TAX MANAGEMENT
MULTISTATE TAX REPORT
BNA Employee-Owned Since 1947
VOL. 16, NO. 1 JANUARY 23, 2009

Constitutional Limitations

Almost 20 years after *McKesson*, the U.S. Supreme Court case that called for ''meaningful backward looking relief'' for taxpayers harmed under an unconstitutional taxing regime, taxpayers remain unsure about the remedies they can expect in such cases. In this article, authors Andres Vallejo and Scott M. Reiber of Morrison & Foerster LLP attempt to provide some clarity through a review of recent court cases that deal with retroactive remedies and a discussion of the factors those courts considered in determining appropriate remedies.

# Predicting the Remedy for Unconstitutional State Taxes: A Review of Recent Decisions Under the *McKesson* Framework

BY ANDRES VALLEJO AND SCOTT M. REIBER

## Introduction

Nearly 20 years after the U.S. Supreme Court's decision in *McKesson v. Division of Alcoholic Beverages and Tobacco* (*McKesson*),[1] the seminal case providing guidance on the appropriate retroactive remedy for unconstitutional state taxes, taxpayers still have little certainty with respect to the remedy they are due when burdened with an unconstitutional tax. States continue to attempt to avoid paying full refunds to taxpayers, and courts have taken conflicting positions with respect to the appropriate remedies in particular cases.

[1] *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990).

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This article attempts to mitigate some of the confusion with respect to the remedies for unconstitutional taxes by discussing some of the factors courts have examined in determining which remedy is appropriate and by examining some recent case law addressing the appropriate remedy for unconstitutional taxes. This article focuses solely on retroactive remedies.

The article discusses retroactive remedies first by providing some background regarding the *McKesson* framework for approaching such remedies and the due process concerns arising out of the application of that framework. Next, the article discusses the primary factors the courts consider in determining the appropriate remedy for unconstitutional state taxes. Finally, the article presents some observations about the intersection between the legal framework applied in this context and some of the policy implications of the application of that framework.

## Unconstitutional State Taxes: A Framework for Analyzing Remedies

### *Historical Background*

For many years, Florida's tax on alcoholic beverages provided preferential treatment for beverages manufactured from certain agricultural crops that were grown

 ISSN 1078-845X

and bottled in Florida.[2] In 1984, however, the U.S. Supreme Court in *Bacchus Imports Ltd. v. Dias*[3] held that a Hawaii statute that exempted locally produced beverages from its tax on alcoholic beverages violated the U.S. Commerce Clause. Florida thus revised its tax on alcoholic beverages to remove the express preference for beverages manufactured from crops grown and bottled in Florida, and instead implemented rate reductions for certain products that are commonly, but not necessarily, grown in Florida and used in alcoholic beverages produced there.

In 1986, McKesson Corp. (McKesson), which manufactured products that did not qualify for Florida's rate reductions, filed refund claims alleging that Florida's statutory scheme was unconstitutional. After being denied by the Florida Office of the Comptroller, McKesson brought suit in Florida state court. The state court found the preferential rate reductions unconstitutional. While the court enjoined the state from enforcing the preferential rate reductions on a going-forward basis, it did not grant McKesson a refund of the excess taxes it had paid under the unconstitutional statutory scheme. The Florida Supreme Court affirmed, and McKesson appealed to the U.S. Supreme Court.

