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New Mexico Supreme Court Upholds Validity of State Electrical Energy Tax

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CASE NOTES

NEW MEXICO SUPREME COURT UPHOLDS VALIDITY OF STATE ELECTRICAL ENERGY TAX

CONSTITUTIONAL LAW: PRE-EMPTION, COMMERCE CLAUSE. New Mexico Supreme Court upholds validity of New Mexico Electrical Energy Tax Act despite constitutional challenges that tax is pre-empted by federal statute and is an impermissible burden on interstate commerce.

In 1975 the New Mexico Legislature passed the Electrical Energy Tax Act[1] [hereinafter EETA or the Act]. The EETA imposes a four-tenths of one mill tax ($.0004) on each kilowatt hour of electricity generated in the State;[2] this tax can be credited against the gross receipts tax due in New Mexico if the electricity is consumed within the State.[3] The Act makes no allowance for a credit against the electrical generation tax for taxes paid on electricity sold outside New Mexico.

Soon after the Act's passage two actions were commenced, one in the district court of New Mexico and the other in the United States Supreme Court. In the Supreme Court, the State of Arizona filed a motion for leave to file a complaint[4] under the Court's original jurisdiction over cases involving controversies between two or more states.[5] The Court declined to exercise its original jurisdiction over the case primarily because the constitutionality of the Act was already under consideration in New Mexico district court.[6]

The district court action was commenced by five major public utilities that generate electricity in New Mexico and sell part or all of their electricity to non-New Mexico consumers.[7] During the pendency of this action, Congress passed a statute prohibiting states from imposing discriminatory taxes on the generation of electricity.[8] The plaintiff utility companies moved for summary judgment. In response, the district court granted summary judgment on a cross-motion filed by defendant Fred O'Cheskey, Commissioner of Revenue.

1. N.M. STAT. ANN. §§72-34-3 & 72-16A-16.1 (Supp. 1975).
2. *Id.* §72-34-3.
3. *Id.* §72-16A-16.1.
4. Arizona v. New Mexico, 425 U.S. 794 (1976).
5. U.S. CONST. art. III, §2.
6. Arizona v. New Mexico, 425 U.S. 794 (1976).
7. Arizona Pub. Serv. Co. v. O'Chesky, ____N.M. ____, 576 P.2d 291, 293 (1978).
8. Tax Reform Act of 1976 §2121(a), 15 U.S.C. §391 (Supp. VI 1976).

The plaintiff utility companies appealed the judgment and reasserted their contention that the tax imposed was an unconstitutional violation of the Supremacy[9] and Commerce Clauses[10] of the United States Constitution. Plaintiffs argued that the federal statute prohibiting discriminatory state taxes on the generation of electricity, by operation of the Supremacy Clause, rendered the New Mexico statute void. They also asserted that, notwithstanding the federal statute prohibiting such taxes, the New Mexico tax was an unconstitutional burden on interstate commerce. In response to these contentions, the New Mexico Supreme Court determined that the EETA was not within the terms of the federal statute prohibiting such taxes and that the tax was not a burden on interstate commerce.[11]

THE FEDERAL PROHIBITION OF DISCRIMINATORY STATE TAXES ON THE GENERATION OF ELECTRICITY

While the case was pending before the state district court, Congress enacted § 2121(a) of the Tax Reform Act of 1976,[12] which provides:

> No state, or political subdivision thereof, may impose or assess a tax on or with respect to the generation or transmission of electricity which discriminates against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. For purposes of this section, a tax is discriminatory if it results, either directly or indirectly, in a greater tax burden on electricity which is generated and transmitted in interstate commerce than on electricity which is generated in intrastate commerce.[13]

On appeal, the utility companies argued that § 2121(a) pre-empted the EETA and rendered it invalid. The court analyzed the statutory language defining "discriminatory" and concluded that the EETA was not discriminatory within the meaning of § 2121(a).

