Special Report / Viewpoint

When Constitutional Law Clashes With Fairness and Good Policy: Remedies for Unconstitutional State Taxes

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States have long defended against constitutional challenges to their taxes not only on the merits but also on the basis that, if successful, the taxpayer would be entitled to no remedy or a seriously compromised one. Indeed, after each of the following landmark U.S. Supreme Court cases striking down state taxes — *McKesson*, *Fulton*, *Hunt-Wesson*, and *South Central Bell* — the state waged an all-out effort to avoid paying full refunds to the winning taxpayers (or to impose retroactive taxes on taxpayers not even involved in the lawsuit), albeit with limited success. In other instances, however, states have succeeded in retaining unconstitutional taxes or increasing the taxes of nonparty taxpayers, raising grave fairness and policy issues. As courts sanction this approach, what might have they sacrificed?

Overview

Two overarching considerations largely govern a taxpayer's remedy for a successful constitutional challenge to a tax: federal constitutional law regarding remedies, and state law regarding statutory construction and remedies.

Federal constitutional law under *McKesson*. Federal constitutional law establishes the broad parameters governing any remedy ultimately pronounced by a state.

The seminal case regarding remedies for unconstitutional taxes is *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990). In *McKesson*, the state courts held that Florida's liquor taxing scheme discriminated against interstate commerce by allowing a tax exemption for alcoholic beverages produced from products commonly grown in Florida. Nevertheless, the state courts refused to allow a refund or any other form of relief for the taxes already paid. McKesson appealed, arguing that it was entitled to a refund at least equal to the difference between the tax imposed on the favored and the disfavored products. The U.S. Supreme Court held that prospective relief alone did not satisfy due process standards, and stated that if the state does not afford predeprivation relief, the Due Process Clause requires the state to provide "meaningful backward-looking relief" to mend the constitutional deprivation. *Id.* at 31.

Although *McKesson* is most properly viewed as addressing the threshold issue of whether a taxpayer who successfully challenged a tax is entitled to retroactive relief, the case nevertheless has virtually single-handedly shaped the landscape of what remedy is required where the taxpayer is entitled to retroactive relief.

McKesson establishes that the underlying defect in the taxing scheme initially will drive what remedy is required to cure it. The Court stated that where a tax is invalid "either because (other than its discriminatory nature) it was beyond the State's power to impose . . . or because the taxpayers were absolutely immune from the tax," the state must "'undo' the unlawful deprivation by refunding the tax previously paid under duress. . . ." *Id.* at 39. For example, if a state had a statute that circumvented constitutional nexus requirements, the tax imposed under that statute would be considered beyond the state's power to impose. Presumably, then, the only available remedy under *McKesson* would be a full refund of the tax paid under the unconstitutional statute.

States have succeeded in retaining unconstitutional taxes or increasing the taxes of nonparty taxpayers, raising grave fairness and policy issues.

Regarding discriminatory taxes, the Court afforded more flexibility for the proper remedy. If a tax is struck down as discriminatory, the state "may cure the invalidity . . . by refunding to petitioner the difference between the tax it paid and the tax it would have been assessed were it extended the same rate reductions that its competitors actually received." *Id.* at 40. Alternatively, "the State may assess and collect back taxes from [the favored class]. . . calibrating the assessment to create in hindsight a nondiscriminatory scheme." *Id.* Finally, the state also may cure discrimination through "a combination of a partial refund to petitioner and a partial retroactive assessment of tax increases on favored competitors. . . ." *Id.*

The Court held that, where the state opts to assess the previously favored class retroactively, "the State's effort to collect back taxes . . . may not be perfectly successful. . . .

Some [taxpayers], for example, may no longer be in business. But a good-faith effort to administer and enforce such a retroactive assessment likely would constitute adequate relief, to the same extent that a tax scheme would not violate the Commerce Clause merely because tax collectors inadvertently missed a few in-state taxpayers." *Id.* at 41.

Giving legislatures unfettered discretion to craft remedies for unconstitutional statutes is potentially rife with problems.

