2007 Supplement

Pomp & Oldman, State and Local Taxation
5th Edition (2005)

Prepared by

Prof. Michael J. McIntyre
Wayne State University Law School
October 15, 2007

Contents

Daimler-Chrysler Corp. v. Charlotte Cuno et al.

126 S. Ct. 1854 (2006), vacating in part and remanding *386 F.3d 738*

Chief Justice Roberts delivered the opinion of the Court. [*1859]

Jeeps were first mass-produced in 1941 for the U.S. Army by the Willys-Overland Motor Company in Toledo, Ohio. Nearly 60 years later, the city of Toledo and State of Ohio sought to encourage the current manufacturer of Jeeps—DaimlerChrysler—to expand its Jeep operation in Toledo, by offering local and state tax benefits for new investment. Taxpayers in Toledo sued, alleging that their local and state tax burdens were increased by the tax breaks for DaimlerChrysler, tax breaks that they asserted violated the *Commerce Clause*. The Court of Appeals agreed that a state tax credit offered under Ohio law violated the *Commerce Clause*, and state and local officials and DaimlerChrysler sought review in this Court. We are obligated before reaching this *Commerce Clause* question to determine whether the taxpayers who objected to the credit have standing to press their complaint in federal court. We conclude that they do not, and we therefore can proceed no further.

I

Ohio levies a franchise tax "upon corporations for the privilege of doing business in the state, owning or using a part or all of its capital or property in [the] state, or holding a certificate of compliance authorizing it to do business in [the] state." *Wesnovtek Corp. v. Wilkins, 105 Ohio St. 3d 312, 313*. . . . A taxpayer that purchases "new manufacturing machinery and equipment" and installs it at sites in the State receives a credit against the franchise tax. See *§ 5733.33(B)(1)* (Lexis 1999).[1] Municipalities in Ohio may also offer partial property tax waivers to businesses that agree to invest in qualifying areas. See *§ 5709.62(C)(1)(a)* (Lexis 2005). With consent from local school districts, the partial property tax waiver can be increased to a complete exemption. See *§ 5709.62(D)(1)*.

In 1998, DaimlerChrysler entered into a contract with the city of Toledo. Under the contract, DaimlerChrysler agreed to expand its Jeep assembly plant at Stickney Avenue in Toledo. In exchange, the city agreed to waive the property tax for the plant, with the consent of the two school districts in which the plant is located. Because DaimlerChrysler undertook to purchase and install "new manufacturing machinery and equipment," it was also entitled to a credit against the state franchise tax. See *§ 5733.33(B)(1)* (Lexis 1999).

Plaintiffs filed suit against various state and local officials and DaimlerChrysler in state court, alleging that these tax benefits violated the *Commerce Clause*. Most of the plaintiffs were residents of Toledo, who paid taxes to both the city of Toledo and State of Ohio. They claimed that they were injured because the tax breaks for

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[1] Ohio has begun phasing out the franchise tax and has discontinued offering new credits against the tax like the one DaimlerChrysler received. See *§§ 5733.01(G)*, *5733.33(B)(1)* (Lexis 2005). Where relevant, therefore, the citations in this opinion are to the statutes in effect at the time DaimlerChrysler made its investment

DaimlerChrysler diminished the funds available to the city and State, imposing a "disproportionate burden" on plaintiffs. App. 18a, 23a, 28a.[2] [*1860]

Defendants removed the action to the United States District Court for the Northern District of Ohio. See *28 U.S.C. § 1441*. Plaintiffs filed motions to remand the case to state court. See *§ 1447(c)*. One of the grounds on which they sought remand concerned their standing. They professed "substantial doubts about their ability to satisfy either the constitutional or the prudential limitations on standing in the federal court," and urged the District Court to avoid the issue entirely by remanding. Plaintiffs' Supplemental Motion for Remand to State Court in No. 3:00cv7247, p. 13, Record Doc. 17 (footnote omitted).

The District Court declined to remand the case, concluding that, "at the bare minimum, the Plaintiffs who are taxpayers have standing to object to the property tax exemption and franchise tax credit statutes under the 'municipal taxpayer standing' rule articulated in *Massachusetts v. Mellon, 262 U.S. 447 (1923)*." App. 78a (citations omitted). On the merits, the District Court found that neither tax benefit violated the *Commerce Clause*. See *154 F. Supp. 2d 1196 (2001)*. The Court of Appeals for the Sixth Circuit agreed with the District Court as to the municipal property tax exemption, but held that the state franchise tax credit violated the *Commerce Clause*. See *386 F.3d 738 (2004)*. The Court of Appeals did not address the issue of standing.

Defendants sought certiorari to review the Sixth Circuit's invalidation of the franchise tax credit and plaintiffs sought certiorari to review the upholding of the property tax exemption. We granted certiorari to consider whether the franchise tax credit violates the *Commerce Clause*, *545 U.S. 1165 (2005)*; the Michigan Supreme Court had decided a similar question contrary to the Sixth Circuit's analysis here. See *Caterpillar, Inc. v. Dept. of Treasury, 440 Mich. 400, 488 N.W.2d 182 (1992)*. We also asked the parties to address whether plaintiffs have standing to challenge the franchise tax credit in this litigation.

II

We have "an obligation to assure ourselves" of litigants' standing under Article III. *Friends of Earth, Inc. v. Laidlaw Environmental Services (TOC), Inc., 528 U.S. 167, 180 (2000)*. We therefore begin by addressing plaintiffs' claims that they have standing as taxpayers to challenge the franchise tax credit.

A

Chief Justice Marshall, in *Marbury v. Madison, 5 U.S. 137 (1803)*, grounded the Federal Judiciary's authority to exercise judicial review and interpret the Constitution

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[2] Other plaintiffs were residents of Toledo who claimed they were injured because they were displaced by the DaimlerChrysler expansion and Michigan residents who claimed injury because DaimlerChrysler would have expanded its operations in Michigan but for the Ohio investment tax credit. Plaintiffs neither identified these allegations as a basis for standing in their merits brief before this Court nor referred to them at oral argument. Any argument based on these allegations is therefore abandoned. See, *e.g., United States v. International Business Machines Corp., 517 U.S. 843, 855, and n. 3 (1996)*.

on the necessity to do so in the course of carrying out the judicial function of deciding cases. As Marshall explained, "those who apply the rule to particular cases, must of necessity expound and interpret that rule." *Id., at 177 (1803)*. Determining that a matter before the federal courts is a proper case or controversy under Article III therefore assumes particular importance in ensuring that the Federal Judiciary respects "'the proper—and properly limited—role of the courts in a democratic society,'" *Allen v. Wright, 468 U.S. 737, 750 (1984)* (quoting *Warth v. Seldin, 422 U.S. 490, 498 (1975))*. If a dispute is not a [*1861] proper case or controversy, the courts have no business deciding it, or expounding the law in the course of doing so.

This Court has recognized that the case-or-controversy limitation is crucial in maintaining the "'tripartite allocation of power'" set forth in the Constitution. *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc., 454 U.S. 464, 474 (1982)* (quoting *Flast v. Cohen, 392 U.S. 83, 95 (1968))*. Marshall again made the point early on, this time in a speech in the House of Representatives. "A case in law or equity," Marshall remarked,

> "was a term . . . of limited signification. It was a controversy between parties which had taken a shape for judicial decision. If the judicial power extended to every *question* under the constitution it would involve almost every subject proper for legislative discussion and decision; if to every *question* under the laws and treaties of the United States it would involve almost every subject on which the executive could act. The division of power [among the branches of government] could exist no longer, and the other departments would be swallowed up by the judiciary." 4 Papers of John Marshall 95 (C. Cullen ed. 1984).

As this Court has explained, "'no principle is more fundamental to the judiciary's proper role in our system of government than the constitutional limitation of federal-court jurisdiction to actual cases or controversies.'" *Raines v. Byrd, 521 U.S. 811, 818 (1997)* (quoting *Simon v. Eastern Ky. Welfare Rights Organization, 426 U.S. 26, 37 (1976))*.

The case-or-controversy requirement thus plays a critical role, and "Article III standing . . . enforces the Constitution's case-or-controversy requirement." *Elk Grove Unified School Dist. v. Newdow, 542 U.S. 1, 11, 124 (2004)*. The "core component" of the requirement that a litigant have standing to invoke the authority of a federal court "is an essential and unchanging part of the case-or-controversy requirement of Article III." *Lujan v. Defenders of Wildlife, 504 U.S. 555, 560 (1992)*. The requisite elements of this "core component derived directly from the Constitution" are familiar: "A plaintiff must allege personal injury fairly traceable to the defendant's allegedly unlawful conduct and likely to be redressed by the requested relief." *Allen, supra, at 751*. We have been asked to decide an important question of constitutional law concerning the *Commerce Clause*. But before we do so, we must find that the question is presented in a "case" or "controversy" that is, in James Madison's words, "of a Judiciary Nature." 2 Records of the Federal Convention of 1787, p. 430 (M. Farrand ed. 1966). That requires plaintiffs, as the parties now asserting federal jurisdiction, to carry the burden of establishing their standing under Article III.[3] [*1862]

B

Plaintiffs principally claim standing by virtue of their status as Ohio taxpayers, alleging that the franchise tax credit "depletes the funds of the State of Ohio to which the Plaintiffs contribute through their tax payments" and thus "diminishes the total funds available for lawful uses and imposes disproportionate burdens on" them. App. 28a; see also Brief for Respondents 24. On several occasions, this Court has denied *federal* taxpayers standing under Article III to object to a particular expenditure of federal funds simply because they are taxpayers. Thus the alleged "deprivation of the fair and constitutional use of [a federal taxpayer's] tax dollar" cannot support a challenge to the conveyance of Government land to a private religious college, *Valley Forge, supra, at 476-482* (internal quotation marks and some brackets omitted), and "the interest of a taxpayer in the moneys of the federal treasury furnishes no basis" to argue that a federal agency's loan practices are unconstitutional, *Alabama Power Co. v. Ickes, 302 U.S. 464, 478 (1938)*; see also *Schlesinger v. Reservists Comm. to Stop the War, 418 U.S. 208 (1974)*; *United States v. Richardson, 418 U.S. 166 (1974).*

The animating principle behind these cases was announced in their progenitor, *Frothingham* v. *Mellon*, decided with *Massachusetts v. Mellon, 262 U.S. 447 (1923).* In rejecting a claim that improper federal appropriations would "increase the burden of future taxation and thereby take [the plaintiff's] property without due process of law," the Court observed that a federal taxpayer's

> "interest in the moneys of the Treasury . . . is shared with millions of others; is comparatively minute and indeterminable; and the effect upon future taxation, of any payment out of the funds, so remote, fluctuating and uncertain, that no basis is afforded for an appeal to the preventive powers of a court of equity."
> *Id., at 486-487.*

This logic is equally applicable to taxpayer challenges to expenditures that deplete the treasury, and to taxpayer challenges to so-called "tax expenditures," which reduce amounts available to the treasury by granting tax credits or exemptions. In either case, the alleged injury is based on the asserted effect of the allegedly illegal activity on public revenues, to which the taxpayer contributes.

Standing has been rejected in such cases because the alleged injury is not "concrete and particularized," *Defenders of Wildlife, supra, at 560*, but instead a grievance the taxpayer "suffers in some indefinite way in common with people generally,"

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[3] Because defendants removed the case from state court to District Court, plaintiffs were not initially the parties that invoked federal jurisdiction. Indeed, plaintiffs initially expressed doubts as to their standing. Nonetheless, because "we presume that federal courts lack jurisdiction unless the contrary appears affirmatively from the record," *Renne v. Geary, 501 U.S. 312, 316 (1991)* (internal quotation marks omitted), the party asserting federal jurisdiction when it is challenged has the burden of establishing it. Whatever the parties' previous positions on the propriety of a federal forum, plaintiffs, as the parties seeking to establish federal jurisdiction, must make the showings required for standing

Frothingham, supra, at 488. In addition, the injury is not "actual or imminent," but instead "conjectural or hypothetical." *Defenders of Wildlife, supra, at 560* (internal quotation marks and citations omitted). As an initial matter, it is unclear that tax breaks of the sort at issue here do in fact deplete the treasury: The very point of the tax benefits is to spur economic activity, which in turn *increases* government revenues. In this very action, the Michigan plaintiffs claimed that they were injured because they lost out on the added revenues that would have accompanied Daimler-Chrysler's decision to expand facilities in Michigan. See n. 2, *supra*.

Plaintiffs' alleged injury is also "conjectural or hypothetical" in that it depends on how legislators respond to a reduction in revenue, if that is the consequence of the credit. Establishing injury requires speculating that elected officials will increase a [*1863] taxpayer-plaintiff's tax bill to make up a deficit; establishing redressability requires speculating that abolishing the challenged credit will redound to the benefit of the taxpayer because legislators will pass along the supposed increased revenue in the form of tax reductions. Neither sort of speculation suffices to support standing. See *ASARCO Inc. v. Kadish, 490 U.S. 605, 614 (1989)* (opinion of Kennedy, J.) ("It is pure speculation whether the lawsuit would result in any actual tax relief for respondents"); *Warth, 422 U.S., at 509* (criticizing a taxpayer standing claim for the "conjectural nature of the asserted injury").

A taxpayer-plaintiff has no right to insist that the government dispose of any increased revenue it might experience as a result of his suit by decreasing his tax liability or bolstering programs that benefit him. To the contrary, the decision of how to allocate any such savings is the very epitome of a policy judgment committed to the "broad and legitimate discretion" of lawmakers, which "the courts cannot presume either to control or to predict." *ASARCO, supra, at 615* (opinion of Kennedy, J.). Under such circumstances, we have no assurance that the asserted injury is "imminent"—that it is "certainly impending." *Whitmore v. Arkansas, 495 U.S. 149, 158 (1990)* (internal quotation marks omitted); see *Defenders of Wildlife, 504 U.S., at 564-565, n. 2*.

The foregoing rationale for rejecting federal taxpayer standing applies with undiminished force to state taxpayers. We indicated as much in *Doremus v. Board of Ed. of Hawthorne, 342 U.S. 429 (1952)*. In that case, we noted our earlier holdings that "the interests of a taxpayer in the moneys of the federal treasury are too indeterminable, remote, uncertain and indirect" to support standing to challenge "their manner of expenditure." *Id., at 433*. We then "reiterated" what we had said in rejecting a federal taxpayer challenge to a federal statute "as equally true when a state Act is assailed: 'The [taxpayer] must be able to show . . . that he has sustained . . . some direct injury . . . and not merely that he suffers in some indefinite way in common with people generally.'" *Id., at 433-434* (quoting *Frothingham, supra, at 488*); see *ASARCO, supra, at 613-614* (opinion of KENNEDY, J.) ("We have likened state taxpayers to federal taxpayers" for purposes of taxpayer standing (citing *Doremus, supra, at 434*)).

The allegations of injury that plaintiffs make in their complaint furnish no better basis for finding standing than those made in the cases where federal taxpayer standing was denied. Plaintiffs claim that DaimlerChrysler's tax credit depletes the

Ohio fisc and "imposes disproportionate burdens on [them]." App. 28a. This is no different from similar claims by federal taxpayers we have already rejected under Article III as insufficient to establish standing. See, *e.g., Frothingham, 262 U.S.* (allegation of injury that the effect of government spending "will be to increase the burden of future taxation and thereby take [plaintiff's] property without due process of law").

State policymakers, no less than their federal counterparts, retain broad discretion to make "policy decisions" concerning state spending "in different ways . . . depending on their perceptions of wise state fiscal policy and myriad other circumstances." *ASARCO, supra, at 615* (opinion of KENNEDY, J.). [*1864] Federal courts may not assume a particular exercise of this state fiscal discretion in establishing standing; a party seeking federal jurisdiction cannot rely on such "speculative inferences . . . to connect [his] injury to the challenged actions of [the defendant]," *Simon, 426 U.S., at 45*; see also *Allen, 468 U.S., at 759*. Indeed, because state budgets frequently contain an array of tax and spending provisions, any number of which may be challenged on a variety of bases, affording state taxpayers standing to press such challenges simply because their tax burden gives them an interest in the state treasury would interpose the federal courts as "'virtually continuing monitors of the wisdom and soundness'" of state fiscal administration, contrary to the more modest role Article III envisions for federal courts. See *id., at 760-761* (quoting *Laird v. Tatum, 408 U.S. 1, 15 (1972)).*

For the foregoing reasons, we hold that state taxpayers have no standing under Article III to challenge state tax or spending decisions simply by virtue of their status as taxpayers.[4]

C

Plaintiffs argue that an exception to the general prohibition on taxpayer standing should exist for *Commerce Clause* challenges to state tax or spending decisions, analogizing their *Commerce Clause* claim to the *Establishment Clause* challenge we permitted in *Flast v. Cohen, 392 U.S. 83. Flast* held that because "the *Establishment Clause* . . . specifically limits the taxing and spending power conferred by Art. I, § 8," "a taxpayer will have standing consistent with Article III to invoke federal judicial power when he alleges that congressional action under the taxing and spending clause is in derogation of" the *Establishment Clause. Id., at 105-106. Flast* held out the possibility that "other specific [constitutional] limitations" on Art. I, § 8, might surmount the "barrier to suits against Acts of Congress brought by individuals who can assert only the interest of federal taxpayers." *392 U.S., at 105, 85*. But as plaintiffs

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[4] The majority of the Courts of Appeals to have considered the issue have reached a similar conclusion. See, *e.g., Booth v. Hvass, 302 F.3d 849 (CA8 2002)*; *Board of Ed. of Mt. Sinai Union Free School Dist. v. New York State Teachers Retirement System, 60 F.3d 106 (CA2 1995)*; *Colorado Taxpayers Union, Inc. v. Romer, 963 F.2d 1394 (CA10 1992)*; *Taub v. Kentucky, 842 F.2d 912 (CA6 1988)*; *Korioth v. Briscoe, 523 F.2d 1271 (CA5 1974)*; but cf. *Arakaki v. Lingle, 423 F.3d 954, 967-969 (CA9 2005)* (finding state taxpayer standing in light of *Hoohuli v. Ariyoshi, 741 F.2d 1169 (CA9 1984)*, but noting that Justice Kennedy's opinion in *ASARCO Inc. v. Kadish, 490 U.S. 605 (1989)*, would "carry persuasive value" absent *Hoohuli*).

candidly concede, "only the *Establishment Clause*" has supported federal taxpayer suits since *Flast*. Brief for Respondents 12; see *Bowen v. Kendrick, 487 U.S. 589, 618(1988)* ("Although we have considered the problem of standing and Article III limitations on federal jurisdiction many times since *[Flast]*, we have consistently adhered to *Flast* and the narrow exception it created to the general rule against taxpayer standing").

Quite apart from whether the franchise tax credit is analogous to an exercise of congressional power under Art. I, § 8, plaintiffs' reliance on *Flast* is misguided: Whatever rights plaintiffs have under the *Commerce Clause*, they are fundamentally unlike the right not to "'contribute three pence . . . for the support of any one [religious] establishment.'" *392 U.S., at 103* [*1865] (quoting 2 Writings of James Madison 186 (G. Hunt ed. 1901)). Indeed, plaintiffs compare the *Establishment Clause* to the *Commerce Clause* at such a high level of generality that almost any constitutional constraint on government power would "specifically limit" a State's taxing and spending power for *Flast* purposes. *392 U.S., at 105*; see Brief for Respondents 14 ("In each case, the harm to be avoided by [the two clauses] is the loss of governmental neutrality"). And even if the two clauses are similar in that they often implicate governments' fiscal decisions, see *id.,* at 13-14, a finding that the *Commerce Clause* satisfies the *Flast* test would leave no principled way of distinguishing those other constitutional provisions that we have recognized constrain governments' taxing and spending decisions. See, *e.g., Arkansas Writers' Project, Inc. v. Ragland, 481 U.S. 221 (1987)* (invalidating state sales tax under the *Free Press Clause*). Yet such a broad application of *Flast*'s exception to the general prohibition on taxpayer standing would be quite at odds with its narrow application in our precedent and *Flast*'s own promise that it would not transform federal courts into forums for taxpayers'"generalized grievances." *392 U.S., at 106.*

Flast is consistent with the principle, underlying the Article III prohibition on taxpayer suits, that a litigant may not assume a particular disposition of government funds in establishing standing. The *Flast* Court discerned in the history of the *Establishment Clause* "the specific evils feared by [its drafters] that the taxing and spending power would be used to favor one religion over another or to support religion in general." *Id., at 103.* The Court therefore understood the "injury" alleged in *Establishment Clause* challenges to federal spending to be the very "extraction and spending" of "tax money" in aid of religion alleged by a plaintiff. *Id., at 106.* And an injunction against the spending would of course redress *that* injury, regardless of whether lawmakers would dispose of the savings in a way that would benefit the taxpayer-plaintiffs personally. See *Valley Forge, 454 U.S., at 514* (Stevens, J., dissenting) ("The plaintiffs' invocation of the *Establishment Clause* was of decisive importance in resolving the standing issue in *[Flast]*").

Plaintiffs thus do not have state taxpayer standing on the ground that their *Commerce Clause* challenge is just like the *Establishment Clause* challenge in *Flast*.

III

Plaintiffs also claim that their status as *municipal* taxpayers gives them standing to challenge the *state* franchise tax credit at issue here. The *Frothingham* Court noted with approval the standing of municipal residents to enjoin the "illegal use of the moneys of a municipal corporation," relying on "the peculiar relation of the corporate taxpayer to the corporation" to distinguish such a case from the general bar on taxpayer suits. *262 U.S., at 486-487*; see *ASARCO, 490 U.S., at 613-614* (opinion of Kennedy, J.) (reiterating distinction). Plaintiffs here challenged the municipal property tax exemption as municipal taxpayers. That challenge was rejected by the Court of Appeals on the merits, and no issue regarding plaintiffs' standing to bring it has been raised. In plaintiffs' challenge to the state franchise tax credit, however, they identify no municipal action contributing to any claimed injury. Instead, they try to leverage the notion of municipal taxpayer standing beyond challenges to municipal action, in two ways. [*1866]

A

First, plaintiffs claim that because state law requires revenues from the franchise tax to be distributed to local governments, *Ohio Rev. Code Ann. § 5733.12* (Lexis 2005), the award of a credit to DaimlerChrysler reduced such distributions and thus depleted the funds of "local governments to which Respondents pay taxes." Brief for Respondents 16. But plaintiffs' challenge is still to the state law and state decision, not those of their municipality. We have already explained why a state taxpayer lacks standing to challenge a state fiscal decision on the grounds that it might affect his tax liability. All plaintiffs have done in recasting their claims as ones brought by municipal taxpayers whose municipalities receive funding from the State—the level of which might be affected by the same state fiscal decision—is introduce yet another level of conjecture to their already hypothetical claim of injury.

And in fact events have highlighted the peril of assuming that any revenue increase resulting from a taxpayer suit will be put to a particular use. Ohio's General Assembly suspended the statutory budget mechanism that distributes franchise tax revenues to local governments in 2001 and again in its subsequent biennial budgets. See Amended Substitute H. B. 94, 124th General Assembly § 140 (2001), available at http://www.legislature.state. oh.us/BillText124/124_HB_94_ENR.pdf (all Internet materials as visited May 12, 2006, and available in Clerk of Court's case file); Amended Substitute H. B. 95, 125th General Assembly § 139 (2003), available at http://www.legislature.state.oh.us/BillText125/125_HB_95_EN2_N.pdf; Amended Substitute H. B. 66, 126th General Assembly § 557.12 (2005), available at http://www. legislature.state.-oh.us/BillText126/126_HB_66_EN2d.pdf. Any effect that enjoining Daimler-Chrysler's credit will have on municipal funds, therefore, will not result from automatic operation of a statutory formula, but from a hypothesis that the state government will choose to direct the supposed revenue from the restored franchise tax to municipalities. This is precisely the sort of conjecture we may not entertain in assessing standing. See *ASARCO, supra, at 614*(opinion of Kennedy, J.).

B

The second way plaintiffs seek to leverage their standing to challenge the municipal property tax exemption into a challenge to the franchise tax credit is by relying on *Mine Workers v. Gibbs, 383 U.S. 715 (1966)*. According to plaintiffs, the "supplemental jurisdiction" recognized in that case supports jurisdiction over all their claims, once the District Court determined they had standing to challenge the property tax exemption. Brief for Respondents 17-18.

Gibbs held that federal-question jurisdiction over a claim may authorize a federal court to exercise jurisdiction over state-law claims that may be viewed as part of the same case because they "derive from a common nucleus of operative fact" as the federal claim. *383 U.S., at 725*. Plaintiffs assume that *Gibbs* stands for the proposition that federal jurisdiction extends to all claims sufficiently related to a claim within Article III to be part of the same case, regardless of the nature of the deficiency that would keep the former claims out of federal court if presented on their own.

Our general approach to the application of *Gibbs*, however, has been markedly more cautious. For example, as a matter of statutory construction of the pertinent jurisidictional provisions, we refused to extend [*1867] *Gibbs* to allow claims to be asserted against nondiverse parties when jurisdiction was based on diversity, see *Owen Equipment & Erection Co. v. Kroger, 437 U.S. 365 (1978)*, and we refused to extend *Gibbs* to authorize supplemental jurisdiction over claims that do not satisfy statutory amount-in-controversy requirements, see *Finley v. United States, 490 U.S. 545 (1989)*. As the Court explained just last Term, "we have not . . . applied *Gibbs*' expansive interpretive approach to other aspects of the jurisdictional statutes." *Exxon Mobil Corp. v. Allapattah Servs., 545 U.S. ___, ___, 545 U.S. 546 (2005) (slip op., at 5)* (applying *28 U.S.C. § 1367*, enacted in 1990, to allow a federal court in a diversity action to exercise supplemental jurisdiction over additional diverse plaintiffs whose claims failed to meet the amount-in-controversy threshold).

What we have never done is apply the rationale of *Gibbs* to permit a federal court to exercise supplemental jurisdiction over a claim that does not itself satisfy those elements of the Article III inquiry, such as constitutional standing, that "serve to identify those disputes which are appropriately resolved through the judicial process." *Whitmore, 495 U.S., at 155*. We see no reason to read the language of *Gibbs* so broadly, particularly since our standing cases confirm that a plaintiff must demonstrate standing for each claim he seeks to press. See *Allen, 468 U.S., at 752* ("The standing inquiry requires careful judicial examination of a complaint's allegations to ascertain whether the particular plaintiff is entitled to an adjudication of the *particular claims* asserted" (emphasis added)). We have insisted, for instance, that "a plaintiff must demonstrate standing separately for each form of relief sought." *Laidlaw, 528 U.S., at 185, 180*; see *Los Angeles v. Lyons, 461 U.S. 95, 109 (1983)*. But if standing were commutative, as plaintiffs claim, this insistence would make little sense when all claims for relief derive from a "common nucleus of operative fact," as they certainly appear to have in both *Laidlaw, supra, at 175-179, 180*, and *Lyons, supra, at 97-98*.

Plaintiffs' reading of *Gibbs* to allow standing as to one claim to suffice for all claims arising from the same "nucleus of operative fact" would have remarkable implications. The doctrines of mootness, ripeness, and political question all originate in Article III's "case" or "controversy" language, no less than standing does. See, *e.g.*, *National Park Hospitality Assn. v. Department of Interior, 538 U.S. 803, 808 (2003)* (ripeness); *Arizonans for Official English v. Arizona, 520 U.S. 43, 67 (1997)* (mootness); *Reservists Comm. to Stop the War, 418 U.S., at 215* (political question). Yet if *Gibbs*'"common nucleus" formulation announced a new definition of "case" or "controversy" for all Article III purposes, a federal court would be free to entertain moot or unripe claims, or claims presenting a political question, if they "derived from" the same "operative facts" as another federal claim suffering from none of these defects. Plaintiffs' reading of *Gibbs*, therefore, would amount to a significant revision of our precedent interpreting Article III. With federal courts thus deciding issues they would not otherwise be authorized to decide, the "'tripartite allocation of power'" that Article III is designed to maintain, *Valley Forge, 454 U.S., at 474*, would quickly erode; our emphasis on the standing requirement's role in maintaining this separation would be rendered hollow rhetoric. As we have explained, "the [*1868] actual-injury requirement would hardly serve the purpose . . . of preventing courts from undertaking tasks assigned to the political branches[,] if once a plaintiff demonstrated harm from one particular inadequacy in government administration, the court were authorized to remedy *all* inadequacies in that administration." *Lewis v. Casey, 518 U.S. 343, 357 (1996).*

Lewis emphasized that "the remedy must of course be limited to the inadequacy that produced the injury in fact that the plaintiff has established." *Ibid.* Plaintiffs' theory of ancillary standing would contravene this principle. Plaintiffs failed to establish Article III injury with respect to their *state* taxes, and even if they did do so with respect to their *municipal* taxes, that injury does not entitle them to seek a remedy as to the state taxes. As the Court summed up the point in *Lewis*, "standing is not dispensed in gross." *Id., at 358, n. 6.*[5]

All the theories plaintiffs have offered to support their standing to challenge the franchise tax credit are unavailing. Because plaintiffs have no standing to challenge that credit, the lower courts erred by considering their claims against it on the merits. The judgment of the Sixth Circuit is therefore vacated in part, and the cases are remanded for dismissal of plaintiffs' challenge to the franchise tax credit.

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[5] In defending the contrary position, plaintiffs rely on three cases from the Courts of Appeals. But two of those cases hold only that, once a litigant has standing to request invalidation of a particular agency action, it may do so by identifying all grounds on which the agency may have "'failed to comply with its statutory mandate.'" *Sierra Club v. Adams, 188 U.S. App. D.C. 147, 578 F.2d 389, 392 (CADC 1978)* (quoting *Sierra Club v. Morton, 405 U.S. 727, 737 (1972))*; see also *Iowa Independent Bankers v. Board of Governors of Fed. Reserve, 167 U.S. App. D.C. 286, 511 F.2d 1288, 1293-1294 (CADC 1975)*. They do not establish that the litigant can, by virtue of his standing to challenge one government action, challenge other governmental actions that did not injure him. In the third case, the Court of Appeals relied substantially on the fact that "all courts possess an inherent power to prevent unprofessional conduct by those attorneys who are practicing before them" in allowing the Government to contest the division of a damages award it was ordered to pay between a plaintiff and his attorney. *Jackson v. United States, 881 F.2d 707, 710-711 (CA9 1989)*. That situation is rather far afield from the question before us.

It is so ordered.

JUSTICE GINSBURG, concurring in part and concurring in the judgment.

Today's decision, the Court rightly points out, is solidly grounded in longstanding precedent, *Frothingham* v. *Mellon* (decided with *Massachusetts v. Mellon), 262 U.S. 447 (1923)*, and *Doremus v. Board of Ed. of Hawthorne, 342 U.S. 429 (1952)*, decisions that antedate current jurisprudence on standing to sue. See *ante*, at 7, 9. *Frothingham* held nonjusticiable a federal taxpayer's suit challenging a federal-spending program. See *262 U.S., at 487* (describing taxpayer's interest as "minute and indeterminable"). *Doremus* applied *Frothingham*'s reasoning to a state taxpayer's suit. *342 U.S., at 434*. These decisions exclude from federal-court cognizance claims, not delineated by Congress, presenting generalized grievances. An exception to *Frothingham*'s rule, recognized post-*Doremus in Flast v. Cohen, 392 U.S. 83 (1968)*, covers certain alleged violations of the *Establishment Clause*. The *Flast* exception has not been extended to other areas. See *Bowen v. Kendrick, 487 U.S. 589, 618 (1988)*; cf. Enrich, Saving [*1869] the States from Themselves: *Commerce Clause* Constraints on State Tax Incentives for Business, *110 Harv. L. Rev. 378, 417-418 (1996).*

One can accept, as I do, the nonjusticiability of *Frothingham*-type federal and state taxpayer suits in federal court without endorsing as well the limitations on standing later declared in *Simon v. Eastern Ky. Welfare Rights Organization, 426 U.S. 26 (1976) (EKWRO), Valley Forge Christian College v. Americans United for Separation of Church and State, Inc., 454 U.S. 464 (1982), Allen v. Wright, 468 U.S. 737 (1984)*, and *Lujan v. Defenders of Wildlife, 504 U.S. 555 (1992).* See *EKWRO, 426 U.S., at 54-66* (Brennan, J., concurring in judgment); *Valley Forge, 454 U.S., at 513-515* (STEVENS, J., dissenting); *Allen, 468 U.S., at 783-795* (Stevens, J., dissenting), and the overturned Court of Appeals opinion, *Wright v. Regan, 211 U.S. App. D.C. 231, 656 F.2d 820, 828-832 (CADC 1981)* (Ginsburg, J.); *Defenders of Wildlife, 504 U.S., at 582-585* (Stevens, J., concurring in judgment); Sunstein, What's Standing after *Lujan*? Of Citizen Suits, "Injuries," and Article III, *91 Mich. L. Rev. 163, 203-205, 228-229 (1992)* (contrasting *Lujan*, *Allen*, and *EKWRO* with *Regents of Univ. of Cal. v. Bakke, 438 U.S. 265 (1978))*; Fletcher, The Structure of Standing, *98 Yale L. J. 221, 267-270 (1988)* (commenting on *Flast* and *Valley Forge*). Noting this large reservation, I concur in the judgment, and in the balance of the Court's opinion.

Granholm v. Eleanor Heald, et al.

544 U.S. 460 (2005)

Kennedy, J., delivered the opinion of the Court, in which Scalia, Souter, Ginsburg, and Breyer, JJ., joined. Stevens, J., filed a dissenting opinion, in which O'Connor, J., joined. Thomas, J., filed a dissenting opinion, in which Rehnquist, C. J., and Stevens and O'Connor, JJ., joined. [*465]

These consolidated cases present challenges to state laws regulating the sale of wine from out-of-state wineries to consumers in Michigan and New York. The details and mechanics [*466] of the two regulatory schemes differ, but the object and effect of the laws are the same: to allow in-state wineries to sell wine directly to consumers in that State but to prohibit out-of-state wineries from doing so, or, at the least, to make direct sales impractical from an economic standpoint. It is evident that the object and design of the Michigan and New York statutes is to grant in-state wineries a competitive advantage over wineries located beyond the States' borders.

We hold that the laws in both States discriminate against interstate commerce in violation of the *Commerce Clause*, Art. I, § 8, cl. 3, and that the discrimination is neither authorized nor permitted by the *Twenty-first Amendment*. Accordingly, we affirm the judgment of the Court of Appeals for the Sixth Circuit, which invalidated the Michigan laws; and we reverse the judgment of the Court of Appeals for the Second Circuit, which upheld the New York laws.

I

Like many other States, Michigan and New York regulate the sale and importation of alcoholic beverages, including wine, through a three-tier distribution system. Separate licenses are required for producers, wholesalers, and retailers. See FTC, Possible Anticompetitive Barriers to E-Commerce: Wine 5-7 (July 2003) (hereinafter FTC Report), available at http://www.ftc.gov/os/2003/07/winereport2.pdf (all Internet materials as visited May 11, 2005, and available in Clerk of Court's case file). The three-tier scheme is preserved by a complex set of overlapping state and federal regulations. For example, both state and federal laws limit vertical integration between tiers. *Id.*, at 5; *27 USC § 205* [*27 USCS § 205*]; see, *e.g.*, *Bainbridge v. Turner, 311 F.3d 1104, 1106 (CA11 2002)*. We have held previously that States can mandate a three-tier distribution scheme in the exercise of their authority under the *Twenty-first Amendment*. *North Dakota v. United States, 495 U.S. 423, 432, 109 L. Ed. 2d 420, 110 S. Ct. 1986 (1990)*; *id., at 447, 109 L. Ed. 2d 420, 110 S. Ct. 1986* (Scalia, J., concurring in judgment). As relevant to today's cases, though, [*467] the three-tier system is, in broad terms and with refinements to be discussed, mandated by Michigan and New York only for sales from out-of-state wineries. In-state wineries, by contrast, can obtain a license for direct sales to consumers. The differential treatment between in-state and out-of-state wineries constitutes explicit discrimination against interstate commerce.

This discrimination substantially limits the direct sale of wine to consumers, an otherwise emerging and significant business. FTC Report 7. From 1994 to 1999, consumer spending on direct wine shipments doubled, reaching $500 million per year, or three percent of all wine sales. *Id.*, at 5. The expansion has been influenced by several related trends. First, the number of small wineries in the United States has significantly increased. By some estimates there are over 3,000 wineries in the country, WineAmerica, The National Association of American Wineries, Wine Facts 2004, http://www.americanwineries.org/newsroom/winefacts04.htm, more than three times the number 30 years ago, FTC Report 6. At the same time, the wholesale market has consolidated. Between 1984 and 2002, the number of licensed wholesalers dropped from 1,600 to 600. Riekhof & Sykuta, Regulating Wine by Mail, 27 Regulation, No. 3, pp. 30, 31 (Fall 2004), available at http://www.cato.org/pubs/regulation/regv27n3/v27n3-3.pdf. The increasing winery-to-wholesaler ratio means that many small wineries do not produce enough wine or have sufficient consumer demand for their wine to make it economical for wholesalers to carry their products. FTC Report 6. This has led many small wineries to rely on direct shipping to reach new markets. Technological improvements, in particular the ability of wineries to sell wine over the Internet, have helped make direct shipments an attractive sales channel.

