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20020241

IN THE SUPREME COURT

STATE OF NORTH DAKOTA

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STATE OF NORTH DAKOTA

B.D.I., Inc., Danov Corporation, and Estuary Corporation, Florida corporations, Appellees, vs. State of North Dakota, by and through its Tax Commissioner, Rick Clayburgh, Appellant.	SUPREME COURT CASE NO. 20020241

ON APPEAL FROM THE JUDGMENT OF THE DISTRICT COURT
SOUTH CENTRAL JUDICIAL DISTRICT
BURLEIGH COUNTY, NORTH DAKOTA
THE HONORABLE ROBERT O. WEFALD, DISTRICT JUDGE

BRIEF OF THE APPELLEES

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I. STATEMENT OF THE ISSUE

The sole issue in this case is whether the district court (the "District Court") was correct in following the unanimous decision of the United States Supreme Court in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), which mandated that the District Court declare N.D.C.C. § 57-38-01.3(1)(g) ("Dividends Received Deduction Statute" or "DRD Statute") as violative of the Commerce Clause of the United States Constitution.

At all times in this brief, the Appellees, D.D.I., Inc., Danov Corporation, and Estuary Corporation, are collectively referred to as "DDI," and the Appellant, the North Dakota Tax Commissioner, is referred to as "Commissioner."

II. STATEMENT OF THE CASE

The Commissioner appeals from a judgment under N.D.C.C. ch. 32-23 declaring the DRD Statute unconstitutional under the Commerce Clause of the United States Constitution.

It is a bedrock principle of constitutional law that a state may not impose a tax that discriminates against interstate commerce by favoring in-state persons, property, or activities over out-of-state persons, property, or activities. On its face and in its application by the Commissioner, the DRD Statute violates this basic principle. The DRD Statute discriminates in favor of in-state persons, property, and activities by providing a taxpayer a dividends received deduction ("DRD") for dividends received from corporations to the extent such corporations conduct their activities in North Dakota and denying a taxpayer a DRD for dividends received from corporations to the extent such corporations conduct their activities outside North Dakota. Based upon this fact, and upon the unanimous Supreme Court decision in *Fulton*, the District Court found that the DRD Statute violates the Commerce Clause.

The Commissioner appeals to this Court.

III. STATEMENT OF FACTS

Both parties agree that this is a summary judgment case and that the salient facts are not in dispute. N.D. Brief at 3. DDI is a Florida corporation which conducted some business in North Dakota. During the years at issue, DDI received income from oil and gas operations in North Dakota (and in other states), and DDI also received dividends from several corporations, including Winn-Dixie Stores, Inc., American Heritage Life Investment Corporation, Cain & Bultman, Inc., First Union Corporation, Barnett Banks, Inc., and Wal-Mart Stores, Inc. These corporations conducted their businesses either wholly or primarily outside of North Dakota.

DDI included income it received from its oil and gas operations as business income subject to apportionment in the calculation of its North Dakota corporate income tax. DDI excluded (entirely) the dividends it received in the calculation of its North Dakota corporate income tax. The Commissioner assessed DDI additional tax, penalties, and interest relating to additional amounts DDI would owe if the dividends they received were included in DDI's North Dakota taxable income according to the DRD Statute.

On December 14, 2001, DDI timely filed administrative complaints with the Commissioner, and declaratory judgment actions with the District Court, challenging the assessments on constitutional grounds. After extensive briefing by both parties (*see* DDI's Appendix ("AA") at 1-19; 220-43; 269-92), on June 6, 2002, the District Court recognized that the United States Supreme Court's decision in *Fulton* was controlling and held the DRD Statute unconstitutional. The Commissioner appeals that decision to this Court.

IV. SUMMARY OF THE ARGUMENT

DDI's argument is simple. The DRD Statute is a facially discriminatory tax, which the Commissioner concedes. The Commissioner has wholly failed to prove the DRD Statute is a compensatory tax. As *Fulton* holds, a discriminatory tax which is not a compensatory tax violates the Commerce Clause. Thus, as the District Court correctly held, *Fulton* plainly dictates that the DRD Statute is unconstitutional.

The Commissioner's arguments to the contrary are wholly without merit. Underlying each of the Commissioner's arguments before this Court is the mistaken view that North Dakota can impose its tax laws in isolation and without regard to taxes that other states might impose. N.D. Brief at 2-3, 19. This view flies in the face of over a century of Supreme Court jurisprudence interpreting the Commerce Clause, most particularly the factually indistinguishable decision in *Fulton*.

Under *Fulton*, the DRD Statute is unconstitutional if it is "facially discriminatory" against interstate commerce unless the Commissioner can prove the DRD Statute constitutes a "compensatory tax." The District Court held the DRD Statute was facially discriminatory and that it did not constitute a compensatory tax. Before this Court, the Commissioner now agrees with the District Court and concedes that the DRD Statute is facially discriminatory. *See* N.D. Brief at 5. Yet, the Commissioner continues to claim, contrary to the holding of the District Court, that the DRD Statute constitutes a compensatory tax. The arguments the Commissioner advances as to why the DRD Statute meets the three-prong test used to identify a compensatory tax, however, are the exact same arguments the North Carolina taxing authority advanced in *Fulton*, and which

the Supreme Court unanimously rejected. Recognizing this, the District Court properly held the DRD Statute did not constitute a compensatory tax.

To avoid this inevitable conclusion, the Commissioner tries to characterize the issue before this Court as one of "first-impression" and his arguments as ones not previously considered by the Supreme Court. N.D. Brief at 15-17. This is not a case of first-impression and it involves no new substantive analysis. *Fulton* is virtually identical to the case at bar and controls as to the DRD Statute's constitutionality, as the District Court recognized. Other states, including California, Wisconsin and Hawaii, have also acknowledged the controlling force of *Fulton* regarding their own DRD statutes. These states recognized, as did the District Court with respect to the DRD Statute, that their statutes were unconstitutional.