State law. Once a statute has been held unconstitutional, state law comes into play in determining which of the foregoing options are feasible and the extent to which they should be employed. Among some state rules that may affect the crafting of remedies for unconstitutional statutes are: severability and/or reformation laws and savings clauses; refund statutes; legislative remedies created after a holding that a statutory scheme is unconstitutional; statutes of limitations for assessing back taxes; and statutes providing generally what remedy is required if a statute is held unconstitutional. Indeed, state law could well be determinative in tailoring the required remedy. For example, once a court determines that a state tax was beyond the state's power to impose, state law may determine the manner in which the appropriate refund should be computed. Or, if a court determines that a state tax discriminates against interstate commerce, state law may govern whether a partial or full refund is warranted, whether back taxes should be imposed on the previously favored class, or whether a hybrid remedy is appropriate.

The Application and Interplay Of Federal Constitutional Law And State Law Regarding Remedies

The subsections below focus on a number of state law principles central to recent decisions addressing the remedies issue, and demonstrate the application and interplay of these state law principles with federal constitutional law. The following illustrations also set the stage for the final discussion regarding the underlying policy concerns in the approach taken by many courts when fashioning remedies for unconstitutional state taxes.

Severability and specific language of refund statutes. One very recent case, *Annenberg v. Commonwealth of Pennsylvania*, 757 A.2d 338 (Pa. 2000), *cert. denied* 121 S. Ct. 385 (Oct. 30, 2000) (No. 00-343), illustrates the role that a state's severability rules and refund statutes may play in fashioning specific remedies. Pennsylvania's personal property tax statute generally allowed counties to tax shares of stock of foreign corporations owned by a resident of the state, but precluded counties from taxing shares of stock in corporations liable for or relieved from Pennsylvania's capital stock or franchise tax. Because the capital stock and franchise taxes were imposed only on corporations incorporated in Pennsylvania or doing business within the state, the Pennsylvania Supreme Court held that the taxing scheme unconstitutionally discriminated against resident shareholders of foreign corporations that did not conduct business within the state.

The taxpayers argued that a refund was required for two reasons. First, they said, the relevant Pennsylvania refund statute required it. Second, they asserted, the entire personal property tax statute had to be stricken because, among other reasons, severing only the offending language would produce a scheme that the legislature never intended. Regarding legislative intent, the legislature had recently rejected a bill that would have extended the personal property tax to all classes of stock. The taxpayers argued that in doing so the legislature communicated that it did not desire the tax on stock to apply to all classes of stock, which would have been the effect of severance.

The Pennsylvania Supreme Court rejected the taxpayers' arguments and denied a refund. The court first concluded that the Pennsylvania refund statute, which provides that a refund is due whenever a political subdivision of the state collects taxes to which it was not "legally entitled," did not apply. The court reasoned that only the exclusion to the stock tax was unconstitutional, and, therefore, the taxes imposed on the plaintiffs were collected legally. Moreover, the court held that, under Pennsylvania law, the offending language was severable, thereby leaving the rest of the tax statute intact. The court then rejected the taxpayers' argument that the legislative intent could be gleaned from the acts of a subsequent legislature. Rather, the court was limited to "examining what the enacting legislature would have done had it known that the exemption it placed in the stock clause was unconstitutional." *Id.* at 21. Apparently concluding that the legislature would have approved the tax without the exclusion, the court determined that the exclusion was severable.

Having determined that the county was "legally entitled" to the taxes collected, the court held that a refund was inappropriate, but did not dictate a specific remedy. Rather the court remanded the case, acknowledging that *McKesson* requires some retroactive remedy to rectify the discrimination. The taxpayers petitioned the U.S. Supreme Court for a writ of *certiorari* arguing that it was not appropriate for the Pennsylvania Supreme Court to remand this case because the only constitutionally permissible remedy was a refund. The U.S. Supreme Court recently denied the taxpayers' request for review. See *Annenberg v. Commonwealth of Pennsylvania*, 757 A.2d 338 (Pa. 2000), *cert. denied* 121 S. Ct. 385 (Oct. 30, 2000) (No. 00-343).

Thus, *McKesson* required the state to provide the *Annenberg* taxpayers "meaningful backward-looking" relief, which could be achieved in a variety of ways, including a refund or retroactive taxation. But it was the state law that narrowed the appropriate remedy and that likely will determine the actual remedy on remand. Had the offending language not been severable under Pennsylvania law, the entire tax statute might have been struck down, and the taxpayers likely would have received a full refund. (For the full text of the Pennsylvania Supreme Court decision in *Annenberg*, see *Doc 2000-15858 (25 original pages)* or *2000 STT 111-32*.)

