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Constitutional Limitations

U.S. Supreme Court's Denial of Cert in Farmer Brothers Case Seals Taxpayer's Victory in Challenge to Discriminatory Deduction

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INTRODUCTION

On Feb. 23, 2004, the U.S. Supreme Court rejected the petition for certiorari filed by the California Franchise Tax Board (FTB) in *Farmer Bros. Co. v. California Franch. Tax Bd.*[1] Thus the book is closed on Farmer Bros.' successful challenge to the state's discriminatory dividends received deduction (DRD) statute, *i.e.*, California Rev. & Tax. Code §24402.[2]

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In this article, we review the legal principles that framed the controversy and provide some insight into what lies ahead now that the litigation has been successfully concluded. At the outset, we briefly summarize the background of the litigation and the decision of the California Court of Appeal that was the target of the FTB's cert. petition. Thereafter, we summarize the grounds raised by the FTB as its basis for seeking U.S. Supreme Court intervention, including particularly the FTB's attempt to convince the court that the discriminatory DRD should be viewed as a complementary tax imposed upon interstate commerce in compensation for other taxes paid solely by intrastate commerce. Next, we provide a brief response to those arguments drawn largely from the Farmer Bros. Brief in Opposition to Certiorari. Whether the debate on the substantive issue had any persuasive effect upon the court in denying the cert. petition is, of course, speculation. Nonetheless, the grounds advanced by the FTB in its cert. petition raise some interesting issues worth exploring in their own

[1] 108 Cal. App. 4th 976 (2003), *cert. denied*, No. S117131, 2003 Cal. LEXIS 6515 (Aug. 27, 2003), *and cert. denied,* 124 S. Ct. 1411 (Feb. 23, 2004).

[2] In terms of its impact upon state revenues, it appears that the *Farmer Bros.* litigation was one of the most expensive tax cases in the state's history. In published reports following the U.S. Supreme Court's denial of the cert. petition, spokespersons for the state estimated the revenue loss associated with the case as high as $1.5 billion, plus an ongoing annual loss of $180 million. *See, e.g.,* David R. Doerr, *U.S. Supreme Court Lets Farmer Bros. Dividend Tax Decision Stand; FTB Likely to Treat it Like Ceridian*, CALTAXLETTER, Vol. XVII, No. 8 (Ronald W. Roach ed., Feb. 27, 2004).

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right, because they shed light upon the nature of proof that a state must advance to meet the requirements of complementary tax defense to an otherwise facially discriminatory tax.

Finally, we address the question of remedies. In this regard, it appears that all taxpayers with valid (timely-filed) claims involving tax years prior to 1999 should expect a refund of the discriminatory taxes collected by the state (albeit with a possible adjustment to disallow as a deduction, expenses attributable to the investment which produced the dividend). In contrast, for taxes paid in 1999 and thereafter, the issue remains very much in play: the FTB apparently intends to deny all DRDs that previously relied upon §24402 as authority on the theory that §24402 has now been voided in its entirety by the litigation. Thus, the FTB apparently intends to disallow a deduction for all dividends received by corporate taxpayers regardless of whether those dividends are drawn from income taxed by California or income taxed by other states. In this discussion, we outline arguments that may be available to taxpayers to challenge the FTB's position and/or encourage new legislation, including a brief description of the efforts underway to enact legislation to restore the insurance company DRD that was struck down in earlier litigation.

BACKGROUND OF LITIGATION

Farmer Bros. Co., a California coffee manufacturer, received dividends from investments in various companies engaged in business in other states as well as, in some cases, in California. Relying upon §24402, Farmer Bros. Co. obtained a deduction in an amount up to 70 percent of the dividends based on its stock ownership in the payor corporations. (The deduction was available in greater percentages as the stock ownership percentage increased.) However, §24402 limited the deduction to dividends considered to have been paid from income that had previously been subject to California tax (which determination rested upon the dividend payor's relative apportionment factors within the state of California).