## *The* McKesson *Framework*

The U.S. Supreme Court reversed the Florida Supreme Court and held that due process requires retroactive relief when taxpayers are forced to pay the tax before having a meaningful opportunity to challenge it. The court stated:

> [I]f a State places a taxpayer under duress promptly to pay a tax when due and relegates him to a postpayment refund action in which he can challenge the tax's legality, the Due Process Clause of the Fourteenth Amendment obligates the State to provide meaningful backward-looking relief to rectify any unconstitutional deprivation.[4]

**Under the *McKesson* framework, the appropriate remedy generally turns on the type of constitutional violation.**

The court further provided, in dicta, a broad framework for the parameters of "meaningful backward-looking relief" with respect to different constitutional violations. First, it indicated that, if a tax was beyond the state's power to impose, either because the tax was unapportioned or because the state lacked jurisdiction over the taxpayer, a refund would be the only appropriate remedy. Second, the court provided three ways[5] in which a state may provide meaningful backward-looking relief to taxpayers burdened by taxes that discriminated against interstate commerce:

- the state could refund the difference between the tax paid and the tax that would have been assessed if the burdened taxpayer had been treated the same as the favored class;
- to the extent consistent with other constitutional restrictions, the state could assess and collect back taxes from the favored class to alleviate any discrimination retroactively; or
- the state could undertake a combination of the first two approaches.[6]

Thus, under the *McKesson* framework, the appropriate remedy generally turns on the type of constitutional violation. For taxes that discriminate against interstate commerce, the remedy may vary depending on due process considerations, state law, and other practical considerations. For unapportioned taxes, a refund is necessarily required, and, as we will describe below, a full refund of the entire amount of the unapportioned taxes is often, but not always, the only remedy that will satisfy federal due process considerations and state law.[7]

## *Federal Due Process Concerns*

While the *McKesson* framework may appear sensible in theory, applying it in practice raises serious additional due process concerns. In particular, the states' reliance on *McKesson* to assess and collect back taxes and to impose retroactive apportionment formulas often runs afoul of due process limitations arising out of a concern for fair systems of taxation in which taxpayers have at least some certainty with respect to decisions made in light of current law and circumstances.

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[2] *Id.* at 22-23.

[3] *Bacchus Imports Ltd. v. Dias*, 468 U.S. 263 (1984).

[4] *McKesson*, 496 U.S. at 31.

[5] *Id.* at 40-41.

[6] In *Ex parte Surtees*, Nos. 1070386, 1070399, 2008 Ala. LEXIS 203, at *8 (Ala. 2008) (opinion subject to formal revision before publication), the Alabama Supreme Court discussed the lower court's decision, which indicated that *McKesson* permitted another option, namely to "refus[e] to give a remedy, *in the rare case in which the state relied on now overturned precedent and the state now faces an extreme hardship if it must give a remedy*" (emphasis in original) (quoting *Vulcan Lands Inc. v. Surtees*, No. 2060607, 2007 Ala. Civ. App. LEXIS 742, at *19 (Ala. Civ. App. 2007). The Alabama Supreme Court did not expressly indicate whether this option was valid, because it held that the state did not rely on overturned precedent in imposing the tax. *Id.* at *8, *11-12. This "option" is troubling for a couple of reasons. First, the U.S. Supreme Court in *McKesson* expressly indicated that "the State's interest in financial stability does not justify a refusal to provide relief." *McKesson*, 496 U.S. at 50. Moreover, permitting a state to avoid paying a refund to a taxpayer in cases in which the state believed the statute was constitutional and where giving a refund would cause the state financial hardship would effectively punish law-abiding taxpayers for the unconstitutional acts of the state. Ironically, it would permit the state to avoid giving refunds in those cases in which the largest refunds were due, as those are the instances most likely to cause extreme hardship to the state. Such an interpretation of *McKesson* cannot be consistent with due process.

[7] The remedy for situations in which the state entirely lacked jurisdiction over a taxpayer will almost always be a full refund of the tax. While there may be situations in which an alternative remedy for jurisdictional violations may be appropriate (*e.g.*, if a state attempted to cure its lack of jurisdiction retroactively), such situations are unlikely. For that reason, this article limits its discussion to the remedies for unapportioned and discriminatory taxes, and does not discuss the remedies for jurisdictional violations.