Finally, the Commissioner faults the District Court's decision for not expressly rejecting his argument that the DRD Statute is constitutional because the DRD Statute serves a legitimate state interest that allegedly cannot be accomplished by any reasonable non-discriminatory alternative. It is abundantly clear that the Commissioner does not satisfy this test because a reasonable non-discriminatory alternative so plainly exists. Namely, North Dakota could have achieved its objective of preventing North Dakota double taxation of North Dakota income without violating constitutional norms by providing an income exclusion for any dividends received from corporations whose income had previously been taxed by *any* state.

This Court should affirm the District Court's decision.

V. LAW AND ARGUMENT

A. North Dakota Cannot Ignore Taxes Other States Might Impose.

The Commissioner believes that North Dakota can impose its tax laws in isolation and that the United States Constitution does not require North Dakota to take into account taxes that other states might impose. N.D. Brief at 2-3, 19. This belief flies in the face of over a century of Supreme Court jurisprudence interpreting the Commerce Clause, and is at odds with the holdings of every court to consider the subject and every state tax commentator to write on the subject. In short, there is no legal authority to support the Commissioner's belief.

1. The Supreme Court Requires a State to Consider the Power of Other States to Impose Taxes.

In assessing the constitutionality of a state tax under the Commerce Clause, the Supreme Court expressly considers the tax burdens other states might impose on the same stream of income. For example, in *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, the Supreme Court, in rejecting Oregon's arguments regarding its statute's constitutionality, noted that Oregon had "ignore[d] the fact that shippers of waste from other States in all likelihood pay income taxes in other States." 511 U.S. 93, 104 n.7 (1994).

In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, the Court explained that "multiple taxation . . . is threatened whenever one State's act of overreaching combines with the possibility that another State will claim its fair share of the value taxed: the portion of value by which one State exceeded its fair share would be taxed again by a State properly laying claim to it." 514 U.S. 175, 184-85 (1995). In *Armco Inc. v. Hardesty*, the Court emphasized that "[i]f Ohio or any of the other 48 States imposes a

like tax on its manufacturers -- which they have every right to do -- then Armco and others from out of State will pay both a manufacturing tax and a wholesale tax while sellers resident in West Virginia will pay only the manufacturing tax." 467 U.S. 638, 644 (1984).

These pronouncements have been a constant theme of the Supreme Court's Commerce Clause jurisprudence since at least the 1930s. For example, in *Gwin, White & Prince v. Henneford*, the Court explained:

> If Washington is free to exact such a tax, other states to which the commerce extends may, with equal right, lay a tax similarly measured for the privilege of conducting within their respective territorial limits the activities there which contribute to the service. The present tax, though nominally local, thus in its practical operation discriminates against interstate commerce, since it imposes upon it, merely because interstate commerce is being done, the risk of a multiple burden to which local commerce is not exposed.

305 U.S. 434, 439 (1939). In *J.D. Adams Manufacturing Co. v. Storen*, the Court reasoned:

> The vice of the statute as applied to receipts from interstate sales is that the tax includes in its measure, without apportionment, receipts derived from activities in interstate commerce; and that the exaction is of such a character that if lawful it may in substance be laid to the fullest extent by states in which the goods are sold as well as those in which they are manufactured. Interstate commerce would thus be subjected to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids.

304 U.S. 307, 311 (1938). *Western Live Stock v. Bureau of Revenue* is to the same effect:

> Local taxes, measured by gross receipts from interstate commerce, have often been pronounced unconstitutional. The vice characteristic of those which have been held invalid is that they have placed on the commerce burdens of such a nature as to be capable in point of substance, of being imposed, with equal right by every state which the commerce touches, merely because

> interstate commerce is being done, so that without the protection of the commerce clause it would bear cumulative burdens not imposed on local commerce.

303 U.S. 250, 255-56 (1938) (citations omitted).

Further, the Supreme Court has on numerous occasions either upheld taxes which would otherwise violate the Commerce Clause because they provided a credit for taxes paid to other states, or indicated that such a credit would save from constitutional infirmity an otherwise unconstitutional tax. In *Oklahoma Tax Commission*, the Court explained:

> We have indeed never upheld a tax in the face of a substantiated charge that it provided credits for the taxpayer's payment of in-state taxes but failed to extend such credit to payment of equivalent out-of-state taxes. To the contrary, in upholding tax schemes providing credits for taxes paid in state and occasioned by the same transaction, we have often pointed to the concomitant credit provisions for taxes paid out of state as supporting our conclusion that a particular tax passed muster because it treated out-of-state and in-state taxpayers alike.

514 U.S. at 193, n.6. *See also Goldberg v. Sweet*, 488 U.S. 252, 264 (1989) ("To the extent that other States' telecommunications taxes pose a risk of multiple taxation, the credit provision contained in the [taxes at issue] operates to avoid actual multiple taxation."); *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 31 (1988) ("The Louisiana taxing scheme is fairly apportioned, for it provides a credit against its use tax for sales taxes that have been paid in other States."); *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*; 483 U.S. 232, 246 (1987) ("The parallel condition precedent for a valid multiple activities exemption eliminating exposure to the burden of a multiple tax on manufacturing and wholesaling would provide a credit against Washington tax liability for wholesale taxes paid by local manufacturers to any State, not just Washington.").