Farmer Bros. Co. challenged the limitation placed on the §24402 deduction as violating the commerce clause—citing among other things, that the statute provides a tax benefit based upon the relative presence of the payor in the state in violation of the U.S. Supreme Court's ruling in *Fulton Corp. v. Faulkner.*[3] The FTB, in turn, countered that the statute did not discriminate against interstate commerce because its purpose was to eliminate double taxation of California income and not to favor in-state commerce. The FTB also argued that the §24402 scheme, in effect, imposed a "compensatory tax" upon a stream of earnings that originates in other states, and that the imposition of this tax insured that the out-of-state earnings bore a California tax equal to that borne by earnings generated from within the state.

COURT OF APPEAL RULING

In holding that the DRD violated the commerce clause, the California Court of Appeal relied principally upon three authorities: *Fulton Corp. v. Faulkner,*[4] which struck down a North Carolina "intangibles tax" that taxed "a fraction of the value of corporate stock owned by North Carolina residents inversely proportional to the corporation's exposure to the State's income tax"; *Ceridian Corp. v. California Franch. Tax Bd.,*[5] which struck down a California dividends received deduction for dividends paid by insurance subsidiaries that was closely similar in concept to the DRD at issue in *Farmer Bros.*; and *D.D.I. Inc. v. North Dakota,*[6] which struck down a North Dakota dividends received deduction that apparently mirrored the DRD at issue in *Farmer Bros. Co*. In reliance upon these authorities, the California court held:

> We conclude that §24402 is discriminatory on its face because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California. As a result, the dividends received deduction scheme favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause.[7]

The court also concluded that the DRD violated the "internal consistency doctrine" because, assuming California's DRD were replicated in other states, the combined tax burden of the dividend payor and the dividend recipient would be greater if the payor and recipient operated in different states than the tax burden would be if the payor and recipient did business wholly within a single state.

Denial of DRD Not Justified As Compensatory Tax

After concluding that the DRD constituted facial discrimination against interstate commerce, the court rejected the FTB's argument that the discrimination could be justified because the restriction on the DRD operated to compensate for the fact that in-state commerce (*i.e.*, dividends qualifying for the DRD) previously had borne a California franchise tax while interstate commerce (*i.e.*, non-qualifying dividends) had been exempt from that tax burden. Initially, the court noted that the U.S. Supreme Court has articulated three conditions as necessary to invoke the so-called compensatory tax defense:

- A state must, as a threshold matter, identify the intrastate tax burden for which the state is attempting to compensate;
- The tax on interstate commerce must be shown roughly to approximate, but not exceed, the amount of the tax on intrastate commerce; and
- The events on which the interstate and intrastate taxes are imposed must be substantially equivalent; that

[3] 516 U.S. 325 (1996).

[4] 516 U.S. 325, 327 (1996).
[5] 85 Cal. App. 4th 875 (2000).
[6] 657 N.W.2d 228 (N.D. 2003).
[7] *Farmer Bros. Co.*, 108 Cal. App. 4th at 986-87.

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is, they must be sufficiently similar in substance to serve as mutually exclusive proxies for each other.[8]

In applying this test, the California court noted that the U.S. Supreme Court has rejected comparisons under the compensatory tax doctrine based simply upon the argument that out-of-state earnings had not been subjected to the state's general income tax. Instead, the supreme court has required a showing that the in-state commerce has borne some specific burden or paid for some benefit for which the state may fairly ask analogous compensation from interstate business. Thus, absent compelling proof that the state's general income tax could be traced to funding a specific program, which was also utilized by the interstate commerce, the court found that it could not ''even begin to make the sorts of qualitative assessments that the compensatory tax doctrine requires.''[9] The court also noted that the compensatory tax doctrine would be particularly difficult to satisfy, where, as here, the identified tax burden was imposed at a different level of commerce (the payor level) than the purported compensatory tax.[10]

FTB'S CERT PETITION

To a large extent, the FTB's cert. petition merely reiterated the arguments made at the court of appeal in its unsuccessful attempt to defend the DRD. However, the FTB cast those arguments in slightly different terms in its attempt to convince the U.S. Supreme Court that the case was of sufficient importance to justify the Court's attention.

