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Supreme Court Holds Illinois Tax on Interstate Telecommunications Does Not Violate Commerce Clause

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RECENT CASES

SUPREME COURT HOLDS ILLINOIS TAX ON INTERSTATE TELECOMMUNICATIONS DOES NOT VIOLATE COMMERCE CLAUSE

In *Goldberg v. Sweet*, ___ U.S. ___, 109 S. Ct. 582 (1989), the United States Supreme Court held that the Illinois Telecommunications Excise Tax Act (“the Tax Act”), Ill. Rev. Stat. ch. 120, pars. 2001-2021 (1987), did not violate the Commerce Clause of the United States Constitution.

Background

The Tax Act, enacted in 1985, imposes a 5% tax on the gross charge of interstate telecommunications. The Tax Act specifically imposes the tax on interstate telephone calls which originate or terminate in Illinois and are charged to an Illinois service address, regardless of where the telephone call is billed or paid. An identical tax is imposed on intrastate telecommunications. In addition, the Tax Act provides a credit to the taxpayer if the taxpayer can demonstrate that the telephone call in question has already been taxed by another state.

Eight months after the Tax Act was passed, Jerome Goldberg and Robert McTigue, Illinois residents subject to the telecommunications tax, filed a class action complaint in state court against the Director of the Department of Revenue for the State of Illinois (“the Director”) and various long-distance telephone carriers, including Sprint. The complaint alleged that the Tax Act was unconstitutional under the Commerce Clause.

Trial Court

The trial court found the Tax Act unconstitutional based on the four-prong test outlined in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The *Complete Auto* test finds a state tax constitutional provided “the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.” 109 S. Ct. at 587, quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The trial

court determined that the tax was not fairly apportioned and thus, that the Tax Act was unconstitutional.

Illinois Supreme Court

The Illinois Supreme Court reversed the trial court’s finding of unconstitutionality. The Illinois Supreme Court also found that the tax was not apportioned because Illinois was potentially taxing telephone calls which could also be taxed by other states. However, the court was satisfied that the credit provision in the Tax Act virtually eliminated the threat of multiple taxation. The court reasoned, therefore, that the apportionment requirement of the *Complete Auto* test had been met. The court also held that the tax was not discriminatory because intrastate calls, as well as interstate calls, were taxed. In addition, the court found that the tax was fairly related to services provided by Illinois. The Illinois Supreme Court thus held the Tax Act valid under the Commerce Clause. *Goldberg, McTigue and Sprint* appealed to the United States Supreme Court asserting that the tax was not fairly apportioned.

United States Supreme Court: The *Complete Auto* Test

The Court first noted the policy considerations behind the *Complete Auto* test. *Complete Auto* rejected the notion that any tax on interstate commerce is unconstitutional and, at the same time, attempted to set forth some limits on the power of the states to tax interstate commerce. All the parties agreed that Illinois had a substantial nexus with the interstate telephone calls and thus that the first prong of the test had been met. Thus, the Court began its analysis with the second prong of the *Complete Auto* test.

Second Prong of *Complete Auto*: Apportionment

The Court stated that the “purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction.” 109 S. Ct. at 588. Although the Constitution does not mandate a particular apportionment formula, the Court has found an internal and external consistency test to be suitable for determining whether a tax is fairly apportioned.

A tax passes the “internally consistent” test if it is structured so that if every state were to impose an identical tax no multiple taxation would result. Appellant Sprint argued that the challenged tax should be compared to similar, not identical, taxes imposed by other states. The Court disagreed. The Court reasoned that such a comparison was unworkable because the validity of state taxes would then turn on “the shifting complexities of the tax codes of 49 other States.” 109 S. Ct. at 588, quoting *Armco, Inc. v. Hardesty*, 467 U.S. 638, 645 (1984). Therefore, the Court applied the “identical tax” standard and found that the Tax Act satisfied the internally consistent test. The Court conjectured that if only those interstate telephone calls which are charged to a service address within the state are taxed, then only that state would tax each call.

The “externally consistent” test is met if a tax applies only to revenues reasonably reflecting the in-state portion of the activity being taxed. The first part of the Court’s externally consistent analysis focused on the economic effects of the tax. The Director argued that the economic effect of the Tax Act was very similar to that of a sales tax. The Court agreed with this argument because the tax imposed by the Tax Act has many of the characteristics of a sales tax: it is assessed against the individual consumer, it is collected by the retailer, and it reasonably reflects the way consumers purchase interstate telephone calls.

The Court next focused on the Tax Act’s potential for multiple taxation. The problem of multiple taxation could result if a consumer splits his or her billing and service addresses between two different states. In such a case, both the billing state and the service state would have a substantial nexus with the interstate telephone call and multiple taxation could result. The Court held the Tax Act protects against multiple taxation because its credit provision provides a credit to the consumer for sales taxes that have been paid in other states. Although a slight risk exists that multiple taxation could result, the Court concluded that the risk is low and in fact prohibited by the credit provision of the Tax Act itself.

Lastly, the Court noted the practical limitations on apportionment. Whereas the Court had previously endorsed apportionment formulas based on the number of miles a train, truck, or bus traveled within the taxing state, that formula could not be applied to the “travels” of an inter-

state telephone call. An interstate telephone call consists of electronic signals traveling throughout a complex computer network. In addition, a call from a specific origin to a specific destination may not always take the same path. A computer automatically activates a different path if a direct path is not available. Therefore, the Court determined that an exact apportionment formula like that used in the transportation cases would be unduly burdensome if applied to interstate telephone calls. Accordingly, the Court found that the Illinois legislature had reached a pragmatic solution to the problem of apportioning taxes in the present-day computerized world.