Approximately 26 States allow some direct shipping of wine, with various restrictions. Thirteen of these States have reciprocity laws, which allow direct shipment from wineries [*468] outside the State, provided the State of origin affords similar nondiscriminatory treatment. *Id.*, at 7-8. In many parts of the country, however, state laws that prohibit or severely restrict direct shipments deprive consumers of access to the direct market. According to the Federal Trade Commission (FTC), "[s]tate bans on interstate direct shipping represent the single largest regulatory barrier to expanded e-commerce in wine." *Id.*, at 3.

The wine producers in the cases before us are small wineries that rely on direct consumer sales as an important part of their businesses. Domaine Alfred, one of the plaintiffs in the Michigan suit, is a small winery located in San Luis Obispo, California. It produces 3,000 cases of wine per year. Domaine Alfred has received requests for its wine from Michigan consumers but cannot fill the orders because of the State's direct-shipment ban. Even if the winery could find a Michigan wholesaler to distribute its wine, the wholesaler's markup would render shipment through the three-tier system economically infeasible.

Similarly, Juanita Swedenburg and David Lucas, two of the plaintiffs in the New York suit, operate small wineries in Virginia (the Swedenburg Estate Vineyard) and California (the Lucas Winery). Some of their customers are tourists, from other States, who purchase wine while visiting the wineries. If these customers wish to obtain Swedenburg or Lucas wines after they return home, they will be unable to do so if they reside in a State with restrictive direct-shipment laws. For example, Swedenburg and Lucas are unable to fill orders from New York, the Nation's second-largest wine market, because of the limits that State imposes on direct wine shipments.

A

We first address the background of the suit challenging the Michigan direct-shipment law. Most alcoholic beverages in Michigan are distributed through the State's three-tier [*469] system. Producers or distillers of alcoholic beverages, whether located in state or out of state, generally may sell only to licensed in-state wholesalers. *Mich. Comp. Laws Ann. §§ 436.1109(1), 436.1305, 436.1403, 436.1607(1)* (West 2000); Mich. Admin. Code *Rules 436.1705* (1990), *436.1719* (2000). Wholesalers, in turn, may sell only to in-state retailers. *Mich. Comp. Laws Ann. §§ 436.1113(7), 436.1607(1)* (West 2001). Licensed retailers are the final link in the chain, selling alcoholic beverages to consumers at retail locations and, subject to certain restrictions, through home delivery. *§§ 436.1111(5), 436.1203(2)-(4).*

Under Michigan law, wine producers, as a general matter, must distribute their wine through wholesalers. There is, however, an exception for Michigan's approximately 40 in-state wineries, which are eligible for "wine maker" licenses that allow direct shipment to in-state consumers. *§ 436.1113(9)* (West 2001); *§§ 436.1537(2)-(3)* (West Supp. 2004); Mich. Admin. Code *Rule 436.1011(7)(b)* (2003). The cost of the license varies with the size of the winery. For a small winery, the license is $25. *Mich. Comp. Laws Ann. § 436.1525(1)(d)* (West Supp. 2004). Out-of-state wineries can apply for a $300 "outside seller of wine" license, but this license only allows them to sell to in-state wholesalers. *§§ 436.1109(9)* (West 2001), *436.1525(1)(e)* (West Supp. 2004); Mich. Admin. Code *Rule 436.1719(5)* (2000).

Some Michigan residents brought suit against various state officials in the United States District Court for the Eastern District of Michigan. Domaine Alfred, the San Luis Obispo winery, joined in the suit. The plaintiffs contended that Michigan's direct-shipment laws discriminated against interstate commerce in violation of the *Commerce Clause*. The trade association Michigan Beer & Wine Wholesalers intervened as a defendant. Both the State and the wholesalers argued that the ban on direct shipment from out-of-state wineries is a valid exercise of Michigan's power under *§ 2 of the Twenty-first Amendment*. [*470]

On cross-motions for summary judgment the District Court sustained the Michigan scheme. The Court of Appeals for the Sixth Circuit reversed. *Heald v. Engler, 342 F.3d 517 (2003)*. Relying on *Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 82 L. Ed. 2d 200, 104 S. Ct. 3049 (1984)*, the court rejected the argument that the *Twenty-first Amendment* immunizes all state liquor laws from the strictures of the *Commerce Clause, 342 F.3d, at 524*, and held the Michigan scheme was unconstitutional because the defendants failed to demonstrate the State could not meet its proffered policy objectives through nondiscriminatory means, *id., at 527.*

B

New York's licensing scheme is somewhat different. It channels most wine sales through the three-tier system, but it too makes exceptions for in-state wineries. As in Michigan, the result is to allow local wineries to make direct sales to consumers in New York on terms not available to out-of-state wineries. Wineries that produce wine only from New York grapes can apply for a license that allows direct shipment to in-state consumers. *N. Y. Alco. Bev. Cont. Law Ann. § 76-a(3)* (West Supp. 2005) (hereinafter N. Y. ABC Law). These licensees are authorized to deliver the wines of other wineries as well, *§ 76-a(6)(a)*, but only if the wine is made from grapes "at least seventy-five percent the volume of which were grown in New York state," *§ 3(20-a)*. An out-of-state winery may ship directly to New York consumers only if it becomes a licensed New York winery, which requires the establishment of "a branch factory, office or storeroom within the state of New York." *§ 3(37)*.

Juanita Swedenburg and David Lucas, joined by three of their New York customers, brought suit in the Southern District of New York against the officials responsible for administering *New York's Alcoholic Beverage Control Law* seeking, *inter alia*, a declaration that the State's limitations on the direct shipment of out-of-state wine violate the *Commerce Clause*. New York liquor wholesalers and representatives [*471] of New York liquor retailers intervened in support of the State.

The District Court granted summary judgment to the plaintiffs. *232 F. Supp. 2d 135 (2002)*. The court first determined that, under established *Commerce Clause* principles, the New York direct-shipment scheme discriminates against out-of-state wineries. *Id., at 146-147*. The court then rejected the State's *Twenty-first Amendment* argument, finding that the "[d]efendants have not shown that New York's ban on the direct shipment of out-of-state wine, and particularly the in-state exceptions to the ban, implicate the State's core concerns under the *Twenty-first Amendment*." *Id., at 148*.

The Court of Appeals for the Second Circuit reversed. *358 F.3d 223 (2004)*. The court "recognize[d] that the physical presence requirement could create substantial dormant *Commerce Clause* problems if this licensing scheme regulated a commodity other than alcohol." *Id., at 238*. The court nevertheless sustained the New York statutory scheme because, in the court's view, "New York's desire to ensure accountability through presence is aimed at the regulatory interests directly tied to the importation and transportation of alcohol for use in New York," *ibid*. As such, the New York direct shipment laws were "within the ambit of the powers granted to states by the *Twenty-first Amendment*." *Id., at 239*.

C

We consolidated these cases and granted certiorari on the following question: "'Does a State's regulatory scheme that permits in-state wineries directly to ship alcohol to consumers but restricts the ability of out-of-state wineries to do so violate the dormant *Commerce Clause* in light of *§ 2 of the Twenty-first Amendment?*'" *541 U.S. 1062, 158 L. Ed. 2d 962, 124 S. Ct. 2389 (2004)*.

For ease of exposition, we refer to the respondents from the Michigan challenge (Nos. 03-1116 and 03-1120) and the petitioners in the New York challenge (No. 03-1274) collectively [*472] as the wineries. We refer to their opposing parties—Michigan, New York, and the wholesalers and retailers—simply as the States.

II

A

Time and again this Court has held that, in all but the narrowest circumstances, state laws violate the *Commerce Clause* if they mandate "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore., 511 U.S. 93, 99, 128 L. Ed. 2d 13, 114 S. Ct. 1345 (1994).* See also *New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 274, 100 L. Ed. 2d 302, 108 S. Ct. 1803 (1988).* This rule is essential to the foundations of the Union. The mere fact of nonresidence should not foreclose a producer in one State from access to markets in other States. *H. P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 539, 93 L. Ed. 865, 69 S. Ct. 657 (1949).* States may not enact laws that burden out-of-state producers or shippers simply to give a competitive advantage to in-state businesses. This mandate "reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Hughes v. Oklahoma, 441 U.S. 322, 325-326, 60 L. Ed. 2d 250, 99 S. Ct. 1727 (1979).*

The rule prohibiting state discrimination against interstate commerce follows also from the principle that States should not be compelled to negotiate with each other regarding favored or disfavored status for their own citizens. States do not need, and may not attempt, to negotiate with other States regarding their mutual economic interests. Cf. *U.S. Const., Art. I, § 10, cl. 3.* Rivalries among the States are thus kept to a minimum, and a proliferation of trade zones is prevented. See *C & A Carbone, Inc. v. Clarkstown,* [*473] *511 U.S. 383, 390, 128 L. Ed. 2d 399, 114 S. Ct. 1677 (1994)* (citing The Federalist No. 22, pp. 143-145 (C. Rossiter ed. 1961) (A. Hamilton); Madison, Vices of the Political System of the United States, in 2 Writings of James Madison 362-363 (G. Hunt ed. 1901)).

Laws of the type at issue in the instant cases contradict these principles. They deprive citizens of their right to have access to the markets of other States on equal terms. The perceived necessity for reciprocal sale privileges risks generating the trade rivalries and animosities, the alliances and exclusivity, that the Constitution and, in particular, the *Commerce Clause* were designed to avoid. State laws that protect local wineries have led to the enactment of statutes under which some States condition the right of out-of-state wineries to make direct wine sales to in-state consumers on a reciprocal right in the shipping State. California, for example, passed a reciprocity law in 1986, retreating from the State's previous regime that allowed unfettered direct shipments from out-of-state wineries. Riekhof & Sykuta, 27 Regulation, No. 3, at 30. Prior to 1986, all but three States prohibited direct-shipments of wine. The obvious aim of the California statute was to open the interstate direct-shipping market for the State's many wineries. *Ibid.* The current patchwork of laws—with some States banning direct shipments altogether, others doing so only for out-of-state wines, and still others requiring reciprocity—is essentially the product of an ongoing, low-level trade war. Allowing States to discriminate against out-of-state wine "invite[s] a multiplication of preferential trade areas destructive of the very purpose of the *Commerce Clause.*" *Dean Milk Co. v. Madison, 340 U.S. 349, 356, 95 L. Ed. 329, 71 S. Ct. 295 (1951).* See also *Baldwin v. G. A. F. Seelig, Inc., 294 U.S. 511, 521-523, 79 L. Ed. 1032, 55 S. Ct. 497 (1935).*

B

The discriminatory character of the Michigan system is obvious. Michigan allows in-state wineries to ship directly to consumers, subject only to a licensing requirement. Out-of-state [*474] wineries, whether licensed or not, face a complete ban on direct shipment. The differential treatment requires all out-of-state wine, but not all in-state wine, to pass through an in-state wholesaler and retailer before reaching consumers. These two extra layers of overhead increase the cost of out-of-state wines to Michigan consumers. The cost differential, and in some cases the inability to secure a wholesaler for small shipments, can effectively bar small wineries from the Michigan market.

The New York regulatory scheme differs from Michigan's in that it does not ban direct shipments altogether. Out-of-state wineries are instead required to establish a distribution operation in New York in order to gain the privilege of direct shipment. N. Y. *ABC Law §§ 3(37), 96.* This, though, is just an indirect way of subjecting out-of-state wineries, but not local ones, to the three-tier system. New York and those allied with its interests defend the scheme by arguing that an out-of-state winery has the same access to the State's consumers as in-state wineries: All wine must be sold through a licensee fully accountable to New York; it just so happens that in order to become a licensee, a winery must have a physical presence in the State. There is some confusion over the precise steps out-of-state wineries must take to gain access to the New York market, in part because no winery has run the State's regulatory gauntlet. New York's argument, in any event, is unconvincing.

The New York scheme grants in-state wineries access to the State's consumers on preferential terms. The suggestion of a limited exception for direct shipment from out-of-state wineries does nothing to eliminate the discriminatory nature of New York's regulations. In-state producers, with the applicable licenses, can ship directly to consumers from their wineries. *§§ 76-a(3), 76(4)* (West Supp. 2005), and *§ 77(2)* (West 2000). Out-of-state wineries must open a branch office and warehouse in New York, additional steps that drive up the cost [*475] of their wine. *§§ 3(37), 96* (West Supp. 2005). See also App. in No. 03-1274, pp. 159-160 (Affidavit of Thomas G. McKeon, General Counsel to the New York State Liquor Authority). For most wineries, the expense of establishing a bricks-and-mortar distribution operation in 1 State, let alone all 50, is prohibitive. It comes as no surprise that not a single out-of-state winery has availed itself of New York's direct-shipping privilege. We have "viewed with particular suspicion state statutes requiring business operations to be performed in the home State that could more efficiently be performed elsewhere." *Pike v. Bruce Church, Inc., 397 U.S. 137, 145, 25 L. Ed. 2d 174, 90 S. Ct. 844 (1970)*. New York's in-state presence requirement runs contrary to our admonition that States cannot require an out-of-state firm "to become a resident in order to compete on equal terms." *Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64, 72, 10 L. Ed. 2d 202, 83 S. Ct. 1201 (1963)*. See also *Ward v. Maryland, 79 U.S. 418, 12 Wall. 418, 20 L. Ed. 449 (1871)*.

In addition to its restrictive in-state presence requirement, New York discriminates against out-of-state wineries in other ways. Out-of-state wineries that establish the requisite branch office and warehouse in New York are still ineligible for a "farm winery" license, the license that provides the most direct means of shipping to New York consumers. N. Y. *ABC Law § 76-a(5)* ("No licensed farm winery shall manufacture or sell any wine not produced exclusively from grapes or other fruits or agricultural products grown or produced in New York state"). Out-of-state wineries may apply only for a commercial winery license. See *§§ 3(37), 76*. Unlike farm wineries, however, commercial wineries must obtain a separate certificate from the state liquor authority authorizing direct shipments to consumers, *§ 77(2)* (West 2000); and, of course, for out-of-state wineries there is the additional requirement of maintaining a distribution operation in New York. New York law also allows in-state wineries without direct-shipping licenses to distribute their wine through other wineries that have the [*476] applicable licenses. *§ 76(5)* (West Supp 2005). This is another privilege not afforded out-of-state wineries.

We have no difficulty concluding that New York, like Michigan, discriminates against interstate commerce through its direct-shipping laws.

III

State laws that discriminate against interstate commerce face "a virtually *per se* rule of invalidity." *Philadelphia v. New Jersey, 437 U.S. 617, 624, 57 L. Ed. 2d 475, 98 S. Ct. 2531 (1978)*. The Michigan and New York laws by their own terms violate this proscription. The two States, however, contend their statutes are saved by *§ 2 of the Twenty-first Amendment*, which provides:

> "The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."

The States' position is inconsistent with our precedents and with the *Twenty-first Amendment's* history. *Section 2* does not allow States to regulate the direct shipment of wine on terms that discriminate in favor of in-state producers.

A

Before 1919, the temperance movement fought to curb the sale of alcoholic beverages one State at a time. The movement made progress, and many States passed laws restricting or prohibiting the sale of alcohol. This Court upheld state laws banning the production and sale of alcoholic beverages, *Mugler v. Kansas, 123 U.S. 623, 31 L. Ed. 205, 8 S. Ct. 273 (1887)*, but was less solicitous of laws aimed at imports. In a series of cases before ratification of the *Eighteenth Amendment* the Court, relying on the *Commerce Clause*, invalidated a number of state liquor regulations.

These cases advanced two distinct principles. First, the Court held that the *Commerce Clause* prevented States from discriminating against imported liquor. *Scott v. Donald, 165 U.S. 58, 41 L. Ed. 632, 17 S. Ct. 265 (1897)*; [*477] *Walling v. Michigan, 116 U.S. 446, 29 L. Ed. 691, 6 S. Ct. 454 (1886)*; *Tiernan v. Rinker, 102 U.S. 123, 26 L. Ed. 103 (1880)*. In *Walling*, for example, the Court invalidated a Michigan tax that discriminated against liquor imports by exempting sales of local products. The Court held that States were not free to pass laws burdening only out-of-state products:

> "A discriminating tax imposed by a State operating to the disadvantage of the products of other States when introduced into the first mentioned State, is, in effect, a regulation in restraint of commerce among the States, and as such is a usurpation of the power conferred by the Constitution upon the Congress of the United States."

116 U.S., at 455, 29 L. Ed. 691, 6 S. Ct. 454.

Second, the Court held that the *Commerce Clause* prevented States from passing facially neutral laws that placed an impermissible burden on interstate commerce. *Rhodes v. Iowa, 170 U.S. 412, 42 L. Ed. 1088, 18 S. Ct. 664 (1898)*; *Vance v. W. A. Vandercook Co., 170 U.S. 438, 42 L. Ed. 1100, 18 S. Ct. 674 (1898)*; *Leisy v. Hardin, 135 U.S. 100, 34 L. Ed. 128, 10 S. Ct. 681, 12 Ky. L. Rptr. 123 (1890)*; *Bowman v. Chicago & Northwestern R. Co., 125 U.S. 465, 31 L. Ed. 700, 8 S. Ct. 689 (1888)*. For example, in *Bowman v. Chicago & Northwestern R. Co., 125 U.S. 465, 31 L. Ed. 700, 8 S. Ct. 689 (1888)*, the Court struck down an Iowa statute that required all liquor importers to have a permit. *Bowman* and its progeny rested in part on the since-rejected original-package doctrine. Under this doctrine goods shipped in interstate commerce were immune from state regulation while in their original package. As the Court explained in *Vance*,

> "the power to ship merchandise from one State into another carries with it, as an incident, the right in the receiver of the goods to sell them in the original packages, any state regulation to the contrary notwithstanding; that is to say, that the goods received by Interstate Commerce remain under the shelter of the *Interstate Commerce clause of the Constitution*, until by a sale in the original package they have been commingled with [*478] the general mass of property in the state."

170 U.S., at 444-445, 42 L. Ed. 1100, 18 S. Ct. 674.

Bowman reserved the question whether a State could ban the sale of imported liquor altogether. *125 U.S., at 499-500, 31 L. Ed. 700, 8 S. Ct. 689*. Iowa responded to

Bowman by doing just that but was thwarted once again. In *Leisy, supra,* the Court held that Iowa could not ban the sale of imported liquor in its original package.

Leisy left the States in a bind. They could ban the production of domestic liquor, *Mugler, supra*, but these laws were ineffective because out-of-state liquor was immune from any state regulation as long as it remained in its original package, *Leisy, supra.* To resolve the matter, Congress passed the *Wilson Act* (so named for Senator Wilson of Iowa), which empowered the States to regulate imported liquor on the same terms as domestic liquor:

> "That all fermented, distilled, or other intoxicating liquors or liquids transported into any State or Territory or remaining therein for use, consumption, sale or storage therein, shall upon arrival in such State or Territory be subject to the operation and effect of the laws of such State or Territory enacted in the exercise of its police powers, to the same extent and in the same manner as though such liquids or liquors had been produced in such State or Territory, and shall not be exempt therefrom by reason of being introduced therein in original packages or otherwise."

Ch 728, 26 Stat 313 (codified at *27 USC § 121* [*27 USCS § 121*]).

By its own terms, the Wilson Act did not allow States to discriminate against out-of-state liquor; rather, it allowed States to regulate imported liquor only "to the same extent and in the same manner" as domestic liquor.

The Court confirmed this interpretation in *Scott, supra. Scott* involved a constitutional challenge to South Carolina's dispensary law, 1895 SC Acts p. 721, which required that [*479] all liquor sales be channeled through the state liquor commissioner. *165 U.S., at 92, 41 L. Ed. 632, 17 S. Ct. 265*. The statute discriminated against out-of-state manufacturers in two primary ways. First, § 15 required the commissioner to "purchase his supplies from the brewers and distillers in this State when their product reaches the standard required by this Act: Provided, Such supplies can be purchased as cheaply from such brewers and distillers in this State as elsewhere." 1895 SC Acts p. 732. Second, § 23 of the statute limited the State's markup on locally produced wines to a 10-percent profit but provided "no such limitation of charge in the case of imported wines." *165 U.S., at 93, 41 L. Ed. 632, 17 S. Ct. 265*. Based on these discriminatory provisions, the Court rejected the argument that the South Carolina dispensary law was authorized by the Wilson Act. *Id., at 100, 41 L. Ed. 632, 17 S. Ct. 265*. It explained that the Wilson Act was "not intended to confer upon any State the power to discriminate injuriously against the products of other States in articles whose manufacture and use are not forbidden, and which are therefore the subjects of legitimate commerce." *Ibid.* To the contrary, the Court said, the Wilson Act mandated "equality or uniformity of treatment under state laws," *ibid.,* and did not allow South Carolina to provide "an unjust preference" to its products "as against similar products of the other States," *id., at 101, 41 L. Ed. 632, 17 S. Ct. 265*. The dissent also understood the validity of the dispensary law to turn in large part on §§ 15 and 23, but argued that even if these provisions were discriminatory the correct remedy was to sever them from the rest of the Act. *Id., at 104-106, 41 L. Ed. 632, 17 S. Ct. 265* (opinion of Brown, J.).

Although the Wilson Act increased the States' authority to police liquor imports, it did not solve all their problems. In *Vance* and *Rhodes*—two cases decided soon after *Scott*—the Court made clear that the Wilson Act did not authorize States to prohibit direct shipments for personal use. In *Vance*, the Court characterized *Scott* as embodying two distinct holdings: First, the South Carolina dispensary law "amount[ed] to an unjust discrimination against liquors, the [*480] products of other States." *170 U.S., at 442, 42 L. Ed. 1100, 18 S. Ct. 674*. This aspect of the *Scott* holding, which confirmed the Wilson Act's nondiscrimination principle, was based "on particular provisions of the law by which the discrimination was brought about." *170 U.S., at 442, 42 L. Ed. 1100, 18 S. Ct. 674*. Second, "in so far as the law then in question forbade the sending . . . of intoxicating liquors for the use of the person to whom it was shipped, the statute was repugnant to [the *Commerce Clause*]." *Ibid.* (citing *Scott, 165 U.S. 58, 41 L. Ed. 632, 17 S. Ct. 265*). See also *170 U.S., at 443, 42 L. Ed. 1100, 18 S. Ct. 674* (distinguishing between the provisions at issue in *Scott* "which were held to operate a discrimination" and those which barred direct shipment for personal use).

This second holding, that consumers had the right to receive alcoholic beverages shipped in interstate commerce for personal use, was only implicit in *Scott. 165 U.S., at 78, 99-100, 41 L. Ed. 632, 17 S. Ct. 265*. The Court expanded on this point, however, not only in *Vance* but again in *Rhodes. Rhodes* construed the Wilson Act narrowly to avoid interference with this right. The Act, the Court said, authorized States to regulate only the resale of imported liquor, not direct shipment to consumers for personal use. *170 U.S., at 421, 42 L. Ed. 1088, 18 S. Ct. 664*. Without a clear indication from Congress that it intended to allow States to ban such shipments, the *Rhodes* Court read the words "upon arrival" in the Wilson Act as authorizing "the power of the State to attach to an interstate commerce shipment," only after its arrival at the point of destination and delivery there to the consignee." *Id., at 426, 42 L. Ed. 1088, 18 S. Ct. 664*. See also *id., at 424, 42 L. Ed 1088, 18 S. Ct. 664*; *Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, 852 (CA7 2000)*. The Court interpreted the Wilson Act to overturn *Leisy* but leave *Bowman* intact. *Rhodes, supra, at 423-424, 42 L. Ed. 1088, 18 S. Ct. 664*. The right to regulate did not attach until the liquor was in the hands of the customer. As a result, the mail-order liquor trade continued to thrive. Rogers, Interstate Commerce in Intoxicating Liquors Before the Webb-Kenyon Act, 4 Va. L. Rev. 353, 364-365 (1917). [*481]

After considering a series of bills in response to the Court's reading of the Wilson Act, Congress responded to the direct-shipment loophole in 1913 by enacting the Webb-Kenyon Act, 37 Stat 699, *27 U.S.C. § 122* [*27 USCS § 122*]. See Rogers, *supra*, at 363-370. The Act, entitled "An Act Divesting intoxicating liquors of their interstate character in certain cases," provides:

> "That the shipment or transportation . . . of any spirituous, vinous, malted, fermented, or other intoxicating liquor of any kind, from one State . . . into any other State . . . which said spirituous, vinous, malted, fermented, or other intoxicating liquor is intended, by any person interested therein, to be received, possessed, sold, or in any manner used, either in the original package or otherwise, in violation of any law of such State . . . is hereby prohibited."

37 Stat, at 699-700.

The constitutionality of the Webb-Kenyon Act itself was in doubt. *Vance* and *Rhodes* implied that any law authorizing the States to regulate direct shipments for personal use would be an unlawful delegation of Congress' *Commerce Clause* powers. Indeed, President Taft, acting on the advice of Attorney General Wickersham, vetoed the Act for this specific reason. S. Rep. No. 103, 63 Cong., 1st Sess., 3-6 (1913); *30 Op. Atty. Gen. 88 (1913)*. Congress overrode the veto and in *Clark Distilling Co. v. Western Maryland R. Co., 242 U.S. 311, 61 L. Ed. 326, 37 S. Ct. 180 (1917)*, a divided Court upheld the Webb-Kenyon Act against a constitutional challenge.

The Court construed the Act to close the direct-shipment gap left open by the Wilson Act. States were now empowered to forbid shipments of alcohol to consumers for personal use, provided that the States treated in-state and out-of-state liquor on the same terms. *Id., at 321-322, 61 L. Ed. 326, 37 S. Ct. 180* (noting that the West Virginia law at issue in *Clark Distilling* "forbade the shipment into or transportation of liquor in the State whether from inside or out"). The Court understood that [*482] the Webb-Kenyon Act "was enacted simply to extend that which was done by the Wilson Act." *Id., at 324, 61 L. Ed. 326, 37 S. Ct. 180*. The Act's purpose "was to prevent the immunity characteristic of interstate commerce from being used to permit the receipt of liquor through such commerce in States contrary to their laws, and thus in effect afford a means by subterfuge and indirection to set such laws at naught." *Ibid.* The Court thus recognized that the Act was an attempt to eliminate the regulatory advantage, *i.e.* its immunity characteristic, afforded imported liquor under *Bowman* and *Rhodes*.

Michigan and New York now argue the Webb-Kenyon Act went even further and removed any barrier to discriminatory state liquor regulations. We do not agree. First, this reading of the Webb-Kenyon Act conflicts with that given the statute in *Clark Distilling*. *Clark Distilling* recognized that the Webb-Kenyon Act extended the Wilson Act to allow the States to intercept liquor shipments before those shipments reached the consignee. The States' contention that the Webb-Kenyon Act also reversed the Wilson Act's prohibition on discriminatory treatment of out-of-state liquors cannot be reconciled with *Clark Distilling*'s description of the Webb-Kenyon Act's purpose—"simply to extend that which was done by the Wilson Act." *242 U.S., at 324, 61 L. Ed. 326, 37 S. Ct. 180*. See also *McCormick & Co. v. Brown, 286 U.S. 131, 140-141, 76 L. Ed. 1017, 52 S. Ct. 522 (1932)*.

The statute's text does not compel a different result. The Webb-Kenyon Act readily can be construed as forbidding "shipment or transportation" only where it runs afoul of the State's generally applicable laws governing receipt, possession, sale, or use. Cf. *id., at 141, 76 L. Ed. 1017, 52 S. Ct. 522* (noting that the Act authorized enforcement of "valid" state laws). At the very least, the Webb-Kenyon Act expresses no clear congressional intent to depart from the principle, unexceptional at the time the Act was passed and still applicable today, *Hillside Dairy Inc. v. Lyons, 539 U.S. 59, 66, 156 L. Ed. 2d 54, 123 S. Ct. 2142 (2003)*, that discrimination against out-of-state goods is disfavored. [*483] Cf. *Western & Southern Life Ins. Co. v. State Bd. of Equalization of Cal.*, 451 U.S. 648, 652-653, 68 L. Ed. 2d 514, 101 S. Ct. 2070 (1981) (holding that the

McCarran-Ferguson Act, *15 U.S.C. § 1011 et seq.* [*15 USCS §§ 1011et seq.*], removed all dormant *Commerce Clause* scrutiny of state insurance laws; *15 USC § 1011* [*15 USCS § 1011*] provides: "Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States").

Last, and most importantly, the Webb-Kenyon Act did not purport to repeal the Wilson Act, which expressly precludes States from discriminating. If Congress' aim in passing the Webb-Kenyon Act was to authorize States to discriminate against out-of-state goods then its first step would have been to repeal the Wilson Act. It did not do so. There is no inconsistency between the Wilson Act and the Webb-Kenyon Act sufficient to warrant an inference that the latter repealed the former. See *Washington v. Miller, 235 U.S. 422, 428, 59 L. Ed. 295, 35 S. Ct. 119 (1914)* (noting that implied repeals are disfavored). Indeed, this Court has twice noted that the Wilson Act remains in effect today. *Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324, 333, n. 11, 12 L. Ed. 2d 350, 84 S. Ct. 1293 (1964)*; *Department of Revenue v. James B. Beam Distilling Co., 377 U.S. 341, 345, n. 7, 12 L. Ed. 2d 362, 84 S. Ct. 1247 (1964)*. See *27 USC § 121* [*27 USCS § 121*].

The Wilson Act reaffirmed, and the Webb-Kenyon Act did not displace, the Court's line of *Commerce Clause* cases striking down state laws that discriminated against liquor produced out of state. The rule of *Tiernan*, *Walling*, and *Scott* remained in effect: States were required to regulate domestic and imported liquor on equal terms. "[T]he intent of . . . the Webb-Kenyon Act . . . was to take from intoxicating liquor the protection of the interstate commerce laws in so far as necessary to deny them an advantage over the intoxicating liquors produced in the state into which they were brought, yet, [the Act does not] show an intent or purpose to [*484] so abdicate control over interstate commerce as to permit discrimination against the intoxicating liquor brought into one state from another." *Pacific Fruit & Produce Co. v. Martin, 16 F. Supp. 34, 39-40 (WD Wash. 1936)*. See also Friedman, Constitutional Law: State Regulation of Importation of Intoxicating Liquor Under *Twenty-first Amendment*, 21 Cornell L. Q. 504, 509 (1936) ("The cases under the Webb-Kenyon Act uphold state prohibition and regulation in the exercise of the police power yet they clearly forbid laws which discriminate arbitrarily and unreasonably against liquor produced outside of the state" (footnote omitted)).

B

The ratification of the *Eighteenth Amendment* in 1919 provided a brief respite from the legal battles over the validity of state liquor regulations. With the ratification of the *Twenty-first Amendment* 14 years later, however, nationwide Prohibition came to an end. *Section 1 of the Twenty-first Amendment* repealed the *Eighteenth Amendment*. *Section 2 of the Twenty-first Amendment* is at issue here.

Michigan and New York say the provision grants to the States the authority to discriminate against out-of-state goods. The history we have recited does not support this position. To the contrary, it provides strong support for the view that *§ 2* restored to the States the powers they had under the Wilson and Webb-Kenyon Acts. "The wording of *§ 2 of the Twenty-first Amendment* closely follows the Webb-Kenyon and Wilson Acts, expressing the framers' clear intention of constitutionalizing the *Commerce Clause* framework established under those statutes." *Craig v. Boren, 429 U.S. 190, 205-206, 50 L. Ed. 2d 397, 97 S. Ct. 451 (1976)* (footnote omitted).

The aim of the *Twenty-first Amendment* was to allow States to maintain an effective and uniform system for controlling liquor by regulating its transportation, importation, and use. The Amendment did not give States the authority to pass nonuniform laws in order to discriminate against [*485] out-of-state goods, a privilege they had not enjoyed at any earlier time.

Some of the cases decided soon after ratification of the *Twenty-first Amendment* did not take account of this history and were inconsistent with this view. In *State Bd. of Equalization of Cal. v. Young's Market Co., 299 U.S. 59, 62, 81 L. Ed. 38, 57 S. Ct. 77 (1936)*, for example, the Court rejected the argument that the Amendment did not authorize discrimination:

> "The plaintiffs ask us to limit this broad command [of *§ 2*]. They request us to construe the Amendment as saying, in effect: The State may prohibit the importation of intoxicating liquors provided it prohibits the manufacture and sale within its borders; but if it permits such manufacture and sale, it must let imported liquors compete with the domestic on equal terms. To say that, would involve not a construction of the Amendment, but a rewriting of it."

The Court reaffirmed the States' broad powers under *§ 2* in a series of cases, see *Mahoney v. Joseph Triner Corp., 304 U.S. 401, 82 L. Ed. 1424, 58 S. Ct. 952 (1938)*; *Indianapolis Brewing Co. v. Liquor Control Comm'n, 305 U.S. 391, 83 L. Ed. 243, 59 S. Ct. 254 (1939)*; *Ziffrin, Inc. v. Reeves, 308 U.S. 132, 84 L. Ed. 128, 60 S. Ct. 163 (1939)*; *Joseph S. Finch & Co. v. McKittrick, 305 U.S. 395, 83 L. Ed. 246, 59 S. Ct. 256 (1939)*, and unsurprisingly many States used the authority bestowed on them by the Court to expand trade barriers. T. Green, Liquor Trade Barriers: Obstructions to Interstate Commerce in Wine, Beer, and Distilled Spirits 4, and App. I (1940) (stating in the wake of *Young's Market* that "[r]ivalries and reprisals have thus flared up").

It is unclear whether the broad language in *Young's Market* was necessary to the result because the Court also stated that "the case [did] not present a question of discrimination prohibited by the *commerce clause*." *299 U.S., at 62, 81 L. Ed 38, 57 S. Ct. 77*. The Court also declined, contrary to the approach we take today, to consider the history underlying the *Twenty-first Amendment. Id., at 63-64, 81 L. Ed. 38, 57 S. Ct. 77*. This reluctance did not, however, reflect [*486] a consensus that such evidence was irrelevant or that prior history was unsupportive of the principle that the Amendment did not authorize discrimination against out-of-state liquors. There was ample opinion to the contrary. See, *e.g., Young's Market Co. v. State Bd. of Equalization of Cal., 12 F. Supp. 140 (SD Cal. 1935)*, rev'd, *299 U.S. 59, 81 L. Ed. 38, 57 S. Ct. 77 (1936)*; *Pacific Fruit*

& Produce Co. v. Martin, supra, at 39; *Joseph Triner Corp. v. Arundel, 11 F. Supp. 145, 146-147 (Minn. 1935)*; Friedman, *supra*, at 511-512; Note, Recent Cases, *Twenty-first Amendment —Commerce Clause*, 85 U. Pa. L. Rev. 322, 323 (1937); W. Hamilton, Price and Price Policies 426 (1938); Note, Legislation, Liquor Control, 38 Colum. L. Rev. 644, 658 (1938); Wiser & Arledge, Does the Repeal Empower a State to Erect Tariff Barriers and Disregard the *Equal Protection Clause* in Legislating on Intoxicating Liquors in Interstate Commerce? 7 Geo. Wash. L. Rev. 402, 407-409 (1939); de Ganahl, The Scope of Federal Power Over Alcoholic Beverages Since the *Twenty-first Amendment*, 8 Geo. Wash. L. Rev. 819, 822-828 (1940); Note, 55 Yale L. J. 815, 819-820 (1946).

Our more recent cases, furthermore, confirm that the *Twenty-first Amendment* does not supersede other provisions of the Constitution and, in particular, does not displace the rule that States may not give a discriminatory preference to their own producers.

C

The modern *§ 2* cases fall into three categories.

First, the Court has held that state laws that violate other provisions of the Constitution are not saved by the *Twenty-first Amendment*. The Court has applied this rule in the context of the *First Amendment*, *44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 134 L. Ed. 2d 711, 116 S. Ct. 1495 (1996)*; the *Establishment Clause*, *Larkin v. Grendel's Den, Inc., 459 U.S. 116, 74 L. Ed. 2d 297, 103 S. Ct. 505 (1982)*; the *Equal Protection Clause*, *Craig, supra, at 204-209, 50 L Ed 2d 397, 97 S Ct 451*; the *Due Process Clause*, *Wisconsin v. Constantineau, 400 U.S. 433,* [*487] *27 L. Ed. 2d 515, 91 S. Ct. 507 (1971)*; and the Import-Export Clause, *Department of Revenue v. James B. Beam Distilling Co., 377 U.S. 341, 12 L. Ed. 2d 362, 84 S. Ct. 1247 (1964)*.