As its primary contention, the FTB argued that the lower court's decision actually discriminated *against* in-state commerce rather than simply requiring equal treatment of interstate commerce. In this regard, the FTB maintained that California had a legitimate interest in alleviating the multiple tax burdens that California, itself, had imposed upon the dividends. While according to the FTB, the state's imposition of a second level tax on receipt of dividend income did not violate any constitutional principle, such multiple taxation could be eliminated by the state as a matter of tax policy, just as the federal government had chosen to eliminate the double U.S. corporate tax burden by the dividends-received deduction of Internal Revenue Code §243.[11] Placed in this perspective, according to the FTB, the DRD did not discriminate against interstate commerce because the California tax burden borne by both in-state and out-of-state commerce remained the same. To prove its point, the FTB advanced the following hypotheticals:

> 1) A dividend-payor, Corporation A, earned $100 that was taxed by California. Its California tax on this income is $8.84 ($100 multiplied by the current statutory rate of 8.84%). Corporation A pays a dividend of the after-tax income, $91.16 ($100-$8.84), to Corporation B. Corporation B receives $91.16 of income. But for section 24402, Corporation B would pay a tax of $8.06 on the receipt of the dividend ($91.16 of income multiplied by the statutory rate of 8.84%). However, section 24402 allows Corporation B to take a deduction of $91.16 with respect to the dividend. Because of the deduction, Corporation B pays no California tax on the dividend. California receives a total tax of $8.84 on the $100 of income earned by Corporation A and paid to Corporation B.
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> 2) A dividend-payor, Corporation C, earned $100 that is not taxed by California. A dividend is paid of the after-tax income, $100.00 to Corporation D. Corporation D receives $100.00, which is taxed by California at the statutory rate of 8.84%, and pays California a tax of $8.84. Corporation D does not receive a deduction under section 24402 because the income from which the dividend was paid was not previously taxed by California. Corporation D has after-tax income of $91.16. California receives a total tax of $8.84 on the $100 of income earned by Corporation C and paid to Corporation D.[12]

In addition to arguing the court of appeal's decision was wrong on the merits, the FTB also argued that the court should grant the cert. petition in order to ''provide necessary guidance''[13] concerning a question that had not previously been addressed by the court in its opinions: whether in meeting the third prong of the compensatory tax defense (that the complementary taxes fall on ''substantially equivalent events''), an income tax imposed upon the operations of a corporation and an income tax imposed upon a shareholder receiving dividends from that operating corporation should be treated (essentially as a matter of law) as imposed upon substantially equivalent events.[14]

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[8] *Farmer Bros. Co.,* 108 Cal. App. 4th at 989.

[9] *Id.* at 991 (quoting *Fulton,* 516 U.S. 325 at 338).

[10] In summary, the California court found that the FTB had failed all three prongs of the compensatory tax defense because (a) the state's identification of its general income tax did not satisfy the requirement that the state identify a cognizable burden that intrastate commerce, but not interstate commerce, had been forced to pay; (b) having failed to identify such a burden, the state could not even begin to show that the intrastate burden was equal or greater than the burden on interstate commerce and (c) because the income taxes in question were imposed upon different taxpayers, the state had not met its burden of showing the compensating tax was imposed upon a substantially equivalent event to that which triggered the facially discriminatory tax. *Farmer Bros. Co.,* 108 Cal. App. 4th at 989-992.

[11] Franchise Tax Board's Petition for a Writ of Certiorari (Cert. Petition) at 7-9. While the deduction provided under I.R.C. §243(a) is limited to dividends paid ''from a domestic corporation which is subject to taxation under this chapter,'' the federal government has adopted a tax credit mechanism for eliminating multiple corporate taxation of dividends paid from foreign corporations. *See* I.R.C. §§901, 902. Moreover, because the federal government is not subject to the Commerce Clause, see generally *Kraft Gen. Foods, Inc. v. Iowa,* 505 U.S. 71 (1992), the limitation on the scope of the deduction provided by I.R.C. §243 should provide no support for an ''analogous'' state limitation.

[12] Cert. petition at 9-10.

[13] Cert. petition at 23.