Third Prong of Complete Auto: Discrimination

The appellants argued that although there is a 5% tax on both interstate and intrastate calls, the Tax Act discriminates against the former because a larger share of the tax burden is allocated to interstate calls. The Court disagreed with this argument for two reasons. First, the economic burden of the tax falls, in either case, on the Illinois taxpayer who is able to change the tax through the Illinois political process. The Court emphasized that “[i]t is not a purpose of the Commerce Clause to protect state residents from their own state taxes.” 109 S. Ct. at 591. Second, the exact portion of the thousands of electronic signals comprising a single telephone call which fall within a particular state cannot be accurately determined. For these reasons the Court concluded that the Tax Act does not discriminate against interstate commerce.

Fourth Prong of Complete Auto: Fair Relation to the Presence and Activities of the Taxpayer

The purpose of the fair relation requirement is to ensure that the tax burden is placed on those persons actually benefiting from the services provided by the state. The Court held that this requirement should not be construed to limit the tax to the cost of services provided by Illinois to telecommunications equipment within Illinois. Instead, this requirement focuses on the wide range of benefits provided to the consumer. For example, here the benefits received by the Illinois taxpayer are not limited to the cost of servicing telephone equipment. The Illinois taxpayer also receives such benefits as telephone service, rental of telephone equipment, and police and fire protection. The Court concluded that the Tax Act is fairly related to the benefits received by Illinois taxpayers.

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ILLINOIS TAX (from page 99)

Concurring Opinions

Justice Stevens and Justice O'Connor disagreed with the majority's reasons for concluding that the Tax Act does not discriminate against interstate commerce. Justice Stevens noted that at least on the surface, the Tax Act appears to discriminate against interstate commerce because interstate calls bear a heavier tax burden. However, both Justices Stevens and O'Connor concluded that the practical economic effect of

the Tax Act is to proportionately tax both intrastate and interstate calls. Justice O'Connor also disagreed with the majority's application of the internal consistency test to state taxes challenged under the Commerce Clause. Finally, Justice Scalia concurred with the judgment of the majority and stated that only those taxes that facially discriminate against interstate commerce violate the Commerce Clause.

Mary L. Smith

PENNSYLVANIA LAW PREVENTING PUBLIC UTILITIES FROM RECOVERING FINANCIAL LOSSES THROUGH RATES OR AMORTIZATION UPHELD

In *Duquesne Light Co. v. Barasch*, — U.S. —, 109 S. Ct. 609 (1989), the United States Supreme Court held that a Pennsylvania statute preventing a public utility company from recovering construction costs of cancelled plants does not violate the Takings Clause of the fifth amendment of the Constitution. The Court ruled that a state is free to set rates for public utilities which balance the interests of the utilities and the public.

Background

In 1967, two public utility companies, Duquesne Light Company ("Duquesne") and Pennsylvania Power Company ("Penn Power"), decided to increase their generating capacity. Duquesne and Penn Power entered into an agreement with several other electric utilities to construct seven nuclear generating units. In 1980, the construction of four of the facilities was halted in part due to the Arab oil embargo and the Three Mile Island accident. The demand for electricity as well as the desirability of nuclear energy as a means to meet that demand had changed. Duquesne and Penn Power respectively had expended \$34,697,389 and \$9,569,665 in construction costs by the time the project was cancelled.

In 1980 and 1981 Duquesne petitioned the Pennsylvania Public Utilities Commission ("the PUC") to gain permission to recoup its losses

over a ten-year period. The PUC found that the cancellation of the project was reasonable given the circumstances and permitted Duquesne and Penn Power to amortize expenditures over a ten-year period. In 1982, Duquesne again petitioned the PUC to obtain a rate increase. In 1983, the PUC allowed Duquesne to increase its revenues \$105.8 million to a total yearly revenue exceeding \$800 million. The rate increase included \$3.5 million in revenue which represented the first payment to Duquesne for its loss from the plants' cancellation. The PUC granted Penn Power the authority to increase its revenues by \$15.4 million to a total of \$184.2 million. This increase included the first year of the ten-year amortization recovery.

Prior to the close of the Duquesne rate proceeding in 1982, the Pennsylvania legislature enacted a law which amended the Pennsylvania Utility Code ("the Act"). The Act prohibited the cost of construction of a utility plant undertaken by a public utility from being included in the rate base or in rates charged by the utility until the facility is "used and useful" to the public. Pa. Stat. Ann. tit. 66, § 1315 (Purdon 1988). Pursuant to the Act, the Pennsylvania Office of the Consumer Advocate ("the Consumer Advocate") requested that the PUC reconsider its order allowing Duquesne to amortize its losses. The PUC reaffirmed its prior decision, interpreting the Act as excluding the costs of canceled facilities from the rate base but not as precluding recovery of costs through amortization.

The Consumer Advocate appealed the PUC's decision to the Pennsylvania Commonwealth Court, which held that the PUC had interpreted the Act correctly. The Consumer Advocate then appealed to the Pennsylvania Supreme Court.