Second, the Court has held that *§ 2* does not abrogate Congress' *Commerce Clause* powers with regard to liquor. *Capital Cities Cable, Inc. v. Crisp, 467 U.S. 691, 81 L. Ed. 2d 580, 104 S. Ct. 2694 (1984)*; *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 63 L. Ed. 2d 233, 100 S. Ct. 937 (1980)*. The argument that "the *Twenty-first Amendment* has somehow operated to 'repeal' the *Commerce Clause*" for alcoholic beverages has been rejected. *Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S., at 331-332, 12 L. Ed. 2d 350, 84 S. Ct. 1293*. Though the Court's language in *Hostetter* may have come uncommonly close to hyperbole in describing this argument as "an absurd oversimplification," "patently bizarre," and "demonstrably incorrect," *ibid.*, the basic point was sound.

Finally, and most relevant to the issue at hand, the Court has held that state regulation of alcohol is limited by the nondiscrimination principle of the *Commerce Clause*. *Bacchus Imports v. Dias, 468 U.S., at 276, 82 L. Ed. 2d 200, 104 S. Ct. 3049*; *Brown-Forman Distillers Corp. v. New York State Liquor Authority, 476 U.S. 573, 90 L. Ed. 2d 552, 106 S. Ct. 2080 (1986)*; *Healy v. Beer Institute, 491 U.S. 324, 105 L. Ed. 2d 275, 109 S. Ct. 2491 (1989)*. "When a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry." *Brown-Forman, supra, at 579, 90 L. Ed. 2d 552, 106 S. Ct. 2080.*

Bacchus provides a particularly telling example of this proposition. At issue was an excise tax enacted by Hawaii that exempted certain alcoholic beverages produced in that State. The Court rejected the argument that Hawaii's discrimination against out-of-state liquor was authorized by the *Twenty-first Amendment. 468 U.S., at 274-276, 82 L. Ed. 2d 200, 104 S. Ct. 3049.* "The central purpose of the [Amendment] was not to empower States to favor local liquor industries by erecting barriers to competition." *Id., at 276, 82 L. Ed. 2d 200, 104 S. Ct. 3049.* Despite attempts to distinguish it in the instant cases, *Bacchus* forecloses any contention that *§ 2 of the Twenty-first Amendment* [*488] immunizes discriminatory direct-shipment laws from *Commerce Clause* scrutiny. See also *Brown-Forman, supra, at 576, 90 L. Ed. 2d 552, 106 S. Ct. 2080* (invalidating a New York price affirmation statute that required producers to limit the price of liquor based on the lowest price they offered out of state); *Healy, 491 U.S., at 328, 105 L. Ed. 2d 275, 109 S. Ct. 2491* (invalidating a similar Connecticut statute); *id., at 344, 105 L. Ed. 2d 275, 109 S. Ct. 2491* (Scalia, J., concurring in part and concurring in judgment) ("The Connecticut statute's invalidity is fully established by its facial discrimination against interstate commerce . . . . This is so despite the fact that the law regulates the sale of alcoholic beverages, since its discriminatory character eliminates the immunity afforded by the *Twenty-first Amendment*").

Recognizing that *Bacchus* is fatal to their position, the States suggest it should be overruled or limited to its facts. As the foregoing analysis makes clear, we decline their invitation. Furthermore, *Bacchus* does not stand alone in recognizing that the *Twenty-first Amendment* did not give the States complete freedom to regulate where other constitutional principles are at stake. A retreat from *Bacchus* would also undermine *Brown-Forman* and *Healy*. These cases invalidated state liquor regulations under the *Commerce Clause*. Indeed, *Healy* explicitly relied on the discriminatory character of the Connecticut price affirmation statute. *491 U.S., at 340-341, 105 L. Ed. 2d 275, 109 S. Ct. 2491. Brown-Forman* and *Healy* lend significant support to the conclusion that the *Twenty-first Amendment* does not immunize all laws from *Commerce Clause* challenge.

The States argue that any decision invalidating their direct-shipment laws would call into question the constitutionality of the three-tier system. This does not follow from our holding. "The *Twenty-first Amendment* grants the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system." *Midcal, supra, at 110, 63 L. Ed. 2d 233, 100 S. Ct. 937.* A State which chooses to ban the sale and consumption of alcohol [*489] altogether could bar its importation; and, as our history shows, it would have to do so to make its laws effective. States may also assume direct control of liquor distribution through state-run outlets or funnel sales through the three-tier system. We have previously recognized that the three-tier system itself is "unquestionably legitimate." *North Dakota v. United States, 495 U.S., at 432, 109 L. Ed. 2d 420, 110 S. Ct. 1986.* See also *id., at 447, 109 L. Ed. 2d 420, 110 S. Ct. 1986* (Scalia, J., concurring in judgment) ("The *Twenty-first Amendment* . . . empowers North Dakota to require that all liquor sold for use in the

State be purchased from a licensed in-state wholesaler"). State policies are protected under the *Twenty-first Amendment* when they treat liquor produced out of state the same as its domestic equivalent. The instant cases, in contrast, involve straightforward attempts to discriminate in favor of local producers. The discrimination is contrary to the *Commerce Clause* and is not saved by the *Twenty-first Amendment*.

IV

Our determination that the Michigan and New York direct-shipment laws are not authorized by the *Twenty-first Amendment* does not end the inquiry. We still must consider whether either State regime "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *New Energy Co. of Ind., 486 U.S., at 278, 100 L. Ed. 2d 302, 108 S. Ct. 1803*. The States offer two primary justifications for restricting direct shipments from out-of-state wineries: keeping alcohol out of the hands of minors and facilitating tax collection. We consider each in turn.

The States, aided by several *amici*, claim that allowing direct shipment from out-of-state wineries undermines their ability to police underage drinking. Minors, the States argue, have easy access to credit cards and the Internet and are likely to take advantage of direct wine shipments as a means of obtaining alcohol illegally. [*490]

The States provide little evidence that the purchase of wine over the Internet by minors is a problem. Indeed, there is some evidence to the contrary. A recent study by the staff of the FTC found that the 26 States currently allowing direct shipments report no problems with minors' increased access to wine. FTC Report 34. This is not surprising for several reasons. First, minors are less likely to consume wine, as opposed to beer, wine coolers, and hard liquor. *Id.*, at 12. Second, minors who decide to disobey the law have more direct means of doing so. Third, direct shipping is an imperfect avenue of obtaining alcohol for minors who, in the words of the past president of the National Conference of State Liquor Administrators, "'want instant gratification.'" *Id.*, at 33, and n 137 (explaining why minors rarely buy alcohol via the mail or the Internet). Without concrete evidence that direct shipping of wine is likely to increase alcohol consumption by minors, we are left with the States' unsupported assertions. Under our precedents, which require the "clearest showing" to justify discriminatory state regulation, *C & A Carbone, Inc., 511 U.S., at 393, 128 L. Ed. 2d 399, 114 S. Ct. 1677*, this is not enough.

Even were we to credit the States' largely unsupported claim that direct shipping of wine increases the risk of underage drinking, this would not justify regulations limiting only out-of-state direct shipments. As the wineries point out, minors are just as likely to order wine from in-state producers as from out-of-state ones. Michigan, for example, already allows its licensed retailers (over 7,000 of them) to deliver alcohol directly to consumers. Michigan counters that it has greater regulatory control over in-state producers than over out-of-state wineries. This does not justify Michigan's discriminatory ban on direct shipping. Out-of-state wineries face the loss of state and federal licenses if they fail to comply with state law. This provides strong incentives not to sell alcohol to minors. In addition, the States can take less restrictive steps to minimize the risk that minors [*491] will order wine by mail. For example, the Model Direct Shipping Bill developed by the National Conference of State Legislatures requires an adult signature on delivery and a label so instructing on each package.

The States' tax-collection justification is also insufficient. Increased direct shipping, whether originating in state or out of state, brings with it the potential for tax evasion. With regard to Michigan, however, the tax-collection argument is a diversion. That is because Michigan, unlike many other States, does not rely on wholesalers to collect taxes on wines imported from out-of-state. Instead, Michigan collects taxes directly from out-of-state wineries on all wine shipped to in-state wholesalers. Mich. Admin. Code *Rule 436.1725(2)* (1989) ("Each outside seller of wine shall submit . . . a wine tax report of all wine sold, delivered, or imported into this state during the preceding calendar month"). If licensing and self-reporting provide adequate safeguards for wine distributed through the three-tier system, there is no reason to believe they will not suffice for direct shipments.

New York and its supporting parties also advance a tax-collection justification for the State's direct-shipment laws. While their concerns are not wholly illusory, their regulatory objectives can be achieved without discriminating against interstate commerce. In particular, New York could protect itself against lost tax revenue by requiring a permit as a condition of direct shipping. This is the approach taken by New York for in-state wineries. The State offers no reason to believe the system would prove ineffective for out-of-state wineries. Licensees could be required to submit regular sales reports and to remit taxes. Indeed, various States use this approach for taxing direct interstate wine shipments, *e.g., N. H. Rev. Stat. Ann. § 178.27* (Lexis Supp. 2004), and report no problems with tax collection. See FTC Report 38-40. This is also the procedure sanctioned by the National Conference of State Legislatures in their Model Direct [*492] Shipping Bill. See, *e.g., S. C. Code Ann. § 61-4-747(C)* (West Supp. 2004).

Michigan and New York benefit, furthermore, from provisions of federal law that supply incentives for wineries to comply with state regulations. The Tax and Trade Bureau (formerly the Bureau of Alcohol, Tobacco, and Firearms) has authority to revoke a winery's federal license if it violates state law. BATF Industry Circular 96-3 (1997). Without a federal license, a winery cannot operate in any State. See *27 USC § 204* [*27 USCS § 204*]. In addition the *Twenty-first Amendment Enforcement Act* gives state attorneys general the power to sue wineries in federal court to enjoin violations of state law. *§ 122a(b)*.

These federal remedies, when combined with state licensing regimes, adequately protect States from lost tax revenue. The States have not shown that tax evasion from out-of-state wineries poses such a unique threat that it justifies their discriminatory regimes.

Michigan and New York offer a handful of other rationales, such as facilitating orderly market conditions, protecting public health and safety, and ensuring regulatory accountability. These objectives can also be achieved through the alternative of an evenhanded licensing requirement. FTC Report 40-41. Finally, it should be noted that improvements in technology have eased the burden of monitoring out-of-state wineries. Background checks can be done electronically. Financial records and sales data can be mailed, faxed, or submitted via e-mail.

In summary, the States provide little concrete evidence for the sweeping assertion that they cannot police direct shipments by out-of-state wineries. Our *Commerce Clause* cases demand more than mere speculation to support discrimination against out-of-state goods. The "burden is on the State to show that 'the *discrimination* is demonstrably justified,'" *Chemical Waste Management, Inc. v. Hunt, 504 U.S. 334, 344, 119 L. Ed. 2d 121, 112 S. Ct. 2009 (1992)* (emphasis in original). The Court has [*493] upheld state regulations that discriminate against interstate commerce only after finding, based on concrete record evidence, that a State's nondiscriminatory alternatives will prove unworkable. See, *e.g., Maine v. Taylor, 477 U.S. 131, 141-144, 91 L. Ed. 2d 110, 106 S. Ct. 2440 (1986)*. Michigan and New York have not satisfied this exacting standard.

V

States have broad power to regulate liquor under *§ 2 of the Twenty-first Amendment*. This power, however, does not allow States to ban, or severely limit, the direct shipment of out-of-state wine while simultaneously authorizing direct shipment by in-state producers. If a State chooses to allow direct shipment of wine, it must do so on evenhanded terms. Without demonstrating the need for discrimination, New York and Michigan have enacted regulations that disadvantage out-of-state wine producers. Under our *Commerce Clause* jurisprudence, these regulations cannot stand.

We affirm the judgment of the Court of Appeals for the Sixth Circuit; and we reverse the judgment of the Court of Appeals for the Second Circuit and remand the case for further proceedings consistent with our opinion.

It is so ordered.

Justice Stevens, with whom Justice O'Connor joins, dissenting.

Congress' power to regulate commerce among the States includes the power to authorize the States to place burdens on interstate commerce. *Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 90 L. Ed. 1342, 66 S. Ct. 1142 (1946)*. Absent such congressional approval, a state law may violate the unwritten rules described as the "dormant *Commerce Clause*" either by imposing an undue burden on both out-of-state and local producers engaged in interstate activities or by treating out-of-state producers less favorably than their local competitors. See, *e.g., Pike v. Bruce Church, Inc., 397 U.S. 137,* *25 L. Ed. 2d 174, 90 S. Ct. 844 (1970)*; *Philadelphia v. New Jersey,* [*494] 437 U.S. 617, 57 L. Ed. 2d 475, 98 S. Ct. 2531 (1978). A state law totally prohibiting the sale of an ordinary article of commerce might impose an even more serious burden on interstate commerce. If Congress may nevertheless authorize the States to enact such laws, surely the people may do so through the process of amending our Constitution.

The New York and Michigan laws challenged in these cases would be patently invalid under well settled dormant *Commerce Clause* principles if they regulated sales of an ordinary article of commerce rather than wine. But ever since the adoption of the *Eighteenth Amendment* and the *Twenty-first Amendment*, our Constitution has placed commerce in alcoholic beverages in a special category. *Section 2 of the Twenty-first Amendment* expressly provides that "[t]he transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."

Today many Americans, particularly those members of the younger generations who make policy decisions, regard alcohol as an ordinary article of commerce, subject to substantially the same market and legal controls as other consumer products. That was definitely not the view of the generations that made policy in 1919 when the *Eighteenth Amendment* was ratified or in 1933 when it was repealed by the *Twenty-first Amendment*.[1] On the contrary, the moral condemnation of the use of alcohol as a beverage represented [*495] not merely the convictions of our religious leaders, but the views of a sufficiently large majority of the population to warrant the rare exercise of the power to amend the Constitution on two occasions. The *Eighteenth Amendment* entirely prohibited commerce in "intoxicating liquors" for beverage purposes throughout the United States and the territories subject to its jurisdiction. While *§ 1 of the Twenty-first Amendment* repealed the nationwide prohibition, *§ 2* gave the States the option to maintain equally comprehensive prohibitions in their respective jurisdictions.

The views of judges who lived through the debates that led to the ratification of those Amendments are entitled to special deference. Foremost among them was Justice Brandeis, whose understanding of a State's right to discriminate in its regulation of out-of-state alcohol could not have been clearer:

> "The plaintiffs ask us to limit *[§ 2's]* broad command. They request us to construe the Amendment as saying, in effect: The State may prohibit the importation of intoxicating liquors provided it prohibits the manufacture and sale within its borders; but if it permits such manufacture and sale, it must let imported liquors compete with the domestic on equal terms. To say that, would involve not a construction of the

[1] In the words of Justice Jackson: "The people of the United States knew that liquor is a lawlessness unto itself. They determined that it should be governed by a specific and particular Constitutional provision. They did not leave it to the courts to devise special distortions of the general rules as to interstate commerce to curb liquor's 'tendency to get out of legal bounds.' It was their unsatisfactory experience with that method that resulted in giving liquor an exclusive place in constitutional law as a commodity whose transportation is governed by a special, constitutional provision." *Duckworth v. Arkansas, 314 U.S. 390, 398-399, 86 L. Ed. 294, 62 S. Ct. 311 (1941)* (opinion concurring in result).

> Amendment, but a rewriting of it. . . . Can it be doubted that a State might establish a state monopoly of the manufacture and sale of beer, and either prohibit all competing importations, or discourage importation by laying a heavy impost, or channelize desired importations by confining them to a single consignee?"

State Bd. of Equalization of Cal. v. Young's Market Co., 299 U.S. 59, 62-63, 81 L. Ed. 38, 57 S. Ct. 77 (1936).[2] [*496]

In the years following the ratification of the *Twenty-first Amendment*, States adopted manifold laws regulating commerce in alcohol, and many of these laws were discriminatory.[3] So-called "dry states" entirely prohibited such commerce; others prohibited the sale of alcohol on Sundays; others permitted the sale of beer and wine but not hard liquor; most created either state monopolies or distribution systems that gave discriminatory preferences to local retailers and distributors. The notion that discriminatory state laws violated the unwritten prohibition against balkanizing the American economy—while persuasive in contemporary times when alcohol is viewed as an ordinary article of commerce—would have seemed strange indeed to the millions of Americans who condemned the use of the "demon rum" in the 1920's and 1930's. Indeed, they expressly authorized the "balkanization" that today's decision condemns. Today's decision may represent sound economic policy and may be consistent with the policy choices of the contemporaries of Adam Smith who drafted our original Constitution;[4] it is not, however, consistent with the policy choices made by those who amended our Constitution in 1919 and 1933.

My understanding (and recollection) of the historical context reinforces my conviction that the text of *§ 2* should be "broadly and colloquially interpreted." *Carter v. Virginia, 321 U.S. 131, 141, 88 L. Ed. 605, 64 S. Ct. 464 (1944)* (Frankfurter, J., concurring).[5] Indeed, [*497] the fact that the *Twenty-first Amendment* was the only Amendment in our history to have been ratified by the people in state conventions, rather than by state legislatures, provides further reason to give its terms their ordinary meaning. Because the New York and Michigan laws regulate the "transportation or importation" of "intoxicating liquors" for "delivery or use therein," they are exempt from dormant *Commerce Clause* scrutiny.

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[2] According to Justice Black, who participated in the passage of the *Twenty-first Amendment* in the Senate, *§ 2* was intended to return "'absolute control' of liquor traffic to the States, free of all restrictions which the *Commerce Clause* might before that time have imposed." *Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324, 338, 12 L. Ed. 2d 350, 84 S. Ct. 1293 (1964)* (dissenting opinion).

[3] See generally Green, Interstate Barriers in the Alcoholic Beverage Field, 7 Law & Contemp. Prob. 717 (1940); *post, at _____ - _____, 161 L. Ed. 2d, at 838-839* (Thomas, J., dissenting).

[4] Cf. *Knickerbocker Ice Co. v. Stewart, 253 U.S. 149, 169, 64 L. Ed. 834, 40 S. Ct. 438 (1920)* (Holmes, J., dissenting) ("I cannot for a moment believe that apart from the *Eighteenth Amendment* special constitutional principles exist against special drink. The fathers of the Constitution so far as I know approved it").

[5] As he added in that case, "since Virginia derives the power to legislate as she did from the *Twenty-first Amendment*, the *Commerce Clause* does not come into play." *Carter v. Virginia, 321 U.S., at 143, 88 L. Ed. 605, 64 S. Ct. 464*.

As Justice Thomas has demonstrated, the text of the *Twenty-first Amendment* is a far more reliable guide to its meaning than the unwritten rules that the majority enforces today. I THEREFORE JOIN HIS PERSUASIVE AND COMPREHENSIVE DISSENTING OPINION.

JUSTICE THOMAS, with whom THE CHIEF JUSTICE, JUSTICE STEVENS, and JUSTICE O'CONNOR join, dissenting.

A century ago, this Court repeatedly invalidated, as inconsistent with the negative *Commerce Clause*, state liquor legislation that prevented out-of-state businesses from shipping liquor directly to a State's residents. The Webb-Kenyon Act and the *Twenty-first Amendment* cut off this intrusive review, as their text and history make clear and as this Court's early cases on the *Twenty-first Amendment* recognized. The Court today seizes back this power, based primarily on a historical argument that this Court decisively rejected long ago in *State Bd. of Equalization of Cal. v. Young's Market Co., 299 U.S. 59, 64, 81 L. Ed. 38, 57 S. Ct. 77 (1936)*. Because I would follow *Young's Market* and the language of both the statute that Congress enacted and the Amendment that the Nation ratified, rather than the Court's questionable reading of history and the "negative implications" of the *Commerce Clause*, *I* respectfully dissent.

I

The Court devotes much attention to the *Twenty-first Amendment*, yet little to the terms of the Webb-Kenyon Act. This is a mistake, because that Act's language displaces any [*498] negative *Commerce Clause* barrier to state regulation of liquor sales to in-state consumers.

A

The Webb-Kenyon Act immunizes from negative *Commerce Clause* review the state liquor laws that the Court holds are unconstitutional. The Act "prohibit[s]" any "shipment or transportation" of alcoholic beverages "into any State" when those beverages are "intended, by any person interested therein, to be received, possessed, sold, or in any manner used . . . in violation of any law of such State."[1] State laws that

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[1] The Webb-Kenyon Act provides: "The shipment or transportation, in any manner or by any means whatsoever, of any spiritous, vinous, malted, fermented, or other intoxicating liquor of any kind from one State, Territory, or District of the United States, or place noncontiguous to but subject to the jurisdiction thereof, into any other State, Territory, or District of the United States, or place noncontiguous to but subject to the jurisdiction thereof, or from any foreign country into any State, Territory, or District of the United States, or place noncontiguous to but subject to the jurisdiction thereof, which said spiritous, vinous, malted, fermented, or other intoxicating liquor is intended, by any person interested therein, to be received, possessed, sold, or in any manner used, either in the original package or otherwise, in violation of any law of such State, Territory, or District of the United States, or place noncontiguous to but subject to the jurisdiction thereof, is prohibited." *27 USC § 122* [*27 USCS § 122*].

regulate liquor imports in the manner described by the Act are exempt from judicial scrutiny under the negative *Commerce Clause*, as this Court has long held. See *McCormick & Co. v. Brown, 286 U.S. 131, 139-140, 76 L. Ed. 1017, 52 S. Ct. 522 (1932)*; *Clark Distilling Co. v. Western Maryland R. Co., 242 U.S. 311, 324, 61 L. Ed. 326, 37 S. Ct. 180 (1917)*; *Seaboard Air Line R. Co. v. North Carolina, 245 U.S. 298, 303-304, 62 L. Ed. 299, 38 S. Ct. 96 (1917)*. The Webb-Kenyon Act's language, in other words, "prevent[s] the immunity characteristic of interstate commerce from being used to permit the receipt of liquor through such commerce in States contrary to their laws." *Clark Distilling, supra, at 324, 61 L. Ed. 326, 37 S. Ct. 180*. [*499]

The Michigan and New York direct-shipment laws are within the Webb-Kenyon Act's terms and therefore do not run afoul of the negative *Commerce Clause*. Those laws restrict out-of-state wineries from shipping and selling wine directly to Michigan and New York consumers. *Ante, at ____ - ____, 161 L. Ed. 2d, at 807*. Any winery that ships wine directly to a Michigan or New York consumer in violation of those state-law restrictions is a "person interested therein" "intend[ing]" to "s[ell]" wine "in violation of" Michigan and New York law, and thus comes within the terms of the Webb-Kenyon Act.

This construction of the Webb-Kenyon Act is no innovation. The Court adopted this reading of the Act in *McCormick & Co. v Brown, supra*, and Congress approved it shortly thereafter in 1935 when it reenacted the Act without alteration, 49 Stat 877; see, *e.g., Keene Corp. v. United States, 508 U.S. 200, 212-213, 124 L. Ed. 2d 118, 113 S. Ct. 2035 (1993)* (applying presumption that reenacted statute incorporates settled judicial construction). *McCormick* considered a state law that prohibited out-of-state manufacturers (as well as in-state manufacturers) from shipping liquor to a licensed in-state dealer without first obtaining a wholesaler permit. The Court held that by shipping liquor into the State without a license, the out-of-state manufacturer "[fell] directly within the terms of" the Webb-Kenyon Act, thus violating it. *286 U.S., at 143, 76 L. Ed. 1017, 52 S. Ct. 522*; see also *Rainier Brewing Co. v. Great Northern Pacific S. S. Co., 259 U.S. 150, 152-153, 66 L. Ed. 868, 42 S. Ct. 436 (1922)* (holding that under the Webb-Kenyon Act, beer importers must "carry" beer into the State "in the manner allowed by the laws of that State"). While the law at issue in *McCormick* did not discriminate against out-of-state products, the construction of the Webb-Kenyon Act it adopted applies equally to state laws that so discriminate. If an out-of-state manufacturer shipping liquor to an in-state distributor without a license "s[ells]" liquor "in violation of any law of such State" within the meaning of Webb-Kenyon, as *McCormick* held, an out-of-state winery directly shipping wine to consumers in violation of even a discriminatory [*500] state law does so as well. The Michigan and New York laws are indistinguishable in relevant part from the state law upheld in *McCormick*.[2]

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[2] The Court notes that *McCormick* held that the Webb-Kenyon Act only authorized "valid" laws, the suggestion being that *McCormick*'s holding applies only to nondiscriminatory (and hence "valid" laws). *Ante, at ____, 161 L. Ed. 2d, at 815-816*. The Court takes this word out of context. By "valid" laws, *McCormick* meant laws

The Court answers that the Webb-Kenyon Act's text "readily can be construed as forbidding 'shipment or transportation' only where it runs afoul of the States' generally applicable laws governing receipt, possession, sale, or use." *Ante, at ____, 161 L. Ed. 2d, at 815*. What the Court means by "generally applicable" laws is unclear, for the Court concedes that the Webb-Kenyon Act allows States to pass laws discriminating against out-of-state wholesalers. See *ante, at ____, ____ - ____, 161 L. Ed. 2d, at 816-817, 819-820.* By "generally applicable [state] laws," therefore, the Court apparently means all state laws except for those that "discriminate" against out-of-state liquor products. See *ante, at ____ - ____, ____ - ____, 161 L. Ed. 2d, at 815-816, 819-820*.

The Court leaves unexplained how this ad hoc exception follows from the Act's text. The Act's language leaves no room for this exception. The Act does not condition a State's ability to regulate the receipt, possession, and use of liquor free from negative *Commerce Clause* immunity on the character of the state law. It does not mention "discrimination," much less discrimination against out-of-state liquor products. Instead, it prohibits the interstate shipment of liquor into a State "in violation of any law of such State." *27 USC § 122* [*27 USCS § 122*]. "[A]ny law of such State" means any law, including a "discriminatory" one.

The Court's distinction between discrimination against manufacturers and discrimination against wholesalers is [*501] equally unjustified. There is no warrant in the Act's text for treating regulated entities differently depending on their place in the distribution chain: The Act applies in undifferentiated fashion to "any person interested therein." A wine manufacturer shipping wine directly to a consumer is an interested party, just as an out-of-state liquor wholesaler is.[3]

The contrast between the language of the Webb-Kenyon Act and its predecessor, the Wilson Act, casts still more doubt on the Court's reading. The Wilson Act provided that liquor shipped into a State was "subject to the operation and effect of the laws of such State . . . to the same extent and in the same manner as though such liquids or liquors had been produced in such State or Territory." *§ 121.* Even if this language does not authorize States to discriminate against out-of-state liquor products, see *ante, at ____, 161 L. Ed. 2d, at 813*, the Webb-Kenyon Act has no comparable language addressing discrimination. The contrast is telling. It shows that the Webb-Kenyon Act encompasses laws that discriminate against both out-of-state wholesalers and out-of-state manufacturers.

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not pre-empted by the National Prohibition Act, rather than laws that treated in-state and out-of-state products equally. See *286 US, at 143-144, 76 L Ed 1017, 52 S Ct 522* (finding the legislation "valid" because the National Prohibition Act did not pre-empt it).

[3] The Court also states that the "Webb-Kenyon Act expresses no clear congressional intent to depart from the principle . . . that discrimination against out-of-state goods is disfavored." *Ante, at ____, 161 L. Ed. 2d, at 815*. That is not correct. It is settled that the Webb-Kenyon Act explicitly abrogates negative *Commerce Clause* review of state laws that fall within its terms. See *supra, at ____, 161 L. Ed. 2d, at 826*. There is no reason to require another clear statement for each sort of law to which it might apply. The only question is whether, fairly read, the Webb-Kenyon Act covers Michigan's and New York's direct-shipment laws. As I have explained, it does.

In support of its conclusion that the Webb-Kenyon Act did not authorize States to discriminate, the Court relies heavily on *Clark Distilling Co. v. Western Maryland R. Co., 242 U.S. 311, 61 L. Ed. 326, 37 S. Ct. 180 (1917). Ante, at ____ - ____, 161 L. Ed. 2d, at 814-815*. Its reliance is misplaced. *Clark Distilling* held that the Webb-Kenyon Act authorized a nondiscriminatory state law, *242 U.S., at 321-322, 61 L. Ed. 326, 37 S. Ct. 180*, and so had no direct occasion to pass on whether the Act also authorized discriminatory laws. Nothing in it implicitly [*502] decided that unsettled question in the manner the Court suggests.

To the extent that it is relevant, *Clark Distilling* supports the view that the Webb-Kenyon Act authorized States to discriminate. Contrary to the Court's suggestion, *Clark Distilling* did not say (on pages 321, 322 or elsewhere, *61 L. Ed. 326, 37 S. Ct. 180*) that the Webb-Kenyon Act "empowered [States] to forbid shipments of alcohol to consumers for personal use, provided that [they] treated in-state and out-of-state liquor on the same terms." *Ante, at ____, 161 L. Ed. 2d, at 815*. Instead, *Clark Distilling* construed the Webb-Kenyon Act to "extend that which was done by the Wilson Act" in that its "purpose was to prevent the immunity characteristic of interstate commerce from being used to permit the receipt of liquor through such commerce in States contrary to their laws." *242 U.S., at 324, 61 L. Ed. 326, 37 S. Ct. 180*. The Court takes this passage only to refer to "nondiscriminatory" state laws, *ante, at ____, 161 L. Ed. 2d, at 815*, but this is not correct. The passage the Court cites implies that the Webb-Kenyon Act also abrogated the nondiscrimination principle of the negative *Commerce Clause*, since that principle flows from the "immunity characteristic of interstate commerce," no less than any other negative *Commerce Clause* doctrine. In other words, *Clark Distilling* recognized that the Webb-Kenyon Act took "the protection of interstate commerce away from *all receipt and possession of liquor prohibited by state law*." *242 U.S., at 325, 61 L. Ed. 326, 37 S. Ct. 180* (emphasis added). *Clark Distilling* thus confirms what the text of the Webb-Kenyon Act makes clear: The Webb-Kenyon Act "extended" the Wilson Act by completely immunizing all state laws regulating liquor imports from negative *Commerce Clause* restraints.[4] [*503]

B

Straying from the Webb-Kenyon Act's text, the Court speculates that Congress intended the Act merely to overrule a discrete line of this Court's negative *Commerce Clause* cases invalidating "nondiscriminatory" state liquor regulation laws, including *Vance v. W. A. Vandercook Co., 170 U.S. 438, 42 L. Ed. 1100, 18 S. Ct. 674 (1898)*, and

[4] The Court also opines that, quite apart from the Webb-Kenyon Act, the Wilson Act "expressly precludes States from discriminating." *Ante, at ____, 161 L. Ed. 2d, at 816*. It does not. The Wilson Act "precludes" States from nothing. Instead, it authorizes them to regulate liquor free of negative *Commerce Clause* restraints by "subject[ing]" imported liquor "to the operation" of state law, taking state law as it finds it. *27 USC § 121* [*27 USCS § 121*]. Even if, as the Court suggests, the Wilson Act does not authorize States to discriminate, *ante, at ____, 161 L. Ed. 2d, at 813*, the Webb-Kenyon Act extends that authorization to cover discriminatory state laws. The only question here is the scope of the broader, more inclusive Webb-Kenyon Act. The Court's argument therefore adds nothing to the analysis.

Rhodes v. Iowa, 170 U.S. 412, 42 L. Ed. 1088, 18 S. Ct. 664 (1898). Ante, at ____ - ____, 161 L. Ed. 2d, at 813-816. According to the majority, *ante, at ____ - ____, 161 L. Ed. 2d, at 816*, the Webb-Kenyon Act left untouched this Court's cases preventing States from regulating liquor in "discriminatory" fashion. See, *e.g., Scott v. Donald, 165 U.S. 58, 41 L. Ed. 632, 17 S. Ct. 265 (1897) (Scott); Walling v. Michigan, 116 U.S. 446, 29 L. Ed. 691, 6 S. Ct. 454 (1886)*; and *Tiernan v. Rinker, 102 U.S. 123, 26 L. Ed. 103 (1880).* The plain language of the Webb-Kenyon Act makes the Court's guesswork about Congress' intent unnecessary. But even taken on its own terms, the majority's historical argument is unpersuasive. History reveals that the Webb-Kenyon Act overturned not only *Vance* and *Rhodes*, but also *Scott* and therefore its "nondiscrimination" principle. The origins of the Webb-Kenyon Act are in this Court's decision in *Leisy v. Hardin, 135 U.S. 100, 34 L. Ed. 128, 10 S. Ct. 681, 12 Ky. L. Rptr. 123 (1890). Leisy* held that States were prohibited from regulating the resale of alcohol imported from outside the State so long as the liquor stayed in its "original packag[e]." *Id., at 124-125, 34 L. Ed. 128, 10 S. Ct. 681.* This rule made it more difficult for States to prohibit the in-state consumption of liquor. Even if a State banned the domestic production of liquor altogether, *Leisy* left it powerless to stop the flow of liquor from outside its borders.

Congress reacted swiftly by enacting the Wilson Act in August of 1890. The Wilson Act authorized States to regulate liquor "upon arrival in such State" whether "in original packages [*504] or otherwise," *27 USC § 121* [*27 USCS § 121*], and therefore subjected imports to state jurisdiction "upon arrival within the jurisdiction of the State." *Rhodes, supra, at 433, 42 L. Ed. 1088, 18 S. Ct. 664* (Gray, J., dissenting). The Wilson Act accordingly abrogated *Leisy* and similar decisions by subjecting liquor imports to the operation of state law once the liquor came within a State's geographic borders.

Rather than holding that the Wilson Act meant what it said, three decisions of this Court construed the Act to be a virtual nullity. The first was *Scott, supra.* South Carolina had decided to regulate traffic in liquor by monopolizing the sale and distribution of liquor. All liquor, whether produced in or out of the State, could be sold to consumers in the State only by the state commissioner of alcohol. *Id., at 66-68, n. 1, 92, 41 L. Ed. 632, 17 S. Ct. 265.* The law thus prohibited out-of-state manufacturers and wholesalers, as well as their in-state counterparts, from shipping liquor directly to consumers.

The appellee, Donald, was a citizen of South Carolina who had ordered liquor directly from out-of-state shippers for his own personal use, rather than through the state monopoly system as South Carolina law required. *Id., at 59, 41 L. Ed. 632, 17 S. Ct. 265*; see also *Scott v. Donald, 165 U.S. 107, 108-109, 41 L. Ed. 648, 17 S. Ct. 262 (1897) (Donald).* South Carolina officials seized the liquor he ordered after it had crossed South Carolina lines, but before he had received it. Donald sued the officials for damages, as well as an injunction allowing him to import liquor directly from out-of-state shippers for his own personal use. *Scott, supra, at 69-70, 41 L. Ed. 632, 17 S. Ct. 265*; *Donald, supra, at 109-110, 41 L. Ed. 648, 17 S. Ct. 262.*

The Court held that South Carolina's ban on the direct shipment of liquor unconstitutionally interfered with the right of out-of-state entities to ship liquor directly to consumers for their personal use, entitling Donald to damages and injunctive relief. *Scott, supra, at 78, 99-100, 41 L. Ed. 632, 17 S. Ct. 265*; *Donald, supra, at 114, 41 L. Ed. 648, 17 S. Ct. 262*; see also *Vance, supra, at 452, 42 L. Ed. 1100, 18 S. Ct. 674* (describing the "ruling" of *Scott* to be that a State could not "forbid the [*505] shipment into the State from other States of intoxicating liquors for the use of a resident"). The Court reasoned that the ban on importation, "in effect, discriminate[d] between interstate and domestic commerce in commodities to make and use which are admitted to be lawful." *Scott, 165 U.S., at 100, 41 L. Ed. 632, 17 S. Ct. 265*. The Court reserved the question whether a state monopoly system that allowed consumers to import liquor directly was constitutional; for the Court, it "suffic[ed]" that South Carolina's ban on imports "discriminate[d] against the bringing of such articles in, and importing them from other States." *Id., at 101, 41 L. Ed. 632, 17 S. Ct. 265*. The Court's excuse for holding that the Wilson Act did not save the State's ban on importation was the same as the Court's excuse today: that the Wilson Act did not authorize "discriminatory" state legislation. *Ibid.* On this basis, the Court affirmed Donald's damages award. *Ibid.*

In response to *Scott*, Senator Tillman of South Carolina quickly introduced the first version of what became the Webb-Kenyon Act. His bill explicitly attempted to reverse the *Scott* decision. The Senate Report on the bill noted that "[t]he effect of [*Scott* was] to throw down all the barriers erected by the State law, in which she is protected by the Wilson bill, and allow the untrammeled importation of liquor into the State upon the simple claim that it is for private use." S. Rep. No. 151, 55th Cong., 1st Sess., 5 (1897). The Report also addressed *Scott*'s holding that South Carolina's ban on importation was "discriminatory" and adopted the *Scott* dissenter's view that the ban on importation effected "no discrimination against citizens of other States." S. Rep. No. 151, at 5. The bill accordingly would have amended the Wilson Act to grant States "absolute control of . . . liquors or liquids within their borders, by whomsoever produced and for whatever use imported." 30 Cong. Rec. 2612 (1897). The bill passed in the Senate without debate. It failed in the House, perhaps because the House Judiciary Committee [*506] added an amendment that barred discrimination against the products of other States, leaving *Scott* intact. H. R. Rep. No. 667, 55th Cong., 2d Sess., 1 (1898).