[14] The FTB also sought to attract the court's attention with another question: namely whether the compensatory tax defense is even applicable where the same tax (*i.e.,* in this case the state income tax) constitutes both the facially discriminatory tax and the allegedly compensatory tax. (The FTB, of course, maintained that the defense should be applicable.) Because the answer to the question was not even in dispute in the litigation, we do not address it further here. Indeed, we certainly know of no reason that the compensatory tax defense could not be invoked when a single levy is involved in different contexts, particularly since the availability of the defense to sales and use tax appears to be premised upon the close align-

Key Arguments

It is worth noting that the FTB faced a formidable hurdle in its petition for *certiorari*. The court accepts very few cases for review. And, here the FTB faced three decisions by three separate courts all arriving at essentially the same conclusion.[15] Those decisions, in turn, were based upon a careful reading of the court's unanimous opinion in *Fulton*, which struck down a tax regime that was functionally identical to the DRDs at issue in the state proceedings. Indeed, an FTB victory on merits almost certainly would have required the court to overturn *Fulton*. Thus, the court's rejection of the cert. petition probably requires little further explanation. The FTB did the best it could with a losing cause. Nonetheless, at least a brief response to the FTB's arguments seems worthwhile, particularly because it may serve to inform the litigation and legislative effort that are sure to follow.

Reduced to its basics, the FTB's central argument suffered from at least two analytical defects. First, the FTB's postulation of an equal tax burden borne by the stream of both intrastate and interstate earnings (shown in its two hypothetical examples, quoted above) is obviously flawed because it ignores the theory and the reality of taxes imposed by other states. When such taxes are considered, the illusion created by the FTB's hypothetical, described above, is revealed: Corporation C's $100 (which is earned outside of California) is first reduced by the taxes of another state (say Arizona); the remaining earnings, which are then paid as a dividend to a California stockholder, are further reduced by taxes imposed by California. No similar double taxation occurs where the dividend payor and payee are both located entirely within California.[16] So viewed, the California's ''tax policy'' of eliminating double taxation of corporate income creates discrimination against interstate commerce. If it were applied by every state, interstate commerce would be double taxed while in-state commerce would bear a single levy. In other words, if it is good tax policy to eliminate multiple taxation of corporate income, and it assuredly is, then that policy must be applied in a manner that does not discriminate, *i.e.*, it must be extended to accommodate taxes imposed by other states as well.[17]

More fundamentally, the FTB's argument (as demonstrated by its hypothetical) also failed to focus upon the real concern that appears to have motivated the court's decision in *Fulton*. In *Fulton*, the court focused upon the effect of the North Carolina tax upon the behavior of a potential investor considering an investment in the stock of a North Carolina corporation versus investment in the stock of a corporation doing business in another state. So viewed, the North Carolina tax created pressure to invest in the home-state securities because the investor would pay an intangibles tax on his or her out-of-state securities, but avoid that tax on North Carolina securities.

Similarly, the California DRD essentially imposed a discriminatory income tax on the owner of out-of-state stock (which paid a dividend) while the owner of stock in California companies paid no such tax. Even if one ignores the FTB's failure to acknowledge taxes imposed by other states on the operating companies in its hypothetical, the FTB's example is nonetheless flawed: it proceeds on the assumption that the burden of the tax imposed upon the operating company in fact is borne by the stockholder in the form of a dollar for dollar reduction in the amount of the dividend received. Put another way, had the operating company paid the California tax of $8.84 (assumed in the hypothetical) on its earnings and still declared a $100 dividend (rather than a dividend reduced by that amount of tax), then an investor in a California company's stock would receive $100, virtually all of which would be deductible for California purposes.[18] In contrast, the investor in a com-

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ment of the two taxes involved, an alignment that would be even closer where both the compensatory tax and the purportedly facially discriminatory tax are, in fact, the same tax levy.

[15] *D.D.I. Inc. v. North Dakota*, 2003 N.D. 32, 657 N.W.2d 228 (N.D. 2003), was decided by the North Dakota Supreme Court. *Ceridian* was decided by another district of the same California Court of Appeal that issued the *Farmer Bros.* decision.

[16] Under current supreme court commerce clause decisions, the analysis of the effects of the DRD upon interstate commerce is probably best grounded by assuming that other states impose a tax regime identical to California's. *See D.D.I. Inc.*, 657 N.W.2d at 234 (noting that the commerce cause's internal consistency analysis requires an assumption of an identical tax in every state rather than proof that other states actually impose a similar tax burden). Nonetheless, a ''real world'' review would have produced the same conclusion since 46 states and the District of Columbia currently impose a tax on corporate income. J&R Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* (2nd Ed. 1993), ¶ 1.02 at p. 1.8.