Legislative remedies created after a holding that a statutory scheme is unconstitutional. Another case at the vanguard of the remedies issue, *W.R. Grace & Co. v. State of Washington, Department of Revenue*, 973 P.2d 1011 (Wash. 1999), *cert. denied* 528 U.S. 950 (Oct. 18, 1999) (No. 99-38), demonstrates the role of a statute passed specifically to remedy a tax that already had been held unconstitutional. Washington

imposed a business and occupation (B&O) tax on the privilege of doing business in the state, including manufacturing and making wholesale sales. Though the same tax rates applied to both activities, under Washington's "multiple activities exemption," local manufacturers enjoyed an exemption from the manufacturing tax for any portion of their output that was subject to the tax on wholesale sales. However, no credit was allowed for taxes paid on sales outside of Washington.

After the B&O tax was held to discriminate against interstate commerce because the "multiple activities exemption" discriminated against out-of-state manufacturers that sold their products within the state, as well as against in-state manufacturers that sold their products out of state, see *Tyler Pipe Indus. Inc. v. Department of Revenue*, 483 U.S. 232 (1987), the Washington Legislature enacted the multiple activities tax credit (MATC). Under the MATC, taxpayers paying the selling tax may take a credit against the tax for any manufacturing tax paid to Washington or any equivalent tax paid to another state. Taxpayers paying a manufacturing tax and selling out of state can take a credit against that tax for any selling tax paid to another state on the same product.

In order for an interstate taxpayer to receive a credit under the MATC, it has to, among other things, identify manufacturing or selling activities in another jurisdiction, trace individual ingredients or products from the manufacturing state to Washington, and maintain extensive records during the tax years in question. Unfortunately, because the MATC was enacted retroactively, and taxpayers had no independent reason to keep such records, many taxpayers engaged in interstate transactions find it impossible to establish a right to a credit. On the other hand, taxpayers engaged in intrastate transactions receive the credit automatically.

According to the taxpayers in *W.R. Grace*, due to the burdens imposed by the MATC, which created a likelihood of receiving no credit at all, the MATC did not afford them "meaningful backward-looking" relief. They also challenged the MATC on discrimination and fair apportionment grounds, and claimed that retroactive application of the MATC violated due process because it interfered with taxpayers' settled expectations and because it was applied too far back in time.

Recognizing that under *McKesson* states are afforded flexibility in fashioning remedies, the Washington Supreme Court dismissed the taxpayers' discrimination and apportionment challenges, stating that those issues had been resolved in prior cases. The court purported to rely on *McKesson* as authority for the state Legislature modifying an offending tax statute retroactively to rectify the constitutional defect, though *McKesson* does not appear to state this explicitly. Thus, the court held that the MATC constituted the proper remedy in this case, and that neither a refund, nor any other type of additional relief, was required. The court never addressed directly the taxpayers' allegations that the MATC did not provide a true remedy. At least the dissent acknowledged that "as a practical matter, the in-state taxpayer enjoys an automatic 100 percent credit whereas the interstate taxpayer is lucky to recoup 1 percent, if that." *Id.* at 1032 (Sanders, J., dissenting). (For the full text of the Washington Supreme Court's decision, see *Doc 1999-12535 (29 original pages)* or *1999 STT 68-42*.)

One of the more interesting questions arising from the *W.R. Grace* litigation is, assuming that a retroactive legislative remedy is permissible in general, would such a remedy be subject to any limitations? *W.R. Grace* does not itself suggest any limits. However, as discussed further at the end of this article, giving legislatures unfettered discretion to craft remedies for unconstitutional statutes is potentially rife with problems.

Statutes of limitations for assessing back taxes and general remedies statutes. Lest taxpayers think they never will receive a refund of unconstitutional taxes, the court in *Ceridian Corp. v. Franchise Tax Bd.* (Cal. Ct. App. Dec. 21, 2000), ordered a full refund of all unconstitutional taxes. *Ceridian* illustrates how a state's statute of limitations on imposing back taxes plays a role in a court's analysis of the remedies issue. And, it provides an example of a state statute dictating generally the remedy for unconstitutional taxes.