The court paid special attention to the phrase "greater tax burden." In interpreting the phrase, the court determined that "greater" meant "larger," not "additional." Using this definition, the court concluded that the tax burden on interstate, as opposed to intrastate, commerce was the same, i.e., four-tenths of one mill on each kilowatt hour. The court was able to reach this conclusion by ignoring

9. U.S. CONST. art. VI, cl. 2.
10. U.S. CONST. art. I, § 8.
11. Arizona Pub. Serv. Co. v. O'Chesky, ____ N.M. ____, 576 P.2d 291, 294 & 296 (1976).
12. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).
13. Tax Reform Act of 1976 § 2121(a), 15 U.S.C. § 391 (Supp. VI 1976).

any additional out-of-state taxes to which interstate electricity generated in New Mexico would be subject.

If the court had considered these out-of-state taxes, then it would have been forced to conclude that the New Mexico tax resulted in a "greater tax burden" for interstate electricity and was, therefore, discriminatory within the meaning of the federal statutory definition. The greater tax burden on interstate electricity results from the inability of the particular utility companies to credit any out-of-state taxes paid on the sale of electricity against the New Mexico generation tax. The EETA allows a credit of the generation tax against gross receipts tax for electricity generated and sold in New Mexico. It is this credit that arguably causes the discrimination.

In response to the argument that the tax credit causes the discriminatory result, the court looked at the burden on the interstate electricity at the time it leaves the state as compared to the tax burden on intrastate electricity at the time of delivery. Under this analysis, the intrastate electricity is subject to the greater tax burden because it is subject to a minimum of a four percent tax on gross sales, whereas the interstate electricity is subject to only an approximate two percent rate. Again, this analysis ignores any out-of-state taxes to which the interstate electricity might be subject.

Looking at the express language of the statute, the court's interpretation of the words defining "discriminatory" is justified. The statute speaks only of a "greater tax burden on electricity which is generated and transmitted in interstate commerce. . . ."[14] Arguably, generation and transmission do not encompass delivery, which is the point at which state taxes are normally computed. In view of this reading of "transmission," the court was justified in ignoring out-of-state taxes on electricity not levied during transmission.

The legislative history of the provision, however, requires a different interpretation of the definition of "discriminatory." In both the Senate Finance Committee Report[15] and the General Explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation,[16] it becomes clear that the generation tax imposed by New Mexico was the kind intended to be prohibited by the statute.

> Congress has learned that one State places a discriminatory tax upon

14. *Id.*

15. S. REP. NO. 94-938 (Parts I & II), 94th Cong., 2d Sess. 437, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3865.

16. STAFF OF THE JOINT COMM. ON TAXATION, 94th Cong., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 638-639, *reprinted in* 1976-2 C.B. 650-651.

> the production of electricity within its boundaries. While the rate of the tax itself is identical for electricity that is ultimately consumed outside the State and electricity which is consumed inside the State, discrimination results because the State allows the amount of the tax to be credited against the gross receipts tax if the electricity is consumed within its boundaries. This credit normally benefits only domiciliaries of the taxing State since no credit is allowed for electricity produced within the State and consumed outside the State. As a result, the cost of the electricity to nondomiciliaries is normally increased by the cost the producer of the electricity must bear in paying the tax. However, the cost to domiciliaries of the taxing State does not include the amount of the tax.
>
> Congress believes that this is an example of discriminatory State taxation which is properly within the ability of Congress to prohibit through its power to regulate interstate commerce.[17]

The mention in the report to "one State" obviously refers to New Mexico since it is the only State to have imposed such a tax. Where the legislative history is so clear, it would be next to impossible for the United States Supreme Court to sustain the interpretation given by the New Mexico Court.

