the U.S. Supreme Court. The high court framed the issue before it as follows: "Is the stock issued for loans made to the government of the United States liable to be taxed by states and corporations?" The Supreme Court based its holding on the borrowing clause of the U.S. constitution and found that the Charleston tax was a "tax on the power to borrow money on the credit of the United States, and consequently, ... repugnant to the constitution."

It is noteworthy that the commerce clause was not mentioned in the decision. More important, however, is the special constitutional status given to federal obligations by the Weston decision. Contrary to Professor Hellerstein's view, federal obligations cannot, under Weston, be treated as just another income element of foreign corporations. Rather, federal obligations hold a special constitutional status, which severely restricts the ability of states to tax the income from such obligations. That special status (as interpreted by later Supreme Court decisions) is codified in 12 U.S.C. 3124a. In sum, the answer to the
question: is there any constitutional doctrine that would require states to treat a foreign corporation's income from federal obligations differently than they treat its income from other sources? -- is yes.

Having settled that crucial question, I reiterate my original thesis: Weston and section 3124a (and the legislative history to that section) stand for the proposition that federal obligations hold a special constitutional status -- not every state in which a foreign corporation has nexus can tax a portion of the income from federal obligations. Only domiciliary states or states that give a foreign corporation a special privilege can tax their share of the income from federal securities. The repeal of the McFadden Act and the Douglas Amendment (without compensatory language giving states the power to grant the privilege of entry to nondomiciliary banks) will eliminate the ability of states to tax the income from federal securities because it will remove the power of states to grant the special privilege of interstate banking to nondomiciliary banks.

ENDNOTES


2. Bendix Autolite Corp. v. Midwesco Enterprises, Inc., 486 U.S. 888 (1988). Exposure to the general jurisdiction of a state would require a foreign corporation to defend a lawsuit there even if the lawsuit arose from events unrelated to the activities of the foreign corporation within the host state. Specific jurisdiction would limit the litigation exposure of a foreign corporation to those actions arising from the activities of the foreign corporation within the host state.


4. Hellerstein is correct that my analysis would lead to a finding that state laws that attempt to tax the income from federal securities held by a nondomiciliary corporation that has no office and no employees in the host state are unconstitutional. My analysis would limit the circumstances under which states could tax the income from federal obligations, thus reducing the possibility of overlapping taxation. Professor Hellerstein's analysis would multiply the circumstances under which states could tax the income from federal obligations, thus increasing the possibility of overlapping taxation.


6. Id. at 469.