  TM-MTR ISSN 1078-845X

The seminal case on the constitutionality of retroactive tax statutes is *United States v. Carlton* (*Carlton*).[8] In *Carlton*, Congress had attempted to close a perceived loophole retroactively in a recently enacted statute that provided a deduction relating to the federal estate tax. The result for the taxpayer's estate in *Carlton* was that the estate, which had taken advantage of the loophole between the time the deduction was originally enacted and the time Congress adopted the curative amendment, was worse off than it would have been had it never attempted to take advantage of the deduction in the first instance.

The U.S. Supreme Court upheld the retroactive application of the amendment, stating that the ''harsh and oppressive'' formulation typically used to determine whether or not a retroactive tax violated the Due Process Clause was equivalent to the prohibition against arbitrary and irrational economic legislation. Thus, '' '[p]rovided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches . . . .' ''[9]

In analyzing whether the amendment in *Carlton* met this test, the court first concluded that the retroactive amendment was neither illegitimate nor arbitrary, because it furthered the rational purpose of retroactively correcting a perceived mistake in the original tax bill, which would have cost the government a substantial amount of money. The court then indicated that ''Congress acted promptly and established only a modest period of retroactivity'' because the amendment was proposed within months of the provision's original enactment and because the period of retroactivity was just over a year.[10]

**While the *McKesson* framework may appear sensible in theory, applying it in practice raises serious additional due process concerns.**

Courts have taken conflicting positions on whether *Carlton* enumerated a two-part test for determining whether a retroactive tax violates the Due Process Clause (*i.e.*, requiring both a rational purpose for the retroactivity and prompt action and a modest period of retroactivity), or whether it merely required that states have a rational basis for implementing the retroactive tax. Permitting states to impose retroactive taxes for an unlimited number of years, however, would leave taxpayers with no finality with respect to their past transactions. As Justice O'Connor indicated in her concurrence in *Carlton*, ''[t]he governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose.''[11]

One case in which the court did not require a modest period of retroactivity is *Montana Rail Link Inc. v. United States* (*Montana Rail*).[12] In that case, the court upheld a statute that retroactively prohibited refunds of taxes erroneously paid as much as six years prior to the statute's promulgation. The Montana Court of Appeals relied exclusively on its findings that the retroactivity served a legitimate legislative purpose and was furthered by rational means. Even though it did not reach the issue of whether there was a modest period of retroactivity, the court stated that ''[a] shorter period of retroactivity would have been arbitrary and irrational'' because it would have upset the settled expectations of a separate class of taxpayers, who relied on the erroneously paid taxes.[13] One may argue, therefore, that *Montana Rail*'s failure to require a modest period of retroactivity is limited to the facts of that case, in which a shorter period of retroactivity would have had adverse effects on another class of taxpayers. Nevertheless, the conceptual approach taken by the court in that case raises troubling possibilities.

Contrary to the Ninth Circuit's analysis in *Montana Rail*, the California Court of Appeal has applied a two-part test in determining whether the due process requirements under *Carlton* were met: ''First, the legislative purpose cannot be either illegitimate or arbitrary. Second, the legislative body must act promptly and establish only a modest period of retroactivity.''[14] While the legislation in that case had a legitimate legislative purpose (curing constitutional defects), the court held that retroactive application of the legislation failed the second prong of the test because the city did not act promptly[15] and because the legislation operated retro-

[8] *United States v. Carlton*, 512 U.S. 26 (1994).

[9] *Id.* at 30-31 (quoting *Pension Benefit Guaranty Corp. v. R. A. Gray & Co.*, 467 U.S. 717, 729-30 (1984)).

[10] *Id.* at 32.

[11] *Id.* at 37-38 (O'Connor, J., concurring).

[12] *Montana Rail Link Inc. v. United States*, 76 F.3d 991 (9th Cir. 1996).

[13] *Id.* at 994.

[14] *City of Modesto v. National Med Inc.* (*NMI*), 128 Cal. App. 4th 518, 528 (2005) (citations omitted).

