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1996 Survey of Rhode Island Law: Cases: Taxation

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Taxation. *Associated Electric & Gas Insurance Services, Ltd. v. Clark*, 676 A.2d 1357 (R.I. 1996). Two percent tax on gross premiums received by out-of-state insurer for insurance sold in Rhode Island did not violate the Due Process Clause of the United States Constitution.¹

If an out-of-state insurance company does not maintain a physical presence in the state, there is a question as to whether a tax on the premiums it receives for policies sold within the state violates its due process rights. In *Associated Electric & Gas Insurance Services, Ltd. v. Clark*,² the Rhode Island Supreme Court held that taxing premiums received by an out-of-state insurer did not violate due process, because the requirement of physical presence was met when the insurer "purposefully availed" itself of the Rhode Island economic market.³

FACTS AND TRAVEL

Associated Electric and Gas Insurance Services, Ltd. (AEGIS), a Bermuda corporation, sold excess-liability insurance to four Rhode Island natural gas utility companies,⁴ but did not file the required gross premium tax returns for the years 1985 through 1990.⁵ Although AEGIS was not licensed or authorized to issue insurance in Rhode Island, such licensure or authorization was not a prerequisite for tax liability in the state.⁶ Even though the insured utility companies contacted AEGIS, and no AEGIS representatives ever came to Rhode Island, the tax administrator determined that the insurance contracts were business transactions subject to tax, because the properties and risks were located

1. The tax was imposed pursuant to Rhode Island General Laws section 44-17-1, which authorizes a tax of two percent on the gross premiums on insurance contracts covering property and risks within the state, sold by "domestic, foreign, or alien insurance compan[ies] . . . transacting business in [Rhode Island]." R.I. Gen. Laws § 44-17-1 (1995). The only exceptions are companies that sell ocean marine insurance, *see id.* § 44-17-6, and fraternal benefit societies, *see id.* § 27-25-1 (1994).

2. 676 A.2d 1357 (R.I. 1996).

3. *Id.* at 1361.

4. The four companies were Providence Energy, Valley Resources, South County Gas, and Bristol and Warren Gas Company. AEGIS actually sold the premiums through its wholly owned subsidiary, AEGIS Services. *Id.* at 1358.

5. *Id.*

6. *Id.*

in Rhode Island.⁷ AEGIS appealed the tax administrator's determination to the district court, which upheld the assessment.⁸ AEGIS then filed a petition for certiorari to the Rhode Island Supreme Court which was granted.⁹

BACKGROUND

Rhode Island General Laws section 44-17-1 states that "[e]very domestic, foreign, or alien insurance company, mutual association, organization, or other insurer" must file an annual tax return, and pay a two percent tax on the gross premiums received for insurance contracts covering "property and risks within the state, written during the calendar year." However, in *State Board of Insurance v. Todd Shipyards Corp.*,¹⁰ the United States Supreme Court held that a five percent premium tax imposed by Texas on a nonresident insured violated the Due Process Clause of the United States Constitution.¹¹ In *Todd Shipyards*, the Court noted that the "transactions took place entirely outside Texas . . . all losses arising under the policies were adjusted and paid outside [the state,] . . . the insurers were not licensed to do business in Texas, [had] no office . . . [there and did] not solicit business . . . [or] investigate risks or claims in Texas."¹² *Todd Shipyards* followed *Allgeyer v. Louisiana*¹³ and its progeny, which invalidated state taxes on out-of-state insurance companies that were not licensed to do business in the state, and had no office or agents in the state.¹⁴ In one case, a tax imposed on reinsurance premiums paid out-of-state was invalidated, "even though both insurance companies were authorized to do business in [the state]."¹⁵ However, these cases have not been uniformly followed by state supreme courts, and a number of cases have upheld taxation of out-of-state insur-

7. *Id.* at 1358-59. The gross premiums on which the two percent tax was assessed totaled \$3,378,335. *Id.* at 1361.