The import of these cases is obvious. The constitutionality of a state's tax is determined not by simply examining the effects on interstate commerce of such tax in a vacuum, but by considering the effects on interstate commerce of such tax *in conjunction with* the taxes that other states might impose. All leading state tax commentators recognize that the Supreme Court's long line of Commerce Clause jurisprudence establishes this proposition. Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* § 4.08[1] at 4-35 through 4-41 and § 8.02[1] at 8-10 through 8-13 (3d ed. 2001)[1]; *see also* Paul J. Hartman, *Federal Limitations on State and Local Taxation*, § 2.14 at 65-76; § 2.15 at 76-81; § 2.16 at 81-87; § 2.17 at 88-101 (1981); Charles A. Trost. *Federal Limitations on State and Local Taxation*, § 2.17 at 36-41; § 2.19 at 89-93 and 129-34 (2002 Supp.). The Commissioner's limiting his focus to only North Dakota taxing measures, and his refusal to consider the effects on interstate commerce of the DRD Statute in conjunction with the taxes that other states might impose, is fundamentally flawed.

2. The DRD Statute Fails to Take Into Account Other States' Power to Tax.

To support his argument, the Commissioner provides a numerical example of how the DRD Statute works in practice. N.D. Brief at 11. Ironically, the Commissioner provides an example which illustrates the precise flaw in the Commissioner's view of the Commerce Clause. The Commissioner's example omits a crucial factor: the tax another state (State X in the example) has the power to impose.

The Commissioner's example assumes that there are two corporations in which DDI might invest, the North Dakota Widget Corporation and the State X Widget

[1] Excerpts from this treatise are attached at AA at 245-58.

Corporation. The North Dakota Widget Corporation does business only in North Dakota and earns $100, all of which is included in the measure of the North Dakota income tax. The State X Widget Corporation does no business in North Dakota so that none of its income has been subject to the North Dakota tax. Both corporations declare a dividend of their after-tax income to DDI. The Commissioner's example also assumes that DDI apportions 100% of its income (*i.e.*, the dividend) to North Dakota and that the applicable tax rate is 10% (instead of the actual rate of 10.5%). To complete the Commissioner's flawed example, assume that State X imposes an income tax, like North Dakota, of 10%. The Commissioner's example, taking into account State X's tax (reflected in bold in the following chart), produces the following comparative tax treatment:

	North Dakota Widget Corporation	State X Widget Corporation
Dividend Payor's Income	100	100
North Dakota Corp. Income Tax on Dividend Payor	10	0
State X Corp. Income Tax on Dividend Payor	**0**	**10**
Income Available for Dividends	90	90
Dividend Paid to DDI	90	90
North Dakota DRD	90	0
Taxable Dividend	0	90
North Dakota Corp. Income Tax on Receipt of Dividend	0	9
Total Tax Paid by Widget Corporation and DDI	10	19
After Tax Dividend Income of DDI	90	81

Clearly, DDI would be taxed less favorably on its out-of-state investment (State X Widget Corporation) than its in-state investment (North Dakota Widget Corporation). As a consequence, DDI, like all other persons subject to North Dakota tax, would be encouraged to invest in North Dakota corporations rather than corporations which operate in other states.[2]

[2] Before the District Court, DDI presented additional numerical examples which reveal the patently discriminatory effect of the DRD Statute. These examples are included in the Appendix. *See* AA at 260-65; 267-68.

This is the exact result which the Commerce Clause forbids – the DRD Statute is a tax statute that imposes a greater burden on interstate commerce than on intrastate commerce. While North Dakota is free to adopt a policy that eliminates taxation of corporations and shareholders on the same income, it may not implement that policy in a selective manner that offends first principles of Commerce Clause jurisprudence by applying the policy (and its concomitant tax benefits) only to the extent that taxpayers engage in in-state activity. The DRD Statute does precisely this. As the following sections demonstrate, the DRD Statute is clearly unconstitutional.

B. The DRD Statute Is a Facially Discriminatory Tax.

The Commissioner has conceded, as he must, that the DRD Statute is facially discriminatory against interstate commerce. N.D. Brief at 5. The force of this concession cannot be overstated. Indeed, state laws discriminating against interstate commerce on their face are "'virtually *per se* invalid.'" *Fulton*, 516 U.S. at 331 (quoting *Oregon Waste*, 511 U.S. at 99). A facially discriminatory tax invokes "the 'strictest scrutiny'" by the Court. *Id.* (quoting *Chem. Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 342-43 (1992), quoting *Hughes v. Okla.*, 441 U.S. 322, 337 (1979)). "As with any other defense of a facially discriminatory tax, the State has the burden to show that the requirements of the compensatory tax doctrine are clearly met." *Fulton*, 516 U.S. at 344.

The Commissioner tries to avoid the clear mandate of *Fulton* by relying on the presumption of constitutionality of North Dakota statutes. N.D. Brief at 6-7. Notwithstanding this presumption, this Court has consistently declared North Dakota statutes unconstitutional in the face of adverse United States Supreme Court decisions. *See, e.g., Muller v. Custom Distrib., Inc.*, 487 N.W.2d 1 (N.D. 1992) (holding, based on *Bendix Autolite Corp. v. Midwesco Enters.*, 486 U.S. 888 (1988), that a North Dakota

statute providing that a person's absence from North Dakota tolls the limitations period violates the Commerce Clause); *Bartles N. Oil Co. v. Jackman*, 150 N.W. 576 (N.D. 1915) (holding, based on *D. E. Foote & Co. v. Stanley*, 232 U.S. 494 (1914), a North Dakota statute providing for inspection fees for goods brought into North Dakota which were substantially higher than the costs of inspection violates the Commerce Clause); *see also Christman v. Emineth*, 212 N.W.2d 543 (N.D. 1973) (holding that, despite presumption of constitutionality of North Dakota statutes, unreasonable classifications in North Dakota statute created invidious discrimination that violated the Equal Protection Clause of the United States Constitution); *Northwestern Imp. Co. v. Morton County*, 47 N.W.2d 543 (N.D. 1951) (holding that, despite presumption of constitutionality of North Dakota statues, county excise tax classifications were discriminatory, unreasonable and arbitrary, and violated the Equal Protection Clause of the United States Constitution).