Meanwhile, the Court continued to narrow the reach of the Wilson Act. In *Rhodes* and *Vance*, the Court even more broadly stripped States of their control over liquor regulation. *Rhodes* did so by holding that the phrase "upon arrival in such State" in the Wilson Act meant that state law could regulate imports only after their delivery to a consignee within the State. *170 U.S., at 421, 42 L. Ed. 1088, 18 S. Ct. 664* (internal quotation marks omitted). This meant that States could regulate imported liquor, even when in its original package, but only after it had been delivered to the eventual consignee. *Rhodes*, in other words, read the Wilson Act to overturn *Leisy*, but not *Bowman v. Chicago & Northwestern R. Co., 125 U.S. 465, 31 L. Ed. 700, 8 S. Ct. 689 (1888)*, which had recognized a constitutional right to import liquor in its original package free from state regulation until it reached its consignee. *Rhodes, supra, at 423, 42 L. Ed. 1088, 18 S. Ct. 664*. Like *Leisy*, then, *Rhodes* seriously hampered the ability of States to intercept liquor at their borders.

Vance involved the constitutionality of a law very similar to the law struck down in *Scott*. After its loss in *Scott*, South Carolina amended its ban on importation. Rather than flatly banning imports unless they went through the state monopoly system, the new law allowed out-of-state wholesalers and manufacturers to ship liquor directly to consumers, but only if the consumer showed that the liquor passed a state-administered test of its purity. *Vance, 170 U.S., at 454-455, 42 L. Ed. 1100, 18 S. Ct. 674*.

Vance had two distinct holdings. First, the Court struck down this condition on the direct importation of liquor as an impermissible burden on "the constitutional right of the non-resident to ship into the State and of the resident in the State to receive for his own use." *Id., at 455, 42 L. Ed. 1100, 18 S. Ct. 674*. The Court derived the right to direct importation primarily from the "ruling" of *Scott* that a State could not "forbid the shipment [*507] into the State from other States of intoxicating liquors for the use of a resident." *170 U.S., at 452, 42 L. Ed. 1100, 18 S. Ct. 674*.

Second, the Court held that, apart from its ban on direct shipments of liquor to consumers, South Carolina's monopoly over liquor distribution was otherwise constitutional. *Id., at 450-452, 42 L. Ed. 1100, 18 S. Ct. 674*. It rejected the argument that this monopoly system was unconstitutionally discriminatory. In particular, the Court reasoned that the monopoly system was not discriminatory because *Scott* had held (a holding that *Rhodes* had fortified) that South Carolina consumers had a constitutional right to import liquor for their own personal use, even if a State otherwise monopolized the sale and distribution of liquor.[5] A monopoly system, the Court implied, was nondiscriminatory under the rule of *Scott* only if it also allowed consumers to import liquor from out-of-state shippers for their own personal use. Three Justices in *Vance* dissented from that holding, on the ground that such a state monopoly system constituted unconstitutional discrimination under, among other cases, *Scott* and *Walling v. Michigan, 116 U.S. 446, 29 L. Ed. 691, 6 S. Ct. 454 (1886). 170 U.S., at 462-468, 42 L. Ed. 1100, 18 S. Ct. 674* (opinion of Shiras, J., joined by Fuller, C. J., and McKenna, J.).

Rhodes and *Vance* swept more broadly than *Scott*. *Rhodes* held that States lacked power to regulate imported liquor before it reached the consignee, regardless of whether the liquor was intended for the consignee's personal use, see *supra, at ____, 161 L. Ed. 2d, at 830*; it did not, as the Court implies, simply repeat *Scott*'s holding that consumers had a right to import liquor for their own personal use. *Ante, at ____, 161*

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[5] See *Vance v. W. A. Vandercook Co., 170 U.S. 438, 451-452, 42 L. Ed. 1100, 18 S. Ct. 674 (1898)* ("But the weight of [the argument that the state monopoly system is discriminatory] is overcome when it is considered that the *Interstate Commerce clause of the Constitution* guarantees the right to ship merchandise from one State into another, and protects it until the termination of the shipment by delivery at the place of consignment, and this right is wholly unaffected by the act of Congress [*i.e.*, the Wilson Act] which allows state authority to attach to the original package before sale but only after delivery. *Scott v Donald, supra; Rhodes* v *Iowa*").

L Ed 2d, at 814. *Rhodes*' holding, [*508] for example, made it easier for bootleggers to circumvent state prohibitions on the resale of imported liquor, because it enabled them to order large quantities of liquor directly from out-of-state interests. For its part, *Vance* held that the right to import for personal use recognized in *Scott* applied even if the State conditioned the right to import directly on compliance with regulatory conditions (*e.g.*, a state-administered purity test). Those broader holdings, consequently, spurred more vigorous congressional attempts to return control of liquor regulation to the States. See R. Hamm, Shaping the *Eighteenth Amendment* 206-212 (1995) (hereinafter Hamm); Rogers, Interstate Commerce in Intoxicating Liquors Before the Webb-Kenyon Act, 4 Va. L. Rev. 353, 364-365 (1917). The legislative debate in subsequent years accordingly focused on their effect. That may be what misleads the majority into believing that the Webb-Kenyon Act took aim only at *Rhodes* and *Vance*.

Yet early versions of the Webb-Kenyon Act, not to mention the Act itself, also overturned *Scott*'s holding that banning the direct shipment of liquor for personal use was unconstitutionally discriminatory. Like Senator Tillman's initial bill, other early versions of the Webb-Kenyon Act took aim at *Scott*, *Rhodes*, and *Vance*. They made clear that out-of-state liquor was subject to state law immediately upon entering the State's territorial boundaries, even if intended for personal use. See Hamm 206, 208.

The version that eventually became the Webb-Kenyon Act was likewise designed to overturn the holdings of all three cases, and thus to reverse *Scott*'s "nondiscrimination" principle. The House Report says that the bill was "intended to withdraw the protecting hand of interstate commerce from intoxicating liquors transported into a State or Territory and intended to be used therein in violation of the law of such State or Territory." H. R. Rep. No. 1461, 62d Cong., 3d Sess., 1 (1913). Thus, the bill targeted *Scott*'s notion (as applied by *Vance*) that imports destined for personal use were [*509] exempt from state regulation. There was no mention of an exception for "discriminatory" state laws, though such an amendment to an earlier version of the Webb-Kenyon Act had been proposed before, see *supra*, *at ____, 161 L. Ed. 2d, at 830*; the idea was that imports were subject to state law once within a State's geographic borders, regardless of the law's character. In fact, proponents of the final version of the bill defeated proposed amendments that would have restrained States from restricting imports destined for personal use, and thereby would have left *Scott* intact. Hamm 215; 49 Cong. Rec. 2921 (1913); see also H. R. Rep. No. 2337, 58th Cong., 2d Sess., 2-3 (1904) (prior unenacted version drawing exception for shipments for in-state personal use).

In contrast to those unenacted amendments, the Webb-Kenyon Act reversed *Scott*, *Rhodes*, and *Vance* by forbidding the importation of liquor "intended to be received, possessed, sold or in any manner used . . . in violation of any law of such state"—regardless of the nature of the state law or the imported liquor's intended use. See *Seaboard Air Line R. Co., 245 U.S., at 304, 62 L. Ed. 299, 38 S. Ct. 96* (noting that the Webb-Kenyon Act allowed States to regulate "irrespective of any personal right in a consignee there to have and consume liquor"). That is why, just four years after its enactment, this Court described the Webb-Kenyon Act as removing "the protection of interstate commerce away from *all receipt and possession of liquor prohibited by state law*." *Clark Distilling, 242 U.S., at 325, 61 L. Ed. 326, 37 S. Ct. 180* (emphasis added).

The foregoing historical account belies the majority's claim that the Webb-Kenyon Act left *Scott* untouched. The Court reasons that the Webb-Kenyon Act overturned only those decisions that "'in effect afford[ed] a means by subterfuge and indirection to set [state liquor laws] at naught,'" *ante, at ____, 161 L. Ed. 2d, at 815* (quoting *Clark Distilling, supra, at 324, 61 L. Ed. 326, 37 S. Ct. 180*), a description the Court takes to cover *Rhodes* and *Vance*, but not *Scott*. However, *Scott*'s holding, by precluding state monopoly systems from prohibiting direct shipments of liquor to consumers, [*510] "set [state liquor laws] at naught" just as *Rhodes* and *Vance* did. The Court concedes that the Webb-Kenyon Act "close[d] the direct-shipment gap" and that *Scott* recognized a constitutional right for consumers to import liquor directly for their own personal use. *Ante, at ____, ____, 161 L. Ed. 2d, at 813-814, 815*. These concessions cannot be squared with Court's simultaneous suggestion, *ante, at ____ - ____, 161 L. Ed. 2d, at 814-816*, that the Webb-Kenyon Act left *Scott* untouched. The only way to overturn *Scott*'s direct-shipment holding was to abrogate its premise that South Carolina's monopoly system was unconstitutionally discriminatory, as Senator Tillman recognized from the start. See *supra, at ____ - ____, 161 L. Ed. 2d, at 829-830*. Reversing *Scott*'s holding that a State could not ban direct shipments of liquor to consumers was a core concern of the Webb-Kenyon Act.

Repudiating *Scott*'s nondiscrimination holding was also essential to ensuring the constitutionality of state liquor licensing schemes and state monopolies on the sale and distribution of liquor. This is so because the constitutionality of these state systems remained in some doubt even after *Vance*. As explained, *Vance* upheld South Carolina's monopoly system (stripped of its ban on direct shipments) as "nondiscriminatory" only because that system had preserved the constitutional right established in *Scott* and *Rhodes* to send and receive direct shipments of liquor free of state interference. *Supra, at ____ - ____, 161 L. Ed. 2d, at 831*. The Court admits that the Webb-Kenyon Act abolished that right. *Ante, at ____, 161 L. Ed. 2d, at 815*. Had the Webb-Kenyon Act done so without also allowing the States to discriminate, *Vance*'s reasoning implied that the Court was likely to strike down state monopoly systems, and therefore probably licensing schemes as well, as unduly "discriminatory." See *170 U.S., at 451, 42 L. Ed. 1100, 18 S. Ct. 674* (equating a state monopoly scheme with a private licensing scheme). The only way to stave off that holding, and so to preserve States' ability to regulate liquor traffic, was to overturn *Scott*'s "nondiscrimination" reasoning. Faced with a Judiciary that had narrowly construed the Wilson Act, see *supra, at ____ - ____, 161 L. Ed. 2d, at 829-831*, [*511] Congress drafted the Webb-Kenyon Act to authorize *all* state regulation of importation, whether or not "discriminatory." Just as *Rhodes* read the Wilson Act to repudiate *Leisy* but not *Bowman*, see *supra, at ____, 161 L. Ed. 2d, at 830*, the majority reads the Webb-Kenyon Act to repudiate *Rhodes* but not *Scott*, committing an analogous error. I would not so construe the Webb-Kenyon Act.

C

The majority disagrees with this historical account primarily by disputing my reading of *Scott*. It reads *Scott* to have held two things: first, that certain discriminatory provisions of South Carolina's monopoly system were not authorized by the Wilson Act, and therefore were unconstitutional; and second, that Donald had a constitutional right to import liquor directly from out-of-state shippers. *Ante, at ____ - ____, 161 L. Ed. 2d, at 813-814*. This recharacterization of *Scott* (together with its mischaracterization of *Rhodes*' holding, see *supra, at ____, 161 L. Ed. 2d, at 830*) is the basis for the Court's contention that the Webb-Kenyon Act only overruled *Scott*'s second holding, leaving the first untouched. *Ante, at ____ - ____, 161 L. Ed. 2d, at 814-816*.

The Court misreads *Scott*. *Scott* had only one holding: that the state monopoly system unconstitutionally discriminated against Donald by allowing him to purchase liquor from in-state stores, but not directly from out-of-state interests. The issue of direct importation was squarely at issue in *Scott*, not simply "implicit." *Ante, at ____, 161 L. Ed. 2d, at 814*. This was the only basis, after all, for affirming Donald's damages award for interference with his ability to import goods directly from outside the State. *Scott*'s reasoning that the South Carolina law was unconstitutionally discriminatory was the basis for affirming that award, not a separate and distinct holding.

While South Carolina law also allowed the state alcohol administrator to discriminate against out-of-state liquor when purchasing liquor for sale through the monopoly system, *ante, at ____, 161 L. Ed. 2d, at 813*, any constitutional defect with those [*512] portions of the law would have been at most grounds for allowing Donald to purchase out-of-state liquor through the state monopoly system, as the dissent argued (and as the majority strains to characterize *Scott*'s actual holding, *ante, at ____, 161 L. Ed. 2d, at 813*). See *165 U.S., at 104-106, 41 L. Ed. 623, 17 S. Ct. 265* (Brown, J., dissenting). But *Scott* rejected that view and held that the broader discrimination effected by the law was grounds for allowing Donald to import liquor directly himself, bypassing the monopoly system entirely. *Scott*'s holding therefore rested on a conclusion that a ban on direct importation was "discrimination" under the negative *Commerce Clause*. That conclusion was natural for Justice Shiras, the author of Scott, whose view apparently was that all state monopoly systems, even ones that seem nondiscriminatory to our modern eyes, were unconstitutionally discriminatory. See *Vance, supra, at 465, 467, 42 L. Ed. 1100, 18 S. Ct. 674* (Shiras, J., dissenting) (citing the nondiscrimination cases *Walling v. Michigan, 116 U.S. 446, 29 L. Ed. 691, 6 S. Ct. 454 (1886)*, and *Minnesota v. Barber, 136 U.S. 313, 34 L. Ed. 455, 10 S. Ct. 862 (1890))*. The Court's narrower understanding of "discrimination" is anachronistic.

Vance confirms this reading of *Scott*. *Vance* correctly characterized *Scott* as establishing a right for consumers to receive shipments of liquor directly from out-of-state sources. *170 U.S., at 452, 42 L. Ed. 1100, 18 S. Ct. 674*. It also characterized *Scott*'s reasoning as resting on the discriminatory character of the state law. *170 U.S., at 449, 42 L. Ed. 1100, 18 S. Ct. 674*. These two descriptions, taken together, suggest that the discriminatory character of the law was the basis for *Scott*'s holding that Donald had a constitutional right to receive liquor directly, instead of a separate holding. Moreover, *Vance* also implied that a monopoly system that did not allow consumers to receive liquor directly was unconstitutionally discriminatory. See *supra, at ____ - ____, 161 L. Ed. 2d, at 831*. That suggestion supports the idea that *Scott* considered a ban on such direct shipments to be discriminatory.

Brennen v. Southern Express Co., 106 S. C. 102, 90 S. E. 402 (1916), likewise bolsters that *Scott* considered South Carolina's ban on direct importation to be unconstitutionally discriminatory, [*513] quite apart from the provisions that authorized the state administrator of alcohol to prefer local products over out-of-state ones. See *ante, at ____, 161 L. Ed. 2d, at 813* (describing discriminatory provisions). In *Brennen*, the court considered the constitutionality of a state monopoly system that channeled all liquor through state dispensaries by banning direct shipments, but that allowed a consumer to import directly one gallon of liquor per month for his own personal use. *106 S. C., at 107-108, 90 S. E., at 403*. Though out-of-state liquor had equal access to the state run liquor dispensaries, see generally 2 S. C. Crim. Code §§ 794-878 (1912) (providing for otherwise nondiscriminatory state-run monopoly system), the court held that this system unconstitutionally discriminated against out-of-state liquor because it allowed consumers to purchase only a limited quantity of liquor via direct shipments, yet unlimited amounts from state stores. The court noted that "there was no limit to the quantity which a citizen who patronized the dispensaries might buy and keep in his possession for personal use," whereas the law limited direct-shipment purchases to a specific quantity each month. *106 S. C., at 108, 90 S. E., at 403*. This, the court reasoned, "was therefore clearly a discrimination made in favor of liquors bought from the dispensaries," and so was unconstitutionally discriminatory under the rule of *Scott*. *106 S. C., at 108, 90 S. E., at 403-404*. The court thus recognized that *Scott*'s reasoning implied that a state monopoly system was unconstitutionally discriminatory unless it allowed consumers to purchase liquor directly from out-of-state shippers on the same terms as they could purchase liquor from the state monopoly system.

Brennan refutes the Court's characterization of *Scott*. It shows that the South Carolina system at issue in *Scott* was "discriminatory" because it banned direct importation, not because its provisions authorized the state alcohol administrator to prefer local products. Even the Court concedes that the Webb-Kenyon Act abrogated the right to direct importation [*514] recognized in *Scott*. See *ante, at ____, ____, 161 L. Ed. 2d, at 813-814, 815*. It follows that the Act also overturned the nondiscrimination reasoning that was the foundation of that right.

In sum, the Webb-Kenyon Act authorizes the discriminatory state laws before the Court today.

II

There is no need to interpret the *Twenty-first Amendment*, because the Webb-Kenyon Act resolves these cases. However, the state laws the Court strikes down are lawful under the plain meaning of *§ 2 of the Twenty-first Amendment*, as this Court's case law in the wake of the Amendment and the contemporaneous practice of the States reinforce.

A

Section 2 of the Twenty-first Amendment provides: "The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited." As the Court notes, *ante, at ____, 161 L. Ed. 2d, at 816-817*, this language tracked the Webb-Kenyon Act by authorizing state regulation that would otherwise conflict with the negative *Commerce Clause*. To remove any doubt regarding its broad scope, the Amendment simplified the language of the Webb-Kenyon Act and made clear that States could regulate importation destined for in-state delivery free of negative *Commerce Clause* restraints. Though the *Twenty-first Amendment* mirrors the basic terminology of the Webb-Kenyon Act, its language is broader, authorizing States to regulate all "transportation or importation" that runs afoul of state law. The broader language even more naturally encompasses discriminatory state laws. Its terms suggest, for example, that a State may ban imports entirely while leaving in-state liquor unregulated, for they do not condition the State's ability to prohibit imports on the manner in which state law treats domestic products. [*515]

The state laws at issue in these cases fall within *§ 2*'s broad terms. They prohibit wine manufacturers from "transport[ing] or import[ing]" wine directly to consumers in New York and Michigan "for delivery or use therein." Michigan law does so by requiring all out-of-state wine manufacturers to distribute wine through licensed in-state wholesalers. *Ante, at ____, 161 L. Ed. 2d, at 807*. New York law does so by prohibiting out-of-state wineries from shipping wine directly to consumers unless they establish an in-state physical presence, something that in-state wineries naturally have. *Ante, at ____ - ____, ____ - ____, 161 L. Ed. 2d, at 807, 810-811*. The *Twenty-first Amendment* prohibits out-of-state wineries from shipping wine into Michigan and New York in violation of these laws. In holding that the Constitution prohibits Michigan's and New York's laws, the majority turns the Amendment's text on its head.

The majority's holding is also at odds with this Court's early *Twenty-first Amendment* case law. In *State Bd. of Equalization of Cal. v. Young's Market Co., 299 U.S. 59, 81 L. Ed. 38, 57 S. Ct. 77 (1936)*, this Court considered the constitutionality of a California law that facially discriminated against beer importers and, by extension, out-of-state producers. The California law required wholesalers to pay a special $500 license fee to import beer, in addition to the $50 fee California charged for wholesalers to distribute beer generally. *Id., at 60-61, 81 L. Ed. 38, 57 S. Ct. 77*. California law thus discriminated against out-of-state beer by charging wholesalers of imported beer 11 times the fee charged to wholesalers of domestic beer.

Young's Market held that this explicit discrimination against out-of-state beer products came within the terms of the *Twenty-first Amendment*, and therefore did not run afoul of the negative *Commerce Clause*. The Court reasoned that the *Twenty-first*

Amendment's words are "apt to confer upon the State the power to forbid all importations which do not comply with the conditions which it prescribes." *Id., at 62, 81 L. Ed. 38, 57 S. Ct. 77.* The Court rejected the argument that a State "must let imported liquors compete with the domestic on equal terms," [*516] declaring that "[t]o say that, would involve not a construction of the Amendment, but a rewriting of it." *Ibid.* It recognized that a State could adopt a "discriminatory" regulation of out-of-state manufacturers as an incident to a "lesser degree of regulation than total prohibition," for example, by imposing "a state monopoly of the manufacture and sale of beer," or by "channel[ing] desired importations by confining them to a single consignee." *Id., at 63, 81 L. Ed. 38, 57 S. Ct. 77.* And far from "not consider[ing]" the historical argument that forms the core of the majority's reasoning, *ante, at ____, 161 L. Ed. 2d, at 817*, *Young's Market* expressly rejected its relevance:

> "The plaintiffs argue that limitation of the broad language of the *Twenty-first Amendment* is sanctioned by its history; and by the decisions of this Court on the Wilson Act, the Webb-Kenyon Act and the Reed Amendment. As we think the language of the Amendment is clear, we do not discuss these matters."

299 U.S., at 63-64, 81 L. Ed. 38, 57 S. Ct. 77 (footnote omitted).

The plaintiffs in *Young's Market* advanced virtually the same historical argument the Court today accepts. Brief for Appellees, O. T. 1936, No. 22, pp 57-75. *Young's Market* properly reasoned that the text of our Constitution is the best guide to its meaning. That logic requires sustaining the state laws that the Court invalidates.

Young's Market was no outlier. The next Term, the Court upheld a Minnesota law that prohibited the importation of 50-proof liquor, concluding that "discrimination against imported liquor is permissible." *Mahoney v. Joseph Triner Corp., 304 U.S. 401, 403, 82 L. Ed. 1424, 58 S. Ct. 952 (1938).* One Term after that, the Court upheld two state laws that prohibited the importation of liquor from States that discriminated against domestic liquor. See *Indianapolis Brewing Co. v. Liquor Control Comm'n, 305 U.S. 391, 394, 83 L. Ed. 243, 59 S. Ct. 254 (1939)* (noting that the *Twenty-first Amendment* permitted States to "discriminat[e] between domestic and imported intoxicating liquors"); [*517] *Joseph S. Finch & Co. v. McKittrick, 305 U.S. 395, 398, 83 L. Ed. 246, 59 S. Ct. 256 (1939).* In sum, the Court recognized from the start that "[t]he *Twenty-first Amendment* sanctions the right of a State to legislate concerning intoxicating liquors brought from without, unfettered by the *Commerce Clause*." *Ziffrin, Inc. v. Reeves, 308 U.S. 132, 138, 84 L. Ed. 128, 60 S. Ct. 163 (1939)*; accord, *Duckworth v. Arkansas, 314 U.S. 390, 398-399, 86 L. Ed. 294, 62 S. Ct. 311 (1941)* (Jackson, J., concurring in result); *Carter v. Virginia, 321 U.S. 131, 138-139, 88 L. Ed. 605, 64 S. Ct. 464 (1944)* (Black, J., concurring); *id., at 139-143, 88 L. Ed. 605, 64 S. Ct. 464* (Frankfurter, J., concurring). The majority gives short shrift to these persuasive contemporaneous constructions of the *Twenty-first Amendment*, as Justice Stevens properly stresses. *Ante, at ____ - ____, 161 L. Ed. 2d, at 823-824* (dissenting opinion).

B

The widespread, unquestioned acceptance of the three-tier system of liquor regulation, see *ante, at ____ - ____, 161 L. Ed. 2d, at 805-806*, and the contemporaneous practice of the States following the ratification of the *Twenty-first Amendment* confirm that the Amendment freed the States from negative *Commerce Clause* restraints on discriminatory regulation. Like the Webb-Kenyon Act, the *Twenty-first Amendment* was designed to remove any doubt regarding whether state monopoly and licensing schemes violated the *Commerce Clause*, as the majority properly acknowledges. *Ante, at ____ - ____, 161 L. Ed. 2d, at 819-820*; see also *supra, at ____, 161 L. Ed. 2d, at 833*. Accordingly, in response to the end of Prohibition, States that made liquor legal imposed either state monopoly systems, or licensing schemes strictly circumscribing the ability of private interests to sell and distribute liquor within state borders. Skilton, State Power Under the *Twenty-First Amendment*, 7 Brooklyn L. Rev. 342, 345-346 (1938); L. Harrison & E. Laine, After Repeal: A Study of Liquor Control Administration 43 (1936).

These liquor regulation schemes discriminated against out-of-state economic interests, just as Michigan's and New York's direct-shipment laws do. State monopolies that did not permit direct shipments to consumers, for example, were [*518] thought to discriminate against out-of-state wholesalers and retailers by favoring in-state products. See *Vance, 170 U.S., at 451-452, 42 L. Ed. 1100, 18 S. Ct. 674*; *supra, at ____ - ____, 161 L. Ed. 2d, at 831*. Private licensing schemes discriminated as well, often by requiring in-state residency or physical presence as a condition of obtaining licenses.[6] Even today, the requirement that liquor pass through a licensed in-state wholesaler is a core component of the three-tier system. As the Court concedes, each of these schemes is within the ambit of the *Twenty-first Amendment*, even though each discriminates against out-of-state interests. *Ante, at ____ - ____, ____ - ____, 161 L. Ed. 2d, at 805-806, 819-820*.

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[6] See Note, Economic Localism in State Alcoholic Beverage Laws-Experience Under the *Twenty-First Amendment*, 72 Harv. L. Rev. 1145, 1148-1149, and n. 25 (1959) (hereinafter Economic Localism); see also 3 Colo. Stat. Ann., ch. 89, § 4(a) (1935) (residency requirement); 17 *Fla. Stat. Ann. § 561.24* (1941) (prohibiting out-of-state manufacturers from being distributors); Ill. Rev. Stat., ch. 43, § 120 (Smith-Hurd 1937) (residency requirement); Ind. Stat. Ann. *§ 3730(c)* (1934) (residency requirement); 1 Md. Ann. Code, Art. 2B, § 13 (1939) (residency requirement); *4B Ann. Laws of Mass., ch. 138, §§ 18, 18A* (1965) (residency requirements); 5 Comp. Laws Mich. § 9209-32 (Supp. 1935) (residency requirement); 1 Mo. Rev. Stat. § 4906 (1939) (citizenship requirement); Neb. Comp. Stat., ch. 53, Art. 3, § 53-328 (1929 and Cum. Supp. 1935) (residency requirement); § 53-317 (physical presence requirement); 1 Nev. Comp. Laws § 3690.05 (Supp. 1931-1941) (residency and physical presence requirements); *2 Rev. Stat. of N. J. § 33:1-25* (1937) (citizenship and residency requirements); N. C. Code Ann. § 3411(103)(1 1/2) (1939) (residency requirement); 1 N. D. Rev. Code § 5-0202 (1943) (citizenship and residency requirements); Ohio Code Ann. § 6064-17 (1936) (residency and physical presence requirements); R. I. Gen. Laws, ch. 163, § 4 (1938) (residency requirement); 1 S. D. Code § 5.0204 (1939) (residency requirement); Vt. Rev. Stat., Tit. 28, ch. 271, § 6156 (1947) (residency requirement); 8 Rev. Stat. Wash. § 7306-23G (Supp. 1940) (physical presence requirement); § 7306-27 (citizenship and residency requirements); Wis. Stat. § 176.05(9) (1937) (citizenship and residency requirements); Wyo. Rev. Stat. Ann. § 59-104 (Supp. 1940) (citizenship and residency requirements).

Many States had laws that discriminated against out-of-state products in addition to out-of-state wholesalers and retailers. See Kallenbach, Interstate Commerce in Intoxicating [*519] Liquors Under the *Twenty-First Amendment*, 14 Temp. L. Q. 474, 483-484 (1940); T. Green, Liquor Trade Barriers: Obstructions to Interstate Commerce in Wine, Beer, and Distilled Spirits 12-19, and App. I (1940) (hereinafter Green).[7] For example, 21 States required that producers who had no physical presence within the State first obtain a special license or certificate before doing business within the State, thus subjecting them to two layers of licensing fees. *Id.*, at 12. Thirteen States charged lower licensing fees for wine manufacturers who used locally grown grapes. *Id.*, at 13. Arkansas went so far as to create a blanket exception to its licensing scheme for locally produced wine. See 2 Pope's Digest of Stat. of Ark. §§ 14099, 14105, 14113 (1937). Eight States taxed out-of-state liquor products at greater rates than in-state products. Green 13. Twenty-nine States exempted exports from excise taxes that were applicable to imports. *Id.*, at 14. At least 10 States (plus the District of Columbia) imposed special licensing requirements on solicitors of out-of-state liquor products. See Harrison & Laine, *supra*, at 194-195. Like the California law upheld in *Young's Market*, 10 States charged wholesalers who dealt in imports greater licensing fees. Economic Localism 1150; Crabb, State Power Over Liquor Under the *Twenty-First Amendment*, 12 U. Det. L. J. 11, 27 (1948); Green 13. Many States also passed antiretaliation statutes limiting or banning imports from other States that themselves discriminated against out-of-state liquor. Economic Localism 1152; Green 14. All told, at least 41 States had some sort of law [*520] that discriminated against out-of-state products, many if not most of which (contrary to the Court's suggestion, *ante, at ____, 161 L. Ed. 2d, at 817*) predated *Young's Market* and its progeny. See, *e.g.*, Green App. I. This contemporaneous state practice refutes the Court's assertion, *ante, at ____ - ____, ____, 161 L. Ed. 2d, at 816-817, 819*, that the *Twenty-first Amendment* allowed States to discriminate against out-of-state wholesalers and retailers, but not against out-of-state products.

Rather than credit the lay consensus this state practice reflects, the Court relies instead on scattered academic and judicial commentary arguing that the *Twenty-first Amendment* did not permit States to enact discriminatory liquor legislation. *Ante, at ____, 161 L. Ed. 2d, at 817*. Most of the commentators and judges the Court cites did not adopt the construction of the Amendment the Court embraces. For example, some argued that the *Twenty-first Amendment* only allowed States to enact nondiscriminatory prohibition laws—*i.e.*, to allow "dry states to remain dry." See Note, 55 Yale L. J. 815, 816-817 (1946); de Ganahl, The Scope of Federal Power Over Alcoholic Beverages Since the *Twenty-First Amendment*, 8 Geo. Wash. L. Rev. 819, 822-823 (1940); Friedman, Constitutional Law: State Regulation of Importation of Intoxicating Liquor

[7] See also, *e.g.*, Ill. Rev. Stat., ch. 43, § 115(h) (Smith-Hurd 1937) (special license for growers of locally grown grapes); Comp. Laws Mich. § 9209-55 (Supp. 1935) (exemption from malt tax for in-state manufacturers); Nev. Comp. Laws § 3690.15 (Supp. 1931-1941) (special importer's fees; lower license fees for manufacturers and wholesalers who deal in in-state products); N. M. Stat. Ann. § 72-806 (Supp. 1938) (licensing exemption for in-state wineries); R. I. Gen. Laws Ann., ch. 167, § 8 (1938) (authorizing state agency to impose retaliatory tax); Utah Rev. Stat. § *46-8-3* (Supp. 1939) (requiring state commission to prefer locally grown products).

Under the *Twenty-First Amendment*, 21 Cornell L. Q. 504, 511-512 (1936); Recent Cases, Constitutional Law—*Twenty-first Amendment*, 85 U. Pa. L. Rev. 322, 323 (1937); W. Hamilton, Price and Price Policies 426 (1938). The Court, by contrast, concedes that a State could have a discriminatory licensing or monopoly scheme. *Ante, at ____ - ____, 161 L. Ed. 2d, at 819-820*. The Court must concede this, given that state practice shows that the *Twenty-first Amendment* authorized such practices, and given that the Webb-Kenyon Act allowed States to enforce their own licensing laws, even if they did not prohibit the use and consumption of liquor entirely. Others apparently defended the position that the *Twenty-first Amendment* did no more than prevent Congress from permitting the direct importation of liquor into a State, leaving [*521] the Constitution untouched. See *Joseph Triner Corp. v. Arundel, 11 F. Supp. 145, 146-147 (Minn. 1935)*; *Young's Market Co. v. State Bd. of Equalization of Cal., 12 F. Supp. 140, 142 (SD Cal. 1935)*, rev'd, *299 U.S. 59, 81 L. Ed. 38, 57 S. Ct. 77 (1936)*. Still others did not state a clear view on the scope of the *Twenty-first Amendment*. See generally Legislation, Liquor Control, 38 Colum. L. Rev. 644 (1938); Wiser & Arledge, Does the Repeal Amendment Empower a State to Erect Tariff Barriers and Disregard the *Equal Protection Clause* in Legislating on Intoxicating Liquors in Interstate Commerce?, 7 Geo. Wash. L. Rev. 402 (1939) (arguing that the *Twenty-first Amendment* did not repeal the *Equal Protection Clause*). Instead of following this confused mishmash of elite opinion—the same sort of elite opinion that drove the expansive interpretation of the negative *Commerce Clause* that prompted the *Twenty-first Amendment* —I would credit the uniform practice of the States whose people ratified the *Twenty-first Amendment*. See *ante, at ____, 161 L. Ed. 2d, at 824-825* (Stevens, J., dissenting).

The majority's reliance on the difference between discrimination against manufacturers (and therefore, their products) and discrimination against wholesalers and retailers is difficult to understand. The pre-*Twenty-first Amendment* "nondiscrimination" principle enshrined in this Court's negative *Commerce Clause* cases could not have prohibited discrimination against the producers of out-of-state goods, while permitting discrimination against out-of-state services like wholesaling and retailing. See *Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 42, 64 L. Ed. 2d 702, 100 S. Ct. 2009 (1980)* (invalidating state law that discriminated against banks, bank holding companies, and trust companies with out-of-state business operations); *Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389, 394-395, 96 L. Ed. 436, 72 S. Ct. 424 (1952)* (invalidating tax that discriminated against solicitors for out-of-state-licensed businesses). Discrimination against out-of-state wholesalers and retailers also risks allowing "economic protectionism." The Court's [*522] concession that the *Twenty-first Amendment* allowed States to require all liquor traffic to pass through in-state wholesalers and retailers shows that States may also have direct-shipment laws that discriminate against out-of-state wineries.

III

Though the majority dismisses this Court's early *Twenty-first Amendment* case law, it relies on the reasoning, if not the holdings, of our more recent *Twenty-first*

Amendment cases. *Ante, at ____ - ____, 161 L. Ed. 2d, at 818-820*. But the Court's later cases do not require the result the majority reaches. Moreover, I would resolve any conflict in this Court's precedents in favor of those cases most contemporaneous with the ratification of the *Twenty-first Amendment*.

A

The test set forth in this Court's more recent *Twenty-first Amendment* cases shows that Michigan's and New York's direct-shipment laws are constitutional. In *Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 82 L. Ed. 2d 200, 104 S. Ct. 3049 (1984)*, this Court established a standard for determining when a discriminatory state liquor regulation is permissible under the *Twenty-first Amendment*. At issue in *Bacchus* was a Hawaii statute that imposed a 20 percent excise tax on liquor, but exempted certain locally produced products from the tax. The Court held that the *Twenty-first Amendment* did not save the discriminatory tax. The Court reasoned that the *Twenty-first Amendment* did not permit state laws that constituted "mere economic protectionism," because the *Twenty-first Amendment's* "central purpose . . . was not to empower States to favor local liquor industries by erecting barriers to competition." *Id., at 276, 82 L. Ed. 2d 200, 104 S. Ct. 3049*. The Court noted that the State did "not seek to justify its tax on the ground that it was designed to promote temperance or to carry out any other purpose of the *Twenty-first Amendment*, but instead acknowledg[ed] that the purpose was 'to promote a local industry.'" *Ibid.* (quoting [*523] Brief for Appellee Dias, O. T. 1983, No. 82-1565, p 40). The Court therefore struck down the tax, "because [it] violate[d] a central tenet of the *Commerce Clause* but [was] not supported by any clear concern of the *Twenty-first Amendment*." *468 U.S., at 276, 82 L. Ed. 2d 200, 104 S. Ct. 3049*; accord, *Brown-Forman Distillers Corp. v. New York State Liquor Authority, 476 U.S. 573, 584-585, 90 L. Ed. 2d 552, 106 S. Ct. 2080 (1986)* ("[O]ur task . . . is to reconcile the interests protected by the" *Twenty-first Amendment* and the negative *Commerce Clause*).