8. *Id.* at 1358.

9. *Id.*

10. 370 U.S. 451 (1962).

11. U.S. Const. amend. XIV, § 1. *Associated Elec.*, 676 A.2d at 1359-60 (quoting *Todd Shipyards*, 370 U.S. at 457).

12. *Associated Elec.*, 676 A.2d at 1360 (quoting *Todd Shipyards*, 370 U.S. at 454-55).

13. 165 U.S. 578 (1897).

14. *Associated Elec.*, 676 A.2d at 1360 (quoting *Todd Shipyards*, 370 U.S. at 453-54).

15. *Id.*

ers which conducted their business within the states solely by mail.¹⁶

ANALYSIS AND HOLDING

In arguing that the tax was unconstitutional under the Due Process Clause, AEGIS relied on *Todd Shipyards*, and claimed that a state court could not "erode or modify decisions by the United States Supreme Court."¹⁷ While agreeing with that general proposition, the Rhode Island Supreme Court noted that various state cases, holding that out-of-state insurance companies could be taxed under certain circumstances, had been dismissed by the United States Supreme Court "for lack of a substantial federal question, which constituted a determination on the merits."¹⁸ Thus, the Rhode Island Supreme Court ruled, "it appears that the maintenance of an office or agents within the state is not a necessary prerequisite to the exercise of the power of taxation."¹⁹ However, the court had more to rely on than a mere inference that could be drawn from the refusal of the United States Supreme Court to hear the state tax cases.²⁰ In *Quill Corp. v. North Dakota*,²¹ the United States Supreme Court held that the right of a state to tax a company under the Due Process Clause does not depend on the physical presence of that company within the state, which is required under the Commerce Clause.²² The Court held that "if a foreign corporation purposefully avails itself of the bene-

16. *Id.* (citing *Illinois Commercial Men's Ass'n v. State Bd. of Equalization*, 671 P.2d 349 (Cal. 1983), *appeal dismissed*, 466 U.S. 933 (1984); *People v. United Nat'l Life Ins. Co.*, 427 P.2d 199 (Cal. 1967), *appeal dismissed*, 389 U.S. 330 (1967); *Ministers Life & Casualty Union v. Haase*, 141 N.W.2d 287 (Wis. 1966), *appeal dismissed*, 385 U.S. 205 (1966)).

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. 504 U.S. 298 (1992).

22. *Associated Elec.*, 676 A.2d at 1360-61 (citing *Quill*, 504 U.S. at 303-07). The Court rejected its decision in a prior case, *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), where it had held that physical presence was "a prerequisite to the right to tax pursuant to the due-process clause." *Id.* at 1361. In overruling *Bellas Hess* on that issue, the Court used the reasoning it had applied in *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), where it found that a state court had in personam and in rem jurisdiction over a foreign corporation that "purposefully avails itself of the benefits of an economic market in the forum state." *Id.* (quoting *Quill*, 504 U.S. at 307-08).

fits of an economic market in the forum state, it may subject itself to the state's in personam jurisdiction even though it has no physical presence in that state."²³ The Rhode Island Supreme Court noted that the clear holding in *Quill* "superseded" *Todd Shipyards*, and was consistent with the state tax cases that "purported to distinguish [*Todd Shipyards*]."²⁴

Once the court determined that *Quill* represented the appropriate standard by which to judge whether AEGIS was liable for the premium tax, it found that "[a] foreign insurer who manages to collect millions of dollars in premiums . . . creates a purposeful economic presence in the state."²⁵ The court also noted that an insurance claim by the utilities might require that AEGIS send personnel into Rhode Island to investigate, in which case "service of process could be made validly upon AEGIS within this state for any dispute arising out of [the insurance]."²⁶

CONCLUSION

After *Associated Electric*, a foreign insurer doing significant business in Rhode Island will most certainly be held liable for state taxes on premiums it receives for insurance policies covering risks within the state. However, it is unlikely that this holding will be limited to insurers, since the same criteria can be applied to almost any type of business. Annual premiums of about \$500,000 per year "create[d] a purposeful economic presence in the state,"²⁷ but at what level will there not be such a presence? Where will the court draw the line, and on what basis? Or is there an implicit invitation in this holding for the legislature to do so?