C. The DRD Statute Is Not a Compensatory Tax.

As a facially discriminatory tax, the DRD Statute can survive constitutional scrutiny only if the Commissioner can prove that "it is a truly 'compensatory tax' designed simply to make interstate commerce bear a burden already borne by intrastate commerce." *Fulton*, 516 U.S. at 331 (quoting *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 647 (1994)).

In order to show that the DRD Statute is a valid compensatory tax, the Commissioner admits that *it has the burden of proof* to (1) identify the intrastate tax for which the interstate tax seeks to compensate, and prove such intrastate tax serves some purpose for which the state may otherwise impose a burden on interstate commerce; (2) identify and prove that the amount of the tax on interstate commerce roughly approximates, but does not exceed, the amount of the tax on intrastate commerce; and (3)

prove that the interstate tax and compensating intrastate tax fall on substantially equivalent events, *i.e.*, events sufficiently similar in substance to serve as mutually exclusive proxies for each other. N.D. Brief at 9; *Or. Waste*, 511 U.S. at 103; *Fulton*, 516 U.S. at 332-33.

The Supreme Court has plainly signaled to the states its skepticism that any state can prove that one of its taxes satisfies the compensatory tax standard unless the tax at issue is a use tax imposed on an out-of-state person, place, or activity to compensate for a sales tax imposed on an in-state person, place, or activity. *Fulton*, 516 U.S. at 344 ("[W]e doubt that [ ] a showing [that the requirements of the compensatory tax doctrine are met] can ever be made outside the limited confines of sales and use taxes . . ."); *Or. Waste*, 511 U.S. at 105 ("[U]se taxes on products purchased out of state are the only taxes we have upheld in recent memory under the compensatory tax doctrine.").

On appeal, the Commissioner makes the same arguments he advanced below as to why the DRD Statute constitutes a compensatory tax. The District Court was correct to reject each of the Commissioner's arguments below, for the Supreme Court had already rejected the very same arguments when advanced by the North Carolina taxing authority in *Fulton*. In fact, the only proffer the Commissioner made to meet his burden of proof was the arguments he set forth in his summary judgment briefs before the District Court. The Commissioner's effort falls woefully short of meeting its burden of proof. Thus, the Commissioner fails to meet his burden of proof as to the three-prong compensatory tax test, and, therefore, the DRD Statute cannot survive constitutional scrutiny.

1. The DRD Statute Does Not Have a Purpose That Justifies a Burden on Interstate Commerce.

The Commissioner argues that the first compensatory tax requirement is met because the DRD Statute has as its purpose to provide a deduction to take into account the North Dakota income tax that has already been imposed on the corporation that is distributing its already taxed income. N.D. Brief at 10. The Supreme Court rejected this very same rationale as inadequate when raised by North Carolina in *Fulton*. This proffered rationale cannot satisfy the first prong of the compensatory tax test because the Commissioner has failed to identify an in-state North Dakota benefit that dividend payees receive to justify the tax.

In *Fulton*, shareholder taxpayers subject to North Carolina's intangibles tax were allowed a deduction equal to the fraction of the income of the issuing corporation (whose stock such shareholders held) that was subject to the income tax in North Carolina. *Fulton*, 516 U.S. at 328. North Carolina tried to characterize the purpose of its intangibles tax in the same manner as the Commissioner characterizes the purpose of the DRD Statute. "[North Carolina] suggests that the intangibles tax, with its taxable percentage deduction, compensates for the burden of the [underlying income tax] paid by corporations doing business in North Carolina." *Id.* at 334.

The Court, however, found North Carolina's purpose insufficient, stating that, "because North Carolina has no general sovereign interest in taxing income earned out of state . . . [North Carolina] must identify some in-state activity or benefit in order to justify the compensatory levy." *Id.* In other words, the North Carolina intangibles tax, by providing an intangibles tax deduction only with respect to income tax paid by the underlying corporation to North Carolina, had the direct effect of taxing income earned

outside of North Carolina, in exchange for which North Carolina had provided no benefit. This is the precise effect of the DRD Statute. *See also Farmers Bros. Co. v. Franchise Tax Bd.*, BC 237663, slip op. (Cal. Super. Ct. Nov. 21, 2001) (Court rejects California's attempt to defend its DRD statute under the same rationale), discussed below at Section V.D.2.

The Supreme Court was clear in *Fulton*: "[North Carolina] must identify some in-state activity or benefit in order to justify the compensatory levy." *Fulton*, 516 U.S. at 334. North Carolina attempted to show that the higher intangible property tax paid on shares owned in out-of-state corporations compensated for that part of North Carolina's income tax paid by in-state corporations which allegedly went to maintain North Carolina's capital markets. This proffered in-state activity or benefit was rejected by the Court. However, unlike North Carolina in *Fulton*, the Commissioner has not even *attempted* to provide this Court with an in-state North Dakota activity or benefit which might justify North Dakota taxing income earned outside of North Dakota under the DRD Statute.[3] Therefore, *a priori*, the Commissioner's argument as to why the DRD Statute satisfies the first prong of the compensatory tax doctrine fails under *Fulton*.[4]

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[3] The only proffer the Commissioner made to satisfy his burden of proof on this first prong was to offer North Dakota's purpose to avoid double taxation of North Dakota source income.

