Kentucky Tax Talk: Taking Up the Dormant Commerce Clause

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The commerce clause of the U.S. Constitution is an affirmative grant of power to Congress to "regulate Commerce … among the several States."

While some with a literal interpretation of the Constitution believe the provision ends there, the implication, developed over hundreds of years of case law, of Congress' power to regulate commerce among the states is the limitation that states cannot implement laws that burden Congress' power to regulate interstate commerce — this is recognized as the dormant commerce clause.[1]

Because the reach and limitations of the dormant commerce clause have been developed by case law, it is important to follow the U.S. Supreme Court's current interpretation of the provision. Historically, dormant commerce clause precedent has been somewhat fickle with courts struggling with its limitations. Now, there is a Kentucky case pending on petition for a writ of certiorari before the U.S. Supreme Court that could present new high court commerce clause precedent.

The U.S. Court of Appeals for the Sixth Circuit's February decision in *Foresight Coal Sales LLC v. Kent Chandler* reversed a lower court's decision that Kentucky's 2021 S.B. 257 discriminates against interstate commerce in its practical effect and purpose, violating the commerce clause.[1]

The issue that sparked this legislation to begin with is Kentucky's severance tax. Kentucky imposes a severance tax on 4.5% of the gross value of minerals, importantly herein coal, extracted in the state. Because Kentucky historically has been a high coal producing state, the severance tax over time has become a staple in Kentucky's tax system.

But because of its long-standing impact on Kentucky taxation, as the state developed the severance tax caused some unexpected disadvantages for Kentucky coal producers. One in particular, at the

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forefront in Foresight, is the Kentucky Public Service Commission's fuel adjustment clause, used in PSC's determination of reasonable utility prices.

The PSC regulates utilities in Kentucky, including maintaining reasonable energy rates for consumers. One way it does this is by allowing utility companies to adjust their base rates by fluctuating fuel costs. Thus, in essence, Kentucky utilities are encouraged to purchase the cheapest coal in order to maintain reasonable utility rates for its customers.

Kentucky's severance tax, and the fact that most other coal producing states do not impose a severance tax, has historically led utility companies not to purchase Kentucky coal. It is not the cheapest option and purchase could result in a finding that the price is not reasonable by the PSC if it chose cheaper fuel.

Given this push and pull between the state's declining coal industry and the long-standing fiscal impact of the severance tax, the Kentucky General Assembly has made efforts to resolve this issue by encouraging more in-state purchasing of Kentucky-mined coal.

The most recent attempt relevant to the Foresight Coal case now pending before the U.S. Supreme Court was in 2019. During the 2019 regular session, the General Assembly passed House Resolution 144 that encouraged the PSC to amend its regulations to account for fuel-related economic impacts, i.e., the Kentucky coal severance tax, when calculating its fuel adjustment to determine reasonable prices.

In response, the PSC amended its regulation, first to exclude Kentucky's severance tax from its calculation of fuel costs, but ultimately excluding any state severance tax from fuel calculations. Foresight Coal, an Illinois coal producer, challenged the amended regulation alleging it was a violation of the commerce clause, as it favored coal producers in severance tax states over producers in nonseverance tax states.

In 2020, the U.S. District Court for the Eastern District of Kentucky denied Foresight Coal's motion for injunctive relief and the case was appealed to the Sixth Circuit. After the issues were briefed, but before oral argument, the PSC agreed to rescind its regulation and

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Foresight Coal dropped the case.

Then in 2021, the General Assembly enacted S.B. 257, directing the Kentucky PSC to subtract severance tax paid from the bid price when determining the reasonableness of coal prices — in essence, codifying the PSC's 2019 amended regulation. Foresight Coal again sued for a preliminary injunction that the district court again denied.

Characterizing this legislation as the state's attempt to "have its cake and eat it too," upon review, the Sixth Circuit reversed the district court's decision, holding that because the result of this policy is that coal from states with severance taxes costs less, it burdens interstate commerce.