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23. *Id.* at 1361 (quoting *Quill*, 504 U.S. at 307-08).

24. *Id.*

25. *Id.*

26. *Id.* at 1361-62 (citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985)).

27. *Id.* at 1361.

Taxation. *Koch Fuels, Inc. v. Clark*, 676 A.2d 330 (R.I. 1996), *cert. denied*, 117 S. Ct. 301 (1996). Gross-earnings tax on sales of fuel oil by out-of-state seller did not violate the Commerce Clause of the United States Constitution, and the seller was an "importer" within the meaning of the Rhode Island Gross-Earnings Tax Act.

Under the Commerce Clause,¹ foreign corporations are not liable for state sales tax unless their activities and the statute in question meet certain standards articulated by the United States Supreme Court.² In *Koch Fuels, Inc. v. Clark*,³ the Rhode Island Supreme Court upheld a tax on fuel oil sold by a foreign corporation for use in Rhode Island, finding that the corporation's activities and the statute met the requisite tests.⁴

FACTS AND TRAVEL

Between 1982 and 1984, Koch Fuels, Inc. (Koch), a Delaware corporation headquartered in Wichita, Kansas, sold 25.6 million gallons of fuel oil worth 18 million dollars to New England Power, the parent company of Narragansett Electric (Narragansett) for use in Narragansett's electrical generating plant located in Providence.⁵ The oil originated in either Texas, Pennsylvania or Massachusetts, and was shipped via common carrier into the Port of Providence.⁶ None of the negotiations for the sales contracts occurred in Rhode Island, and invoices were sent to, and paid from, Massachusetts.⁷ Although Koch was registered to do business in Rhode Island, and paid Rhode Island corporate taxes in the years in which it sold fuel oil, it had no employees within the state, and did not rent, lease or own real property in Rhode Island.⁸ The terms of the fuel oil contracts were "f.o.b. Providence,"⁹ thus title, possession and risk of loss passed from Koch to Narragansett in

1. U.S. Const. art. 1, § 8, cl. 3.

2. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (articulating the standards).

3. 676 A.2d 330 (R.I. 1996), *cert. denied*, 117 S. Ct. 301 (1996).

4. *Id.* at 332.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. The term f.o.b. means "free on board" at some location, e.g., Providence. It is a delivery term requiring the seller to ship the goods and bear the expense and risk of loss to the f.o.b. point designated. Since delivery and payment are made at

Providence.¹⁰ The sales to Narragansett were Koch's only business contacts with any entity in Rhode Island.¹¹

In 1988, the Rhode Island Division of Taxation (Tax Division) issued a notice-of-deficiency determination to Koch for five of the six fuel oil sales it made to Narragansett.¹² Koch made a timely request for an administrative hearing, after which the tax administrator issued a final order affirming the assessment.¹³ Koch filed for de novo review of the decision in the district court.¹⁴ The district court affirmed the assessment, and Koch filed a petition for a writ of certiorari to the Rhode Island Supreme Court, which was granted.¹⁵

BACKGROUND

When faced with a constitutional challenge to a statute, the Rhode Island Supreme Court begins with the assumption that legislatures are presumed to act within their "constitutional limits" when they enact legislation.¹⁶ In *Seibert v. Clark*,¹⁷ an out-of-state trucking company claimed that a decal fee imposed only on out-of-state truckers violated the Commerce Clause of the United States Constitution.¹⁸ In *Seibert*, the Rhode Island Supreme Court relied primarily on *Complete Auto Transit, Inc. v. Brady*,¹⁹ as it did in the instant case. The court noted that the challenger in a taxation case must overcome the presumption of constitutionality and prove that the tax was unconstitutional "beyond a reasonable doubt."²⁰

When a tax is challenged under the Commerce Clause, the United States Supreme Court determines whether the state has

the f.o.b. location, that is also the location where title usually passes. Black's Law Dictionary 444 (6th ed. 1990); UCC § 2-319.