Michigan's and New York's direct-shipment laws are constitutional under *Bacchus*. Allowing States to regulate the direct shipment of liquor was of "clear concern" to the framers of the Webb-Kenyon Act and the *Twenty-first Amendment*. *Bacchus, supra, at 276, 82 L. Ed. 2d 200, 104 S. Ct. 3049*. The driving force behind the passage of the Webb-Kenyon Act was a desire to reverse this Court's decisions that had precluded States from regulating the direct shipment of liquor by out-of-state interests. See *supra, at ____ - ____, 161 L. Ed. 2d, at 832-834*. The laws struck down in *Scott v. Donald, 165 U.S. 58, 41 L. Ed. 632, 17 S. Ct. 265 (1897)*, and *Vance v. W. A. Vandercook Co., 170 U.S. 438, 42 L. Ed. 1100, 18 S. Ct. 674 (1898)*, required out-of-state manufacturers to ship liquor through the State's liquor regulation scheme—exactly what the Michigan and New York schemes do. By contrast, there is little evidence that purely protectionist tax exemptions like those at issue in *Bacchus* were of any concern to the framers of the Act and the Amendment. Moreover, if the three-tier liquor regulation system falls within the "core concerns" of the *Twenty-first Amendment*, then so do Michigan's and New York's direct-shipment laws. The same justifications for requiring wholesalers and retailers to be in-state businesses equally apply to Michigan's and New York's direct-shipment laws. For example, States require liquor to be shipped through in-state wholesalers because it is easier to regulate in-state wholesalers and retailers. State officials can better enforce their regulations by inspecting the premises and attaching the property of in-state entities; "[p]resence ensures accountability." *358 F.3d 223, 237 (CA2 2004).* [*524] It is therefore understandable that the framers of the *Twenty-first Amendment* and the Webb-Kenyon Act would have wanted to free States to discriminate between in-state and out-of-state wholesalers and retailers, especially in the absence of the modern technological improvements and federal enforcement mechanisms that the Court argues now make regulating liquor easier. *Ante, at ____ - ____, 161 L. Ed. 2d, at 821-822.* Michigan's and New York's laws simply allow some in-state wineries to act as their own wholesalers and retailers in limited circumstances. If allowing a State to require all wholesalers and retailers to be in-state companies is a core concern of the *Twenty-first Amendment*, so is allowing a State to select only in-state manufacturers to ship directly to consumers, and therefore act, in effect, as their own wholesalers and retailers.

B

The Court places much weight upon the authority of *Bacchus*. *Ante, at ____ - ____, 161 L. Ed. 2d, at 819.* This is odd, because the Court does not even mention, let alone apply, the "core concerns" test that *Bacchus* established. The Court instead *sub silentio* casts aside that test, employing otherwise-applicable negative *Commerce Clause* scrutiny and giving no weight to the *Twenty-first Amendment* and the Webb-Kenyon Act. *Ante, at ____ - ____, ____ - ____, 161 L Ed 2d, at 809-811, 820-822.* The Court therefore at least implicitly acknowledges the unprincipled nature of the test *Bacchus* established and the grave departure *Bacchus* was from this Court's precedents. See *468 U.S., at 278-287, 82 L. Ed 2d 200, 104 S. Ct. 3049* (Stevens, J., dissenting); *James B. Beam Distilling Co. v. Georgia, 501 U.S. 529, 554-557, 115 L. Ed. 2d 481, 111 S. Ct. 2439 (1991)* (O'Connor, J., dissenting). *Bacchus* should be overruled, not fortified with a textually and historically unjustified "nondiscrimination against products" test. *Bacchus*' reasoning is unpersuasive. It swept aside the weighty authority of this Court's early *Twenty-first Amendment* case law, see *468 U.S., at 281-282, 82 L. Ed. 2d 200, 104 S. Ct. 3049* (Stevens, J., dissenting), because the *Bacchus* Court thought it "'an absurd [*525] oversimplification'" to conclude that "'the *Twenty-first Amendment* has somehow operated to "repeal" the *Commerce Clause*,'" *id., at 275, 82 L. Ed. 2d 200, 104 S. Ct. 3049* (quoting *Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324, 331-332, 12 L. Ed. 2d 350, 84 S. Ct. 1293 (1964)).* The *Twenty-first Amendment* did not impliedly repeal the *Commerce Clause*, but that does not justify *Bacchus*' narrowing of the *Twenty-first Amendment* to its "core concerns."

The *Twenty-first Amendment*'s text has more modest effect than *Bacchus* supposed. Though its terms are broader than the Webb-Kenyon Act, the *Twenty-first Amendment* also parallels the Act's structure. In particular, the *Twenty-first Amendment* provides that any importation into a State contrary to state law violates the Constitution, just as the Webb-Kenyon Act provides that any such importation contrary to state law violates federal law. Its use of those same terms of art shows that just as the Webb-Kenyon Act repealed liquor's negative *Commerce Clause* immunity, the *Twenty-first Amendment* likewise insulates state liquor laws from negative *Commerce Clause* scrutiny. Authorizing States to regulate liquor importation free from negative *Commerce Clause* restraints is a far cry from precluding Congress from regulating in that field at all. See *Bacchus, supra, at 279, n. 5, 82 L. Ed. 2d 200, 104 S. Ct. 3049* (Stevens, J., dissenting). Moreover, *Bacchus*' concern that the *Twenty-first Amendment* repealed the *Commerce Clause* is no excuse for ignoring the independent force of the Webb-Kenyon Act, which equally divested discriminatory state liquor laws of *Commerce Clause* immunity.

Stripped of *Bacchus*, the Court's holding is bereft of support in our cases. *Bacchus* is the only decision of this Court holding that the *Twenty-first Amendment* does not authorize the in-state regulation of imported liquor free of the negative *Commerce Clause*. Given the uniformity of our early case law supporting even discriminatory state laws regulating imports into States, then, Michigan's and New York's laws easily pass muster under this Court's cases. [*526]

Nevertheless, in support of *Bacchus*' holding that "state regulation of alcohol is limited by the nondiscrimination principle of the *Commerce Clause*," the Court cites *Brown-Forman Distillers Corp. v. New York State Liquor Authority, 476 U.S. 573, 90 L. Ed. 2d 552, 106 S. Ct. 2080 (1986)*, and *Healy v. Beer Institute, 491 U.S. 324, 105 L. Ed. 2d 275, 109 S. Ct. 2491 (1989). Ante, at ____ - ____, 161 L. Ed. 2d, at 819-820*. At issue in those cases was the constitutionality of protectionist legislation that controlled the price of liquor in other States. *Brown-Forman, supra, at 582-583, 90 L. Ed. 2d 552, 106 S. Ct. 2080*; *Healy, supra, at 337-338, 105 L. Ed. 2d 275, 109 S. Ct. 2491*. In invalidating such a statute, *Brown-Forman* found that the *Twenty-first Amendment*, by its terms, gives "New York only the authority to control sales of liquor in New York, and confers no authority to control sales in other States." *476 U.S., at 585, 90 L. Ed. 2d 552, 106 S. Ct. 2080*; see also *Healy, supra, at 342-343, 105 L. Ed. 2d 275, 109 S. Ct. 2491* (following *Brown-Forman*'s construction). *Brown-Forman* and *Healy* are beside the point in these cases. *Brown-Forman* did not involve a facially discriminatory law. See *476 U.S., at 579, 90 L. Ed. 2d 552, 106 S. Ct 2080*. And unlike *Healy*, there is no claim here that the Michigan and New York laws do anything but regulate within their own borders, thereby interfering with the ability of other States to exercise their own *Twenty-first Amendment* power.

Equally inapposite are the cases the Court cites concerning state laws that violate other provisions of the Constitution or Acts of Congress. *Ante, at ____ - ____, 161 L. Ed. 2d, at 818-819*. Cases involving the relation between the *Twenty-first Amendment* and Congress' affirmative *Commerce Clause* power are irrelevant to whether the *Twenty-first Amendment* protects state power against the negative implications of the *Commerce Clause*. See *James B. Beam, supra, at 556, 115 L. Ed. 2d 481, 111 S. Ct. 2439* (O'Connor, J., dissenting); *Bacchus, supra, at 279, 82 L. Ed. 2d 200, 104 S. Ct. 3049*, and n 5 (Stevens, J., dissenting). Similarly, my interpretation of the *Twenty-first Amendment* would not free States to regulate liquor unhampered by other constitutional restraints, like the *First Amendment* and the *Equal Protection Clause*. As this Court explained in *Craig v. Boren, 429 U.S. 190, 205-207, 50 L. Ed. 2d 397, 97 S. Ct. 451 (1976)*, the text and history of the *Twenty-first Amendment* [*527] demonstrate that it displaces liquor's negative *Commerce Clause* immunity, not other constitutional provisions.

IV

The Court begins its opinion by detailing the evils of state laws that restrict the direct shipment of wine. *Ante, at ____ - ____, 161 L. Ed. 2d, at 805-806*. It stresses, for example, the Federal Trade Commission's opinion that allowing the direct shipment of wine would enhance consumer welfare. FTC, Possible Anticompetitive Barriers to E-Commerce: Wine 3-5 (July 2003), available at http://www.ftc.gov/os/2003/07/winereport2.pdf (as visited May 12, 2005, and available in Clerk of Court's case file). The Court's focus on these effects suggests that it believes that its decision serves this Nation well. I am sure that the judges who repeatedly invalidated state liquor legislation, even in the face of clear congressional direction to the contrary, thought the same. See *supra, at ____ - ____, 161 L. Ed. 2d, at 828-831*. The *Twenty-first Amendment* and the Webb-Kenyon Act took those policy choices away from judges and returned them to the States. Whatever the wisdom of that choice, the Court does this Nation no service by ignoring the textual commands of the Constitution and Acts of Congress. The *Twenty-first Amendment* and the Webb-Kenyon Act displaced the negative *Commerce Clause* as applied to regulation of liquor imports into a State. They require sustaining the constitutionality of Michigan's and New York's direct-shipment laws.

I respectfully dissent.

National Wine & Spirits, Inc. v State of Michigan

477 Mich. 1088, 729 N.W.2d 234 (2007)

Opinion

On order of the Court, the motion for reconsideration of this Court's November 29, 2006 order is considered, and it is DENIED, because it does not appear that the order was entered erroneously.

Markman, J., concurs and states as follows:

I concur in the order denying plaintiffs' motion for reconsideration for essentially the reasons set forth by the Court of Appeals. I therefore agree with the majority that an opinion of this Court is unnecessary. However, given that we held plaintiffs' application in abeyance pending the United States Supreme Court's decision in *Granholm v Heald, 544 U.S. 460, 125 S. Ct. 1885; 161 L. Ed. 2d 796 (2005)*, and then twice heard oral arguments on the issues presented, I wish to add something more to this Court's order of denial.

The statute at issue here, *MCL 436.1205(3)*, prohibits an authorized distribution agent (ADA) that is licensed as a wine wholesaler from "dualing," i.e., selling a brand of wine in an area in which another wine wholesaler has already been licensed to sell that brand, unless the wine wholesaler was dualing on or before September 24, 1996.[1] Plaintiffs [*1089] contend that *§ 205(3)* violates the Commerce Clause and the *Equal Protection Clause of the United States Constitution.*

The Commerce Clause, US Const, art I, § 8, provides that Congress shall have the power "[t]o regulate Commerce . . . among the several States . . . ." Derived from this is the so-called "dormant" Commerce Clause that prohibits state laws that discriminate against or unduly burden interstate commerce. *General Motors Corp v Tracy, 519 U.S. 278, 287 (1997).*

The restriction in *§ 205(3)* applies to all ADA wine wholesalers that were not already dualing on or before September 24, 1996. It does not distinguish between in-

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[1] *MCL 436.1205(3)* provides: An authorized distribution agent shall not have a direct or indirect interest in a supplier of spirits or in a retailer. A supplier of spirits or a retailer shall not have a direct or indirect interest in an authorized distribution agent. An authorized distribution agent shall not hold title to spirits. After September 24, 1996, an authorized distribution agent or an applicant to become an authorized distribution agent who directly or indirectly becomes licensed subsequently as a wholesaler shall not be appointed to sell a brand of wine in a county or part of a county for which a wholesaler has been appointed to sell that brand under an agreement required by this act. A wholesaler who directly or indirectly becomes an authorized distribution agent shall not sell or be appointed to sell a brand of wine to a retailer in a county or part of a county for which another wholesaler has been appointed to sell that brand under an agreement required by this act, unless that wholesaler was appointed to sell and was actively selling that brand to retailers in that county or part of that county prior to September 24, 1996, or unless the sale and appointment is the result of an acquisition, purchase, or merger with the existing wholesaler who was selling that brand to a retailer in that county or part of that county prior to September 24, 1996.

state and out-of-state ADA wine wholesalers. Because the restriction in *§ 205(3)* on dualing does not so distinguish, it regulates ADA wine wholesalers evenhandedly. Therefore, *§ 205(3)* does not discriminate against or unduly burden interstate commerce in violation of the Commerce Clause.

In order to obtain a wine wholesale license in Michigan, one must have resided in Michigan for at least one year. *MCL 436.1601(1).*[2] Plaintiffs argue that because of this residency requirement, as of September 24, 1996, only Michigan residents were dualing wine wholesalers, and *§ 205(3)* effectively prohibits companies that did not dual in Michigan on or before September 24, 1996, from ever dualing in Michigan. Thus, say plaintiffs, the Legislature has "permanently barred" any out-of-state ADA/wine wholesalers from ever dualing.

First, out-of-state ADA/wine wholesalers are not "permanently barred" from dualing because *§ 205(3)* allows them to dual if they acquire, purchase, or merge with a company that dualed in Michigan on or before September 24, 1996.

Second, plaintiffs have not properly challenged the one-year residency requirement of *MCL 436.1601(1).* At oral arguments, plaintiffs' counsel stated, "We have not challenged *[§ 601(1)]* nor do we think it is critical to our case." Further, whether plaintiffs would have standing to challenge the residency requirement of *§ 601* is questionable given that National Wine & Spirits, L.L.C., is a Michigan resident and a licensed wine wholesaler in Michigan. As plaintiffs' counsel acknowledged at oral argument, when asked why they had not challenged the residency requirement of *§ 601*, "[B]ecause we are operating now. We have met the residency requirement . . . ."

The *Fourteenth Amendment of the United States Constitution* provides, "nor shall any State . . . deny to any person within its jurisdiction the equal protection of the laws." *US Const, Am XIV*. The rational basis test is used to review equal protection challenges to social or economic [*1090] legislation. *Phillips v Mirac, Inc, 470 Mich. 415, 434; 685 N.W.2d 174 (2004).* The parties agree that the rational basis test is the appropriate test in this case. "Under this test, 'courts will uphold legislation as long as that legislation is rationally related to a legitimate government purpose.'" *Id. at 433* (citation omitted). "This highly deferential standard of review requires a challenger to show that the legislation is '"arbitrary and wholly unrelated in a rational way to the objective of the statute."'" *Id.* (citation omitted).

The rational basis test considers whether the "'classification itself is rationally related to a legitimate governmental interest.'" But the rational basis test does not test "the wisdom, need, or appropriateness of the legislation . . . ." We examine the purpose with which the legislation was enacted, not its effects: "That the accommodation struck may have profound and far-reaching consequences . . . provides all the more reason for this Court to defer to the congressional judgment unless it is demonstrably

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[2] *MCL 436.1601(1)* provides: "A wholesale licensee or an applicant for a wholesale license, if an individual, shall be licensed only if that individual has resided in this state for not less than 1 year immediately prior to the date of issuance of the license."

arbitrary or irrational." In discerning the purpose, we look to "any set of facts, either known or which could reasonably be assumed, even if such facts may be debatable." [*Id. at 434-435* (citations omitted).]

Regardless of whether *MCL 436.1205(3)* constitutes wise or prudent legislation, it is rationally related to an apparent governmental interest, namely, that of preventing ADAs from dominating the wholesale wine market, while protecting the business interests of wine wholesalers who were dualing on or before September 24, 1996. As the Court of Appeals explained:

> We conclude that the classification based on date is rationally related to defendant's purpose. Before 1996, there were no ADAs because the distribution of alcohol was handled solely by Michigan's Liquor Control Commission. After defendant allowed ADAs to distribute alcohol, it realized that ADAs receiving state subsidies that were also wine wholesalers had an unfair economic advantage over wine wholesalers that were not ADAs. In order to prevent this specific unfair advantage, it decided to preclude ADA/wholesalers from dualing. But because some ADA/wholesalers already had dualing agreements, defendant did not take away their pre-existing right to dual. It was necessary for the Legislature to insert a date prior to the date the statute was effective because if it had not ADAs and wholesalers would have had a window of time in which to obtain licenses and/or dualing agreements. In other words, it would have allowed circumstances to be altered beyond the status quo. . . . Rather than penalizing a wine wholesaler that already had a dualing agreement when/if it became an ADA, the Legislature allowed the wine wholesaler to continue to operate under their preexisting agreement. [*1091]

Because *§ 205(3)* is rationally related to a legitimate government purpose, it does not violate the *Equal Protection Clause*.

Plaintiffs' application for leave to appeal was held in abeyance pending the decision in *Heald*. In *Heald*, the United States Supreme Court held that allowing in-state wineries to sell wine directly to consumers, but prohibiting out-of-state wineries from doing so, discriminated against interstate commerce in violation of the Commerce Clause and that the discrimination is neither authorized nor permitted by the *Twenty-first Amendment*.[3] Because I agree with the Court of Appeals that the statute at issue in the instant case does not discriminate against interstate commerce in violation of the Commerce Clause, there is no need to address whether the *Twenty-first Amendment* would authorize or permit any discrimination against interstate commerce.

TAYLOR, C.J., joins the statement of MARKMAN, J. CAVANAGH AND WEAVER, JJ., would grant reconsideration.

KELLY, J., dissents and states as follows:

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[3] *Section 2 of the Twenty-first Amendment* provides: "The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."

Plaintiffs brought an action challenging the constitutionality of *MCL 436.1205(3)*. The statute prevents an authorized distribution agent (ADA) from acting as a wine wholesaler and distributor in an area where a wholesale agreement existed before September 24, 1996. An exception exists for an ADA with respect to the brands of wine it sold in the area before that date.

Both the trial court and the Court of Appeals found the statute constitutional. This Court heard oral argument on the application for leave to appeal and granted full briefing and argument on the merits of the case. However, the Court then inexplicably decided that leave to appeal had been improvidently granted. I joined Justice Cavanagh's statement dissenting from that decision. Now plaintiffs have filed a motion for reconsideration. I would grant that motion, reverse the judgment of the Court of Appeals, and hold that *MCL 436.1205(3)* is unconstitutional as applied.

Facts of the Case

Following the adoption of the *Twenty-first Amendment*,[4] Michigan enacted the Michigan Liquor Control Act of 1933.[5] Under the act, there were no private distributors of spirits. Rather, the state itself purchased spirits and distributed them to licensed outlets using a three-tiered system. This model was intended to keep manufacturers, wholesalers, and retailers separate and distinct. In contrast to the distribution of spirits, the distribution of wine is and always has been done by private parties. [*1092]

In 1996, the State of Michigan ended its role in warehousing and distributing spirits and adopted a system whereby authorized distribution agents handled these functions. The state paid the ADAs for their services. In the course of privatizing warehousing and delivery, the state also imposed eligibility and operational restrictions on the ADAs. Certain of those restrictions are at issue in the case and are contained in *MCL 436.1205(3)*.[6] They prohibit ADAs who wish to sell given brands of wine wholesale from doing so in areas where a wholesaler has already been assigned to sell those

[4] US Const, Am XXI.

[5] *MCL 436.1 et seq.*, repealed by 1998 PA 58, effective April 14, 1998.

[6] *MCL 436.1205(3)* provides: (3) An authorized distribution agent shall not have a direct or indirect interest in a supplier of spirits or in a retailer. A supplier of spirits or a retailer shall not have a direct or indirect interest in an authorized distribution agent. An authorized distribution agent shall not hold title to spirits. After September 24, 1996, an authorized distribution agent or an applicant to become an authorized distribution agent who directly or indirectly becomes licensed subsequently as a wholesaler shall not be appointed to sell a brand of wine in a county or part of a county for which a wholesaler has been appointed to sell that brand under an agreement required by this act. A wholesaler who directly or indirectly becomes an authorized distribution agent shall not sell or be appointed to sell a brand of wine to a retailer in a county or part of a county for which another wholesaler has been appointed to sell that brand under an agreement required by this act, unless that wholesaler was appointed to sell and was actively selling that brand to retailers in that county or part of that county prior to September 24, 1996, or unless the sale and appointment is the result of an acquisition, purchase, or merger with the existing wholesaler who was selling that brand to a retailer in that county or part of that county prior to September 24, 1996.

brands. An exception exists for ADAs that were selling those brands in those areas before September 24, 1996.

Since the end of Prohibition, Michigan law has required every wine wholesaler to be a Michigan resident for one year before obtaining a wholesaler's license. See *MCL 436.1601*. The effect of *MCL 436.1205(3)* is that only in-state companies can take advantage of the exception, because only they were licensed wine wholesalers on September 24, 1996.

Plaintiffs National Wine & Spirits, Inc.; NWS Michigan, Inc.; and National Wine & Spirits, L.L.C., brought suit challenging *MCL 436.1205(3)*.[7] Plaintiffs argue that the statute violates the Commerce Clause[8] [*1093] and the Equal Protection Clause[9] of the United States Constitution. The trial court determined that the statute violated neither and granted summary disposition to defendants. The Court of Appeals affirmed.

Analysis of the Law

The Commerce Clause

Article 1, § 8 of the United States Constitution gives Congress the power to regulate commerce among the states. The United States Supreme Court has inferred, as a necessary corollary to this power, that state and local laws placing an undue burden on interstate commerce cannot be upheld. This principle has generally become known as the "Dormant Commerce Clause." The United States Supreme Court has adopted a two-tiered approach to determining whether a state regulation violates the Dormant Commerce Clause.

> When a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, [it is] generally struck down . . . . When, however, a statute has only indirect effects on interstate commerce and regulates evenhandedly, [it must be] examined whether the State's interest is legitimate and whether the burden on interstate commerce clearly exceeds the local benefits. . . . In either situation the critical consideration is the overall effect of the statute on both local and interstate activity.

[*Brown-Forman Distillers Corp v New York State Liquor Authority, 476 U.S. 573, 579, 106 S. Ct. 2080; 90 L. Ed. 2d 552 (1986).*]

Recently, in explaining its Dormant Commerce Clause jurisprudence, the United States Supreme Court said that states may not enact laws that burden out-of-state producers or shippers simply to give a competitive advantage to in-state businesses. *Granholm v Heald, 544 U.S. 460, 472, 125 S. Ct. 1885; 161 L. Ed. 2d 796 (2005).* Laws that establish a competitive advantage deprive citizens of the right to access the markets of

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7 Defendants are the state of Michigan and the Michigan Beer & Wine Wholesalers Association of Michigan. Michigan Beer & Wine Wholesalers represents 75 percent of the licensed wholesalers in Michigan. It intervened in the action on April 17, 2002.

8 *US Const, art I, § 8, cl 3.*

9 *US Const, Am XIV, § 1.*

other states on equal terms. *Id. at 473.* A state law will violate the Commerce Clause if it forces differential treatment of in-state and out-of-state economic interests that benefits the former while burdening the latter. *Id. at 472.*

After the *Twenty-first Amendment* was adopted, the United States Supreme Court appeared to support the view that, when alcohol was involved, the amendment gave states the authority to discriminate against out-of-state goods. *Id. at 484-485.* However, this view has been abandoned, and it is now clear that the *Twenty-first Amendment* does [*1094] not give states the right to pass discriminatory laws in the area. The state regulation of alcohol, like other articles in interstate commerce, is limited by the Commerce Clause. *Id. at 487.*

MCL 436.1205(3) is Subject to Strict Scrutiny

The Commerce Clause problem with *MCL 436.1205(3)* is not straightforward. To appreciate the magnitude of the constitutional issue, it is necessary to understand the law's effects.

MCL 436.1205(3) creates two categories of ADAs: (1) ADAs that were wholesaling wine before September 24, 1996 (the favored class) and (2) ADAs that were not (the disfavored class). The two classes are treated differently but, within each class, every ADA is treated the same. At first blush, treating ADAs differently depending on whether they were in the wholesaling business on a certain date would seem not to create a Commerce Clause issue. It is only when one considers that solely Michigan companies were able to wholesale wine before September 24, 1996,[10] that the constitutional problem comes into focus.

Because only Michigan companies could sell wine wholesale in Michigan before September 24, 1996, the favored class contains only Michigan companies. The members of this class are given a distinct advantage over all other ADAs. The reason is that only they can act as wine wholesalers and distributors in areas where a preexisting wholesale agreement exists.[11] By giving a class of Michigan companies this advantage, the law creates a system where out-of-state ADAs can never compete on the same terms as the favored class of Michigan ADAs. When a state statute discriminates against interstate

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[10] See *MCL 436.1601.* The constitutionality of the residency requirement is not at issue. Justice Markman finds this to be a determinative factor. It is not. *MCL 436.1205(3)* locks in place a system that discriminates in favor of local commerce. Plaintiffs can challenge the effects of *MCL 436.1205(3)* without challenging the residency requirement.

[11] An ADA that was selling alcohol wholesale in Michigan before September 24, 1996, can continue to sell all the brands of wine in the state that it was selling on that date. One that was not can sell brands of wine wholesale only in areas where there is not a preexisting wholesale agreement for those brands. By September 24, 1996, every brand of wine sold in Michigan had been assigned to a wholesaler. Ninety-seven percent of the brands sold today in Michigan were being sold then. Thus, there are very few brands sold today for which there was not a preexisting wholesale agreement on September 24, 1996. Consequently, it is almost impossible for ADAs that were not selling here before that date to compete effectively in the market. Also, ADAs that can participate in this market are able to develop cost savings that they can pass on to suppliers. Obviously, ADAs that cannot develop these cost savings have a much harder time competing with ADAs that can.

commerce by favoring in-state economic [*1095] interests over out-of-state interests, it is subject to strict scrutiny. *Brown-Forman Distillers Corp, 476 U.S. at 578*. Because this law favors in-state entities over out-of-state entities, it can survive only if it can withstand strict scrutiny.[12]

To survive strict scrutiny, the state must demonstrate that the law in question actually furthers the purported legitimate state interest, and no less discriminatory means exist to accomplish this interest. *New Energy Co of Indiana v Limbach, 486 U.S. 269, 278, 108 S. Ct. 1803; 100 L. Ed. 2d 302 (1988)*. Intervening defendant Michigan Beer & Wine Wholesalers Association claims that the purpose of this statute is to protect existing wine wholesalers from ADAs that might desire to become wine wholesalers. It argues that this protection is needed because, without it, ADA wholesalers would have a built-in advantage over non-ADA wholesalers and could gobble up the market.

Assuming this is a legitimate purpose, there is a less discriminatory way to accomplish it. The Legislature could ban all ADAs, not just those that began wholesaling after September 24, 1996, from wholesaling brands of wine in areas where there is a preexisting wholesale agreement covering them.[13] Because this law is not narrowly tailored to achieve the government's interest, it is invalid and must be struck down.[14]

Conclusion

MCL 436.1205(3) locks in place a system that provides an advantage to a class of Michigan companies that no out-of-state company will ever be able to match. For this reason, it violates the *Commerce Clause of the United States Constitution* and should be struck down. I dissent from the order denying plaintiffs' motion for reconsideration. I would grant the motion and reverse the judgment of the Court of Appeals.

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[12] When more than one wholesaler sells the same brand of wine in the same area it is known as "dualing." In finding *MCL 436.1205(3)* constitutional, Justice Markman relies on the fact that an out-of-state company could "dual" if it acquired, purchased, or merged with a company that "dualed" before September 24, 1996. *Ante* at 2. The fact that a hypothetical situation can be envisioned where the statute could be constitutionally applied does not save the statute from a constitutional challenge. See *Brown-Forman Distillers Corp, 476 U.S. at 579*. ("When a state statute directly regulates or discriminates against interstate commerce, or when its *effect* is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry.") (emphasis added). Justice Markman also refers to the possibility that the *Twenty-first Amendment* may authorize the discrimination at issue. *Ante* at 4. The state regulation of alcohol is limited by the Commerce Clause the same as state regulation of any other article in interstate commerce. *Heald, 544 U.S. at 487*.

[13] At least two Michigan companies that were wholesalers as of September 24, 1996 have become ADAs. They handle approximately 70 percent of the wholesale business in the state. If the Legislature was concerned about unfair competition from ADAs, this question arises: Why did it include a loophole that allows two companies representing 70 percent of the market to become ADAs and continue to wholesale every brand of wine they sold before September 24, 1996?

[14] The defendants have argued that there can be no Commerce Clause violation because the disfavored class created by this law also contains Michigan companies. This is irrelevant and does not erase the discriminatory effect. The fact that a statute favors one class of in-state entities over another does not mitigate its burden on interstate commerce. *Fort Gratiot Sanitary Landfill v Michigan Dep't of Natural Resources, 504 U.S. 353, 357-358, 112 S. Ct. 2019; 119 L. Ed. 2d 139 (1992)*. [*1096]

Microsoft Corporation v. Franchise Tax Board of California

39 Cal. 4th 750, *139 P.3d 1169 (2006)*

Opinion: Werdegar, J.

Ours is a global economy. In contrast, government, and the taxing authority used to fund it, is national and local. This geographic disparity generates difficulties when each jurisdiction seeks its piece of the economic pie, a pie generated by economic activity that knows no borders. [*755]

The Uniform Division of Income for Tax Purposes Act (UDITPA)[1] attempts to address these problems and fairly assess corporate taxes. Adopted by the District of Columbia and 22 states, including California, it seeks to establish uniform rules for the attribution of corporate income, rules that in theory will result in an equitable taxation scheme—equitable to each jurisdiction, seeking its own fair share, and equitable to the taxpayer, who in the absence of uniform rules faces the prospect of having the same income taxed by two, three, or more different states.

(1) The UDITPA's application is not always clear.[2] This case requires us to resolve how the UDITPA should apply to income arising from the redemption of marketable securities, a critical aspect of the operations of the treasury departments of many large corporations, including plaintiff Microsoft Corporation (Microsoft). We conclude (1) the redemption of marketable securities at maturity generates "gross receipts" that are includible in the formula used to calculate a multistate entity's tax, but (2) the Franchise Tax Board (the Board) has met its burden of establishing that, in this instance, an alternate formula should be used to calculate Microsoft's tax.

The UDITPA

(2) The United States Constitution bars taxation of extraterritorial income. (*Container Corp. v. Franchise Tax Bd. (1983) 463 U.S. 159, 164* (*Container Corp.*); *ASARCO Inc. v. Idaho State Tax Comm'n. (1982) 458 U.S. 307, 315*; *Barclays Bank Internat., Ltd. v. Franchise Tax Bd. (1992) 2 Cal.4th 708, 714* (*Barclay's Bank*).) However, it permits taxation of "an apportionable share of the multistate business carried on in part in the taxing State" (*Allied-Signal, Inc. v. Director, Div. of Taxation (1992) 504 U.S. 768, 778*) and grants states some leeway in separating out their respective shares of this multistate income, not mandating they use any particular formula (*Container Corp., at p. 164*). One constitutional method of apportionment, the unitary business/formula apportionment method, "calculates the local tax base by first [*756] describing the scope

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[1] Uniform Division of Income for Tax Purposes Act, 7A part 1 West's Uniform Laws Annotated (2002) page 141.

[2] The UDITPA "was adopted by the States primarily to prevent federal legislation in [the area of allocating income among states], and as such, has the aspects of a shotgun wedding." (Keesling, *The Combined Report and Uniformity in Allocation Practices* (1974) in Multistate Tax Com., 7th Ann. Rep. (1974) p. 34.)

of the 'unitary business'[3] of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." (*Container Corp., at p. 165.*) The UDITPA is generally based on this method. (*Ibid.*)

(3) Under the UDITPA, a unitary enterprise's income is divided into "business income" and "nonbusiness income." (*Hoechst Celanese Corp. v. Franchise Tax Bd. (2001) 25 Cal.4th 508, 518* (*Hoechst*); see *Rev. & Tax. Code, § 25120, subds. (a), (d).*)[4] With some exceptions, nonbusiness income is generally allocated directly to the taxpayer's domiciliary state. (*Hoechst, at p. 518*; *§§ 25123-25127.*) In contrast, business income is apportioned among the states according to a formula. The portion of a taxpayer's business income attributable to economic activity in a given state is determined by combining three factors: payroll, property, and sales. (*§ 25128.*) Each factor is a fraction in which the numerator measures activity or assets within a given state, while the denominator includes all activities or assets anywhere. (*§§ 25129, 25132, 25134.*) The combination of these fractions is used to determine the fraction of total global business income attributable to the given state. (See *Container Corp., supra, 463 U.S. at p. 170*; *Barclay's Bank, supra, 2 Cal.4th at p. 715.*)[5] This method provides a rough but constitutionally sufficient approximation of the income attributable to business activity in each state. (*Container Corp., at pp. 170, 183-184*; *Barclay's Bank, at pp. 718-721.*)

(4) Only the sales factor is at issue here. The sales factor is a ratio comparing sales in a given state to total sales everywhere. (*§ 25134.*) Sales are measured by counting a business's "gross receipts." (*§ 25120, subd. (e).*) [*757] Increases in in-state gross receipts will lead to a larger fraction, greater apportioned income, and higher tax; conversely, increases in out-of-state gross receipts will lead to a reduction in the fraction attributable to California and a reduction in California tax.

(5) The UDITPA contains a relief provision. If application of the foregoing provisions fails to "fairly represent the extent of the taxpayer's business activity in this state," the taxpayer may seek or the Board may impose an alternate method of calculation to achieve an equitable result. (*§ 25137.*)

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[3] "A unitary business is generally defined as two or more business entities that are commonly owned and integrated in a way that transfers value among the affiliated entities." (*Citicorp North America, Inc. v. Franchise Tax Bd. (2000) 83 Cal.App.4th 1403, 1411, fn. 5 [100 Cal. Rptr. 2d 509].*)

[4] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

[5] During the tax year at issue, 1991, California simply averaged the three fractions:

CA Property/Total Property + CA Payroll/Total Payroll + CA Sales/Total Sales/3 × Total Income = Taxable Income

(*Barclay's Bank, supra, 2 Cal.4th at p. 715, fn. 2*; former § 25128, added by Stats. 1966, ch. 2, § 7, p. 179, repealed by Stats. 1993, ch. 946, § 1, p. 5441.) California has since amended the formula to give double weight to the sales factor for most business activity. (*§ 25128.*)

Factual and Procedural Background

Microsoft is an international software company with principal offices in the State of Washington. Microsoft and its worldwide subsidiaries operate as a unitary business. Microsoft's business generates excess operating cash, which its treasury department invests in various short-term marketable securities.[6] Some of these securities Microsoft resells to third parties; others it holds and redeems at maturity. These investments are generally short-term; in 1991, the tax year at issue, approximately 80 percent of investment receipts came from securities held for 30 days or less.

In an amended 1991 California tax return, Microsoft reported the income of its treasury department as business income and the entire amount it received from sales and redemptions of marketable securities, $5.7 billion, as gross receipts. In its audit, the Board accepted the treatment of treasury department income as business income and allowed the inclusion of securities sales as gross receipts, but disallowed the return of capital for securities redemptions. That is, for securities held to maturity, it counted as gross receipts only the price differential between the redemption price and the purchase price. Because redemptions of securities were credited to Microsoft's treasury department in Washington State and contributed to Microsoft's sales factor denominator but not its sales factor numerator, inclusion of the full price in the sales factor would have had the effect of diluting that factor (from roughly 11 percent to 3 percent) and cutting Microsoft's California income tax nearly in half, while inclusion of only the net price differential had the effect of increasing Microsoft's sales factor and its state tax. (See *§ 25134*.)

Microsoft exhausted its administrative remedies without success and filed a refund suit. After a bench trial, the trial court ruled for Microsoft, holding that the entire amount received when Microsoft redeemed its securities at maturity [*758] counted as gross receipts. The trial court further held that the Board had failed to carry its burden of showing that a *section 25137* modification to the formula used to compute Microsoft's tax was necessary to achieve a fair representation of Microsoft's California business.