[17] Indeed, had California crafted its relief from double taxation in the form of a statutory credit (to be claimed by the recipient) against taxes imposed upon the payor of the dividend, there would appear to be little controversy that the commerce clause would require extension of any such credit to taxes paid to other states. For example, in discussing the workings of the compensatory tax defense in the context of a sales and use tax, the court has stated:

> ''[I]n upholding tax schemes providing credits for taxes paid in state and occasioned by the same transaction, we have often pointed to concomitant credit provisions for taxes paid out of state as supporting our conclusion that a particular tax passed muster because it treated out-of-state and in-state taxpayers alike. See, *e.g., Itel Containers Int'l Corp. v. Huddleston*, 507 U.S. 60, 74 (1993); *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 31 (1988) (''The . . . taxing scheme is fairly apportioned, for it provides a credit against its use tax for sales taxes that have been paid in other States''); *General Trading Co. v. State Tax Comm'n of Iowa*, 322 U.S. 335 (1944); *Silas Mason, supra* at 584. A general requirement of equal treatment is thus amply clear from our precedent.''

Okla. Tax Comn. v. Jefferson Lines, 514 U.S. 175, 192 (1995). While the court concludes this discussion with the caveat that it was expressing no opinion on ''the need for equal treatment when a credit is allowed for payment of in-state or out-of-state taxes by a third party,'' *Id.* (citing *Darnell v. Indiana*, 226 U.S. 390 (1912)), less than a year later, the court resolved any ambiguity this limitation might have created by holding that *Darnell* was ''no longer good law under the Commerce Clause.'' *Fulton*, 516 U.S. at 346. *See also* ''*Darnell* simply cannot be reconciled with the compensatory-tax decisions cited in the Court's opinion . . .'' *Id.* at 348 (Chief Justice Rehnquist concurring).

[18] Presumably, the DRD in this case would be limited to $91.16 and thus (depending upon the source of the additional $8.84 dividend) the investor could be exposed to tax of approximately $0.74 on the $100 dividend. Thus, the favored investor in a California company would have a net after-tax dividend of $99.26 compared to the investor in an out-of-state company which would have a net after-tax dividend of $91.16.

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pany doing all of its business in another state, would not receive any deduction for the dividend received.

The California DRD essentially imposed a discriminatory income tax on the owner of out-of-state stock (which paid a dividend) while the owner of stock in California companies paid no such tax.

The FTB's desire to gloss over this assumption explains in part the purportedly ''unaddressed'' question posed by the FTB in the cert. petition, namely whether an income tax imposed upon the operations of a corporation and an income tax imposed upon a shareholder receiving dividends from that operating corporation should be treated (essentially as a matter of law) as imposed upon substantially equivalent events. In other words, only if one is willing to make that assumption (essentially as a matter of law) can one conclude that the tax burden on the investor is necessarily the same when his or her investment involves a California corporation versus an investment in an out-of-state operation.

As the court observed in *Fulton,* determining whether two taxes imposed upon different taxpayers at different levels should be treated as imposed upon a substantially equivalent event, is a ''complex factual inquir[y]'' that courts ''are poorly equipped to evaluate with precision'' because the question, at bottom, is whether the economic incidence of a tax should be treated as different than the normal incidence of that tax.[19] For example, determining whether a tax imposed upon an operating company should be viewed as borne by its shareholders (because its effects are passed through) may turn upon whether the operating company has sufficient market power to pass the tax to its customers in the form of a price increase, rather than to its shareholders. Because the *Farmer Bros.* appeal lacked both the factual record and any expert analysis upon which to evaluate whether the two taxes described in the FTB's hypothetical were imposed upon the same class taxpayers (*i.e.*, the recipient of the dividend), there would appear to have been no basis upon which the FTB could have established its claim that the DRD satisfied the compensatory tax defense since it could never have satisfied the third prong of the test, *i.e.*, proof that the two taxes in question were imposed upon substantially equivalent events.