[4] The Commissioner tries to disguise his failure to provide an in-state North Dakota activity or benefit to justify the DRD Statute by providing a misleading numerical example to demonstrate that the DRD Statute does not discriminate against interstate commerce. N.D. Brief at 10-12. The example provides no in-state activity or benefit, and thus provides no insight as to the first compensatory tax test. Furthermore, as discussed above at Section V.A.2., the Commissioner's example is fundamentally flawed and, when corrected, demonstrates the patently discriminatory effect the DRD Statute has on interstate commerce.

2. The DRD Statute Does Not Approximate the Burden on Intrastate Commerce.

The Commissioner argues that the second compensatory tax test is met because the tax rate on dividends that do not qualify for a DRD under the DRD Statute is 10.5%, and the tax rate on profits earned by the North Dakota corporation paying a dividend is also 10.5%. N.D. Brief at 12. The Commissioner then concludes that because the nominal tax rates are equal, the DRD Statute approximates the burden on interstate commerce.[5] Again, the Commissioner fails to recognize that North Carolina raised the very same tax rate equivalence argument in *Fulton*. The Court unequivocally rejected it.

To avoid *Fulton*, the Commissioner argues that, unlike *Fulton*, in which the allegedly compensatory taxes did not bear any relationship to one another, the North Dakota tax on a dividend payor and the tax on a dividend payee do indeed bear the needed relationship because their nominal rates are the same. N.D. Brief at 12, 16. North Dakota is, as North Carolina was in *Fulton*, comparing "apples to oranges." 516 U.S. at 337.

Through its corporate income tax, North Dakota, like North Carolina, funds a host of services, most of which do not benefit corporations doing business outside North Dakota. The Commissioner does not even attempt to identify the portion of its corporate income tax imposed on income earned inside North Dakota that should be paired with the

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[5] The only proffer the Commissioner made to satisfy his burden of proof on this second prong was to note the nominal rate equivalency between the taxes.

supposedly compensatory burden on out-of-state business activity that is achieved by denying a DRD to payees who receive dividend income from out-of-state payors.[6]

Indeed, as the Court in *Fulton* noted of North Carolina, because North Dakota's corporate income tax is a general levy and not earmarked for a specific purpose, such comparison would be virtually impossible. "A state defending . . . a [tax] scheme as one of [compensatory] taxation . . . has the burden of showing that the actual incidences of the two tax burdens are different enough from their nominal incidences so that the real taxpayers are within the same class, and that therefore a finding of combined neutrality on interstate competition would at least be possible." *Id.* at 340. The Commissioner has not even *attempted* to show that dividend payors and dividend payees are in the same class. Because the Commissioner has made no such attempt, it is impossible to conclude that the actual rates of taxation are similar to their nominal rates. The Commissioner has thus failed to show that the DRD Statute satisfies the second compensatory tax test.

3. The DRD Statute Does Not Fall on Substantially Equivalent Events.

To prove that the North Dakota tax falls on substantially equivalent events, the Commissioner argues that, through the DRD Statute, the North Dakota tax on dividend payors complements the North Dakota tax on dividend payees by ensuring at least one level of North Dakota tax applies to North Dakota source income, but not two levels of

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[6] Of course, when the *Fulton* court noted that, "The math is fine, but . . . the example compares apples to oranges," it explicitly recognized that even if the effective tax rates were identical, such fact is unavailing for this very reason. 516 U.S. at 337. The fact that North Dakota taxes dividend income and underlying income at the same nominal rate is therefore off-point.

North Dakota taxes.[7] N.D. Brief at 12, 13. Again, the Supreme Court expressly rejected this argument when raised by North Carolina in *Fulton*. The Court held that this compensatory tax requirement typically cannot be satisfied "when the allegedly compensating taxes fall respectively on taxpayers who are differently described, as, for example, resident shareholders and corporations doing business out of state." 516 U.S. at 340. Dividend *payors* are quite clearly differently described than dividend *payees*.

In particular, the Commissioner cannot contend that one tax complements the other *only when the dividend-paying corporations earn income from in-state sources.* That is the essence of unconstitutional tax discrimination.[8] In concluding that one tax complements the other, the Commissioner fails to take into account the fact that the profits out of which dividends are paid may have been subject to tax in a state other than North Dakota. A tax on a corporation's profit is completely different than a tax on a shareholders dividends. The DRD Statute provides a deduction for taxes paid to North Dakota on the underlying profits out of which a dividend is paid, but does not provide a similar deduction for taxes paid to another state on the same such profits. Such a provision does not satisfy this third compensatory tax test.

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[7] The only proffer the Commissioner made to satisfy his burden of proof on this third prong was to explain that one tax complements the other by ensuring one level of North Dakota tax on North Dakota source income.

[8] It would be as if a state were to argue that it need not give a credit against its use taxes for sales taxes paid to other states because the sales tax complements the use tax *only* when both the sale and use occur within the state. But such a tax would plainly be unconstitutional. *See* Walter Hellerstein, Michael J. McIntyre & Richard D. Pomp, *Commerce Clause Restraints on State Taxation After Jefferson Lines*, 51 Tax L. Rev. 47, 66-67 (1995). A copy of the article is attached at AA at 64-117.

D. The DRD Statute Has the Same Effect As the Unconstitutional Tax in *Fulton* and Other Unconstitutional State Taxes.

The Commissioner asserts that the District Court erred in concluding that the intangibles tax in *Fulton* and the DRD Statute were "'very similar,'" and that the unconstitutionality of the DRD Statute is well-settled. N.D. Brief at 13-14, 16-17. The Commissioner is wrong.