The only method of saving the EETA from invalidation would be for the United States Supreme Court to find that the federal statute prohibiting such tax is an unconstitutional exercise of Congress' power to regulate commerce. New Mexico could argue that generating electricity is a purely local concern and, therefore, not part of interstate commerce, which was the conclusion drawn by the United States Supreme Court in *Utah Power & Light Co. v. Pfost.*[18]

Unfortunately, such an argument has no vitality in the light of two decisions rendered subsequent to *Utah Power & Light Co.*, namely, *United States v. Wrightwood Dairy Co.*[19] and *Wickard v. Filburn.*[20] In *Wrightwood,* a case involving the power of Congress to regulate the price of admittedly intrastate milk, the United States Supreme Court found that Congress' commerce power could reach wholly intrastate activities.

> The commerce power is not confined in its exercise to the regulation of commerce among the states. It extends to those activities intrastate which so affect interstate commerce or the exertion of the power of Congress over it, as to make regulations of them appropriate means to the attainment of a legitimate end, the effective

17. *Id.*
18. 386 U.S. 165 (1932).
19. 315 U.S. 110 (1942).
20. 317 U.S. 111 (1942).

execution of the granted power to regulate interstate commerce.[21]

Even more forceful language appears in *Wickard v. Filburn*, a case in which the Supreme Court upheld Congress' power to prohibit, as a means of carrying out Congress' farm prices support program, the growing of wheat soley for home consumption.

> [E]ven if appellee's activity [the growing of wheat for home consumption] be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce, and this irrespective of whether such an effect is what might at some earlier time have been defined as "direct" or "indirect."[22]

Clearly, the "substantial economic impact" required for triggering Congress' power to regulate interstate activities is present in the EETA. Congress, in light of these cases, has the power, exercised it, and thereby prohibited state electrical generation taxes of the kind enacted by New Mexico.

THE COMMERCE CLAUSE QUESTION

The utility companies also argued that the electrical generation tax, by being a burden on interstate commerce, violated the Commerce Clause of the United States Constitution and was therefore unconstitutional. In answering this argument, the Court applied the two traditional tests for determining whether state taxation on interstate commerce constitutes an undue burden. These were the discrimination and the multiple burden tests.

The utility companies contended that the application of EETA was discriminatory because the credit allowed against the gross receipts tax resulted in an additional burden on interstate electricity not borne by in-state sales of electricity generated in New Mexico. In analyzing the alleged discriminatory nature of the energy tax, the court asked whether the tax placed an additional burden on interstate commerce not borne by intrastate commerce, i.e., whether the tax erected a barrier that put out-of-state businesses at a competitive disadvantage.

In addressing the question of competitive disadvantage, the court found none. The court, however, looked only at the effect of the tax on out-of-state producers selling in New Mexico. As the court pointed out, such producers are not subject to a generation tax, and if they were, the statute provides for a credit against the New Mexico

21. 315 U.S. 110, 119 (1942).
22. 317 U.S. 111, 125 (1942).

gross receipts tax for such an out-of-state tax. In the theoretical sense, then, there can be no competitive disadvantage. As to the in-state producers selling to out-of-state markets, the court noted no competition with those producers selling in-state. Therefore, without competition there could be no discrimination.

Needless to say, the discrimination test cannot appropriately be applied to the sale of electricity. Electricity is sold by state regulated monopolies. A monopoly can hardly be subject to a competitive disadvantage where its customers are not free to buy the commodity elsewhere.

The public utility companies next contended that the EETA was discriminatory because of its sole and exclusive impact on interstate commerce. The utility companies cited *Michigan-Wisconsin Pipeline Co. v. Calvert,*[23] a United States Supreme Court case involving the validity of a Texas statute imposing a tax on the occupation of gathering gas (the initial extraction of gas from liquid hydrocarbons for transmission in an established pipeline network). The Court held, inter alia, that a state tax imposed on local activity is only valid if that activity does not constitute such an integral part of the flow of interstate commerce as to be realistically inseparable from it and that allowing a state tax of this kind would establish the equal right in other states to impose similar taxes on the same commodity, thereby putting a multiple tax burden on interstate commerce.