After holding unconstitutional California's statute regarding deductions for dividends received from insurance companies, the court in *Ceridian* stated that "the parties agree that retroactive tax collection in this case is impossible, since the tax years in question are 1978-1982, and the statute of limitations for assessment or collection of a tax deficiency is four years." *Id.* at *25. Thus, solely because the years in question were not within the four-year statute of limitations, the court affirmed the trial court's holding requiring a refund for the constitutional violation in question.

Can a state legislature legally limit court-ordered remedies for taxes violating the federal constitution?

Whereas the years in *Ceridian* were quite old, challenges to the statute in *Ceridian*, as well as a similar statute (Cal. Rev. and Tax. Code section 24402), no doubt will arise for years that are within the normal four-year statute of limitations. The court in *Ceridian* did not address the remedy issue under those circumstances stating that "only Ceridian's refund claim is before us. Accordingly, we express no general opinion regarding the appropriate remedy in other cases. . . ." *Id.* at *25, n.9. Certainly, the Franchise Tax Board will argue that the proper remedy in cases where the years in question still are within the four-year statute of limitations is assessing back taxes on the favored class. Moreover, the state likely will rely on *McKesson's* language that the state's efforts to impose back taxes need not be perfect, and that only "a good-faith effort [is necessary] to administer and enforce [ ] a retroactive assessment. . . ." *McKesson*, 496 U.S. at 41. Unfortunately, *McKesson* provides no guidance regarding what may or may not constitute a "good-faith effort."

In *Ceridian*, the state also relied on a general remedies statute, Cal. Rev. and Tax. Code section 19393, in an attempt to avoid paying a refund. Section 19393 provides in relevant part that if a deduction under the corporate income and franchise tax is held invalid on constitutional grounds, the tax liability of the favored taxpayer shall be recomputed, disallow-

ing the deduction. The state argued that section 19393 required the state to remedy discrimination by increasing the tax of the favored taxpayers through disallowing the deduction that was held to be discriminatory rather than affording a refund. The trial court had concluded that section 19393 applied only to discrimination against national banks. However, the Court of Appeal declined to address the scope of section 19393, stating that "even if [it] is broad enough to cover Ceridian, it cannot provide the constitutionally required relief in this case [because the applicable statute of limitations is closed for the years in question]." *Id.* The court concluded that "section 19393 violates a taxpayer's right to due process, where, as here, the retroactive assessment it provides cannot lawfully be collected. Accordingly, the trial court did not err by awarding Ceridian the stipulated refund." *Id.* (For the full text of the California Court of Appeal's decision, see *Doc 2001-196 (12 original pages)* or *2001 STT 1-7*. For a column in the "States of Mind" series on the ruling, see *State Tax Notes*, Jan 15, 2001, p. 185; *2001 STT 10-17*; or *Doc 2001-1439 (4 original pages).*)

Had the statute of limitations been open, and had the court concluded that section 19393 applied to corporations other than national banks, the result likely would have been quite different. In any event, section 19393 raises some interesting questions: Can a state legislature legally limit court-ordered remedies for taxes violating the federal constitution? Is it appropriate for the legislature to prescribe a generally applicable remedy without knowing anything about the tax or why it was unconstitutional? Is it good policy?

Other broader issues. Other courts, while allowing a partial or full refund under *McKesson*, have invited states to advance alternative remedies, such as eliminating discrimination through retroactively taxing the previously favored class of taxpayers. For example, in *Scottsdale Princess Partnership v. Department of Revenue*, 958 P.2d 15 (Ariz. Ct. App. 1997), the court mandated that the state provide a partial refund of improperly collected taxes. It rejected the state's argument that discrimination should be cured by retroactively taxing the favored class of taxpayers and stated that such a remedy would be "harsh and oppressive." *Id.* at 21. However, the court also observed that the county never indicated that it would be willing to take the steps necessary for retroactive taxation and, so, it left open the possibility that retroactive taxation might be appropriate under other circumstances. (For the full text of the Arizona Court of Appeals' decision, see *Doc 97-14521 (9 pages)* or *97 STN 103-5*.)

If a tax is retroactively replaced with a new tax, all planning that a taxpayer did may become academic.