NO RULING ON REMEDIES

In regard to the matter of remedies, neither the court of appeal opinion, nor the cert. petition addressed the issue for the simple reason that the FTB did not appeal the trial court's order that Farmer Bros. receive a refund of the tax paid as a consequence of the discriminating limits on the DRD. The FTB's determination not to appeal may be traced to its realization that the statute of limitations on all of the years at issue in *Farmer Bros.* would be closed before the final resolution of the case. Thus, while the U.S. Supreme Court's decision in *McKesson Corp. v. Div. of Alcoholic Beverages & Tobacco*[20] provides a theoretical foundation for remedying discrimination either by granting a refund to the interstate commerce that suffered the discrimination or by increasing the tax on the favored intrastate commerce, that choice would not be available in *Farmer Bros.* Indeed, by the time the supreme court denied the cert. petition, the general statute of limitations for corporate taxpayers had closed not only for the years at issue in the litigation (1998 and prior years) but was on the verge of closing for an additional tax year (*i.e.*, the general corporate statute of limitations for calendar year 1999 closed on March 15, 2004) just weeks after the court's decision. In any event, the FTB's decision not to appeal was an acknowledgement that it would not be in a position to tax the favored commerce and therefore refunds to the disfavored commerce were appropriate.[21]

IMPLICATIONS FOR FUTURE

Based upon the FTB's reaction to the *Ceridian* litigation, it appears that the FTB intends to take the position that §24402 as a whole is void and taxpayers may no longer claim the benefits or suffer the detriments of the deduction.[22] Indeed, informal sources at the FTB have indicated that the FTB already has begun to issue notices of deficiency based upon reversing any deductions taken under the DRD for tax years 1999 and thereafter.

In the face of this undertaking, it seems likely that litigation will arise to challenge the legality of the FTB's action. There are a number of potential arguments for doing so: First, taxpayers may argue that the FTB's enforcement actions to collect additional taxes from taxpayers who obtained an advantage of the discriminatory DRD do not actually level the playing field as required by *McKesson.* Those arguments may be based upon one of two themes:

- that the collection of a tax years after the discrimination occurred does not undo the competitive advantages enjoyed by taxpayers who paid a lower tax in past years; and
- that the FTB's audit and collection procedures are not sufficiently robust to constitute the type of effort contemplated by *McKesson.*[23] This second argument, particularly, may hold greater weight for 1999 given that the FTB had little time following the court's denial of the cert. petition in which to launch a widespread effort to collect additional taxes from the favored class that benefited from the DRD.

Second, taxpayers almost certainly will maintain that the court's decision in *Farmer Bros.* goes only to the of-

[19] *Fulton*, 516 U.S. at 341-42.

[20] 496 U.S. 18 (1990).

[21] See *Ceridian Corp. v. California Franch. Tax Bd.*, 85 Cal. App. 4th 875 (2000) (where the statute of limitations bars any assessment of additional tax from the favored class of taxpayers the only permissible remedy is a refund).

[22] Memorandum from Winston Mah and Dale Isaac, FTB, to General Tax Audit Staff and Multistate Tax Audit Staff (Apr. 26, 2002) (on file with author) (instructing the FTB Audit Staff that no deduction under §24410 is to be allowed for tax years ending on or after Dec. 1, 1997).

[23] *See McKesson Corp.*, 496 U.S. at 41 (1990).

fending restriction on the DRD. By excising the unconstitutional restriction on the limits of the deduction, the statute continues to operate in a manner consistent with legislative intent in eliminating multiple taxation of corporate earnings. [24]

It appears that the FTB intends to take the position that §24402 as a whole is void and taxpayers may no longer claim the benefits or suffer the detriments of the deduction.

Third, the court of appeal's reliance upon the internal consistency doctrine in its Commerce Clause analysis may be viewed as evidence that the offense of the current DRD is that it effectively seeks to tax income earned in other states.[25] This infirmity was also acknowledged by the trial court in its opinion in *Farmer Bros*.[26] Given that the infirmity is taxing income beyond California's jurisdiction to tax, taxpayers may argue that the proper remedy is simply to extend the deduction and eliminate the unconstitutional tax.