1. The Effect of the DRD Statute Is the Same As That of the *Fulton* Intangibles Tax.

While on the one hand the Commissioner states that the North Carolina tax in *Fulton* is completely dissimilar from the DRD Statute, on the other hand the Commissioner describes the North Carolina tax in a manner which reveals that, for all relevant purposes, it is in fact identical to the DRD Statute. The Commissioner writes:

> [Under the intangibles tax], if a corporation did all of its business in North Carolina and paid corporate income tax on 100% of its income, the dividend payee would receive a deduction under the intangibles tax of 100% of the value of the stock. If the dividend-paying corporation did 50% of its business and paid North Carolina corporate income tax on 50% of its income, the resident would only receive 50% of the stock's value as a deduction from the intangibles tax.

N.D. Brief at 14. Thus, even the Commissioner recognizes (correctly) that, under the intangibles tax in *Fulton*, a taxpayer would receive a deduction directly proportional to the percentage of the business the corporation whose stock he held did in North Carolina (and thus directly proportional to the tax such corporation paid to North Carolina). The DRD Statute has the precise same effect.

As with the North Carolina intangibles tax in *Fulton*, under the DRD Statute a dividend payee receives a deduction directly proportional to the percentage of the business the payor corporation does in North Dakota. As the Court stated in *Fulton*:

> A regime that taxes [a payee] only to the degree that [the underlying corporation] participates in interstate commerce favors domestic corporations over their foreign competitors . . . and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

516 U.S. at 333. For all purposes of determining constitutionality under the Commerce Clause, the intangibles tax in *Fulton* and the DRD Statute are identical.

2. Tax Statutes Having the Same Effect As the DRD Statute Have Been Uniformly Struck Down As Unconstitutional.

The Commissioner argues that the unconstitutionality of the DRD Statute is not well-settled. N.D. Brief at 16. The Commissioner's argument is without foundation. Every court to consider the issue has uniformly struck down DRD statutes similar to North Dakota's DRD Statute as violative of the Commerce Clause.

A recent California decision is directly on point. *Farmers Bros. Co. v. Franchise Tax Bd.*, No. BC237663, slip op. (Cal. Super. Ct. Nov. 21, 2001).[9] In *Farmers*, a California court invalidated, under the Commerce Clause, a statute almost identical to the DRD Statute. The California statute allowed for up to a 70 percent DRD based upon the extent to which the payor corporation was subject to California's corporate income and franchise taxes. As in this case, the taxing authority argued that the statute was a constitutional compensatory tax because its purpose was to prevent double taxation of the same stream of income. *Id.* The California court disagreed:

> By the device of giving harsher tax treatment to dividends from out-of-state businesses, California has managed to accomplish by indirection what it cannot do by direction, namely, it effectively has levied an in-lieu tax based upon corporate income streams occurring beyond its borders. By subjecting shareholders of foreign corporations to different treatment, the State says, in effect, "since we can't impose a franchise tax on your business at the front end, we'll tax you personally in an equivalent sum at

[9] Opinion is attached at AA at 119-21.

> the back end." It is a scheme too clever by half, and one that facially places an unconstitutional burden on interstate commerce.

Id. at 2.

The *Farmers Bros.* decision followed an earlier California appellate court decision, *Ceridian Corp. v. Franchise Tax Board*, 102 Cal. Rptr. 2d 611 (Cal. App. 2001). The California Court of Appeals struck down a statute that allowed a deduction for a dividend received from an insurance company only to the extent the dividend was "paid from income from California sources." *Id.* at 615. The taxing authority claimed that the statute was not discriminatory because it prevented double taxation of the same stream of income. *Id.* at 617. The California Court of Appeals disagreed and held the tax unconstitutional. The court rejected the state's argument as a "non-sequitur" and explained that the "fact that the tax scheme may serve some other laudatory purpose [such as preventing double taxation] does not save it from a commerce clause challenge." *Id.* at 619. As with California's double taxation rationale in both *Farmers* and *Ceridian*, the Commissioner's double taxation rationale offered to justify the DRD Statute does not transform the DRD Statute into a constitutional statute.

A Wisconsin court reached the same result in declaring Wisconsin's DRD statute unconstitutional. The Wisconsin statute permitted an exclusion from gross income for dividends received but only if 50% or more of the payor corporation's net income was subject to Wisconsin tax. *NCR Corp. v. Wis. Dep't of Revenue*, Nos. 92 CV 1516 & 92 CV 1525, LEXIS 93 STN 102-21 (Wis. Cir. Ct. of Dane County Branch 13 Apr. 30, 1993). The court concluded that "dividends paid by a local Wisconsin business are treated more favorably than dividends paid by non-Wisconsin businesses. . . . Because

its dividends are not taxed in Wisconsin, a Wisconsin corporation becomes a more attractive target for investment dollars than a comparable non-Wisconsin corporation."[10]

The Hawaii taxing authority reached the same conclusion voluntarily by announcing it would not enforce its DRD statute but would allow all taxpayers to claim a DRD. Hawaii Dep't of Taxation, Announcement No. 98-5, WL RIA SLT HI OM (Feb. 26, 1998) ("Based on cases litigated in other jurisdictions . . . [the Hawaii DRD statute] is likely to be found unconstitutional in limiting the 70% dividends deduction to dividends received from payor corporations having a threshold presence in Hawaii . . . . ").[11]

In fact, no court in any jurisdiction has held constitutional a statute similar to the DRD Statute. Every decision has been to the contrary. This case presents no new issue for this Court. The law applicable to this case is indeed well-settled.