10. *Koch Fuels*, 676 A.2d at 332.

11. *Id.*

12. The Tax Division issued the notice-of-deficiency pursuant to a statute that provided for an "an annual tax rate of one percent (1%) of gross earnings . . . derived . . . from the sale of petroleum products in this state." R.I. Pub. Laws ch. 9, art. 6, § 1 (repealed 1986), quoted in *Koch Fuels*, 676 A.2d at 332.

13. *Koch Fuels*, 676 A.2d at 332.

14. R.I. Gen. Laws § 8-8-24 (1995).

15. *Koch Fuels*, 676 A.2d at 332.

16. *Seibert v. Clark*, 619 A.2d 1108, 1113 (R.I. 1993) (citations omitted).

17. *Id.*

18. *Id.*

19. 430 U.S. 274 (1977).

20. *Seibert*, 619 A.2d at 1113 (citations omitted).

unduly burdened interstate commerce, or whether it simply has taken its "fair share" of the expenses.²¹ *Complete Auto Transit* established the four part test by which a state or local tax is evaluated under the Commerce Clause.²² Under this test, there must exist a substantial nexus between the taxed activity and the taxing state, the tax must be fairly apportioned, the tax may not discriminate against interstate commerce, and the tax must be fairly related to the services provided by the taxing state.²³

ANALYSIS AND HOLDING

As a threshold matter, the Rhode Island Supreme Court determined whether the "gross-earnings" tax was really a "sales or use tax," despite the caption and wording of the statute.²⁴ The court noted that even though the statute was entitled, "Gross Earnings Tax of Petroleum Companies," it was actually a sales tax, as defined by the statute, because it covered only the transactions occurring in Rhode Island, whereas a true "gross earnings" tax would have included out-of-state transactions as well.²⁵ In so holding, the court relied on *Complete Auto Transit*, where the United States Supreme Court noted that, in construing state tax statutes, it considered the practical effect of the statute, not the formal language.²⁶

The Rhode Island Supreme Court next evaluated the tax under the Commerce Clause test announced in *Complete Auto Transit*. First, in finding that Koch's fuel oil sales in Rhode Island constituted a substantial nexus with the state, the court agreed that the standard required a physical presence, as articulated by the United States Supreme Court in *Quill Corp. v. North Dakota*.²⁷

21. John E. Nowak & Ronald D. Rotunda, *Constitutional Law* § 8.11, at 303 (4th ed. 1991).

22. U.S. Const. art. 1, § 8, cl. 3.

23. *Koch Fuels v. Clark*, 676 A.2d 330, 333 (R.I. 1996) (citing *Complete Auto Transit*, 430 U.S. at 279).

24. *Id.*

25. "Gross sales" is defined as "earnings from sales of tangible personal property . . . where shipments are made to points within the state . . . [but] does not include those earnings from sales to out-of-state customers for marketing, distribution or consumption outside this state." 1982 Pub. Laws ch. 9, art. 6, § 1 (repealed 1986), *quoted in Koch Fuels*, 676 A.2d at 333.

26. *Koch Fuels*, 676 A.2d at 333 (citing *Complete Auto Transit*, 430 U.S. at 279).

27. 504 U.S. 298, 314 (1992).