Although the Sixth Circuit noted the notoriously muddy waters of the dormant commerce clause, the court nevertheless waded through the variety of case law interpreting the doctrine. Both parties agreed that unconstitutional discrimination is defined by differential treatment that benefits in-state economic interests and burdens out-of-state economic interests, and the fact that a law can violate the commerce clause on its face as well as through a discriminatory effect. However, the parties took different positions as to the reach of the dormant commerce clause.

Foresight Coal took the broader approach, arguing that discriminatory purpose is enough to violate the commerce clause and that if the law's designed effect is to discriminate out-of-state commerce and benefit in-state commerce, which was the conceded purpose of S.B. 257, it must violate the commerce clause.

The PSC argued that there must be more than discriminatory purpose; rather, there must be significant evidence that the actual impact of the law creates a burden on interstate commerce.

Ultimately, the Sixth Circuit held that commerce clause jurisprudence requires a discriminatory purpose, but regardless, S.B. 257 was discriminatory in effect and in purpose.

The district court had found for the PSC, noting that the cost of fuel is only one of several factors that the PSC must consider when making a reasonableness decision. Evidence of at least one utility company purchasing more expensive coal based on other

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considerations showed that even with S.B. 257 in effect, Kentucky utilities could still purchase out-of-state coal, and so the court found the law was not discriminatory.

The Sixth Circuit instead held that the district court used the wrong legal analysis. The Sixth Circuit chose a broader interpretation of commerce clause precedent, finding:

the question the Commerce Clause cases ask is whether S.B. 257 burdens Illinois coal, not whether that burden is so insurmountable that no Illinois coal will ever again be sold to a Kentucky utility. … The question isn't even whether Foresight will necessarily lose market share. Instead, any economic disadvantage will do — whether measured in loss of market share or in lost profits due to decreased prices.

The Sixth Circuit also disagreed with PSC's argument that the parties weren't burdened or benefited by S.B. 257 because the law creates an even playing field from the previous calculations, which inherently disadvantaged states with severance taxes.

The court held that despite a leveling effect, the law had a discriminatory impact to achieve such leveling and thus still violates the commerce clause. The decision stated that "such a tit for tat is precisely the kind of economic Balkanization the dormant commerce clause seeks to prevent."

Thus, the Sixth Circuit clearly drew a line in the sand. It decided that it would follow a broader interpretation of the commerce clause, noting a certain level of evidentiary support is not required to prove a law burdens interstate commerce. Now, both parties have submitted their respective briefs and the case stands pending before the Supreme Court, which will decide whether to review the Sixth Circuit's order and opinion. While a number of issues have been raised by both parties, it seems the most intriguing and potentially impactful are the arguments raised as to the legitimacy and scope of the dormant commerce clause.

In the introduction to its petition for a writ of certiorari, the PSC immediately questions the source, or lack thereof, of the dormant commerce clause in the U.S. Constitution.

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Whether the Supreme Court takes or declines this case could have a significant impact on dormant commerce clause jurisprudence.

If the court declines the case, it will send the message that the court has no intention of limiting the scope of the dormant commerce clause, which could mean heightened scrutiny of state laws that touch interstate commerce.

However, if the court is looking to provide more flexibility for states to enact legislation affecting interstate activity or to send a message that the dormant commerce clause should be interpreted more narrowly, this case could be the court's avenue to achieve such goal.

While it is unlikely that the Supreme Court would completely invalidate the dormant commerce clause, it is not far-fetched to think the court may take up the case, given the court's current makeup and its recent decisions relating to limiting the Constitution's implied powers.

If taken up by the Supreme Court, its decision may not only affect coal providers and Kentucky utility companies, but also any state or business considering commerce clause claims. Either way, the decision would affect dormant commerce clause jurisprudence. If the court declines to consider the case, additional broad interpretations of the dormant commerce clause could be adopted by lower courts — but if it takes the case and limits the scope of the dormant commerce clause, it could affect how states consider legislation in the future.

The U.S. Supreme Court's conference on the case is set for Sept. 26.

For more information, contact any member of Frost Brown Todd's Tax practice group.

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[1] https://apps.legislature.ky.gov/recorddocuments/bill/21RS/sb257/bill.pdf

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