Fourth, taxpayers may argue that a disallowance of the DRD provided by §24402 also may be viewed as violating the equal protection clause of the U.S. and California Constitutions since dividends paid by legal entities included within a combined report of unitary income will continue to enjoy a full dividend elimination under §25106 even though no rational basis exists for distinguishing between the multiple tax burden that arises in that context and the multiple tax that would be imposed by a repeal of §24402.[27]

[24] *See* Cal. Rev. & Tax. Code §23057 (California's severability clause applicable here); *see also Kopp v. Fair Political Practices Comn.*, 11 Cal. 4th 607, 660-61 (1995) (recognizing a court's authority to reform statutes in accord with legislative intent if the Legislature would have preferred the reform to the statute as a whole being found unconstitutional). The *Ceridian* court refused to reform §24410 because the formula used to calculate the deduction required broad substantive changes to operate constitutionally. Given the level of reform required, the court found that rewriting §24410 would be an ''encroachment on the legislative function in violation of the separation of powers doctrine.'' *Ceridian Corp.*, 85 Cal. App. 4th at 889. By contrast, it appears that §24402 will operate constitutionally if only the offending subsection is stricken. For this reason, §24402 may be more amenable to reform than §24410.

[25] *See Hunt-Wesson, Inc. v. California Franch. Tax Bd.*, 528 U.S. 458 (2000) (disallowance of an otherwise allowable deduction based upon the amount of out of state income is effectively an extraterritorial tax on the out of state income).

[26] *See Farmer Bros. Co. v. California Franch. Tax Bd.*, Case No. BC269404 (Calif. Super. Ct. March 18, 2002).

[27] *See generally Safeway Stores Inc. v. California Franch. Tax Bd.*, 3 Cal. 3d 745 (1970) (dividends not deductible despite inclusion of payor in the same combined report with the recipient because inclusion of the payor's income, in and of itself, does not result in California taxation of that income).

Taxpayers may be expected to launch such challenges if for no other reason than the fact that a continued existence of the DRD undoubtedly reflects the sound economic policy that corporate earnings should not be subject to multiple taxation. Indeed, as the FTB itself noted in its cert. petition, California has embodied this tax policy against multiple taxation (at least of its own making) since the outset of the corporate income tax.[28] Even in these times of budget shortfalls, it seems hard to imagine anyone making a principled argument that corporate earnings should be subject to multiple taxes as they make their way up the corporate chain.

POSSIBLE LEGISLATION

Regardless of what happens in litigation, it appears likely that the California Legislature will ultimately be called upon to determine the fate of the DRD. In predicting what legislative action might occur, it is useful to examine the efforts which have occurred over the last few years to amend the insurance DRD, *i.e.*, which the court of appeal struck down as discriminatory in *Ceridian*. In that effort, interested taxpayers have faced tough demands from the FTB and Legislature that any legislative fix also address unrelated perceived tax loopholes enjoyed by the insurance industry perhaps in part to pay for the cost of a DRD refund. Recently, the FTB also has proposed that the deduction mechanism of the DRD be replaced with a credit mechanism whereby California taxes would be reduced only to the extent of other state taxes actually imposed upon the underlying earnings. While such a system has the advantage (from the state's viewpoint) of tailoring the elimination of multiple taxation to the amount of actual taxes imposed (at a minimum lowering the cost because most states have a lower tax rate than California), it also introduces considerable complexity in matching the dividends to the taxes actually imposed, particularly where states rely upon a different basis for tax (*e.g*., gross receipts).

CONCLUSION

While the conclusion of Farmer Bros.' challenge to California's DRD may have been predictable, the twists and turns of the litigation provided new insight into the tests for determining when a tax constitutes facial discrimination against interstate commerce, and particularly when the compensatory tax defense may be applied to save an otherwise discriminatory tax. The decision now leaves in its wake questions regarding the proper remedy for the unconstitutional limitations of the DRD, including whether a nondiscriminatory DRD will continue to provide relief from multiple taxation of corporate income. As the courts and the Legislature review this issue in the midst of California's budgetary crisis, hopefully they will keep in view the broader economic policy concerns.

[28] Cert. petition at 9 (citing *Safeway Stores, Inc.*, 3 Cal. 3d at 750).

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