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Commerce Clause, First Department: R.J. Reynolds Tobacco Company v. City of New York Department of Finance

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U.S. CONST. art. I, § 8, cl. 3:

The Congress shall have the power . . . to regulate Commerce . . . among the several states

SUPREME COURT, APPELLATE DIVISION

FIRST DEPARTMENT

R.J. Reynolds Tobacco Company

v.

City of New York Department of Finance¹

(decided December 9, 1997)

The New York City Department of Finance issued a notice of determination after discovering a tax deficiency upon the audit of plaintiff's, R.J. Reynolds Tobacco's, tax returns.² The tax deficiency concerned the extent of plaintiff's deduction for plaintiff's out-of-state property.³ New York City's Department of Finance found that plaintiff's deductions violated New York City's General Corporation Tax.⁴ Specifically, plaintiff's 1987 and 1988 tax returns took the accelerated depreciation deduction permitted under the Internal Revenue Code⁵ and failed to

¹ 667 N.Y.S.2d 4 (1st Dep't 1997).

² *Id.* at 7.

³ *Id.*

⁴ *Id.* at 6-7. The Corporation Tax is embodied in Title XI of the Administrative Code. The Code provides in pertinent part: "[E]very domestic or foreign corporation that does business, employs capital, or owns or leases property in the city in a corporate or organized capacity shall annually pay a tax, upon the basis of its entire net income." N.Y. ADMIN. CODE § 11-603. Under another Code provision, the corporate taxpayer cannot take an accelerated depreciation deduction if the depreciated property had been as "placed in service in New York" after 1984. N.Y. ADMIN. CODE § 11-602.

⁵ I.R.C. § 168. This section law governs the accelerated depreciation deduction in New York. *Id.*

distinguish between its property placed in service within and out of the state.⁶

Plaintiff challenged the constitutionality of the relative provisions of the Administrative Code and the Supreme Court, New York County, granted summary judgment to plaintiff.⁷ The provisions were declared unconstitutional by the court and the statute was found to be in violation of the Commerce Clause of the United States Constitution.⁸ Consequently, the notice of determination was declared void and the City was permanently enjoined from exacting compliance with the notice in addition to the "subject Code provisions."⁹

The Department of Finance appealed the decision of the Supreme Court, New York County,¹⁰ and the Appellate Division, First Department, affirmed the lower court's decision to grant plaintiff's motion for summary judgment.¹¹ The Appellate Division found that the City "failed to articulate what constitutionally legitimate local purpose is being served" and that the "[o]rdinance in question had the practical effect of discriminating against taxpayers doing business in New York who have commercial property located outside of New York."¹²

Plaintiff, R.J. Reynolds Tobacco Company, a New Jersey corporation,¹³ with its principal place of business located in North Carolina, is involved in the manufacture and sale of cigarettes in interstate commerce.¹⁴ During the years 1987 and 1988, plaintiff's manufacturing facilities were located mostly in Winston Salem, North Carolina, but it distributed and marketed

⁶ *Reynolds*, 667 N.Y.S.2d at 7.

⁷ *Id.*

⁸ U.S. CONST. art. I, § 8, cl. 3. The Commerce Clause provides that: "[T]he Congress shall have the Power . . . to regulate Commerce...among the several states." *Id.*

⁹ *Reynolds*, 667 N.Y.S.2d at 7.

¹⁰ *Id.*

¹¹ *Id.* at 11.

¹² *Id.* at 8.

¹³ *Id.* at 5.

¹⁴ *Id.*

tobacco products throughout New York.¹⁵ This New York activity is subject to New York City's taxing law.¹⁶

New York City generally permitted plaintiff's use of federal deductions on the corporation's federal tax return.¹⁷ However, the City did not permit plaintiff's accelerated depreciation deduction for property not located in New York state.¹⁸ This is significant because accelerated depreciation allows for "the relative greater deductibility during the early years, which releases funds that otherwise would be embarked for taxes."¹⁹

Defendants argued on appeal that the statute at issue does not violate the Commerce Clause, because it does not impose a burden on interstate commerce and even if a burden did exist, the statute is not discriminatory.²⁰ The Appellate Division, however, found the tax to be facially discriminatory in burdening out-of-state business over local business,²¹ resulting in a benefit to local business.²² To pass constitutional muster, "the state tax must be applied to an activity with a substantial nexus with the taxing state; it must be fairly apportioned; it must not discriminate against interstate commerce, and it must be fairly related to the services provided by the state. . . ."²³ After finding the statute to be "facially discriminatory," the burden shifted to the City to show the existence of a "legitimate local benefit" that could not be achieved by less discriminatory means.²⁴ The City failed to meet this burden and consequently the Appellate Division found that no legitimate purpose existed and the tax was unconstitutional.²⁵

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at 7.