The Court of Appeal reversed, deciding the case solely on *section 25137* grounds. It held that inclusion of Microsoft's securities redemptions in its gross receipts would seriously distort the formula's representation of Microsoft's California business and that the Board's proposed exclusion of the returned capital portion of these redemptions was authorized under *section 25137*. We granted review.

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[6] During 1991, these securities included commercial paper, corporate bonds, United States Treasury bills and notes, discount notes, United States money market preferred securities, United Kingdom money market preferred securities, fixed rate auction preferred securities, floating rate notes, loan participations, municipal bonds, and loan repurchase agreements.

Discussion

I. *Redemptions as Gross Receipts*

Microsoft asks us to apply a substantial evidence standard of review to the question whether the full amount or net price difference of its redemptions constitutes gross receipts for purposes of the UDITPA, arguing that both the nature of its investments and the extent of its activity here and out-of-state involve factual issues. We decline. The factual attributes of Microsoft's transactions are undisputed. Similarly, the parties have stipulated to the relevant facts concerning the scope of Microsoft's activities in California and elsewhere. While the parties dispute the proper legal characterization of Microsoft's transactions under the UDITPA, "[t]he application of a taxing statute to uncontradicted facts is a question of law, and this court is accordingly not bound to accept the trial court's findings of fact made from the uncontradicted facts shown in the parties' stipulation and the documentary evidence." (*Communications Satellite Corp. v. Franchise Tax Bd. (1984) 156 Cal. App. 3d 726, 746.*)

(6) As with any issue of statutory interpretation, we begin with the text of the relevant provisions. If the text is unambiguous and provides a clear answer, we need go no further. (*Hoechst, supra, 25 Cal.4th at p. 519.*) If the language supports multiple readings, we may consult extrinsic sources, including but not limited to the legislative history and administrative interpretations of the language. Where, as here, the Legislature has adopted a uniform act, the history behind the creation and adoption of that act is also relevant. (*Ibid.*)

(7) Under *section 25120, subdivision (e)*, "'Sales' means *all gross receipts* of the taxpayer not allocated [as nonbusiness income] under *Sections 25123 through 25127* of this code." (Italics added.) The term "gross receipts" is undefined. Microsoft argues that gross receipts include the entire amount [*759] received upon redemption of a marketable security. The Board argues that gross receipts include only the net difference between the amount received and the original purchase price.

(8) We agree with Microsoft that the meaning of "gross receipts" in the UDITPA more naturally includes the entire redemption price of marketable securities. "Gross" implies the whole amount received, not just the amount received in excess of the purchase price.[7] To only consider the net price difference as "gross receipts" is an awkward fit with the statutory language, at best. To the extent the language is ambiguous, we generally will prefer the interpretation favoring the taxpayer. (*Edison California Stores, Inc. v. McColgan (1947) 30 Cal.2d 472, 476.*)

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[7] See, e.g., Black's Law Dictionary (8th ed. 2004) pages 722-723 (gross receipts are "[t]he total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deductions," citing *26 U.S.C. § 448*); American Heritage Dictionary (2d college ed. 1982) page 578 (gross means "[e]xclusive of deductions; total"); *County of Sacramento v. Pacific Gas & Elec. Co. (1987) 193 Cal.App.3d 300, 309* (plain meaning of gross receipts is total amount received, without deduction); *section 6012* (defining gross receipts for sales and use tax purposes as "the total amount of the sale or lease or rental price," without deduction for the cost of the property sold).

(9) The Board, however, argues that only amounts received as consideration count as gross receipts, only the net price difference is consideration, and thus only the net difference should be treated as a receipt. We disagree. In the purchase of a 28-day Treasury bill at 99 and its redemption at 100,[8] for example, the investor exchanges money now for a larger sum of money in 28 days. The Federal Reserve's consideration is the entire amount it receives now; the investor's consideration is the entire larger, but deferred, amount it receives upon redemption. The transaction occurs because the Federal Reserve views the money it receives now as more valuable than the money it must pay later, while the investor views the money it will receive later as more valuable than the money it has now. The difference between the purchase and redemption price is a measure of either gross income or net receipts, not a measure of consideration. (Cf. *Gray v. Franchise Tax Bd. (1991) 235 Cal. App. 3d 36, 42 [286 Cal. Rptr. 453]* [gross income is "the excess of the sales price over the cost of goods sold"]; *MCA, Inc. v. Franchise Tax Board (1981) 115 Cal. App. 3d 185, 197-198* [gross receipts differs from gross income in that the latter subtracts the cost of goods sold].)

While the language of *section 25120* supports Microsoft's interpretation, it is not unambiguous and does not by itself preclude either side's proposed interpretation. Thus, we turn to extrinsic interpretive aids. [*760]

The legislative history behind the UDITPA favors Microsoft's position. As in *Hoechst, supra, 25 Cal.4th at pages 522-523*, because the Legislature adopted the UDITPA almost verbatim, we look to the drafting history of the UDITPA. An early version of the UDITPA defined "sales" as "all income of the taxpayer" not otherwise allocated, but this provision was amended to define "sales" instead as "all gross receipts of the taxpayer" not otherwise allocated. (Compare Proceedings of Com. of Whole for UDITPA, transcript of Aug. 22, 1956, p. 5 ["income" definition] with Proceedings of Com. of Whole for UDITPA, transcript of July 9, 1957, p. 28 ["gross receipts" definition].) This amendment suggests the choice of "gross receipts" was intentional and the drafters had in mind a definition of "sales" that encompassed more than just gross income.

Agency interpretation of *section 25120* likewise supports Microsoft, albeit in a more limited fashion. (See *Hoechst, supra, 25 Cal.4th at pp. 523-525* [relying on State Board of Equalization (SBE) decisions to interpret the UDITPA].) Consistent with Microsoft's interpretation of the statute, the SBE has interpreted gross receipts to include the full amount of any redemptions. In *Appeals of Pacific Telephone & Telegraph* (May 4, 1978) [1978-1981 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-858, page 14,907-36 (*Pacific Telephone & Telegraph*), as here, the taxpayer's treasury department invested idle cash in short-term securities such as Treasury bills, government obligations, certificates of deposit, and commercial paper, selling some but holding most investments to maturity. The SBE concluded "the gross receipts from these activities come within the literal definition of 'sales' that are includible in the sales factor." (*Id.* at p. 14,907-42.) However,

[8] Prices for securities such as Treasury bills are quoted based on a par value of 100. Thus, a $10,000 Treasury bill sold at 99 would be sold for 1 percent less than the face redemption value of the bill, i.e., $9,900.

because the inclusion of sales and redemptions in gross receipts was not a major point of contention or analysis, we do not place great weight on this decision.[9] (See *Yamaha Corp. of America v. State Bd. of Equalization (1998) 19 Cal.4th 1, 14-15.*)

(10) In deciding how to apply *section 25120*, we look as well to the economic reality of the taxed transaction. For purposes of taxation, what matters is substance, not form. "In applying this doctrine of substance over form, the [United States Supreme] Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." (*Frank Lyon Co. v. United States (1978) 435 U.S. 561, 573.*) Thus, we focus on the actual rights and benefits acquired, not the labels used. When we consider the economic reality [*761] of a security redemption, it becomes clear Microsoft is correct: "gross receipts" include the entire redemption price.

(11) The key is the similarity between the sale and the redemption of a marketable security. The Board concedes that when an investor sells a marketable security to a third party, the *entire* sale price is includible as gross receipts, just as it would be for the sale of any other tangible or intangible property. But from the perspective of the taxpayer, economically a sale and a redemption are indistinguishable. In the sale of a security one day before maturity, the investor relinquishes the bundle of rights that go with the security in exchange for, let us say, a sale price of 99.98. In a redemption upon maturity, the investor relinquishes the identical bundle of rights on the maturity date for the full par value of 100. From the perspective of the investor's balance sheet, the transactions are identical (the minor price differential aside), notwithstanding that different labels apply. The difference between the transactions exists only with respect to the *other* side of the transaction, that of the recipient: in one case, a third party acquires the same bundle of rights the investor had, and in the other, because the recipient is the original issuer of the security, the security is retired. Because from a tax perspective we are concerned only with the economic activity of the taxpayer/investor, we can discern no reason to treat the two transactions differently. We conclude the full redemption price, like the full sale price, must be treated as gross receipts.

This rule is consistent with the application of "gross receipts" to a wide range of other transactions that include a return of capital. Thus, for example, when a taxpayer enters into a cost plus fixed fee contract, pursuant to which the taxpayer is reimbursed for its outlay of costs and paid a fee in addition, the entire amount received—both the fee and the reimbursed costs—is included in gross receipts. (See *Cal. Code Regs., tit. 18, § 25134, subd. (a)(1)(B).*)[10] When a taxpayer sells off equipment used in its business—a

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[9] A second case relied on by Microsoft, *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (June 2, 1989) [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-740, page 25,549 (*Merrill Lynch*), provides no additional support. In *Merrill Lynch*, the taxpayer sold securities and included the entire sale price in its gross receipts. Thus, the case involved sales, not redemptions. Moreover, the Board did not contest the taxpayer's categorization of the entire price as gross receipts, and so the SBE assumed it to be correct.

[10] All further references to Regulations are to the California Code of Regulations, title 18, unless otherwise indicated.

truck, for example—the entire sale price, not just the sale price less cost of goods and adjustments for depreciation, constitutes gross receipts. (*Id.*, *subd. (a)(1)(F)*.) We see no reason to treat redemptions on maturity differently for gross receipts purposes.

The Board argues, and the Court of Appeal intimated, that differential treatment is justified because in one instance, the sale to a third party, there is a "sale," while in the other there is no sale. This argument promotes form over substance. We care about the nature of the transaction, not the label attached. We use different labels to distinguish a third party sale from a redemption on maturity because, as noted above, for the security's recipient [*762] the transactions have different consequences. From the perspective of the taxpayer/investor, however, they are identical; hence, from the perspective of tax law, they should be treated identically. Moreover, we note that under Regulation *section 25134, subdivision (a)(1)*, gross receipts include payments arising not just from sales but from "transactions and activity in the regular course of" the taxpayer's business as well. Thus, we place no great emphasis on the significance of the label "sale."

The Board further argues that a sale the day before redemption is different because it carries with it an additional risk of loss—the risk the security might be sold for less than the purchase price. The Board, however, fails to explain why this difference would justify treating a sale and redemption differently for gross receipts purposes, nor do we discern any reason it would.

The Board argues that its position is supported by a different source of administrative interpretation than the agency decisions relied on by Microsoft, to wit, Regulation *section 25134, subdivision (a)(1)(A)* , which includes in gross receipts "all interest income." This means, the Board argues, that by negative implication gross receipts exclude a return of principal. The surrounding text demonstrates the error in this interpretation: "Gross receipts for this purpose means gross sales, less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales." (*Ibid.*) This subdivision thus includes interest *in addition to* the principal price for any sale of goods or products. It does not support a reading of gross receipts that includes interest but excludes the principal sale price.

The Board also points to two judicial decisions it contends support its interpretation of gross receipts. (*City of Los Angeles v. Clinton Merchandising Corp. (1962) 58 Cal.2d 675* (*Clinton Merchandising*); *County of Sacramento v. Pacific Gas & Electric Co., supra, 193 Cal. App. 3d 300.*) In *Clinton Merchandising*, we addressed whether a municipal tax on gross receipts should apply to the principal of intracompany loans made within a family of affiliated corporations. We concluded it should not. (*Clinton Merchandising, at p. 681.*) That decision is of little help. We treated repayment of corporate loans between affiliates as the functional equivalent of a principal reimbursing its agent for monies advanced by the agent. Thus, we held that money collected or paid out by an agent on behalf of its principal did not constitute gross receipts. (*Id. at p. 682.*) Here, we are presented not with intracompany loans between Microsoft affiliates, but receipts from investments made with third parties.

In *County of Sacramento v. Pacific Gas & Electric Co., supra, 193 Cal. App. 3d at pages 309-312*, the Court of Appeal addressed whether a [*763] franchise fee assessed against gross receipts should apply to the intracompany use of gas and electricity and concluded it should not because nothing was received. Like *Clinton Merchandising*, *County of Sacramento* involved intracompany transactions in which nothing was received from outside the taxed entity. It sheds no light on the proper understanding of gross receipts in the context of payments received from outside Microsoft.

Finally, the Board asks us to follow out-of-state decisions concluding that gross receipts under the UDITPA apply only to the net difference between sale or redemption price on the one hand, and purchase price on the other. However, we find a split of authority. While many courts have adopted the Board's position,[11] others have adopted Microsoft's.[12] On balance, we find the latter cases better reasoned than the former. The progenitor of the former line of cases, *AT&T, supra, 476 A.2d 800*, rests its holding on the notion that interpreting New Jersey's receipts factor to include all receipts from short-term securities investments would produce "absurd results." (*Id. at p. 802*.) The cases following *AT&T* reason similarly. (See *Walgreen Ariz. Drug Co. v. Ariz. Dept. of Revenue, supra, 97 P.3d at pp. 899-900*; *Sherwin-Williams Co. v. Ind. Dept. of State Revenue, supra, 673 N.E.2d at p. 852*.) There are two problems with these "absurd results" cases. First, they do violence to the language of the statutes they interpret. In each case, the same language governs both sales of off-the-shelf products and sales of securities. *AT&T* and its progeny offer no explanation why in one instance that language should require inclusion of gross proceeds and in the other require inclusion of only net proceeds. Second, they overlook the fact no absurd result is required. As the Tennessee Court of Appeals has explained: "With deference to sister jurisdictions, this court is reluctant to apply the same 'absurd result standard.' An absurd result is not necessary for, in spite of the plain language of [the sales factor statute], the commissioner may opt for a different scheme of assessment whenever the resulting apportionment does not fairly represent the taxpayer's business in this state." (*Sherwin-Williams Co. v. Johnson, supra, 989 S.W.2d at p. 715*.) The UDITPA contains an equitable relief provision so that, in cases where application of the statutory sales definition results in excessive distortion, an "absurd result" may be avoided. (See *§ 25137*.) [*764]

Nor do we find a legislative consensus over whether in a redemption of securities the full or net price constitutes gross receipts. Some states retain the same partially

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[11] See *Walgreen Ariz. Drug v. Ariz. Dept. of Rev. (Ariz.Ct.App. 2004) 97 P.3d 896, 899-902*; *Sherwin-Williams Co. v. Dept. of Rev. (Ind.Tax 1996) 673 N.E.2d 849, 851-853*; *American Tel. & Tel. Co. v. Taxation Div. Director (App.Div. 1984) 194 N.J. Super. 168 (AT&T)*.

[12] See *American Tel. & Tel. Co. v. Tax Appeal Bd. (1990) 241 Mont. 440*; *Sherwin-Williams Co. v. Dept. of Revenue (2000) 329 Ore. 599*; *Sherwin-Williams Co. v. Johnson (Tenn.Ct.App. 1998) 989 S.W.2d 710, 712-715*; *United States Steel Corp. v. Wisconsin Dept. of Revenue* (Appeals Com. 1985) 1985 Wis. Tax Lexis 89, *23-*24.

ambiguous language as California.[13] Other states expressly acknowledge that redemptions generate gross receipts, then exclude them by statute.[14] Still other states define gross receipts in a way that expressly includes only the net gain from redemptions or excludes them entirely.[15] The lack of consensus is even clearer when we consider that some of the foregoing statutes have been amended since 1991, the tax year at issue here. During that year, certainly no legislative consensus obtained as to the treatment of redemptions. 14

This legislative and judicial division of opinion offers no persuasive reason to reject the interpretation of gross receipts most naturally suggested by the text of the statute, the economic reality of sales and redemptions, and agency interpretation. In any event, there is another way to achieve uniformity, as we discuss in part II., *post*.

II. *Section 25137: Fair Representation of Microsoft's Business Activity*

A. *The scope of section 25137*

(12) Our conclusion that the full redemption price constitutes gross receipts does not end matters. The UDITPA includes a relief provision for dealing with any unreasonable calculations rote application of the three-factor formula may yield. *Section 25137* provides: "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: [¶] (a) Separate accounting; [¶] (b) The exclusion of any one or more of the factors; [¶] (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or [¶] (d) The employment of any other method to effectuate an [*765] equitable allocation and apportionment of the taxpayer's income." Here, the Board argues that inclusion of the full price does not fairly represent the extent of Microsoft's business activity in California. As the party invoking *section 25137*, the Board has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable. (See *§ 25137*; *Colgate-Palmolive Co. v. Franchise Tax Bd. (1992) 10 Cal.App.4th 1768, 1786*; *In the Matter of the Appeal of Crisa Corp.* (June 20,

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[13] E.g., *Idaho Code section 63-3027, subdivision (a)(5)*; *Kentucky Revised Statutes Annotated section 141.120, subsection (1)(g)*; *Montana Code Annotated section 15-31-302, subsection (5)*; *New Mexico Statutes Annotated section 7-4-2, subdivision (F)*; *North Dakota Century Code section 57-38.1-01, subsection (6)*; *Utah Code Annotated section 59-7-302, subdivision (5)*.

[14] E.g., *Florida Statutes Annotated section 220.15, subsection (5)(a)*; Massachusetts General Laws, chapter 63, section 38, subdivision (f); *Oregon Revised Statutes section 314.665, subdivision (6)(a)*; *72 Pennsylvania Statutes section 7401, subdivision (3)2(a)(1)(E)*.

[15] E.g., *Colorado Revised Statutes section 39-22-303, subdivision (4)(b)*; *Connecticut General Statutes section 12-218, subsection (c)(2)(C)(3)*; *North Carolina General Statutes section 105-130.4, subdivision (a)(7)(d)*; *Rhode Island General Laws section 44-11-14, subdivision (a)(2)(v)*; *Wisconsin Statutes section 71.04, subdivision 7(f)(5)*.

2002) [2000-2003 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 403-295, pp. 30,352, 30,358 (*Crisa Corp.*).)[16] We agree with the Court of Appeal that the Board has done so.

In language we find persuasive, the SBE has interpreted *section 25137* to allow correction of distortions arising from the operation of a large corporate treasury department. In *Pacific Telephone & Telegraph*, *supra*, Cal.Tax Rptr. (CCH) ¶ 205-858, page 14,907-36, as here, the taxpayer corporate group maintained an out-of-state treasury department that invested in short-term securities. These investments produced less than 2 percent of the company's business income, but 36 percent of its gross receipts.[17] The SBE described the sales factor as intended to "reflect the markets for the taxpayer's goods or services" and asked whether inclusion of all investment receipts would serve that function. (*Id.* at p. 14,907-43.) It answered in the negative: "The inclusion of this enormous volume of investment receipts substantially overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made by all other states, including California, which supply the markets for the . . . services provided by [taxpayer]. Moreover, we are unable to accept, even for a moment, the notion that more than 11 percent of [taxpayer's] entire unitary business activities should be attributed to *any* single state solely because it is the center of working capital investment activities that are clearly only an incidental part of one of America's largest, and most widespread, businesses. We conclude, therefore, that UDITPA's normal provisions 'do not fairly represent the extent of the taxpayer's business activity in this state,' and that [the Board] is authorized, under section [*766] *25137*, to require a deviation from the normal rules." (*Ibid.*) If one substitutes "Washington" for "New York" and "24 percent" for "11 percent," these words are equally applicable to this case.

More recently, in *Crisa Corp.*, *supra*, Cal.Tax Rptr. (CCH) ¶ 403-295, page 30,352, the SBE reiterated that operation of a large treasury department unrelated to a taxpayer's main business is a paradigmatic example of circumstances warranting invocation of *section 25137*. It included in a nonexclusive list of such circumstances that "[o]ne or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. For example, the taxpayer continuously reinvests a large pool of 'working capital,' generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services provided by the taxpayer as its primary business." (*Crisa Corp.*, at p. 30,360.)

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[16] Both Microsoft and amicus curiae General Motors Corporation erroneously suggest the Board must show " 'the income attributed to that State is in fact "out of all appropriate proportions to the business transacted ... in that State," [citation], or has "led to a grossly distorted result," [citation].' " (*Container Corp., supra, 463 U.S. at p. 170*.) This is the *constitutional* standard for striking down a tax under the due process and commerce clauses. However, *section 25137*'s application is not confined to correcting unconstitutional distortions. (See *Twentieth Century-Fox Film Corp. v. Department of Revenue (1985) 299 Ore. 220* [interpreting identical UDITPA relief provision].) The Board need only satisfy the lesser statutory standard quoted in the text.

[17] By comparison, the distortional impact is even greater here; Microsoft's short-term investments produced less than 2 percent of the company's income, but 73 percent of its gross receipts.

In contrast, in *Merrill Lynch*, *supra*, Cal.Tax Rptr. (CCH) ¶ 401-740, page 25,549, the SBE rejected application of *section 25137*. The taxpayer bought and sold securities as its principal business, both as an agent/broker (throughout the country) and as a principal/underwriter (primarily in New York), and included the underlying cost of the securities in its gross receipts. (*Merrill Lynch*, at p. 25,551.) The Board objected to inclusion of full gross receipts for securities bought as a principal/underwriter, but the SBE rejected that argument. The taxpayer's sale of securities on its own account was not qualitatively different from its main business, and the resulting quantitative difference between the standard formula and the Board's proposed formula was on the order of 23 to 36 percent. (*Id.* at p. 25,554.) This case is analogous to *Pacific Telephone & Telegraph*, *supra*, Cal.Tax Rptr. (CCH) ¶ 205-858, page 14,907-36, not *Merrill Lynch*; here, Microsoft's treasury functions are qualitatively different from its principal business, and the quantitative distortion from inclusion of its investment receipts is substantial.

A salutary effect of the conclusion that *section 25137* applies here is that it achieves uniformity, a central goal of the UDITPA. (See *Hoechst, supra, 25 Cal.4th at p. 526*; *§ 25138* [UDITPA "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it"]; Keesling & Warren, *California's Uniform Division of Income for Tax Purposes Act, Part I* (1968) 15 UCLA L.Rev. 156, 156.) While there is a nationwide split over whether the return of investment capital is included in gross receipts, those states that do include it and have addressed the further [*767] application of UDITPA's relief provision uniformly allow use of that provision to ameliorate resulting distortions.[18]

In *Sherwin-Williams Co. v. Johnson, supra, 989 S.W.2d 710*, the taxpayer's Ohio treasury department generated short-term investment receipts that exceeded the gross receipts from its principal paint business. The court concluded that, though under the plain language of the UDITPA, as adopted by Tennessee, these investment receipts were gross receipts, UDITPA's relief provision allowed the State of Tennessee to exclude the return of capital from investment receipts in order to cure distortion and fairly represent the taxpayer's activities in and out of state. (*Id. at pp. 715-716*; Tenn. Code. Ann. § 67-4-812, subsection (a) [parallel provision to *Cal. Rev. & Tax. Code, § 25137*].)

Similarly, in *American Telephone & Telegraph Co. v. State Tax Appeal Bd., supra, 787 P.2d 754*, the Montana Supreme Court upheld application of UDITPA's relief provision to short-term investment receipts generated by the taxpayer's New York treasury department. Though these receipts fell within the statutory definition of "sales" as "all gross receipts," their inclusion would skew the results of the standard formula and underallocate income to states outside New York. Consequently,

[18] Amicus curiae the Multistate Tax Commission, an administrative agency charged with promoting uniform state income tax laws, argues that the overwhelming majority of states exclude from gross receipts the return of capital from short-term investment receipts, but do so in different ways, some by excluding it from the definition of gross receipts, others by concluding that inclusion can be distortive, and urges us to adopt either approach to achieve uniformity. We adopt the latter approach.

application of the relief provision was appropriate. (*Id. at pp. 757-759*; see *Mont. Code Ann. § 15-31-312* [parallel provision to *Cal. Rev. & Tax. Code, § 25137*].)

The SBE and these sister-state courts implicitly recognize that the problem arising from inclusion of the full sale or redemption price of a short-term security is not that the full price is not gross receipts. Rather, the problem is one of scale: short-term securities investments involve margins (i.e., differences between cost and sale price) that may be several orders of magnitude different than those for other commodities. When a short-term marketable security is sold or redeemed, the margin will often be, in absolute terms, quite small (though of course the *annualized* returns may well be perfectly respectable). Microsoft's treasury activities provide a perfect illustration. Its 1991 redemptions totaled $5.7 billion, while its income from those investments totaled only $10.7 million—a less than 0.2 percent margin. In contrast, its nontreasury activities produced income of $659 million and gross receipts of $2.1 billion, for a margin of more than 31 percent, roughly 170 times greater. [*768]

This situation, when one mixes apples—the receipts of low-margin sales—with oranges—those of much higher margin sales—presents a problem for the UDITPA. The UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state. This can be seen by examining the statutory formula. Recall the general formula:

CA Property/Total Property + CA Payroll/Total Payroll + CA Sales/Total Sales/3 × Total Income = Taxable Income

(*Ante*, fn. 5; former § 25128, added by Stats. 1966, ch. 2, § 7, p. 179, repealed by Stats. 1993, ch. 946, § 1, p. 5441.) Setting the payroll and property factors to zero in order to focus on the role of the sales factor gives the following:

1/3 × CA Sales/Total Sales × Total Income = Taxable Income

which is the same as

1/3 × Total Income/Total Sales × CA Sales = Taxable Income

Because (Total Income/Total Sales) is essentially a company's average worldwide margin, this formula in effect estimates the income attributable to a state by multiplying the average worldwide margin by the in-state receipts to approximate the in-state income.

(13) This approximation works well enough in the absence of huge variations in state-to-state margins. It also provides a necessary antidote to strictly geographic accounting that may overlook the interdependence of operations across state lines or be susceptible to manipulation. However, modern corporate treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation's business pose a problem. Under the UDITPA, the operations and gross receipts of a treasury department are properly attributed to the state where the department operates—here, Washington. (See *§ 25136*.) The nature of these operations means that Microsoft's true margin for its Washington operations will

be much, much lower than the worldwide average, and its margin for every other state will be much higher than the worldwide [*769] average.[19] Thus, rotely applying the worldwide average margin (Total Income/Total Sales) to each state's gross receipts would result in severely underestimating the amount of income attributable to every state *except* the state hosting the treasury department, for which state the income would be correspondingly severely overestimated. In such circumstances, rote application of the standard formula does not fairly represent the extent of a taxpayer's activity in each state, except in the rare instance when corresponding imprecision in the payroll and property factors may happen to balance out this distortion.[20]

Microsoft argues that comparison of the income and receipts from its short-term investments in marketable securities against those from the rest of its business activities is a separate accounting analysis foreclosed by our and the United States Supreme Court's previous decisions. We disagree. The analysis suffers neither of the vices we and the United States Supreme Court have condemned; it involves neither a separate jurisdiction-by-jurisdiction accounting that overlooks the interdependence of operations in different jurisdictions (*Container Corp., supra, 463 U.S. at p. 181*; *John Deere Plow Co. v. Franchise Tax Bd. (1951) 38 Cal.2d 214, 225-227)* nor a separate entity-by-entity accounting that ignores the interdependence (and non-arm's-length dealing) between members of the unitary group (*Butler Bros. v. McColgan (1942) 315 U.S. 501, 507-508*; *Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at pp. 479-483*). Rather, the analysis simply underscores the qualitative recognition that the different nature of short-term investments means that mixing short-term gross receipts with gross receipts from other types of business activity involves an apples-to-oranges comparison that may require correction. [*770]

(14) Microsoft further argues that *Revenue and Taxation Code section 25137* can apply only to unique, nonrecurring situations. (See *Regs., § 25137, subd. (a)* ["[*Revenue and Taxation Code s]ection 25137* may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions"].) The frequency with which the issue of large corporate treasury department receipts arises, it contends, renders the issue nonunique and disqualifies this situation from treatment under

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[19] As noted above, Microsoft's 1991 margin for its Washington treasury operations was 0.2 percent, and its margin for its nontreasury operations was more than 31 percent, roughly 170 times greater. Its average worldwide margin (including both elements) was 8.6 percent ($670 million/$7.8 billion).

[20] In an article written shortly after California adopted the UDITPA, John S. Warren, California's representative to the National Conference of Commissioners on Uniform State Laws, which approved the UDITPA, recognized precisely this problem with the sales factor. He posited a scenario in which a company has $1 million in income that, under ordinary application of the three-factor formula, would be split equally between two states, X and Y. It sells a building in state X for $1 million, but the sale generates no income. Inclusion of the $1 million in receipts is technically required by UDITPA's explicit definition of sales and will greatly increase attribution of income to state X, even though the sale has had little or no effect on the company's actual income. In this scenario, Warren and co-author Frank Keesling acknowledged, strict application of the *section 25120, subdivision (e)* sales definition distorts the proper attribution of income. (Keesling & Warren, *California's Uniform Division of Income for Tax Purposes Act, Part II* (1968) 15 UCLA L.Rev. 655, 669-670 (hereafter Keesling & Warren II).)

Revenue and Taxation Code section 25137. Again, we disagree. Systematic oversights and undersights are equally a matter of statutory concern. Nothing in the language of Regulation *section 25137* persuades us otherwise. While *Revenue and Taxation Code section 25137* "ordinarily" applies to nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains an inquiry into whether the formula "fairly represent[s]" a unitary business's activities in a given state, and when it does not, the relief provision may apply. (See *Crisa Corp.*, *supra*, Cal.Tax Rptr. (CCH) ¶ 403-295, at pp. 30,358-30,360; *Pacific Telephone & Telegraph*, *supra*, Cal.Tax Rptr. (CCH) ¶ 205-858, p. 14,907-36; *Union Pacific Corp. v. State Tax Com'n (Idaho 2004) 139 Idaho 573 [83 P.3d 116, 120-121]* [applying relief provision to recurring situation, sales of accounts receivables].)[21]

Moreover, as the Board correctly notes, declining to apply UDITPA's relief provision to this type of situation would create a significant loophole exploitable through subtle changes in investment strategy. By shifting investments to shorter and shorter maturities, a unitary group could reduce its state tax liability to near zero, particularly if it placed its treasury department in a state that statutorily excluded the return of investment capital from gross receipts.

B. *Application*

The stipulated evidence establishes that mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other business activity seriously distorts the standard formula's attribution of income to each state. These transactions generated minimal income (just [*771] under 2 percent of Microsoft's business income for 1991) but enormous receipts (approximately 73 percent of gross receipts for 1991). Their inclusion in the standard formula would result in reducing roughly by half the estimated income attributed to California, and likely every state other than Washington, depending on property and payroll factors. The distortion the Board has shown here is of both a type and size properly addressed through invocation of *section 25137*; application of the standard formula does not fairly represent the extent of Microsoft's business in California. Like the Court of Appeal, we hold the trial court's contrary conclusion was not supported by substantial evidence.[22]

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[21] Commentators share this view. Professor William J. Pierce, the original drafter of the UDITPA, viewed the sale of intangibles as a problem area and acknowledged, "[T]here are many unusual fact situations connected with this type of income and probably the general provisions of [UDITPA] Section 18 [the relief provision, codified in *section 25137*] should be utilized for these cases." (Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747, 780.) More generally, he saw section 18 of the UDITPA as necessary to deal with potentially unconstitutional results, but also as a provision that gave "both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved." (Pierce, at p. 781; see also Keesling & Warren II, *supra*, 15 UCLA L.Rev. at p. 675 & fn. 81.)

[22] Microsoft argues any distortion resulting from inclusion of redemption gross receipts is partially counterbalanced by a distortion resulting from the failure of the standard formula to include intangible property in the property factor. However, Microsoft conceded at trial it was not challenging the Legislature's (and UDITPA's) decision to disregard intangible property when estimating business activity in each state (see *§ 25129*)

(15) This leaves only the question whether the Board's proffered alternative is a reasonable one. The Board proposes to include in the denominator of the sales factor only the net receipts from Microsoft's redemptions. Because the net receipts are so small in comparison with Microsoft's nontreasury income and receipts, the inclusion of net receipts here is reasonable. If the Board's proposal is reasonable, we are not empowered to substitute our own formula. (See *§ 25137*; *McDonnell Douglas Corp. v. Franchise Tax Bd. (1968) 69 Cal.2d 506, 514-515.*) We caution, however, that in other cases the Board's approach may go too far in the opposite direction and fail the test of reasonableness. By mixing net receipts for a particular set of out-of-state transactions with gross receipts for all other transactions, it minimizes the contribution of those out-of-state transactions to the taxpayer's income and exaggerates the resulting California tax.[23] If, unlike here, reasury operations provide a substantial portion of a taxpayer's income, this exaggeration may result in an apportionment that does not fairly represent California business activity.

In closing, we note the Court of Appeal's argument that policy reasons favor systematic exclusion of the return of capital from investment redemptions, rather than a requirement that the Board document distortions resulting [*772] from application of the standard formula on a case-by-case basis. Absent a global redefinition of gross receipts to exclude such returns, smaller distortions insufficient to trigger a reappraisal under *section 25137* may slip through the cracks, resulting in underestimation of the tax owed California. This concern may well be valid. Recognizing this problem, numerous other state legislatures have amended their respective income apportionment statutes to expressly exclude investment returns of capital from the definition of gross receipts.[24] Amicus curiae the Multistate Tax Commission has proposed model regulations to likewise exclude investment returns of capital from gross receipts.[25] The Legislature is free to follow these leads.[26] In the absence of legislative action, however, we are not free judicially to amend the UDITPA to achieve this result.

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and, even if we were to assume the omission of intangible property could be a relevant offset, Microsoft failed to establish the extent of any resultant distortion. The Board had to establish a source of distortion; having done so, it did not have to disprove the existence of every other conceivable source of distortion.

[23] Consider two sales: a sale for $10 that yields $1 in income in state X, and a sale for $10,000 that yields $1 in income in state Y. If one includes gross receipts from both sales, one concludes that state Y's contribution to sales is 1,000 times greater than state X's. On the other hand, if one corrects for this by including only the net receipts from the second sale—the $1—one concludes that state X's contribution to sales is 10 times greater than state Y's contribution. The truth doubtless lies somewhere in between.

[24] E.g., *Florida Statutes Annotated, section 220.15, subsection (5)(a)*; Massachusetts General Laws, chapter 63, section 38, subdivision (f); *Oregon Revised Statutes, section 314.665, subdivision (6)(a)*; *72 Pennsylvania Statutes, section 7401, subdivision (3)2(a)(1)(E)*; *Wisconsin Statutes, section 71.04, subdivision 7(f)(5)*.

[25] Multistate Tax Com., Model Regulations, regulations IV.2(a)(5) (excluding return of capital from investment redemption receipts), IV.18(c)(4) (excluding return of capital from investment sale receipts).

[26] Indeed, legislation has been introduced that would prospectively change the treatment of investment returns of capital under the UDITPA. (See Assem. Bill No. 1037 (2005-2006 Reg. Sess.) as amended Aug. 7, 2006, § 1.)

Disposition

For the foregoing reasons, we affirm the judgment of the Court of Appeal.

Lanco, Inc., v. Director, Division of Taxation (New Jersey)

379 N.J. Super. 562, 879 A.2d 1234 (*2005*), aff'd 188 N.J. 380 (2006), cert. den. (2007)

The opinion of the court was delivered by Stern, P.J.A.D.

This case presents the important question, as the Tax Court stated it, of "whether New Jersey may constitutionally subject a foreign corporation to the Corporation Business Tax (*N.J.S.A. 54:10A-1 et seq.,* 'the CBT'), where the corporation has no physical presence in the state and derives income from a New Jersey source only pursuant to a license agreement with another corporation that conducts a retail business here." *Lanco, Inc. v. Director, Div. of Taxation, 21 N.J. Tax 200, 203 (Tax 2003).*

Defendant, Director of the Division of Taxation, appeals from an order of January 9, 2004, entering judgment for plaintiff taxpayer "since it does not have a taxable nexus in the State which would subject it to New Jersey's Corporate Business Tax." Plaintiff, which licenses intellectual property (trademarks, trade names and service marks) to Lane Bryant, a clothing retailer, has no real or personal property or personnel in the State, and the Tax Court, in a published opinion, held that because plaintiff was not physically present in New Jersey, subjecting it to the tax would violate the *Commerce Clause of the federal constitution. Lanco, supra, 21 N.J. Tax at 214.* On this appeal the Director argues that Lanco [*564] derived receipts from sources in the State, thereby making it subject to the tax, and that "there are no constitutional impediments to application of the corporation business tax to plaintiff given its substantial nexus to New Jersey" because there was no violation of the *due process clause* (which is not contested before us)[27] or the Commerce Clause (which is the critical issue contested on the appeal). Thus, the critical issue is whether the taxpayer must have a physical presence in the state in order to constitute the required "substantial nexus" necessary to satisfy the Commerce Clause under *Quill Corp. v. North Dakota, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992)*, which applied that test and held physical presence was necessary in the context of a sales and use tax.