The New Mexico court did not address the Supreme Court's holding prohibiting state taxes where the local activity is inextricably linked to interstate commerce. The reason for this evasion is obvious: the generation of electricity, although denominated a local activity by the United States Supreme Court case of *Utah Power & Light Co. v. Pfost,* is realistically inseparable from the transmission of electricity. However, the New Mexico court could have made use of *Calvert's* discussion of *Utah Power & Light Co.* The Court in *Calvert* distinguished *Utah Power & Light Co.,* stating that the generation of electricity is not like gathering gas; instead, it is, the Court noted, clearly local in nature and not inextricably linked to interstate commerce.[24]

Instead of addressing the connection of local activity to interstate commerce, the New Mexico court focused on the multiple burden test elicited in *Calvert.* The court distinguished the case on the grounds that the generation of electricity, unlike the gathering of gas, allows, by its very nature, only a one-time tax; the act of generating a

23. 347 U.S. 157 (1954).
24. *Id.* at 168.

given amount of electricity can only occur once. Consequently, the court reasoned, there could be no multiple burden because generation, unlike transmission, can occur only in one state. The generation of electricity occurring in New Mexico can be taxed only by New Mexico; therefore, multiple taxation on the act of generation is precluded.

The court's reasoning is sound only if *Utah Power & Light Co.* remains a viable precedent. The case has never been overruled, yet its reasoning stems from a time when the Supreme Court had the habit of declaring unconstitutional New Deal legislation based on Congress' power to regulate commerce. As a result, the continued vitality of *Utah Power & Light Co.* depends on how the current United States Supreme Court would decide the question of the local nature of electrical power generation.

The United States Supreme Court, since *Utah Power & Light Co.*, has had the opportunity to review the problem presented by state taxation of electrical generation. In both instances a state court upheld a state tax on the generation of electricity, and in both cases the Supreme Court declined review. In *Public Utility Dist. No. 2 v. State*,[25] the Supreme Court dismissed the appeal for want of a substantial federal question, even though the claims asserted by the utility companies were similar to those presented in *Utah Power & Light Co.* And in *Virginia Electric & Power Co. v. Haden*,[26] the Supreme Court denied certiorari notwithstanding the decision of the West Virginia Supreme Court upholding the validity of a state tax on the manufacture of electricity in the face of claims made by the public utilities that the tax was an unlawful burden on interstate commerce.

The likelihood of the United States Supreme Court reaching the question presented in *Utah Power & Light Co.* is small. It is far more likely that the Court, if it accepts review, will determine that the New Mexico energy tax is within the federal statutory prohibition of such taxes. Such a determination, which is compelled by the applicable legislative history, would avoid the burden on interstate commerce issue.

CONCLUSION

Because of the posture of the case and the legal issues to be addressed, the New Mexico Supreme Court was precluded from con-

25. 82 Wash.2d 232, 510 P.2d 206 (1973), *appeal dismissed for want of a substantial federal question*, 414 U.S. 1106 (1974).

26. 200 S.E.2d 848 (W. Va. 1973), *cert. denied* 416 U.S. 916 (1974).

sidering the question of a state's power to protect its citizens' physical and economic welfare through the taxation of activities that produce deleterious effects on the general welfare of the populace and that in turn benefit residents of other states. By consuming electricity generated in New Mexico, Texas, Arizona, and California have exported their air pollution and utility boomtown problems to New Mexico and have used the Commerce Clause as a guise for invalidating a tax designed to remedy the problems created by such exportation. Clearly, if electrical generation plants existed in any one of their states, resulting in enormous amounts of air pollution, stress on local public services, and thousands of acres of strip-mined land, they would legitimately expect such an industry to pay for the social and environmental damage done. The prohibition of the electrical energy tax will force New Mexico to assume more of the social and environmental costs while other states enjoy the benefits of having electricity without having to pay the social costs of generating it in their own back yards.

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