¹⁸ *Id.*

¹⁹ *Id.* at 6.

²⁰ *Id.* at 7.

²¹ *Id.* at 11.

²² *Id.*

²³ *Id.* at 8.

²⁴ *Id.* at 9.

²⁵ *Id.* The court held that the taxing ordinance imposed unequal treatment on taxpayers "results solely from the situs of their activities and provides a commercial advantage on local businesses." *Id.*

In *Associated Industries v. Lohman*,²⁶ the United States Supreme Court explained that the Commerce Clause “embodies a negative command forbidding the States to discriminate against interstate trade.”²⁷ The Court specifically adhered to the significance in protecting the country from “economic protectionist” measures, such as additional taxes, which burden out-of-state businesses for the benefit of in-staters.²⁸ The tax at issue involved an additional use tax that exempted sales of goods that took place within the state.²⁹ When using the test outlined above, the Court found the scheme to be “impermissibly discriminatory” in certain localities.³⁰

In interpreting the protection afforded by the Commerce Clause, the *Reynolds* court cited to *American Telephone & Telegraph company v. New York Department of Taxation & Finance*³¹ in which a similar tax apportionment to the case at bar was “not practically necessary as well as being constitutionally offensive.”³² The New York Court of Appeals stressed the importance of preserving “the economic unit” of the nation.³³ Hence, in following the same test as the previous two cases cited, the Court of Appeals concluded that the discriminatory tax

²⁶ 511 U.S. 641 (1994).

²⁷ *Id.* at 646.

²⁸ *Id.* at 647.

²⁹ *Id.* The State of Missouri created an “additional use tax of 1.5% on the privilege of storing, using, or consuming within the State any article of personal property purchased outside the State.” *Id.* at 644 (citing MO. REV. STAT. § 144.748 (1993)). Petitioner, Aminox Foils, Inc., a manufacturing firm in Missouri, claimed the tax law was impermissibly discriminatory “against interstate commerce.” *Id.* at 645. In considering the validity of the tax, the United States Supreme Court asserted that the Commerce Clause “embodies a negative command forbidding the States to discriminate against interstate trade.” *Id.* at 646. Therefore, the Court held that the tax was unconstitutional in its discrimination against interstate trade. *Id.* at 647.

³⁰ *Id.* at 656.

³¹ 84 N.Y.2d 31, 637 N.E.2d 257, 614 N.Y.S.2d 366 (1994).

³² *Id.* at 35, 637 N.E.2d at 259, 614 N.Y.S.2d at 368. AT&T challenged a New York tax law that required long distance carriers “to deduct its carrier access expense from its interstate and international receipts prior to apportionment.” *Id.* at 34, 637 N.E.2d at 258, 614 N.Y.S.2d at 367.

³³ *Id.* at 34, 637 N.E.2d at 259, 614 N.Y.S.2d at 368.

treatment towards long-distance telephone carriers engaged in interstate commerce was serving a legitimate benefit that could not be served by other methods.³⁴

In deciding the issue of whether a corporate tax statute of the New York City Administrative Code, that forbade corporations doing business in the state to take certain deductions on out-of-state property, while permitting the deductions for in-state property, is an unconstitutional violation of the Commerce Clause,³⁵ the *Reynolds* court found the tax discriminatory and unconstitutional.³⁶ This is a broad interpretation of the Commerce Clause.

As demonstrated by the First Department, the Commerce Clause grants Congress a plenary power over interstate commerce. However, federal and state courts have allowed states to tax interstate commerce when the tax bears a substantial nexus to the taxing state, and where such tax is fairly related to the benefits the taxing state provides.³⁷ If the state cannot overcome the presumption of facial discrimination with a showing of a legitimate local benefit that could not be achieved without some measure of discrimination, the tax will be deemed unconstitutional.³⁸

³⁴ *Id.* at 35, 637 N.E.2d at 259, 614 N.Y.S.2d at 368.

³⁵ *R.J. Reynolds Tobacco Co. v. City of New York*, 667 N.Y.S.2d 4, 9 (1st Dep't 1997).

³⁶ *Id.* at 32.

³⁷ See *supra* note 23 and accompanying text.

³⁸ See *supra* notes 24 and 25 and accompanying text.