The Rhode Island Supreme Court found that Koch's activities rose to the level of a physical presence in Rhode Island because Koch retained control over the oil until it reached Narragansett's terminus in Providence, including the right to cancel before delivery, and the oil was the entire and exclusive cargo of the common carriers hired to bring it into Rhode Island.²⁸

The second part of the *Complete Auto Transit* test requires the tax to be fairly apportioned, so that interstate commerce is not unfairly burdened.²⁹ If both internal and external consistency exists, the tax is fairly apportioned.³⁰ To be internally consistent, an entity must not be subject to multiple taxation if every state were to impose an identical tax.³¹ Since the statute applied only to fuel-oil sales actually made in Rhode Island, the court found that even if every state imposed the identical tax, there could be only one tax on each sale.³² To be externally consistent, the tax must be reasonably related to the in-state component of the taxed activity.³³ On this issue, Koch argued that its sales in Rhode Island included numerous activities that occurred outside the state, and was therefore unfairly apportioned, unless adjusted.³⁴ The court disagreed that the tax was unfair, and stated that under the United States Supreme Court's holding in *American Trucking Ass'n v. Scheiner*,³⁵ a state is not required to adopt a tax that is administratively burdensome.³⁶

Addressing the third question, whether the tax discriminated against interstate commerce, the Rhode Island Supreme Court held that the party challenging the constitutionality of a taxing statute has the burden to produce evidence of its discriminatory effect.³⁷ After reviewing the record, the supreme court held that there was no evidence that the tax favored Rhode Island petroleum companies at the expense of out-of-state companies; thus, Koch had failed to meet its burden on this issue.³⁸

28. *Koch Fuels*, 676 A.2d at 334.

29. *Id.* (citing *Quill*, 504 U.S. at 313).

30. *Id.* (citing *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989)).

31. *Id.*

32. *Id.*

33. *Id.* (citing *Goldberg*, 488 U.S. at 262).

34. *Id.* at 334-35.

35. 483 U.S. 266 (1987).

36. *Koch Fuels*, 676 A.2d at 335 (citing *American Trucking*, 483 U.S. at 296).

37. *Id.* (citing *Seibert v. Clark*, 619 A.2d 1108, 1116 (R.I. 1993)).

38. *Id.*

The fourth part of the *Complete Auto Transit* test requires that the tax be "fairly related to the presence and activities of the taxpayer within the state."³⁹ Koch argued that because it had no employees or property in Rhode Island, it did not benefit from the tax revenues.⁴⁰ The supreme court first noted that the purpose of this test was to limit the reach of a state's taxing authority in order to avoid undue burdens on interstate commerce.⁴¹ The court disagreed that Koch received no benefits from Rhode Island, pointing out that the state provided shipping facilities, and had emergency equipment in case of an oil spill, which was a real risk, considering that Koch had shipped 25.6 million gallons of oil into Rhode Island over a three year period.⁴²

In its final argument, Koch insisted that it was not an "importer" within the meaning of the statute, because an importer is the recipient of the goods.⁴³ On this point, the court held that the language of the statute clearly defined an "importer" as an entity in the "business of importing or causing to be imported."⁴⁴ Having found that Koch fit the definition of the entity to be taxed under the statute, the court held that the statute did not violate the Commerce Clause because it was fairly apportioned, did not discriminate against interstate commerce, and was fairly related to the activities being taxed. Finally, the court found a substantial nexus between Koch's activities and Rhode Island that amounted to a physical presence; thus, as applied to Koch, the tax did not violate the Commerce Clause.⁴⁵

CONCLUSION

Even though the statute at issue in this case had been repealed by the time *Koch* came before the Rhode Island Supreme Court, the court's analysis is important as a guide to future challenges to a taxation statute under the Commerce Clause. *Koch* is consistent with the court's analysis in *Seibert*, and emphasizes that out-of-state companies with more than an incidental tie to

39. *Id.*

40. *Id.*

41. *Id.* (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992)).

42. *Id.* at 335-36.

43. *Id.* at 336.

44. *Id.* (quoting 1982 R.I. Pub. Laws ch. 9, art. 6, § 1 (repealed 1986)).

45. *Id.* at 333.

Rhode Island will be not be exempted from paying Rhode Island sales and use taxes.

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