[15] Although courts have taken conflicting positions as to whether the second prong of the two-part test from *Carlton* is itself a two-part test, requiring both prompt legislative action and a modest period of retroactivity, or whether it requires only a modest period of retroactivity, most courts have applied the second prong focusing only on a modesty requirement. *Compare IEC Arab Ala. Inc. v. City of Arab*, No. 2070174, 2008 Ala. Civ. App. LEXIS 523 (Ala. Civ. App. 2008) (discussing only modesty); *Johnson Controls Inc. v. Rudolph* (*Johnson Controls*), No. 2004-CA-001566-MR, 2006 Ky. App. LEXIS 132, 17-27 (Ky. Ct. App. 2006), *review granted by Rudolph v. Johnson Controls Inc.*, No. 2006-SC-0416-DG, 2007 Ky. LEXIS 195 (Ky. 2007) *and Johnson Controls Inc. v. Burnside*, No. 2007-SC-0819-DG, 2007 Ky. LEXIS 276 (Ky. 2007) (same); *and Baker v. Arizona Dept. of Rev.*, 209 Ariz. 561, 568-69 (Ariz. Ct. App. 2005) (same) with *NMI*, 128 Cal. App. 4th at 528-29 (discussing both promptness and modesty). Moreover, even those courts that have discussed whether the legislation was ''prompt'' have taken conflicting positions as to the appropriate event from which to measure whether the legislative action was prompt. *See, e.g.*, *Carlton*, 512 U.S. at 33 (measuring promptness from date of the statute's original enactment);

This article was originally published in the BNA Tax Management *Multistate Tax Report* and BNA Tax Management *State Tax Library*. Tax Management Inc. is a subsidiary of The Bureau of National Affairs, Inc., 1801 S. Bell St., Arlington, Va. 22202 (www.bnatax.com).

actively to approximately eight years prior to its enactment—not a modest period of retroactivity.[16]

The Kentucky Court of Appeals has addressed directly the question of whether *Carlton* limited retroactive tax legislation to those statutes enacted promptly and with modest periods of retroactivity.[17] The court rejected the state's argument that *Carlton* did not impose a ''modesty'' requirement and held that a period of retroactivity of over five years exceeded constitutional limitations.[18] Moreover, it criticized the Ninth Circuit's decision in *Montana Rail* for failing to discuss *Carlton*'s modesty requirement and distinguished the case on the grounds that the Ninth Circuit was concerned with protecting the rights of another class of taxpayers, rather than simply protecting state funds.[19] The *Johnson Controls* case is currently on review before the Kentucky Supreme Court. We believe that the court should uphold the lower court's decision with respect to retroactivity as a correct interpretation of the law.

Thus, while there is some dispute as to the framework for analyzing retroactive tax statutes under *Carlton*, in most cases courts should require both that:

- the retroactivity be for a legitimate purpose and furthered by rational means, and

- the legislature act promptly and impose the retroactive tax only for a modest period.

This way, taxpayers will have at least some degree of finality as to their prior transactions.[20] The application of this concept to the remedies for unapportioned and discriminatory taxes is discussed in greater detail below.

*NMI*, 128 Cal. App. 4th at 528-29 (measuring promptness from the date the taxpayer first claimed that the tax was unconstitutional); *NationsBank of Tex. N.A. v. United States*, 269 F.3d 1332, 1337 (Fed. Cir. 2001) (measuring promptness from date prior statute lapsed). In any event, while taxpayers may have some arguments under the prompt legislative action prong, it seems unlikely given the current state of the law that such arguments, in and of themselves, ultimately would convince a court. As such, this article will focus on the requirement of a modest period of retroactivity, which appears to be a more solid line of argument for taxpayers.

[16] The California Court of Appeal relied, in part, on *Gutknecht v. City of Sausalito*, 43 Cal. App. 3d 269, 282 (1974), decided before *Carlton*, for the proposition that California courts have generally not upheld retroactive tax statutes going back more than the current tax year.

