A city in State X is a center for businesses that assemble personal computers. Components for these computers are manufactured elsewhere in State X and in other states, then shipped to the city, where the computers are assembled.

A city ordinance imposes a special license tax on all of the many companies engaged in the business of assembling computers in that city. The tax payable by each such company is a percentage of the company's gross receipts earned in the state.

A State X statute that authorizes municipalities to impose this license tax has a "State X content" provision. To comply with this provision of the state statute, the city license tax ordinance provides that the tax paid by any assembler of computers subject to this tax ordinance will be reduced by a percentage equal to the proportion of computer components manufactured in State X.

A company assembles computers in the city and sells them from its offices in the city to buyers throughout the United States. All of the components of its computers come from outside State X. Therefore, the company must pay the city license tax in full without receiving any refund. Other computer assemblers in the city use components manufactured in State X in varying proportions and, therefore, are entitled to partial reductions of their city license tax payments.

Following prescribed procedure, the company brings an action in a proper court asking to have the city's special license tax declared unconstitutional on the ground that it is inconsistent with the negative implications of the commerce clause.

In this case, should the court rule in favor of the company?

A. No, because the commerce clause does not interfere with the right of a state to foster and support businesses located within its borders by encouraging its residents to purchase the products of those businesses.

B. No, because the tax falls only on companies resident in State X and, therefore, does not discriminate against or otherwise adversely affect interstate commerce.

C. Yes, because any tax on a company engaged in interstate commerce, measured in whole or in part by its gross receipts earned in the state, is a per se violation of the negative implications of the commerce clause.

D. Yes, because the tax improperly discriminates against interstate commerce by treating in-state products more favorably than out-of-state products.

Explanation:

The commerce clause gives Congress extensive power to regulate interstate commerce, which encompasses nearly all activities that affect two or more states. As a result, the negative implication of this clause—ie, the **dormant commerce clause**—prohibits **states and municipalities** from unduly burdening interstate commerce. A state or municipal **tax on interstate commerce** is an **undue burden *unless*** the tax:

- is applied to persons or activities with a **substantial nexus** to the taxing state or municipality
- is **fairly apportioned** to avoid taxing interstate activities performed in other states
- does **not discriminate** by favoring local over out-of-state entities *and*
- is **fairly related** to services and benefits provided by the taxing state or municipality.

Here, the city's license tax applies to all companies that assemble computers in the city (substantial nexus) at a percentage of their gross receipts (fairly apportioned). The tax is likely reasonable compared to the services provided by the city (fairly related). But it *discriminates* against interstate commerce by allowing companies to reduce their taxes by using computer components manufactured in the state, thereby treating in-state products more favorably than out-of-state products **(Choice B)**. Therefore, the court should rule in favor of the company.

(Choice A) States and municipalities can encourage their residents to purchase products from businesses located within their borders. But these entities cannot violate the dormant commerce clause when doing so.

(Choice C) A tax on a company engaged in interstate commerce, measured in whole or in part by its gross receipts, is *not* a per se (ie, automatic) violation of the negative implications of the commerce clause. Instead, such a tax complies with the "fairly apportioned" requirement imposed by this clause.

Educational objective:

A state or municipal tax on interstate commerce is valid if it is (1) levied on persons or activities that have a substantial nexus with the taxing entity, (2) fairly apportioned, (3) nondiscriminatory, and (4) fairly related to the services provided by the taxing entity.

References

- U.S. Const. art. I, § 8, cl. 3 (commerce clause).
- Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977) (setting forth the four-factor test used to determine if a state or municipal tax violates the dormant commerce clause).

- 71 Am. Jur. 2d State and Local Taxation § 168 (2019) (explaining that a state tax favoring in-state over out-of-state economic interests is invalid).