Similarly, following *Smith v. New Hampshire*, 692 A.2d 486 (N.H. 1997), on remand, the Merrimack County Superior Court stated that "the state has not suggested an alternative remedy [to a refund], such as a credit toward future taxes or a retrospective collection of taxes from those who had enjoyed the benefit of the unconstitutional exemptions." *Smith v. New Hampshire*, No. 95-E-059 (Merrimack Superior Court 2000), at p. 28. This case is now pending before the New Hampshire Supreme Court.

Lurking in the background of all future remedies disputes will be an argument raised in the *certiorari* petition to the U.S. Supreme Court in *Annenberg*, namely that two post-*McKesson* decisions require a full refund of all unconstitutional taxes: *Reich v. Collins*, 513 U.S. 106 (1994), and *Newsweek, Inc. v. Florida Department of Revenue*, 522 U.S. 442 (1998). According to the plaintiffs, those cases clarified that "where a state has held out a clear and certain postdeprivation remedy — and that remedy is a refund — that form of meaningful backward-looking relief may not be taken away from the taxpayer 'in mid-course.'" Petition for Writ of *Certiorari* at 12, *Annenberg v. Commonwealth of Pennsylvania*, 757 A.2d 338 (Pa. 2000), *cert. denied* 121 S. Ct. 385 (Oct. 30, 2000) (No. 00-343). The plaintiff in *W.R. Grace* made a similar argument in its petition for review to the U.S. Supreme Court. We are not aware of any cases extending *Reich* and *Newsweek* beyond the principle that a retroactive remedy is required to the notion of what actual remedy is required. However, when the U.S. Supreme Court finally grapples with this interpretation, we may find that it has some merit. (For the full text of the Supreme Court's decision in *Reich*, see *94 STN 236-23*. For the full text of the Supreme Court's decision in *Newsweek*, see *Doc 98-7059 (3 pages)* or *98 STN 36-9*.)

Do Certain of the Recent Decisions Constitute Bad Tax Policy?

Though it may be too soon to tell whether there are clear trends in the law regarding the approach courts are taking to remedies for unconstitutional taxes, several possible trends suggested by the cases discussed above are especially troubling to us.

First, there is the possible trend toward states successfully retaining unconstitutional taxes. If such a trend ensues, the deterrent effect on taxpayer lawsuits could cause taxpayers to be left at the mercy of legislatures to impose constitutional taxing schemes. Moreover, the judicial power *and duty* to review the constitutionality of legislation could be diminished greatly. Beyond these policy considerations, there is a basic question of fairness raised by not refunding unconstitutional taxes to the taxpayers who brought the successful lawsuit.

Second, there is an even more unsettling possible trend toward imposing back taxes on taxpayers who were not parties to the constitutional challenge, whether in a discrimination case or otherwise. From a policy perspective, such an approach seems especially misguided. When states, apparently due to a desire to offset sizeable refunds by a new source of revenue, endeavor to collect back taxes from taxpayers that were not even parties to the litigation, the potential for further litigation by the newly assessed taxpayers is evident.

Third, there is a possible trend toward retroactively amending tax statutes or creating a remedy through legislation for past periods. This, too, raises serious policy quandaries. For example, if the legislature attempts to cure a constitutional defect by amending the offending statute, but doesn't quite cure the defect, then another round of litigation must begin only to have the legislature try again, and perhaps again. If a tax is retroactively replaced with a new tax, all planning that a taxpayer did may become academic. This affects decisions about how to structure one's business affairs. It also affects simple recordkeeping that the taxpayer would have undertaken (i.e., to establish a tax liability or to secure a credit or other remedy) but didn't because it did not appear necessary under prior law.

Another concern is whether states will be permitted to circumvent voter approval requirements in the guise of establishing a remedy for an unconstitutional tax.

The cases discussed above all purport to decide remedies issues on the basis of the language in *McKesson*. However, *McKesson*'s discussion of remedies in fact was *dicta*. And, given the number of permutations that could and do arise in the context of remedies for unconstitutional state taxes, it is likely that the Court did not foresee clearly all of the ramifications of actually applying those principles in real situations. While it is appropriate for lower courts to use *McKesson's* language for guidance, conforming to state law as well, those courts must establish boundaries around such language in a manner that is sensible, fair, and promotes good policy. Though the policy concerns we have identified do not necessarily rise to the level of legal arguments binding on the state courts, we can only hope that courts will begin to see the broader effects of their decisions and use their authority in a responsible way, taking these considerations into account. ✩

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