[17] *Johnson Controls Inc. v. Rudolph*, No. 2004-CA-001566-MR, 2006 Ky. App. LEXIS 132 (Ky. Ct. App. 2006), *review granted by Rudolph v. Johnson Controls Inc.*, No. 2006-SC-0416-DG, 2007 Ky. LEXIS 195 (Ky. 2007), and *Johnson Controls Inc. v. Burnside*, No. 2007-SC-0819-DG, 2007 Ky. LEXIS 276 (Ky. 2007).

[18] *Johnson Controls* at *18-21.

[19] *Id.* at *24.

[20] In addition to the due process analysis outlined above, other commentators have raised good arguments that a ''manifest injustice'' concept should apply to the due process analysis and/or that the *ex post facto* clause should be invoked to bar retroactive tax increases, either of which would provide even greater protections for taxpayers. *See, e.g.*, Paul H. Frankel and Amy F. Nogid, *The Manifest Justice of the Manifest Injustice Doctrine: The Time Has Come to Invoke the Ex Post Facto Clause to Bar Retroactive Tax Increases*, 49 State Tax Notes 599 (Aug. 6, 2008).

## Determining the Appropriate Remedy Under *McKesson*

The remedy for an unconstitutional tax will depend, in large part, on the type of constitutional violation. The Due Process Clause of the U.S. Constitution and state law will constrain, and often dictate, the appropriate remedy for each constitutional violation. This article focuses on unapportioned and discriminatory taxes, and in this section, describes some of the relevant considerations in determining the appropriate remedy for such taxes.

### *Remedies for Unapportioned Taxes*

As described above, *McKesson* stated that a refund was required for an unapportioned tax.[21] The question, then, is whether the state must refund the entire unapportioned tax paid, or whether it may, in effect or in fact, apply a retroactive apportionment formula and only refund the portion of the tax apportioned outside the jurisdiction. While states typically favor imposing retroactive apportionment formulas over issuing full refunds, in most cases such practice violates due process and/or may not be permitted by state law.

#### Retroactive Apportionment Formulas

Retroactive taxes generally must be limited to a modest period of retroactivity. Assuming the courts take this requirement seriously and interpret it narrowly (as we believe they should), it effectively precludes the imposition of retroactive apportionment formulas in most cases because, by the time a tax is deemed unconstitutional, any retroactive apportionment scheme, to be effective, must reach back several years.

In *NMI*, the California Court of Appeal refused to apply a retroactive apportionment formula enacted by the city of Modesto in response to a determination that its unapportioned tax ordinance was unconstitutional. The court found that the retroactivity period of ''up to eight years'' was not a modest period of retroactivity and, therefore, would violate the taxpayers' due process rights.[22] The court reached this conclusion in part because applying the apportionment formula retroactively would require the taxpayer to ''produce documentation from up to nine years ago that it otherwise was never required to maintain.''[23] The court stated that ''[g]enerally in California, courts have upheld the retroactive application of tax laws only where such retroactivity was limited to the current tax year.''[24]

[21] *McKesson*, 496 U.S. at 39.

[22] *NMI*, 128 Cal. App. 4th at 529.

[23] *Id.*

[24] *Id.* (citations omitted). The court in *NMI* also indicated that the city of Modesto had not acted promptly in imposing the retroactive apportionment formula because it took several years from the date the taxpayer challenged the constitutionality of the ordinance for the city to amend the ordinance and promulgate the applicable retroactive guidelines. *Id.* at 528-29.