The Tax Court succinctly stated the relevant facts as follows:

> Plaintiff Lanco, Inc., ("Lanco") is a Delaware corporation that owns certain intangible property (trademarks, trade names and service marks). The parties have

[27] We need not comment on the Tax Court's thorough and well-reasoned analysis of the Due Process issue, *see Lanco, supra, 21 N.J. Tax at 214-17*, as plaintiff does not endeavor to defend the judgment on due process grounds.

> stipulated that Lanco has no offices, employees, or real or tangible property in New Jersey. Lanco licenses Lane Bryant, Inc., ("Lane Bryant") to utilize the intangible property in the conduct of Lane Bryant's retail operations, including those in New Jersey, and in return receives royalty payments from Lane Bryant. Lanco and Lane Bryant are affiliated corporations, but the common ownership is not material to the constitutional issue concerning the determination by the defendant, Director of the Division of Taxation ("Director"), that activity under the license agreement makes Lanco subject to taxation in New Jersey. It is the determination that Lanco is obliged to file under the CBT, rather than the calculation of tax claimed to be due, that is contested.

[*Lanco, supra, 21 N.J. Tax at 203* (footnote omitted).]

In *Quill Corp. v. North Dakota, 504 U.S. 298, 301, 112 S.Ct. 1904, 1907, 119 L.Ed.2d 91, 99 (1992)*, the State of North Dakota sought to impose a duty to collect a use tax on "an out-of-state mail-order house that ha[d] neither outlets nor sales representatives in the State." Quill sold office furniture by mail order catalogue and advertising, and delivered it by mail or common carrier. The Court held that, while the *Due Process Clause* [*565] "minimum contacts" jurisprudence did not bar the state from requiring Quill, as the seller, to collect a use tax, there was an insufficient nexus under the Commerce Clause to permit such a tax. *Quill, supra, 504 U.S. at 313, 112 S.Ct. at 1913-14, 119 L.Ed.2d at 101.* According to Justice Stevens, "[t]he two standards are animated by different constitutional concerns and policies":

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.

[*Quill, supra, 504 U.S. at 312, 112 S.Ct. at 1913, 119 L.Ed.2d at 106.*]

The Court discussed the four factors it first enunciated in *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326, 331 (1977)*, to determine whether a state tax will withstand a commerce clause challenge:

> Under *Complete Auto's* four-part test, we will sustain a tax against a Commerce Clause challenge so long as the "tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."

[*Quill, supra, 504 U.S. at 311, 112 S.Ct. at 1912, 119 L.Ed.2d at 105.*]

In discussing the four factors the *Quill* Court explained that "[t]he second and third parts of that analysis, which require fair apportionment and non-discrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce." *Quill, supra, 504 U.S. at 313, 112 S.Ct. at 1913, 119 L.Ed.2d at 107.* "The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Ibid.* The Court stated:

> Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, . . . a corporation may have the [*566] "minimum contacts" with a taxing State as required by the *Due Process Clause*, and yet lack the "substantial nexus" with that State as required by the Commerce Clause.

[*Quill, supra, 504 U.S. at 313, 112 S.Ct. at 1913-14, 119 L.Ed.2d at 107* (footnote omitted).]

Accordingly, for purposes of the Commerce Clause, the *Quill* court maintained the "bright-line, physical-presence requirement [established by *National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967)*, for imposition] of sales and use taxes." *Quill, supra, 504 U.S. at 317, 112 S.Ct. at 1916, 119 L.Ed.2d at 110*.[28]

The Director argues that "the rationale for abandoning a physical-presence requirement for *Due Process Clause* purposes recognizes that businesses engage in significant levels of commercial activity in a state without ever 'setting foot' there," and businesses foresee being subject to state tax laws as a result of commercial activity directed at a particular state. The Director further contends that "[t]here is no principled reason why the Commerce Clause should require a corporation's physical presence to justify State taxation . . . provided the State can establish that the corporation derives significant benefits from continued and deliberate economic activity in the taxing State." The Director also emphasizes that *Quill* involved vendors whose only connection with customers was by common carrier or the United States mail, but here there is a long-term contractual relationship with a related corporation that operates retail-clothing outlets throughout New Jersey.

Defendant further asserts that the agreement between plaintiff and Lane Bryant "promotes increased retail purchases of merchandise" at stores in New Jersey, and that "growth in retail sales burdens [New Jersey] by increasing traffic, requiring police and [*567] fire protection, and imposing demands on the labor pool."[29] Defendant therefore argues that this case is distinguishable from *Quill* and *Bellas Hess*, on which *Quill* relied, where they merely sent mail order catalogs into a state without obtaining the benefits and protection of state services and labor which derive from its physical presence. In this case, the Director maintains that plaintiff and its related entity, Lane Bryant, enjoy numerous benefits provided by New Jersey including: (1) "protection afforded by the New Jersey judiciary to [plaintiff's] rights under the licensing

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[28] As will be further developed hereinafter, a careful reading of *Quill* reflects the express limitation for sales and use taxes as a matter of *stare decisis* in light of *Bellas Hess*, even though "the *Bellas Hess* rule appears artificial at its edges." *Quill, supra, 504 U.S. at 315, 112 S.Ct. at 1914, 119 L.Ed.2d at 108*.

[29] Many facts were stipulated, and we rely on the Tax Court's recitation of facts. Because we reverse the Tax Court on the Commerce Clause holding (and merely address the fundamental issue presented), we will allow further development before that court of any remaining relevant or material factual contest which may affect the taxability, determination of apportionment of income attributable to New Jersey, or tax for any particular tax year in question.

agreement and its right to protect its trademarks and service marks"; (2) maintenance of New Jersey's highway system and production of an "educated workforce"; and (3) "police, fire and judicial protection" of the physical property upon which Lanco's trademarks are used, even if owned by Lane Bryant.

We agree with the Director that *Quill* does not apply to taxes other than sales and use taxes, *Quill, supra, 504 U.S. at 314, 112 S.Ct. at 1914, 119 L.Ed.2d at 108* (stating "[w]e have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes . . . ."), and that the Corporation Business Tax may be constitutionally applied to impose a tax on plaintiff's income from licensing fees attributable to New Jersey.

In *Geoffrey Inc. v. South Carolina Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13, 18, cert. denied, 510 U.S. 992, 114 S.Ct. 550, 126 L.Ed.2d 451 (1993)*, the Supreme Court of South Carolina noted the distinction between the taxes involved in *Quill* and income taxes:

> It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus. [*568] *American Dairy Queen [v. Taxation & Revenue Dep't], 93 N.M. [743] at 747, 605 P.2d [251] at 255 (1979). See* also *Int'l Harvester Co. v. Wisconsin Dep't of Taxation, 322 U.S. 435, 441-442, 64 S.Ct. 1060, 1063-64, 88 L.Ed. 1373, 1379 (1944)* (a state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are within the protection of the state and entitled to the numerous other benefits which it[] confers); *J. Hellerstein & W. Hellerstein, supra,* at 6.08 (any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present). A taxpayer who is domiciled in one state but carries on business in another is subject to taxation measured by the value of the intangibles used in his business. *Curry[v. McCanless], 307 U.S. [357] at 368, 59 S.Ct. [900] at 906, 83 L.Ed. [1339] at 1348 (1939).* We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a "substantial nexus" with South Carolina.

[*Geoffrey, Inc., supra, 437 S.E.2d at 18.*][30]

Accordingly, the South Carolina Supreme Court upheld the income tax imposed against the owner of trade names and trademarks for which Toys 'R Us paid a license fee for use in South Carolina. *Id. at 17.*

The recent and, in our view, the more persuasive authority leads us to join the jurisdictions which have followed *Geoffrey* and to uphold the tax. This is particularly true because, as the Tax Court stated, "the CBT statute is clearly intended to reach foreign corporations engaged in business activities within the state to the full extent that is constitutionally permissible." *Lanco, supra, 21 N.J. Tax at 214*, citing *Roadway Express, Inc. v. Director, Div. of Taxation, 50 N.J. 471, 483, 236 A.2d 577 (1967), appeal*

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[30] In *Geoffrey* there was no commerce clause challenge based on the discrimination or unfair apportionment prongs. *Geoffrey* also rejected a due process challenge and found Geoffrey purposefully directed its activities to South Carolina by allowing the use of trademarks and intangible assets in the state. *Id. at 17.*

dismissed, 390 U.S. 745, 88 S.Ct. 1443, 20 L.Ed.2d 276 (1968). See also Bendix Corp. v. Director, Div. of Taxation, 125 N.J. 20, 592 A.2d 536 (1991) (assessment of capital gains tax on sales by corporation doing business in multiple states), *rev'd, sub nom. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992).* [*569]

In *A & F Trademark, Inc. v. Tolson, 167 N.C. App. 150, 605 S.E.2d 187 (2004), petition for cert. filed, __ U.S. __, 126 S. Ct. 353, 163 L.Ed.2d 62, 73 U.S.L.W. 3719* (U.S. 2005), decided since the Tax Court's opinion in this case, the North Carolina Court of Appeals upheld the assessment of corporate franchise and income taxes against wholly-owned, non-domiciliary subsidiary corporations of Limited, Inc. *Id. at 192-93.* Like the plaintiffs in the case before us, the North Carolina taxpayers were related to a clothing retailer with stores in North Carolina and contended "that the presence of their intangible property in North Carolina [as a result of license fees paid for use of trademarks] is irrelevant in light of the lack of physical presence of offices, facilities, employees and real or tangible property," and that the United States Supreme Court's opinion in *Bellas Hess* required a finding that the tax sought to be imposed by North Carolina violated the Commerce Clause. *Id. at 193.* Specifically, the taxpayers asserted that "they did not have a substantial nexus with North Carolina because they have no physical presence in [the] State." *Ibid.*

The North Carolina Court of Appeals rejected the argument because "[b]oth *Bellas Hess* and *Quill* involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state." *Ibid.* According to the North Carolina Court of Appeals, the Supreme Court's decision in *Bellas Hess*, "'stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause'" to support the tax, *ibid.* (quoting *Quill, supra, 504 U.S. at 311, 112 S.Ct. at 1912, 119 L.Ed.2d at 106*), and *Quill* ultimately concluded that, "for purposes of sales and use taxes assessed against vendors whose only contact with a state is by mail or common carrier, the substantial nexus prong of *Complete Auto* could appropriately be determined by a 'bright-line, physical presence requirement.'" *Id. at 194*, quoting *Quill, 504 U.S. at 317, 112 S.Ct. at 1916, 119 L.Ed.2d at 110.* [*570]

The North Carolina Court of Appeals stated three reasons for declining to adopt the broader reading of *Quill* as requiring a physical presence for income tax purposes. *Id. at 194-95.* "First, the tone in the *Quill* opinion hardly indicates a sweeping endorsement of the bright-line test it preserved, and the Supreme Court's hesitancy to embrace the test certainly counsels against expansion of it." *Id. at 194.* This was because in its discussion of the Commerce Clause, the Supreme Court noted that "while *Bellas Hess* did not conflict with recent Commerce Clause cases, 'contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.'" *Ibid.* (quoting *Quill, supra, 504 U.S. at 311, 112 S.Ct. at 1912, 119 L.Ed.2d at 105*). Stated differently, "recent Commerce Clause decisions .. . signaled a 'retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible substantive approach.'" *Ibid.* (quoting *Quill, 504 U.S. at 314, 317, 112 S.Ct. at 1914, 1915, 119 L.Ed.2d at 107, 110*). According to the North Carolina Court of Appeals:

> The [United States Supreme] Court further observed the physical-presence test, though offset by the clarity of the rule, was "artificial at its edges." *Quill, 504 U.S. at 315, 112 S.Ct. at 1914, 119 L.Ed. 2d at 108.* In addition, the Court twice noted that in other types of taxes, it had never articulated the same physical-presence requirement adopted in *Bellas Hess, see Quill, 504 U.S. at 314 and 317, 112 S.Ct. at 1914 and 1915, 119 L.Ed.2d at 108 and 110*, but cautioned that the failure to expand the *Bellas Hess* rule established for sales and use taxes to other types of taxes did not imply that the *Bellas Hess* rule as applied to sales and use taxes was vestigial or disapproved. *Id.* Nonetheless, the Court's choice to abstain from rejecting the *Bellas Hess* rule for sales and use taxes fails to argue persuasively that the rule should, for lack of rejection, be augmented to cover other types of tax. While the Supreme Court may ultimately choose to expand the scope of the physical-presence test reaffirmed in *Quill* beyond sales and use taxes, its equivocal reaffirmation of that test does not readily make that choice self-evident.

[*A & F Trademark, supra, 605 S.E.2d at 194.*]

The North Carolina court in *A & F Trademark* further stated that the retention of the *Bellas Hess* test in *Quill* was based on the principle of *stare decisis* and the "substantial reliance" on the physical-presence test, which had "become part of the basic framework of a sizable industry." *Ibid.* (quoting *Quill, supra, 504 U.S. at 317, 112 S.Ct. at 1916, 119 L.Ed.2d at 110*). The North Carolina [*571] court concluded that it "need look no further than the language in *Quill* to summarily dispense with the possibility that *stare decisis* plays an analogous role" in a case involving neither the use or sales tax because the Supreme Court had twice expressed that the bright-line, physical-presence requirement of *Bellas Hess* "had not been adopted in other forms of taxation." *Ibid.* Furthermore, the court dismissed the possibility that analogous substantial reliance--as discussed in *Quill*--existed in the present case "since the physical-presence requirement has never been established by judicial precedent for other forms of taxation," and the North Carolina form of taxation was relatively new. *Ibid.*

Finally, *A & F Trademark* relied on Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill, 8 State Tax Notes 671, 676 (1995)*, and found "important distinctions between sales and use taxes [as compared to] income and franchise taxes 'that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test'" for taxation beyond the use and sales taxes. *A & F Trademark, supra, 605 S.E.2d at 194-95.* The court quoted the Hellerstein article to the effect that the "'[United States]' Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is not essential to the state's income tax on income of a nonresident."' *Id. at 194-95* (quoting *Hellerstein, supra*, at 676).

Thus, the North Carolina court in *A & F Trademark* followed the determinationin *Geoffrey* which our Tax Court rejected, and concluded:

> [W]e reject the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, we hold that under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause. *Accord Geoffrey, 437 S.E.2d at 18* (holding that "by licensing intangibles [to Toys 'R Us, an affiliated operating store,] for use in [South Carolina] and deriving income from their use [t]here, Geoffrey ha[d] a 'substantial nexus' with South Carolina"); *Kmart [Properties, Inc. v. Taxation and Revenue Dep't of New Mexico, 2006 NMCA 26, 131 P.3d 27, 33, 2001 N.M. App. LEXIS 133] (N.M.Ct.App., 2001)* (holding that "the use of KPI's [the wholly-owned trademark [*572] holding company licensor] marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishe[d] a sufficient nexus between that income and the legitimate interests of the state and justifie[d] the imposition of a state income tax").

[*A & F Trademark, supra, 605 S.E.2d at 195.*]

Of particular interest, the court addressed this very case and stated:

> We are also cognizant of the holding of the New Jersey Tax Court in a case involving one of the taxpayers before this Court on the same issue. *Lanco, Inc. v. Dir., Div. of Tax'n., 21 N.J. Tax 200 (2003).* In that case, the New Jersey Tax Court concluded "that the physical presence of the taxpayer or its employee(s), agent(s), or tangible property in a jurisdiction has been and remains a necessary element for a finding of substantial nexus under the *Commerce Clause of the United States Constitution.*" *Id., 21 N.J. Tax at 214*. We respectfully disagree. Summarizing the salient portions of that opinion, the New Jersey Tax Court (1) found it "illogical" to have a physical presence as a constitutional necessity for sales and use taxes but not for income tax, (2) opined physical presence, as a prerequisite to state taxation of income, was "fully consistent with and strongly suggested by the Commerce Clause cases decided before *Quill*" because the circumstances of those cases involved taxpayers who were physically present in the state attempting to impose the tax, and (3) stated "other state court cases decided since *Quill* do not follow the *Geoffrey* rule." *Id., 21 N.J. Tax at 208-09.*
>
> Regarding the first reason given by the New Jersey Tax Court, the *Quill* opinion itself twice notes the singularity of its adoption and reaffirmation of the physical-presence test for Commerce Clause nexus in the arena of sales and use taxes. Moreover, as illustrated by our analysis herein, we disagree with the New Jersey Tax Court that there do not exist certain distinctions between the tax at issue in *Quill* and those considered in the instant case that justify divergent treatment. Regarding the second reason, we do not accord the same import to pre-Quill cases in which it was far more likely that a taxpayer would be required to be physically present (in the traditional commercial sense) in a state in order to earn income there. Lastly, the third reason espoused by the New Jersey Tax Court rings hollow. For example, in discussing *General Motors Corp. v. City of Seattle, 107 Wn. App. 42, 25 P.3d 1022 (2001), cert. den., 535 U.S. 1056, 122 S.Ct. 1915, 152 L.Ed.2d 825 (2002)*, the New Jersey Tax Court dismisses the Washington appellate court's express declaration that it "decline[d] to extend *Quill's* physical presence requirement" to a business and occupation tax on the basis that the taxpayers in that case had a physical presence in that jurisdiction. The corporation's physical presence can hardly serve to obscure the Washington Court's

> unequivocal choice to stand with *Geoffrey's* containment of the *Quill* physical-presence test. More importantly, any assertion that *Geoffrey* has not been, by and large, approved of in subsequent cases cannot be sustained. *See* J. Hellerstein & W. Hellerstein, State Taxation, Para. 6.11[3] at 6-16 (Warren, Gorham & Lamont, 3d ed. Cum.Supp. 2004) (comprehensively analyzing judicial and administrative post-Geoffrey developments and summarizing that, although mixed, "judicial and administrative reaction to the opinion across the country has generally supported [*Geoffrey's*] position that [*573] *Quill's* physical-presence test of Commerce Clause nexus does not extend to income taxes").

[*Id. at 195-96* (footnote omitted).]

Similarly, in *Secy, Dep't of Revenue v. Gap (Apparel), Inc., 886 So. 2d 459, 461-62 (La.Ct.App.2004)* (per curiam) (hereinafter *"GAP"*), the Louisiana Court of Appeals held that the state could impose a corporate income tax on Gap Apparel, a Delaware corporation, in circumstances involving intangible property almost identical to the facts before us. Apparel authorized the Gap and its affiliates to use registered trademarks, trade names and service marks for which it received "a royalty based on the net sales of the licensed products." *Id. at 461.* The court upheld the tax despite the absence of real or personal property, employees or other presence in Louisiana and the absence of the entry of any licensing agreement there, *id. at 462*, stating:

> [I]t is clear that the marks licensed by Apparel have been used in Louisiana in such a way as to become an integral part of the licensees' businesses in this state. Numerous marks (i.e. Gap, Baby Gap, Gap Kids, Pro Fleece) have been licensed by Apparel and used by the licensees to conduct and promote their businesses in this state. Clearly, the intangibles have acquired a business situs in Louisiana and are subject to taxation in this state.

[*Gap, supra, 886 So.2d at 462.*]

We are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax and that the New Jersey Business Corporation Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey.

Accordingly, we reverse the judgment of the Tax Court and remand for further proceedings relating to the tax imposed consistent with this opinion.[31]

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[31] It is unclear from the argument before us as to whether the unresolved dispute involves more than one year, *see Lanco, supra, 21 N.J. Tax at 203-04 n. 1*, and other issues not disposed of by stipulation. As noted, *supra, at 566, 879 A.2d at 1237, footnote 2* of this opinion, we have resolved the critical issue under review, and we remand to the Tax Court for resolution of all open issues or questions which arise in light of our judgment. However, because of the constitutional issue involved, we stay the remand if plaintiff files a timely direct appeal or, to be safe in case the Supreme Court does not consider the issue "substantial," *see R. 2:2-1(a)(1)*, pending decision on a petition for certification.

Tax Commissioner (West Virginia) v. MBNA America Bank, N.A.

640 S.E.2d 226 (2006), *cert. den.* 127 S. Ct. 2997 (2007)

Opinion: Maynard, Justice:

Appellant MBNA America Bank appeals the June 27, 2005, order of the Circuit Court of Kanawha County that ruled that imposition of West Virginia's business franchise tax and corporation net income tax on MBNA, a Delaware Corporation, for tax years 1998 and 1999, does not violate the Commerce Clause. For the reasons that follow, we affirm the circuit court.

I. Facts

Appellant MBNA America Bank is a foreign corporation which has its principal place of business and commercial domicile in Wilmington, Delaware. During the two years in question, 1998 and 1999, MBNA had no real or tangible personal property and no employees located in West Virginia. The principal business of MBNA at the relevant times in this case was issuing and servicing VISA and MasterCard credit cards. This business included the extension of unsecured credit to customers who use these credit cards. MBNA promoted its business in West Virginia via mail and telephone solicitation.

As noted above, the two tax years at issue are 1998 and 1999. In 1998, MBNA's gross receipts attributable to West Virginia customers amounted to $8,419,431.00, and in 1999, its gross receipts amounted to [*228] $10,163,788.00. For tax year 1998, MBNA paid a West Virginia Business Franchise Tax[32] of $32,010.00 and a West Virginia Corporation Net Income tax[33] of $168,034.00. For tax year 1999, MBNA paid a Business Franchise Tax in the amount of $42,339.00 and a Corporation Net Income Tax in the amount of $220,897.00.

Thereafter, MBNA filed refund claims with the State Tax Commissioner seeking the return of the business franchise and corporation net income taxes paid for 1998 and 1999, on the basis that the Tax Commissioner lacked jurisdiction over MBNA. The Commissioner denied the refunds based on its finding that MBNA regularly engaged in business in West Virginia under the applicable statutes.[34]

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[32] The West Virginia Business Franchise Tax is found in *W.Va. Code §§ 11-23-1, et seq*. According to *W.Va. Code § 11-23-1* (1985) the tax is imposed on corporations and partnerships for the privilege of doing business in this state.

[33] The West Virginia Corporation Net Income Tax is found in *W.Va. Code §§ 11-24-1, et seq*.

[34] The statutory nexus required for the business franchise tax is found in *W.Va. Code § 11-23-5a(d)* (1996), which states in part:

> A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

The statutory nexus required for the West Virginia corporation net income tax is found in *W.Va. Code § 11-24-7b(d)* (1996) which provides in part:

MBNA subsequently filed an appeal from the Tax Commissioner's decision with the Office of Tax Appeals (hereafter "OTA"). By decision dated October 22, 2004, the Chief Administrative Law Judge (hereafter "ALJ") of the OTA ruled in favor of MBNA and authorized refunds to MBNA of its 1998 and 1999 franchise and corporation net income taxes. The ALJ reasoned that under the Commerce Clause, a state may not subject an activity to a tax unless that activity has a "substantial nexus" with the taxing state. The ALJ further reasoned that a substantial nexus requires a finding that the putative taxpayer has a physical presence in the taxing state, and mere economic exploitation of the market is not sufficient. Because it was agreed that MBNA does not have a physical presence in West Virginia, the ALJ concluded that the State's business franchise and corporation net income taxes could not be imposed on MBNA's activity within the State.

The Tax Commissioner appealed the ALJ's decision to the Circuit Court of Kanawha County. The circuit court reversed the decision of the ALJ. According to the circuit court, physical presence is not necessary in order to show a substantial nexus for purposes of [**6] state taxation of foreign corporations. Rather, the circuit court found that MBNA's significant business in the state is sufficient to meet the substantial nexus standard. Therefore, concluded the circuit court, MBNA had a substantial nexus with West Virginia during the tax years in question so that imposition of the State's business franchise and corporate net income taxes on MBNA did not violate the Commerce Clause. MBNA now appeals the circuit court's order.

II. Standard of Review

The Court has previously recognized that a lower court's determination of whether a state tax violates the Commerce Clause is reviewed *de novo. See Hartley Marine Corp. v. Mierke, 196 W.Va. 669, 474 S.E.2d 599 (1996)* (explaining that review of lower court judgment on whether state legislation interferes with free flow of interstate commerce is *de novo*). [*229]

III. Discussion

The single issue[35] raised in this appeal is whether application of West Virginia's business franchise and corporation net income taxes to MBNA, a business with no physical presence in this state, violates the *Commerce Clause of the United States Constitution.*[36] In Article 1, § 8 of the United States Constitution, Congress is expressly

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A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

[35] In its petition for appeal to this Court, MBNA also raised an assignment of error concerning fair apportionment of the taxes at issue. However, MBNA subsequently abandoned this assignment of error.

[36] We are mindful that our task herein is a difficult one. The United States Supreme Court has acknowledged that its dormant Commerce Clause law "is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'" *Quill Corp. v. North Dakota, 504 U.S. 298, 315-316, 112 S. Ct. 1904, 1915, 119 L. Ed. 2d 91 (1992)* (*quoting Northwestern States Portland Cement Co.*

granted the authority "[t]o regulate Commerce with foreign Nations, and among the several States."[37] The Supreme Court has determined that the Commerce Clause, in addition to being a positive grant of power to Congress, also acts to prevent certain state regulation that interferes with interstate commerce. *See South Carolina State Highway Dept. v. Barnwell Bros., Inc., 303 U.S. 177, 58 S. Ct. 510, 82 L. Ed. 734 (1938).* This prohibition on state action is known as the "negative" or "dormant" Commerce Clause.

Of relevance to the instant case is the fact that in the last two years bills have been introduced in both houses of Congress to amend *15 U.S.C. § 381* to apply to, in addition to tangible property, all other forms of property, services, and other transactions fulfilled from a point outside the State. *See* H.R. 1956, 109th Congress (April 28, 2005); H.R. 4845, 109th Congress (March 2, 2006); S. 2721, 109th Congress (May 4, 2006). These bills have not been enacted into law.

The Supreme Court's interpretation of the dormant Commerce Clause "has evolved substantially over the years, particularly as that Clause concerns limitations on state taxation powers." *Quill Corp. v. North Dakota, 504 U.S. 298, 309, 112 S. Ct. 1904, 1911, 119 L. Ed. 2d 91 (1992)* (citation omitted). In tracing this evolution, the Court has explained:

> Our early cases, beginning with *Brown v. Maryland, 25 U.S. 419, 12 Wheat. 419, 6 L. Ed. 678 (1827),* swept broadly, and in *Leloup v. Port of Mobile, 127 U.S. 640, 648, 8 S. Ct. 1380, 1384, 32 L. Ed. 311 (1888)*, we declared that "no State has the right to lay a tax on interstate commerce in any form." We later narrowed that rule and distinguished between direct burdens on interstate commerce, which were prohibited, and indirect burdens, which generally were not. *See, e.g., Sanford v. Poe, 69 F. 546 (CA 6 1895), aff'd sub. nom., Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 220, 17 S. Ct. 305, 41 L.*

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v. Minnesota, 358 U.S. 450, 457-458, 79 S. Ct. 357, 362, 3 L. Ed. 2d 421 (1959). Likewise, this Court has characterized this area of the law as "nebulous at best," *Hartley Marine Corp., 196 W.Va. at 677, 474 S.E.2d at 607*, and commented that,

> It would be a Herculean, if not impossible task, to review and harmonize the myriad decisions of the Supreme Court of the United States on the subject of interstate commerce and exactly what incidents thereof may be constitutionally taxed by the States. The dissenting opinions in many of those cases make clear that the task of reconciling all the decisions is more difficult than was the task of Theseus as he threaded his way through the famous Cretan Labyrinth in search of the Minotaur.

J.C. Penney Co., Inc. v. Hardesty, 164 W.Va. 525, 527, 264 S.E.2d 604, 607 (1979) (*quoting Roy Stone Transfer Corp. v. Messner, 377 Pa. 234, 243-44, 103 A.2d 700, 705 (1954))*.

[37] An example of Congress's regulation of interstate commerce is found in *15 U.S.C. § 381(a) (2000)*, which provides that,

> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

> *Ed. 683 (1897).* [*230] *Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 256-258, 58 S. Ct. 546, 549-550, 82 L. Ed. 823 (1938)*, and subsequent decisions rejected this formal, categorical analysis and adopted a "multiple-taxation doctrine" that focused not on whether a tax was "direct" or "indirect" but rather on whether a tax subjected interstate commerce to a risk of multiple taxation. However, in *Freeman v. Hewit, 329 U.S. 249, 256, 67 S. Ct. 274, 278, 91 L. Ed. 265 (1946)*, we embraced again the formal distinction between direct and indirect taxation, invalidating Indiana's imposition of a gross receipts tax on a particular transaction because that application would "impos[e] a direct tax on interstate sales."

Quill, 504 U.S. at 309-310, 112 S. Ct. at 1911.

The Court subsequently abandoned formal distinctions in favor of looking at the practical effects of state taxing statutes. In *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977)*, the Court set forth the current test for determining whether a state tax violated the Commerce Clause. This Court recognized the *Complete Auto* test in Syllabus Point 1 of *Western Maryland Ry. Co. v. Goodwin, 167 W.Va. 804, 282 S.E.2d 240 (1981)*, where we held that,

> A state tax on interstate commerce will not be sustained unless it: "(1) has a substantial nexus with the State; (2) is fairly apportioned; (3) does not discriminate; and (4) is fairly related to the services provided by the State." *Maryland v. Louisiana, [451] U.S. [725], [754], 101 S. Ct. 2114, 2133, 68 L. Ed. 2d 576 (1981).*[38] (Footnote added).

The current issue deals solely with the "substantial nexus" prong of the *Complete Auto* test. Specifically, we are asked to decide whether the substantial nexus standard can only be met by showing that the putative taxpayer has an actual physical presence in the taxing state. In answering this question, we must consider the Supreme Court's decisions in *National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 87 S. Ct. 1389, 18 L. Ed. 2d 505 (1967)*, overruled, in part, Quill supra,[39] and *Quill*, the Court's most recent pronouncement on state tax jurisdiction.

Bellas Hess involved an attempt by Illinois to require a mail-order business to collect and pay use taxes on goods purchased within the state. National Bellas Hess (hereinafter "National") was incorporated in Delaware and had its principal place of business in Missouri. It had neither outlets nor employees in Illinois. Twice a year, National mailed catalogues to the company's customers in Illinois. Orders for merchandise were mailed by customers to National's Missouri plant, and the ordered items were mailed to the customers either by mail or common carrier. National challenged the Illinois use tax levied against it on the basis, *inter alia*, that it created an unconstitutional burden on interstate commerce. The Supreme Court held that Illinois had no power to impose the use tax on National. The Court based its decision in part

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[38] This test is referred to in *Maryland v. Louisiana* as the *Complete Auto* test and is generally known by that name. Therefore, we refer to it as the *Complete Auto* test in this opinion.

[39] *Quill* overruled *Bellas Hess* to the extent that *Bellas Hess* held that a showing of the taxpayer's physical presence in the taxing state was necessary to sustain the constitutionality of a sales and use tax against a challenge under the *Due Process clause*.

on the undue burden placed on interstate commerce by compliance with a host of administrative regulations governing the collection of sales and use taxes.

In 1992, the Supreme Court reaffirmed in *Quill* its *Bellas Hess* holding to the extent that *Bellas Hess* held that a showing of the taxpayer's physical presence in the taxing state was necessary to sustain a sales and use tax against a challenge under the Commerce Clause.[40] Quill was a Delaware corporation with offices and warehouses in Illinois, California, and Georgia. It sold office equipment and supplies, and solicited business through catalogs, flyers, advertisements in national periodicals, and telephone calls. Customers received their ordered merchandise from Quill through mail or common carrier. Despite the fact that Quill had no employees in North Dakota, and that its [*231] tangible property in North Dakota was "either insignificant or nonexistent," *504 U.S. at 302, 112 S. Ct. at 1907*, Quill was required to collect a use and sales tax from its North Dakota customers and remit it to the state. Quill challenged imposition of the tax on the ground that North Dakota did not have the power to compel it to collect a use tax from its North Dakota customers.

In addressing this issue, the Supreme Court first indicated that in determining the propriety of a state use tax on an out-of-state corporation "the nexus requirements of the *Due Process* and Commerce Clauses are not identical." *504 U.S. at 312, 112 S. Ct. at 1913.*[41] The analysis under the *Due Process Clause*, explained the Court, is comparable to that used in determining whether a State can exercise personal jurisdiction over a person. Specifically, there must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." *504 U.S. at 306, 112 S. Ct. at 1909 (quoting Miller Brothers Co. v. Maryland, 347 U.S. 340, 344-345, 74 S. Ct. 535, 539, 98 L. Ed. 744 (1954)).* This is in order to ensure that imposition of a duty to collect a use tax on an out-of-state corporation does not offend traditional notions of fairness. Further, the Court found that the minimum connection is satisfied where the business "is engaged in continuous and widespread solicitation of business within a State[] [because] [s]uch a corporation clearly has fair warning that [its] activity may subject [it] to the jurisdiction of the foreign sovereign." *504 U.S. at 308, 112 S. Ct. at 1911* (internal quotation marks and citations omitted). The Court concluded that the *Due Process Clause* does not require physical presence in a State for the imposition of a duty to collect a use tax.

The Commerce Clause and its nexus requirement, in contrast, explained the Court, "are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. . . . Accordingly, we have ruled that [the Commerce] Clause . . . bars state regulations that unduly burden interstate commerce." *504 U.S. at 312, 112 S. Ct. at 1913.*

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[40] *See* fn. 8, *infra*.

[41] "*Quill* . . . was the first [Supreme Court] decision to bifurcate the *Due Process* and Commerce Clause analyses used to determine a state's jurisdiction to tax under the U.S. Constitution." Christina R. Edson, *Quill's Constitutional Jurisprudence And Tax Nexus Standards In An Age Of Electronic Commerce* 49 Tax Lawyer 893, 894 (Summer 1996).

(Citations omitted). "Thus, 'the substantial nexus' requirement is . . . a means for limiting state burdens on interstate conference." *504 U.S. at 313, 112 S. Ct. at 1913.* The *Quill* Court ultimately concluded that for purposes of imposing on an out-of-state business the duty of collecting use and sales taxes on in-state customers, the *Complete Auto* substantial nexus prong would best be determined by application of a "bright-line, physical-presence requirement." *504 U.S. at 317, 112 S. Ct. at 1916.*

The major question left open by the Supreme Court's opinion in *Quill* is the one that now confronts us: Does the physical presence requirement applicable to determining the constitutionality of requiring out-of-state mail-order houses to collect use taxes on in-state sales under the Commerce Clause extend to other types of state taxes? MBNA's position is that *Quill* extends to the business franchise and corporation net income taxes at issue. The Tax Commissioner posits, on the other hand, that physical presence is not a requirement of the substantial nexus standard in regards to the taxes at issue.[42] [*232]

After careful consideration of the parties' arguments, the relevant legal authority, and the Court's reasoning in *Quill,* we conclude that *Quill's* physical-presence requirement for showing a substantial Commerce Clause nexus applies only to use and sales taxes and not to business franchise and corporation net income taxes. There are several reasons for our conclusion. First, we agree with the Tax Commissioner that a close reading of *Quill* indicates that its reaffirmation of the *Bellas Hess* physical-presence test for use and sales taxes under the Commerce Clause is grounded primarily on *stare decisis.* For example, the Court in *Quill* notes that "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases." *Quill, 504 U.S. at 311, 112 S. Ct. at 1912.* The Court further indicated that "the *Bellas Hess* rule has engendered substantial reliance and has become part of the basic framework of a sizable industry. The interest in stability and orderly development of the law that undergirds the doctrine of *stare decisis* therefore counsels adherence to settled precedent." *Id., 504 U.S. at 317, 112 S. Ct. at 1916* (internal quotations and citation omitted). Finally, the Court concluded that "the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law." *Id.*

[42] The Tax Commissioner cites several cases to this Court in support of its position that *Quill's* physical-presence requirement applies only to sales and use taxes including *Lanco, Inc. v. Director of Taxation, 379 N.J.Super. 562, 22 N.J. Tax 636, 879 A.2d 1234 (2005)*; *A&F Trademark, Inc. v. Tolson, 167 N.C.App. 150, 605 S.E.2d 187 (2004), cert. denied, 546 U.S. 821, 126 S. Ct. 353, 163 L. Ed. 2d 62 (2005)*; *Secretary, Dep't of Revenue, State of La. v. Gap (Apparel), Inc., 886 So. 2d 459 (La.App. 2004)*; and *Geoffrey, Inc. v. S.C. Tax Com'n, 313 S.C. 15, 437 S.E.2d 13 (1993).* We find the persuasiveness of these cases to be limited, however, because the primary issue in each case is whether a state has jurisdiction to impose a state income tax on foreign corporations with no physical presence in the taxing state but whose intangibles, such as a trademark, are used in the state by a licensee. These courts reason, in part, that the intangibles located in the state provide a sufficient nexus for income tax purposes. In the instant case, there is no claim that MBNA has intangibles in West Virginia that provide a sufficient nexus for tax purposes.