3. The DRD Statute Does Not Serve a Legitimate Local Purpose That Cannot Be Served By Reasonable Non-Discriminatory Alternatives.

The Commissioner cites *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988), and *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 100-01 (1994), for the proposition that the DRD Statute, despite the fact that it is facially discriminatory against interstate commerce and fails to qualify as a valid compensatory tax, might nevertheless pass constitutional muster if it serves a legitimate local purpose that cannot be adequately served by a non-discriminatory alternative. N.D.

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[10] The court's opinion appears at AA at 123-52. The Wisconsin Court of Appeals certified the question to the Wisconsin Supreme Court for review. *See Wis. Dep't of Revenue v. NCR Corp.*, No. 93-1800, 1996 Wisc. App. LEXIS 995 (Wis. Ct. App. July 31, 1996). However, after the Wisconsin Supreme Court accepted review, the parties settled the case.

[11] The Hawaii taxing authority's announcement appears at AA at 154-55.

Brief at 17-18. The Commissioner's reliance on the no non-discriminatory alternative test is misplaced.

The Supreme Court has never held that there was no non-discriminatory alternative to a tax that discriminated against interstate commerce. As noted by the leading state tax commentator, while "the Court [has] suggest[ed] in some cases that if there are no nondiscriminatory alternatives to a challenged state tax, the tax might be sustained[.] [t]he Court has never sustained a discriminatory tax on such a basis. however, perhaps because there is virtually always a nondiscriminatory alternative . . . namely, a nondiscriminatory tax that raises the same amount of revenues as the discriminatory exaction." Hellerstein & Hellerstein, *supra* § 4.14 at 4-127 and 4-128, n.553 (citation omitted).

The theory of the no non-discriminatory alternative does have an important application when assessing the constitutionality of a non-tax regulatory measure; it does not have an application in the tax context. *Maine v. Taylor*, 477 U.S. 131 (1986), cited by the Commissioner, illustrates the role of the no non-discriminatory alternative in the regulatory context. A Maine statute prohibited the importation of baitfish into the state. Such statute was clearly discriminatory. *Id.* at 138. The Court nevertheless upheld the import ban as serving a legitimate local purpose, *i.e.*, protecting Maine fisheries from parasites brought in with imported baitfish, for which no non-discriminatory alternative existed. The Court upheld the district court's finding that implementing sampling and inspection procedures for testing imported baitfish was not a non-discriminatory alternative because their development would take a considerable amount of time to implement.

The *Maine v. Taylor* no non-discriminatory alternative rationale, however, has no application to this case. The Commissioner asserts that the DRD Statute's purpose is to avoid double taxing North Dakota corporate income. N.D. Brief at 11. He asserts that North Dakota is entitled to discriminate against interstate commerce to avoid taxing North Dakota income twice. However, unlike the inability of Maine to rid the state of parasitic baitfish short of a ban on their importation, North Dakota can achieve its *exact* goal of avoiding North Dakota double taxation *without* implementing a discriminatory tax.

North Dakota could simply exempt from taxation dividends received by a payee corporation to the extent the underlying payor's income was subject to tax in *any* state, rather than only to the extent the underlying payor's income was subject to tax in North Dakota. Such a statute would clearly prevent the double taxation of North Dakota income by North Dakota (North Dakota's stated purpose), and would clearly pass constitutional muster because it would not be a discriminatory tax. North Dakota thus cannot possibly argue that there is no reasonable non-discriminatory alternative to its facially discriminatory DRD Statute.

Indeed, in the very tax authorities relied upon by the Commissioner (*New Energy* and *Oregon Waste*), the Court expressly rejected the no non-discriminatory alternative arguments raised by the applicable taxing authorities because in each case non-discriminatory alternatives did in fact exist (as they always will). In most tax cases, the Court does not even mention that such a theoretical possibility exists. Indeed, the Court in *Fulton* did not even discuss the theoretical possibility that North Carolina could not achieve its purpose with a non-discriminatory alternative. Rather, the Court concluded

simply that, "North Carolina's intangibles tax facially discriminates against interstate commerce, it fails justification as a valid compensatory tax, and, accordingly, it cannot stand." 516 U.S. at 346. The Supreme Court in *Fulton* recognized, as the District Court did in this case, that it is impossible for a state to establish that no non-discriminatory alternative to a discriminatory tax statute exists.

E. The DRD Statute Is In Any Event Unconstitutional under the Commerce Clause's Internal Consistency Requirement.

Even assuming *arguendo* that the DRD Statute was a valid compensatory tax, the DRD Statute would still be unconstitutional because it is not "internally consistent," which is an entirely separate requirement for validity under the Commerce Clause. *See* Walter Hellerstein, *Is 'Internal Consistency' Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 Mich. L. Rev. 138, 177-78 (1988).[12]

The Commissioner has previously admitted the applicability of the internal consistency test to this case.[13] AA at 287-91. Under the internal consistency doctrine, "a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result." *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989). The doctrine thus focuses upon whether interstate commerce would bear a heavier tax burden than

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[12] A copy of this article is attached at AA at 178-218.