   ISSN 1078-845X

**While states typically favor imposing retroactive apportionment formulas over issuing full refunds, in most cases such practice violates due process and/or may not be permitted by state law.**

States may distinguish *NMI* from cases in which the taxpayer would not be required to produce documentation that it was not previously required to maintain or in which no additional obligations were placed upon the taxpayer. In *Ventas Finance I LLC v. California Franch. Tax Bd.* (*Ventas*),[25] for example, the court permitted retroactive apportionment for a period of several years in large part (or possibly in whole) because the taxpayer stipulated to the apportionment methodology and factors. Unfortunately, in relying upon the parties' stipulation, the court in *Ventas* punted on the crucial legal issues which, in our view, favored the taxpayer. The California Supreme Court recently denied review, leaving us with a decision that appears limited to its facts and thus provides no general guidance with respect to the remedy issues. That said, the thrust of the *Ventas* case (and others like it) suggests that the permissible period of retroactivity under the Due Process Clause may turn on the obligations of the taxpayer under the retroactive legislative scheme.[26]

## Failed Efforts to Seek Judicial Reform

When the legislature has not enacted a retroactive apportionment formula, principles drawn from state law (constitutional and/or statutory) may preclude the courts from reforming statutes to include apportionment formulas. In *Stonebridge Life Ins. Co. v. Oregon Dept. of Rev.* (*Stonebridge*),[27] the court refused to reform Oregon's unconstitutional apportionment scheme without legislative action. The court stated that ''[i]n Oregon, it is the role of the legislature to craft laws, and it is the role of the courts to interpret them. . . . [T]here can be no tax collected absent a legislatively approved alternative mechanism for imposing taxation.''[28]

Without a legislatively approved alternative apportionment formula, the court indicated, it must grant the taxpayer a full refund.[29] The court further concluded that it could not even implement an apportionment formula on which the parties agreed if that formula had not been approved by the legislature.[30] In stark contrast to the *Ventas* court in California (which essentially punted on the important legal questions before it), the Oregon tax court addressed directly and, in our view, decided correctly the important remedy issues involved.

While California law does not appear to deny as categorically the courts' ability to fashion a retroactive apportionment formula, in practice, courts will generally be precluded from doing so absent legislative approval or agreement of the parties. In *Ventas*, the Court of Appeal determined that an LLC ''fee'' measured by the taxpayer's ''total income from all sources reportable to this state for the taxable year'' was actually an unapportioned tax.[31] The court indicated that it could reform the statute to include an apportionment formula only if it could conclude that: ''(i) it is possible to reform the statute in a manner that closely effectuates policy judgments clearly articulated by the enacting body, and (ii) the enacting body would have preferred the reformed construction to invalidation of the statute.''[32] Because the court could not ''say with confidence'' that reformation would be consistent with the policy judgment of the legislature, it refused to reform the statute. The court noted that ''[i]n the context of cases involving tax statutes that violate the Commerce Clause, the courts have consistently declined to exercise the power of judicial reformation to cure the constitutional violation.''[33]

**While the court in *Ventas* concluded it did not have the power to reform the statute, the practical result of the decision was to permit reformation of the statute.**

Despite holding that it could not reform the statute to include an apportionment formula, the court in *Ventas* ultimately calculated the refund due to the taxpayer based on an apportionment formula not contained in the statute. The court reasoned that the parties had stipulated to the calculation of the factors under an apportionment formula that would redress the constitutional violation and that would not place a burden on the taxpayer to prove the apportionment factors (as was the case in *NMI*, discussed above). Thus, unlike the court in *Stonebridge* that rejected the stipulation of the parties because accepting the stipulation would constitute impermissible reformation, the court in *Ventas*—incorrectly in our view—calculated the refund due

[25] *Ventas Finance I LLC v. California Franch. Tax Bd.*, 165 Cal. App. 4th 1207 (2008).

[26] Other decisions are consistent with this view that courts often rely on practical implementation concerns as opposed to the substantive law. *See, e.g., Macy's Dept. Stores Inc. v. City and County of San Francisco*, 143 Cal. App. 4th 1444 (Cal. Ct. App. 2006) (permitting a partial refund of an unconstitutional tax rather than a full refund when the additional calculations required would not place any additional burdens on the taxpayer); *General Motors Corp. v. City and County of San Francisco*, 69 Cal. App. 4th 448 (Cal. Ct. App. 1999) (requiring the City of San Francisco to refund taxes in part because the City's alternative proposed remedy would have placed an undue burden on the taxpayer to produce information).