This reasoning is supported by several legal commentators. *See* John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective, 45 Wm. & Mary L.Rev. 319 (October 2003)* (arguing that the *Quill* Court relied on *stare decisis* rather than defending the physical presence test on the merits); Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1, 11 State Tax Notes 177, 179-80* (July 15, 1996) (maintaining that *Quill* is essentially a political decision responding to concerns about retroactivity and the practical consequences of overruling *Bellas Hess*); Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard,* 54 TAX LAWYER 105, 113 (Fall, 2000) (opining that "[a] primary basis for the [*Quill*] holding was the Court's conclusion that the mail order industry had grown in large part in reliance on *Bellas Hess*[,] [and] [b]ecause the *Bellas Hess* rule had become the 'basic framework' of a sizable industry) (footnotes omitted). Thus, because *Quill's* physical-presence test for sales and use taxes was based in large part on the mail order industry's reliance on *Bellas Hess,* we are not compelled to apply *Quill's* physical presence standard to the present circumstances.

Second, the Supreme Court appears to have expressly limited *Quill's* scope to sales and use taxes. First, the *Quill* Court noted that "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Quill, 504 U.S. at 314, 112 S. Ct. at 1914.* Also, the Court commented that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id., 504 U.S. at 317, 112 S. Ct. at 1916.* We believe that a reasonable construction of this language clearly implies that *Quill* applies only to sales and use taxes and not to other types of state taxes.[43] [*233]

Third, the *Bellas Hess* and *Quill* courts based their decisions in part on the fact that compliance with administrative regulations in the collection of sales and use taxes places an undue burden on interstate commerce. Specifically, the *Bellas Hess* Court explained:

> In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction . . . between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, which until now has been

[43] One legal commentator has interpreted these portions of the *Quill* opinion to mean that,

> the Commerce Clause's physical presence requirement was not necessarily applicable to other tax types nor dictated by sound Commerce Clause jurisprudence and that the Court was motivated by principles of stare decisis flowing from *Bellas Hess*. It appears the Court intentionally left itself open for future decisions involving other types of taxes. Therefore, *Quill's* physical presence requirement may not apply to future non-use tax collection decisions.

Edson, 49 TAX LAWYER at 925.

> generally recognized by the state taxing authorities, is a valid one, and we decline to obliterate it. . . . For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government.
>
> The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control.

Bellas Hess, 386 U.S. at 758-760, 87 S. Ct. at 1392-1393 (internal quotation marks and footnotes omitted).

According to the Court, at the time *Bellas Hess* was decided, local sales taxes were imposed by over 2,300 localities, many of them accompanied by a use tax, utilizing several different rates. *Id., 386 U.S. at 759 fn. 12* and fn. 13, *87 S. Ct. at 1393 fn. 12* and fn. 13.[44]

The *Quill* Court likewise recognized the potential burden on interstate commerce posed by North Dakota's sales and use taxes.

> North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions.

Quill, 504 U.S. at 313 fn. 6, 112 S. Ct. at 1913 fn. 6, citing Bellas Hess, 386 U.S. at 759-760, 87 S. Ct. at 1393 (noting that the "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations") (additional citation omitted).

In contrast to the sales and use taxes described in *Bellas Hess* and *Quill,* the franchise and income taxes at issue in this case do not appear to cause the same degree of compliance burdens. As noted above, the task of collecting taxes and remitting them to the government demands knowledge of a multitude of administrative regulations, including various deductions and tax rates, as well as record-keeping requirements. Also, as a general matter, sales and use taxes must be remitted to the government on a more frequent basis than income and franchise taxes. For example, in West Virginia vendors are charged with the duty of collecting from purchasers the consumer sales

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[44] In Edson, 49 Tax Lawyer at 911, it is noted that in 1996, when that article was written, there were over 6,100 state and local jurisdictions that imposed sales taxes using varied tax rates.

and service tax and paying the tax to the Tax Commissioner on a monthly basis. This entails making out and mailing to the Commissioner a return for the preceding month on a prescribed form showing the total gross proceeds of the vendor's business during that [*234] time, the gross proceeds of the vendor's business upon which the tax is based, the amount of the tax for which the vendor is liable, and any further information necessary in the computation and collection of the tax which the Commissioner may require. *See W.Va. Code § 11-15-16* (2003). In contrast, income and franchise taxes are paid by the business entity itself so that no collection duties are involved. Also, income and franchise taxes are generally paid annually. *See e.g., W.Va. Code § 11-23-9* (1996) (persons subject to business franchise tax shall make and file an annual return) and *W.Va. Code § 11-24-13* (1993)[45] (requiring annual filing of corporation net income tax return).[46]

Finally, we believe that the *Bellas Hess* physical-presence test, articulated in 1967, makes little sense in today's world. In the previous almost forty years, business practices have changed dramatically. When *Bellas Hess* was decided, it was generally necessary that an entity have a physical presence of some sort, such as a warehouse, office, or salesperson, in a state in order to generate substantial business in that state. This is no longer true. The development and proliferation of communication technology exhibited, for example, by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there. For this reason, we believe that the mechanical application of a physical-presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state.

Accordingly, we now hold that the United States Supreme Court's determination in *Quill Corp. v. North Dakota, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992)*, that an entity's physical presence in a state is required to meet the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977)*, applies only to state sales and use taxes and not to state business franchise and corporation net income taxes.

Rather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes. At least one legal commentator has suggested such a test and to some degree defined its parameters. *See* Edson, 49 Tax Lawyer at 943. According to this commentator, a substantial economic presence standard "incorporates due process 'purposeful direction' towards a state while examining the degree to which a company has exploited a local market." *Id.* Further, "[a] substantial economic presence analysis involves an examination of both the quality and quantity of the company's economic presence." *Id.,* 49 Tax Law. at 944. Finally, under this test, "[p]urposeful

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45 We note, however, that taxpayers whose liability for these taxes exceeds a specified amount are charged with paying estimated taxes for the taxable year on a quarterly basis. *See W.Va. Code § 11-23-13* (1987).

46 Of course, administrative regulations involved in the payment of any type of tax most likely would not be a concern today due to the common use of computers and the availability of specialized software.

direction towards a state is analyzed as it is for *Due Process Clause* purposes," and the Commerce Clause analysis requires the additional examination of "the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." *Id.*, 49 Tax Law. at 945. We find this rationale persuasive and will apply it in determining the constitutionality of the taxes at issue.

First, however, we must address several objections proffered by MBNA to the application of any standard other than physical presence. Initially, MBNA contends that a greater nexus requirement should be applied to the imposition of direct taxes such as those at issue because such taxes are actually more burdensome. This is because sales and use taxes merely require an entity to collect the tax from consumers and remit the tax money to the government, thus suffering the administrative complications and inconvenience but not the cost of the tax. In sharp contrast, says MBNA, franchise and income taxes not only have compliance burdens but also must be paid from the entity's own pocket. For support, MBNA cites *National Geographic Society v. California Bd. of Equalization*, [*235] *430 U.S. 551, 97 S. Ct. 1386, 51 L. Ed. 2d 631 (1977)*, in which the Supreme Court distinguished between a use tax and a direct tax and implied that a higher Commerce Clause standard would be required to support the imposition of a direct tax.[47]

We do not agree with MBNA's argument on this issue. Notably, the Supreme Court's comment in *National Geographic Society* was dicta in that it was not necessary to the decision in that case. In contrast, the *Bellas Hess* and *Quill* Courts placed significant weight on the fact that there are substantial compliance burdens attached to the collection of sales and use taxes. Therefore, we reject MBNA's claim that the imposition of direct taxes is a greater burden than the duty to collect taxes so that the *Bellas Hess/Quill* physical-presence test should also apply to the imposition of the direct taxes at issue.[48]

MBNA also argues that adoption of any substantial nexus requirement short of showing actual physical presence is in fact simply applying a Due Process minimum contacts standard in violation of *Quill* which expressly held that the *Due Process* and Commerce Clause analyses are separate. We disagree. The *Due Process Clause* requires

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[47] Specifically, the Court in *National Geographic Society* reasoned that,

> The case for the validity of the imposition upon the out-of-state seller enjoying such services of a duty to collect a use tax is even stronger. The out-of-state seller runs no risk of double taxation. The consumer's identification as a resident of the taxing State is self-evident. The out-of-state seller becomes liable for the tax only by failing or refusing to collect the tax from that resident consumer. Thus, the sole burden imposed upon the out-of-state seller by statutes [imposing a use tax] is the administrative one of collecting it.

430 U.S. at 558, 97 S. Ct. at 1391 (citations omitted).

[48] MBNA notes that in *Western Maryland Ry. Co. v. Goodwin, 167 W.Va. 804, 826, n. 3, 282 S.E.2d 240, 253 n. 3 (1981)*, this Court quoted with approval a party's brief for the proposition that "the form of the tax is irrelevant to the due process questions of nexus and state benefits." This statement does not inform our present analysis for several reasons. First, it is dicta. Second, it was prior to the Supreme Court's bifurcation of *Due Process* and Commerce Clause analyses. Finally, it was prior to the distinction made by the *Quill* Court between the test to be used in determining the constitutionality of sales and use taxes versus other types of state taxes.

merely some minimum connection between a state and the person, property or transaction it seeks to tax. In contrast, a substantial nexus under the Commerce Clause requires that an entity's contacts with the taxing state be more frequent and systematic in nature. Additionally, an entity's exploitation of the market must be greater in degree than under the Due Process standard so that its economic presence can be characterized as significant or substantial. In sum, although a substantial economic presence standard is by nature more elastic than the bright-line physical presence test, we are convinced that when properly applied, a greater nexus is required under the substantial economic presence standard that under the minimum contacts analysis.

Finally, MBNA avers that the only case from a foreign jurisdiction that is factually on point with the instant case is *J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831 (Tenn.Ct.App. 1999)*, in which the Tennessee appellate court applied the physical-presence test to Tennessee's attempted imposition of income taxes on an out-of-state credit card company. While we acknowledge that *J.C. Penney* is factually on point and addresses the same issue as the one before us, for the reasons set forth above we reject the reasoning in *J.C. Penney*, and decline to apply it to the instant case.[49]

We now turn our attention to the facts of the instant case to determine whether MBNA had a substantial nexus with this State during the time period in question. The record shows that MBNA continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia. Further, in tax year 1998, [*236] MBNA had significant gross receipts attributable to West Virginia customers in the amount of $8,419,431.00, and in tax year 1999, MBNA had significant gross receipts attributable to its West Virginia customers in the amount of $10,163,788.00. In light of these facts, this Court has no trouble concluding that MBNA's systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*.[50]

Finally, prior to concluding, we simply wish to acknowledge the great challenge in applying the Commerce Clause to the ever-evolving practices of the marketplace. James Madison, Benjamin Franklin, and the other Framers at the Constitutional Convention who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine. The Framers' concept of commerce consisted of goods

[49] MBNA also argues that physical presence has been a base-line fact in every tax nexus case decided by the Supreme Court since *Complete Auto*. In other words, says MBNA, the Supreme Court has never upheld a finding of nexus in any case involving a state tax where the putative taxpayer had no in-state presence. It is equally true, however, as noted by the Commissioner, that no Supreme Court decision has applied the *Bellas Hess* physical presence requirement to a state income tax. Thus, we are not persuaded by MBNA's argument.

[50] MBNA also asserts that the circuit court confused the first prong of the *Complete Auto* test with the fourth prong in determining the validity of the taxes at issue. We need not decide this issue because this Court's analysis is based entirely on the "substantial nexus" prong of *Complete Auto*. It is axiomatic that "[t]his Court may, on appeal, affirm the judgment of the lower court when it appears that such judgment is correct on any legal ground disclosed by the record, regardless of the ground, reason or theory assigned by the lower court as the basis for its judgment." Syllabus Point 3, *Barnett v. Wolfolk, 149 W.Va. 246, 140 S.E.2d 466 (1965)*.

transported in horse-drawn, wooden-wheeled wagons or ships with sails. They lived in a world with no electricity, no indoor plumbing, no automobiles, no paved roads, no airplanes, no telephones, no televisions, no computers, no plastic credit cards, no recorded music, and no iPods. Likewise, it would have been impossible for the Framers to imagine our world. When they fashioned the Commerce Clause, they could not possibly have foreseen the complex and varied ways that commerce is conducted today, especially via the internet and electronic commerce. It would be nonsense to suggest that they could foresee or fathom a time in which a person's telephone call to his or her local credit card company would be routinely answered by a person in Bombay, India, or that a consumer could purchase virtually any product on a computer with the click of a mouse without leaving home. This recognition of the staggering evolution in commerce from the Framers' time up through today suggests to this Court that in applying the Commerce Clause we must eschew rigid and mechanical legal formulas in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense. This is what we have attempted to do herein.

IV. Conclusion

In conclusion, for the reasons set forth above, we affirm the June 27, 2005, order of the Circuit Court of Kanawha County and conclude that West Virginia's imposition of its business franchise and corporation net income taxes on MBNA for the tax years 1998 and 1999, did not violate the Commerce Clause.

Affirmed.

Davis, C.J., Concurring:

In this case, MBNA, an out-of-state credit card company disputed the imposition of business franchise and corporation net income taxes on its profits[1] generated from West Virginia residents in the years 1998 and 1999. The majority opinion, applying sound legal analysis, determined that the application of the taxes did not violate the Commerce Clause because MBNA's business activity in this State constituted a significant economic presence sufficient to meet the substantial nexus standard. I fully concur in the majority decision and its analysis. I have chosen to write separately to emphasize the correctness of the legal analysis articulated in the majority decision and, further, to respond to several misconceptions contained in the dissenting opinion.

In the lone dissenting opinion, my colleague chastises the majority and states that "there is no precedential support whatsoever for the conclusions reached by the majority decision. None. None at the state level. None at the federal level." *See* Dissenting [*242] opinion, pgs 1-2. The critical point that the dissent fails to acknowledge is that there is no established precedent, either way, from the United States Supreme Court. The sole decision on this topic is from the Tennessee Court of

[1] In 1998, MBNA had gross profits of $8,419,431.00 from its West Virginia customers. In 1999, the gross profits were $10,163,788.00. *See* Majority opinion, p. 2.

Appeals. *See generally J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999).* It has long been held that "in considering and deciding the constitutionality of a tax imposed and collected by this state, in the light of a provision of the Constitution of the United States, this Court is bound by applicable decisions of the Supreme Court of the United States." Syl. pt. 2, in part, *State ex rel Battle v. B.D. Bailey & Sons, Inc., 150 W. Va. 37, 146 S.E.2d 686 (1965).* However, no such requirement exists as to decisions rendered by other state courts. Moreover, it is expressly left to each state to regulate commerce inside its borders, within the confines of constitutional directives.

The majority opinion performed a critical analysis of the United States Supreme Court decision in *Quill Corp. v. North Dakota, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992).* The *Quill* opinion considered the Commerce Clause in connection with use and sale taxes, not the types of taxes at issue in the present case. Therefore, while the *Quill* opinion is instructive, it is not exactly on point with the case *sub judice*. The majority opinion succinctly interpreted the *Quill* decision, which determined that a physical presence was needed prior to imposing in-state sales taxes on an out-of-state mail-order house under the Commerce Clause. In its analysis, the majority of this Court correctly observed that physical presence is not a requirement of the substantial nexus standard with regard to the taxes at issue herein. Taking into account the realism of today's world, the majority astutely recognized that *Quill*'s physical presence requirement for showing a substantial nexus under the Commerce Clause applies only to use and sales taxes and not to business franchise and corporation net income taxes, which are the taxes at issue in the present case. Such an interpretation was invited by the *Quill* Court when it noted that it has not adopted a bright line, physical presence requirement in any area except sales and use taxes. *See* Majority opinion, p. 14. In its interpretation of *Quill*, the majority opinion correctly recognized the legal differences between the *Due Process Clause* and the Commerce Clause, as well as the even finer distinctions between the application of sales and use taxes as opposed to business franchise and corporation net income taxes. The majority opinion articulates and appreciates these distinctions; the dissenting opinion does not.

Further, the dissenting opinion, in its discussion regarding the physical presence component of the substantial nexus prong, strays from the issue before this Court by discussing at length the minimum contacts required under the Due Process Clause. In so doing, the dissenting opinion accuses the majority of merging *Due Process* and *Commerce Clause* nexus requirements. However, the majority opinion correctly addresses this argument, which was first raised by MBNA, by recognizing the contact requirements under both doctrines. The majority opinion concludes that "although a substantial economic presence standard is by nature more elastic than the bright-line physical presence test, we are convinced that when properly applied, a greater nexus is required under the substantial economic presence standard [than] under the minimum contacts analysis." *See* Majority opinion, pgs. 21-22.

Moreover, the dissenting opinion's lengthy discussion of the *Due Process Clause* is unwarranted and prone to create confusion. The application of the *Due Process Clause* is not the issue presented for resolution in this case nor does it play any role in the decision reached by the majority of the Court. The question that was brought for our review was, solely, "whether application of West Virginia's business franchise and corporation net income taxes to MBNA, a business with no physical presence in this state, violates the *Commerce Clause of the United States Constitution*." Majority opinion, p. 5 (footnote omitted). Significantly, as recognized by the majority opinion, the requirements for satisfying the *Due Process Clause* and the Commerce Clause are different. *See* Majority opinion, p. 10 ("In addressing this issue, the Supreme Court first indicated that in determining [*243] the propriety of a state use tax on an out-of-state corporation 'the nexus requirements of the *Due Process* and Commerce Clauses are not identical.'" (internal citation omitted)). The *Due Process Clause* is concerned with notions of fairness, while the Commerce Clause is aimed at the effects of state regulation on the national economy. Thus, the dissenter's analysis under the *Due Process Clause* is wholly irrelevant and inapplicable to the issue before the Court in this case.

The final point I wish to address is the dissent's unexplained and rigid adherence to a physical presence requirement for all types of taxes. The dissenting opinion argues that the taxing scheme at issue impermissibly burdens interstate commerce, yet it fails to explain how such an impermissible scheme occurs. *See* Syl. pt. 3, *Battle, 150 W. Va. 37, 146 S.E.2d 686* ("A tax imposed pursuant to an act of the legislature of this state will not be held to contravene the commerce clause of Article I, Section 8 of the Constitution of the United States unless the imposition of the tax discriminates against or imposes an undue burden on interstate commerce. Such a tax will not be held to violate the commerce clause merely because it relates to or affects interstate commerce in some indirect, incidental and inconsequential manner."). When a company, whether out-of-state or in-state, earns millions of dollars[2] directly as a result of its dealings with West Virginia customers, should it not be compelled to pay taxes?[3] If not, then all companies would only deal with out-of-state customers so as to avoid all business franchise and corporation net income taxes. Such a result is perverse, especially when considering the climate of today's business world where new technology has made it possible for businesses to span the globe. I see no reason why a small "mom and pop" store in the State of West Virginia, with gross receipts in the thousands, should be compelled to pay business franchise and corporation net income taxes due to its physical presence in the State, while a large corporation, like MBNA, who makes millions of dollars from West Virginia's economy, would be exempt from such taxes simply because it has no physical presence here. As the majority shrewdly points out, in today's world, a business does not necessarily need a physical presence anywhere. MBNA's significant economic presence in this State meets the substantial nexus standard; thus, it should not be exempt from state taxation.

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[2] *See* note 1, *supra*.

[3] On its multimillion dollar gross profits, *see* note 1, *supra*, MBNA was required to pay, in 1998, a business franchise tax of $32,010.00 and a corporation net income tax of $168,034.00. In 1999, MBNA was required to pay a business franchise tax of $42,339.00 and a corporation net income tax of $220,897.00. *See* Majority opinion, p. 2.

Because the majority correctly addressed and resolved the issues in this case, I respectfully concur with the opinion of the Court.

Benjamin, Justice, Dissenting:

In its opinion finding tax liability for an out-of-state corporation with no presence, tangible or intangible,[1] in West Virginia on income realized out-of-state by that corporation from accounts kept out-of-state, the majority, in its opinion, boldly goes where no court has gone before. In doing so, the majority relies not on bedrock constitutional principles or on established legal precedent, but rather on legal commentaries with thinly veiled state-favoring taxing agendas, a strained and inaccurate reading of the United States Supreme Court's decision in *Quill Corp. v. North Dakota, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992)*, and a unilateral restatement of the important policy [*237] considerations which led to the inclusion of the Commerce Clause within the United States Constitution because, according to the majority opinion, the framers could not possibly have foreseen the future. The majority opinion gives legal sanction to a state taxing scheme which impermissibly burdens the interstate commerce of the nation. I therefore dissent.

There is no precedential support whatsoever for the conclusions reached by the majority decision. None. None at the state level. None at the federal level. Ignoring that our consideration here should be the effect of the tax in question on interstate commerce, rather than the type of tax it is, none of the rhetoric raised by the majority opinion explains why a state's imposition of a tax on an out-of-state corporation with no presence, tangible or intangible, on income realized from an out-of-state account does not adversely affect the nation's interstate commerce, an analysis identified by the United States Supreme Court as the cornerstone of constitutional jurisprudence. *Id.*; *Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251, 119 L. Ed. 2d 533 (1992)*. The only state court decision on point with the specific credit card issues raised herein determined that the State of Tennessee exceeded its taxing jurisdiction in attempting to collect taxes from an out-of-state corporation on income generated by out-of-state credit accounts. *J.C. Penney National Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999)*, *cert. denied*, *531 U.S. 927, 121 S. Ct. 305, 148 L. Ed. 2d 245 (2005*;

State taxation of companies engaged in interstate commerce must comport with the Due Process and *Commerce Clauses of the United States Constitution*. In *Quill*, the United States Supreme Court emphasized that separate constitutional analyses are required in evaluating the validity of state taxes under each provision. *Quill, 504 U.S. at 305* ("The two constitutional requirements differ fundamentally [and] reflect different constitutional concerns."). Though both the *Due Process Clause* and the Commerce Clause require an out-of-state taxpayer to have established a meaningful nexus with a

[1] See Majority Opinion, page 1 (". . . MBNA has no real or tangible personal property . . . in West Virginia.") and Note 11, page 12 (In the instant case, there is no claim that MBNA has intangibles in West Virginia that provide a sufficient nexus for tax purposes.")

given state to be the proper subject of taxation of that state, imposition of a tax on an out-of-state taxpayer may meet the less stringent nexus requirements of the *Due Process Clause*, yet fail to meet the more substantial nexus requirements of the Commerce Clause. *Id.* ("[W]hile a State may, consistent with the *Due Process Clause*, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the Commerce Clause.")

Among the most fundamental precepts of state taxation from a Commerce Clause perspective is that there must be a "substantial nexus" between the interstate activity sought to be taxed and the taxing State. *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977).* Under *Complete Auto*, a state tax is permitted under the Commerce Clause if it (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state. *430 U.S. at 279.*[2] While I agree with my colleagues that the "substantial nexus" prong of this test is ripe for clarification by the United States Supreme Court, I disagree with them to the extent that the majority opinion finds insufficient guidance in the existing jurisprudence of the United States Supreme Court to conclude that the State's present attempt to levy a tax on income realized outside the State by an out-of-state corporation with no presence, tangible or intangible, in the State violates the Commerce Clause.

Three years after deciding *Complete Auto*, the Supreme Court noted in *Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 100 S. Ct. 1223, 63 L. Ed. 2d 510 (1980)*, that for an [*238] application of state tax jurisdiction to be constitutional under the *Due Process Clause*, there must be: (1) nexus or some *minimal* connection between the taxing state and the activity from which the income is derived; and (2) a rational relationship between the income attributed to the taxing state and the interstate values of the enterprise. *445 U.S. at 436-7.* These constitutional requirements were subsequently confirmed in *D.H. Holmes Co. v. McNamara, 486 U.S. 24, 108 S. Ct. 1619, 100 L. Ed. 2d 21 (1988), Allied-Signal*, and *Quill.*

Reading *Complete Auto* and *Mobil Oil* together, one discerns two aspects to the consideration of nexus. First, there must be an adequate connection between the taxing state and the out-of-state corporation upon which a tax is being assessed; *i.e.*, a "presence" consideration. Second, there must also be an adequate connection between the taxing state and the event which gives rise to the claimed tax; *i.e.*, a "transaction" consideration.

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[2] There is often overlap in the consideration of these four requirements. The "substantial nexus" requirement is said to protect against undue burdens on interstate commerce while fair apportionment is understood to guard against taxes which have the effect of "pass[ing] an unfair share of the tax burden onto interstate commerce." *Quill, 504 U.S. at 313.* In practical effect, the exercise of multiple taxation by several states under the apportionment standard may lead to apportionment issues which likewise should be considered under the "substantial nexus" standard.

Prior to the United States Supreme Court's decisions in *Allied-Signal* and *Quill*, some argued for a merging of the *Due Process* and Commerce Clause nexus considerations through application of a so-called "economic exploitation" nexus consideration. *Quill* establishes that, for Commerce Clause purposes, a higher presence nexus is required than the minimal nexus connection required for Due Process purposes. In other words, a corporation's "presence" may suffice for taxing jurisdiction under the minimal Due Process nexus test, but fail to meet the "substantial" higher presence nexus test required by the Commerce Clause.

We must assume that the United States Supreme Court chose its words carefully in setting forth the first prong of the *Complete Auto* test, that the tax in question is sought by the taxing state to be applied "to an activity" with a substantial nexus with the taxing state. Even if the majority opinion was correct, which I believe it was not, that MBNA's interstate activities constitute a sufficiently high showing of presence to permit taxing jurisdiction under the "substantial" nexus test of the Commerce Clause, the majority opinion simply reaches the question of whether the State of West Virginia may seek to tax MBNA as an out-of-state corporation. The majority opinion completely fails to consider the effect of the tax on interstate commerce. On this second question of whether a state can impose tax on income generated out-of-state, the majority opinion likewise fails. Here, there is no question but that the credit card accounts which give rise to MBNA's income are located outside West Virginia.

I must admit to being intrigued by the majority opinion's description of its nexus requirement as a "significant economic presence test" as much for its vagueness as for its embodiment as the antithesis of the "bright line" standards set forth by the United States Supreme Court in *Quill and National Bellas Hess v. Department of Revenue of Illinois, 386 U.S. 753, 87 S. Ct. 1389, 18 L. Ed. 2d 505 (1967), overruled, in part, by Quill.* The reality is that by endorsing a nexus standard which permits West Virginia to assess a tax on an out-of-state corporation with no property, tangible or intangible, in this state on income realized from credit accounts maintained and serviced in another state, the majority merges the nexus requirements of the *Due Process Clause* and the Commerce Clause and effectively returns to the merged nexus jurisprudence of 1967, in *Bellas Hess*, albeit with the minimal due process requirements now carrying the day for nexus determination rather that the physical presence requirement of *Bellas Hess*. While MBNA may meet the minimal nexus requirement for it to be on notice from a due process basis that it may be subject to taxation, the majority opinion fails to show how the out-of-state credit account, which is the basis for the income sought to be taxed, meets the substantial nexus requirements of *Complete Auto* and *Quill*. Indeed, one might seriously question the due process basis for West Virginia's attempted actions herein.[3] [*239]

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[3] One might well argue that the State of West Virginia, under the facts of this case, is attempting to engage in extraterritorial taxation. "Under both the *Due Process* and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164, 103 S. Ct. 2933, 2939, 77 L. Ed. 2d 545, 552 (1983)* (quoting *ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315, 102 S. Ct. 3103, 3108, 73 L. Ed. 2d 787, 794 (1982)*).

The majority opinion attempts mightily to distinguish between forms of taxes, such as sales and use taxes on the one hand, and income and franchise taxes on the other hand, in attempting to defend its disregard for the substantial nexus standards required in *Quill*. The majority's argument appears to be that because the instant case concerns the taxation of income realized by an out-of-state corporation from accounts in Delaware and because *Quill* instead involved use and sales taxes from purchases made by purchasers within the taxing state with delivery of goods to occur also within the taxing state, this Court is at liberty to disregard those parts of *Quill* with which it disagrees. This argument is not persuasive. In so disregarding the substantial nexus requirements of *Quill* because *Quill* involved use and sales taxes, it is interesting that the majority opinion nevertheless fully embraces the precedent of the United States Supreme Court in *Complete Auto*, a case which also involved use and sales taxes—not income taxes. Perhaps the real dichotomy here may not be between sales and income taxes, with the relevant question being when is a tax not a tax, but how the limitations set forth in the United States Constitution can be avoided to provide the State with a better opportunity to expand its taxing opportunities.

The reality is that the United States Supreme Court has not generally treated the question of state authority to tax interstate commerce as turning on the specific type of tax involved. Rather, the United States Supreme Court has focused instead on the effect of the tax which the taxing state seeks to levy on interstate commerce, regardless of the type of tax.[4] Indeed, there is no immediately clear doctrinal foundation which can be observed for distinguishing sales and use tax collection on sales between states from income taxes sought to be collected from out-of-state companies for income realized from out-of-state intangible accounts simply because the out-of-state corporation availed itself of the United States mails and other forms of interstate communication.[5]

The jurisprudential reality is that the United States Supreme Court has never held in any state tax case that the nexus requirements of the Commerce Clause can be satisfied in the absence of a taxpayer's physical presence in the taxing state. The principles of *stare decisis* are no less relevant to state taxes in general, than they are to sales and use taxes particularly, when Congress has the ultimate power to prescribe the appropriate law in this area. *See*, *Quill, 504 U.S. at 316-17.* Cases decided by the United States Supreme Court both before and after *Quill* have made it clear that a substantial

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[4] In *Tyler Pipe Industries v. Washington State Department of Revenue, 479 U.S. 1015, 107 S. Ct. 664, 93 L. Ed. 2d 717 (1986)*, the tax in question was a business and occupation tax. The Court framed the nexus question as whether the activities performed in the taxing state on behalf of Tyler Pipe was significantly associated with Tyler Pipe's ability to establish and maintain a market for its sales. This case involved the imposition of a direct tax, similar to the income tax at issue herein.

[5] In *Quill*, the Supreme Court while noting that it had not "in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes," stated that "silence does not imply repudiation of the *Bellas Hess* rule." *Quill, 504 U.S. at 314*. In *Bellas Hess*, the Supreme Court described its decision in *Scripto, Inc. v. Carson, 362 U.S. 207, 80 S. Ct. 619, 4 L. Ed. 2d 660 (1960)*, a case involving a corporation physically present in the taxing state, as the Court's "furthest constitutional reach to date" of subjecting a corporation to state taxing. *Bellas Hess, 386 U.S. at 757*.

nexus is required for the imposition of *any* state tax on an out-of-state corporation. *See*, *Allied-Signal, 504 U.S. at 778* ("The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation at all."); *Commonwealth Edison Co. v. Montana, 453 U.S. 609, 626, 101 S. Ct. 2946, 69 L. Ed. 2d 884 (1981)* ("Under this threshold test, the interstate business must have a substantial nexus with the State before *any* tax may be levied on it.") It would be a strange constitutional doctrine that would countenance one nexus standard for sales and use taxes under the Commerce Clause, [*240] and a more relaxed nexus standard for corporate net income and other state taxes.[6]

In the first place, it does not appear that the differences between the use tax collection obligation and liability for income taxation are so significant as to justify different rules under the Commerce Clause. It is certainly difficult to see distinctions that give effect to physical presence as a necessary element for "substantial nexus" for some taxes and not for others. Arguably, the collection of use and sales taxes involves no more complexity than the determination of individual state income tax liability for a multistate corporation involved in interstate commerce where each taxing state has separate laws and seeks to maximize the definition of that which each such state contends may be taxed from out-of-state.[7] Arguably, if taxes should be treated differently under the Commerce Clause based on what the taxing state claims to tax rather than on the tax's actual impact on interstate commerce, one might well argue that something more than a due process minimal nexus standard should be considered for non-transactional taxes such as income taxes. Under such an argument, one might be tempted to argue that the minimum nexus standard for due process considerations in cases such as *Quill*, which involved transactions which had a tangible connection with a given state, were not intended to also apply to income taxes which a taxing state sought to apply to income generated by accounts located outside the taxing state. As this endeavor demonstrates, the same speculation which the majority employs to attempt to differentiate "substantial nexus" standards based on tax types could be alternatively applied in any number of ways not so attractive to taxing states. Absent precedential support for differentiating "substantial nexus" standards based upon tax types, this Court should resist the State's invitation for us to speculate based on

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[6] Contrary to the apparent contempt held by some for the benefits of "bright line" rules which avoid undue burdens on interstate commerce by the demarcation of a discrete realm of commercial activity that is free from interstate taxation, one might consider not only the settled expectations of taxpayers, but also the benefit to the national economy that such "bright lines" have been in the development of that economy over the last several decades. Surely interstate commerce is as worthy of protection from improper income and other taxes as it is from sales and use taxes. *See*, *Quill, 504 U.S. at 315*.

[7] Assume for the moment that a Delaware bank maintains a credit account for a customer with a Weirton, West Virginia mailing address. Assume further that that customer travels to Steubenville, Ohio and, using his credit account, makes a sizeable electronic purchase with the intent of paying for his purchase over several months. At the end of the month, the customer electronically pays a portion of his credit account balance from his place of employment using funds he has in his Pittsburgh, Pennsylvania bank account. In such a scenario, which fully involves the interstate nature of today's economy, how should the Delaware bank maintain its records for determination of income taxes?

semantics and, instead, focus on the effect which the state tax has on interstate commerce—here, attempting to levy an income tax on an out-of-state corporation with no property, tangible or intangible, in West Virginia where the income in question was generated from credit accounts held outside of this state.

The majority opinion also claims that a variety of changes—changes which it claims were not of a type which could be foreseen by the framers of the United States Constitution—support their extension of state tax jurisdiction into a realm considered by all others to be unconstitutional. Initially, I note some measure of foreboding anytime a court invokes the "foreseeability of the framers'" as a basis for a decision—fear not because the rule of *stare decisis* is about to be followed by the court, but rather because the court is about to engage in some form of legislative activism for which the only support is political, not legal.[8] Here, the rationale for the majority's "economic exploitation" nexus approach, which [*241] might more accurately be termed a "tax it if you can follow it, even if it is earned in another state" nexus approach, rings remarkably like the arguments set forth in Justice Fortas' dissent in *Bellas Hess*. In his dissent to the 1967 case, Justice Fortas advocated for an "economic exploitation nexus" test for state taxing jurisdiction. *Bellas Hess, 386 U.S. at 761-62*. Justice Fortas argued that Bellas Hess should be subject to the taxing jurisdiction of Illinois because of its "large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market." *Id., at 761*. Furthermore, Justice Fortas argued that Bellas Hess enjoyed ". . . the benefits of, and profits from the facilities nurtured by, the State of Illinois as fully as if it were a retail store or maintained salesmen therein." *Id., at 762*. I find it remarkable that our Court now endorses this same position—a position which the United States Supreme Court has rejected.

Yet our Court has not been the only court to embrace Justice Fortas' arguments. So too did the North Dakota Supreme Court, in its decision in *Quill*. Therein, that state supreme court, also claiming changes in society and economy, stated that ". . . within the context of contemporary society and commercial practice, we conclude that the concept of nexus encompasses more than mere physical presence within the state, and that the determination of nexus should take into consideration all connections between the out-of-state seller and the state, all benefits and opportunities provided by the State, and should stress economic realities rather than artificial benchmarks." *State by and through Heitkamp v. Quill Corp., 470 N.W.2d 203, 215 (N.D. 1991), rev'd, 504 U.S. 298, 112 S. Ct. 1904, 111 L. Ed. 2d 91 (1992)*. As *Quill* demonstrates, when given the chance to again consider the "economic exploitation" nexus argument, the United States Supreme Court once again declined.

[8] I must admit to some disdain for the rather elite nature of "foreseeability of the framers" arguments. Frequently, such invocations serve no purpose other than an attempt to excuse legislating from the bench. Other times, such invocations simply serve as the argument of last resort by courts searching for a legal basis to justify result-based decision-making. Caution should by necessity be the watchword when any court seeks to expand the power of the State on the basis of the "foreseeability of the framers" argument.

While the majority herein apparently believes, as did the North Dakota Supreme Court in *Quill*, that it may disregard the actual nexus decisions of the United States Supreme Court in favor of a theoretical nexus argument which favors the State's ability to reach out and tax income generated out-of-state by an out-of-state corporation with no presence, tangible or intangible, in West Virginia, I believe the sage reminder of Justice Scalia (joined in by Justices Kennedy and Thomas) should serve as a reminder of our duty in considering this case:

> We have recently told lower courts that "[i]f a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [they] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 109 S. Ct. 1917, 1921, 104 L. Ed. 2d 526 (1989).

Quill, 490 U.S. at 303.

We would do well to follow the precedent that is applicable herein and not attempt to anticipate an overruling by the United Supreme Court of its prior jurisprudence. The taxes in question are unconstitutional.