[13] While not relied upon by the District Court, this Court may still affirm the District Court decision on the basis that the DRD Statute fails the internal consistency test. It is a well-established principle of North Dakota law that a judgment will not be reversed because it rests upon an inapplicable ground if an applicable ground not expressly relied upon by the lower court would support the same outcome the lower court reached. *See, e.g., Peters-Riemers v. Riemers*, 2001 ND 62, 624 N.W.2d 83, 88 (N.D. 2001); *Wachter v. Gratech Co.*, 2000 ND 62, 608 N.W.2d 279, 289 (N.D. 2000); *First Nat'l Bank of Belfield v. Burich*, 367 N.W.2d 148, 154 (N.D. 1985). As such, even if this Court finds that the DRD Statute is a valid compensatory tax, the Court should nonetheless affirm the District Court decision because the DRD Statute is still unconstitutional under the independent internal consistency requirement of the Commerce Clause.

intrastate commerce in the event that every state adopted a tax regime identical to the tax regime under scrutiny. If so, the tax regime must be struck down, even if the taxpayer has no evidence that it was actually subjected to more burdensome taxation. *Am. Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 284 (1987) (striking down Pennsylvania's unapportioned flat tax on trucks for violating internal consistency); *Tyler Pipe Indus., Inc.*, 483 U.S. at 247-48 (striking down Washington's Business and Occupations ("B&O") tax for failing the internal consistency test); *Armco Inc.*, 467 U.S. at 644-45 (striking down West Virginia's B&O tax for failing the internal consistency test); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983) (setting forth the internal consistency test).

In its most recent case considering the internal consistency doctrine, the Court described the test as follows:

> Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax.

Okla. Tax Comm'n, 514 U.S. at 185.

North Dakota's taxation of dividend income clearly fails the internal consistency test. If every state adopted North Dakota's DRD scheme, only taxpayers who invested in corporations that confined their activities to a single state would receive a 100 percent DRD. If a corporation's businesses strayed across state lines, a taxpayer receiving a dividend from such corporation would face an increased liability because the DRD would

fall below 100 percent. Thus, interstate activity would bear a greater burden than intrastate activity in violation of the internal consistency doctrine. For a numerical example proving how the DRD Statute fails the internal consistency test, see AA at 18-19 and 267-68.

F. The Rationale Behind the DRD Statute Is Inconsistent with National and International Efforts to Avoid Double Taxation.

The Commissioner also emphasizes that there are national and international policies against double taxation, and that this case involves the constitutional right of North Dakota to implement the same policy as that of the national government and the international community of eliminating or mitigating the double taxation of corporate income. N.D. Brief at 2, 18-19. The Commissioner's argument fails on at least two levels.

First, it is quite curious that the Commissioner makes this argument in the first instance because the Commissioner himself expressly recognizes that "the federal government and the international community are *not* subject to the same constitutional constraints that apply to the states." *Id.* at 2 (emphasis added). The Commissioner, thus, admits the obvious -- neither the United States nor any international body is subject to the interstate commerce constraints of the Commerce Clause.

Second, and more fundamentally, the Commissioner's argument proves the exact opposite of what the Commissioner intends. Unlike the DRD Statute, which provides a North Dakota taxpayer a DRD *only* with respect to underlying income taxed by North Dakota, United States international taxation, and, in particular, the foreign tax credit sections of the United States Internal Revenue Code of 1986 (Sections 901 and 902, specifically referenced by the Commissioner. N.D. Brief at 18), provide foreign tax

credits with respect to income taxes paid to a jurisdiction *other than* the United States. *Snap-On Tools, Inc. v. United States*, 26 Cl. Ct. 1045, 1050 (1992) ("The credit protects domestic corporations operating through foreign subsidiaries from double taxation on the same income, i.e., taxation first by the foreign jurisdiction, when the income is earned by the subsidiary, and second by the United States, when the income is received as a dividend by the parent corporation."), *aff'd*, 26 F.3d 137 (Fed. Cir. 1994); Joseph Isenbergh, *International Taxation, U.S. Taxation of Foreign Persons and Foreign Income*, ¶ 1.2 (3d ed. 2002) ("One of the first concerns of someone considering overseas operations therefore is whether the ensuing tribute to various sovereigns will be bearable. Double taxation is inevitably a dominant concern of all systems of international taxation. The problem is obvious enough that most countries have taken steps, both in unilateral provisions of their own laws and through international agreements, to limit the multiple taxation of income from economic activity connected with more than one country.")

Thus, the Commissioner's analogy of the DRD Statute to the Section 901 and 902 credits is fundamentally flawed. A correct analogy would be between the Section 901 and 902 credits and a modified statute which provided a DRD for taxes paid to any jurisdiction, rather than solely to North Dakota. Unlike the DRD Statute, this modified statute would be analogous to the Section 901 and 902 credits, would not be discriminatory (facially or otherwise) against interstate commerce, and would be a constitutional taxation measure under the Commerce Clause.

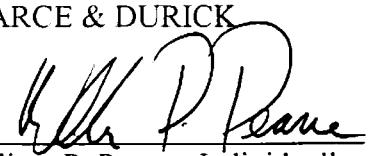
VI. CONCLUSION

North Dakota's system of taxing dividend income under the DRD Statute violates the Commerce Clause of the United States Constitution because it is a facially

discriminatory tax that does not constitute a compensatory tax. The DRD Statute is also unconstitutional because it violates the internal consistency test of the Commerce Clause. Accordingly, DDI respectfully requests the Order and Judgment of the District Court be affirmed.

DATED this 22nd day of November, 2002.

PEARCE & DURICK

By 

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CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that true and correct copies of the following documents:

BRIEF OF THE APPELLEES
and
APPELLEES APPENDIX

were on the 22nd day of November, 2002, served by placing the same in the United States mail, postage prepaid, properly addressed to the following:

Ms. Donnita A. Wald
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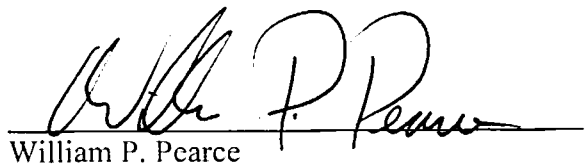

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