[27] *Stonebridge Life Ins. Co. v. Oregon Dept. of Rev.*, 18 Or. Tax 461 (Or. Tax Ct. 2006).

[28] *Id.* at 465-66.

[29] *Id.* at 466.

[30] *Id.* at 468. (''[A] reapportionment agreed upon by the parties is a reapportionment nonetheless. . . . Yet no amount of pleading, stipulation, or argument can confer upon the court the authority to reapportion taxpayer's income.'').

[31] *Ventas*, 165 Cal. App. 4th at 1213.

[32] *Id.* at 1224, quoting *Ceridian Corp. v. California Franch. Tax Bd.*, 85 Cal. App. 4th 875, 889 (2000).

[33] *Id.* at 1224; *see also NMI*, 128 Cal. App. 4th at 528 (refusing to make a ''substantive change to the law'' by adding an apportionment provision because ''[s]uch judicial policymaking and encroachment on the legislative function is improper'').

based upon the parties' stipulation. While the court in *Ventas* concluded it did not have the power to reform the statute in question, the practical result of the decision was to permit reformation of the statute—at least with respect to the parties to the case at issue—upon stipulation of the parties.

## Remedies for Discriminatory Taxes

Unlike the remedies for unapportioned taxes, which are limited to refunds, the U.S. Supreme Court in *McKesson* indicated that a discriminatory tax may be remedied by imposing back taxes on the favored class as well. Whether the appropriate remedy is a refund of the discriminatory tax or the imposition of back taxes on the favored class often will turn on federal due process and state law considerations.

### Imposing Back Taxes—Due Process Concerns

The due process concerns associated with retroactive taxation discussed above also apply to the imposition of back taxes on the favored class to remedy discriminatory taxes. Indeed, the due process concerns are even stronger in this context because the retroactive tax is being imposed against persons not party to the suit. For this reason, some courts have been reluctant to impose back taxes on the favored class as a remedy for discriminatory taxes. That said, many states, including California, have attempted and continue to attempt to impose back taxes on the favored class when faced with a defeat on the constitutionality of their statutes.

An example of the judiciary's reluctance to impose back taxes on the favored class is *Scottsdale Princess P'ship. v. Arizona Dept. of Rev.* (*Scottsdale*.)[34] In *Scottsdale*, the court determined that the statute in question unconstitutionally discriminated against certain taxpayers. The court required a partial refund to the taxpayer to remedy the discrimination.[35] It expressly rejected the state's argument that the discrimination should be cured by retroactively taxing the favored class, because such retroactive taxation would be ''harsh and oppressive,'' and would raise ''significant due process concerns.''[36] The court left open the possibility that taxing the favored class may be an appropriate remedy in some circumstances, however, when it observed that the county never indicated that it would be willing to take the steps necessary for retroactive taxation.[37] This opinion indicates that the practical implementation of the remedy by the state taxing authority is an important factor to consider in reviewing the state's proposed course of action. This is important because, as we mentioned above, the *McKesson* framework may seem sensible in theory, but imposing back taxes on the favored class in a discrimination case may be quite difficult to accomplish in practice.

[34] *Scottsdale Princess P'ship. v. Arizona Dept. of Rev.*, 191 Ariz. 499 (Ariz. Ct. App. 1997).
[35] *Id.* at 505.
[36] *Id.*
[37] *Id.*

**Some courts have been reluctant to impose back taxes on the favored class as a remedy for discriminatory taxes.**

Despite the potential due process concerns associated with imposing back taxes on the favored class, California has continued to pursue such a remedy in the wake of the California Court of Appeal's decision in *Farmer Bros. v. California Franch. Tax Bd.* (*Farmer Bros.*).[38] The court in *Farmer Bros.* held that a provision that permitted a dividends-received deduction only for dividends from corporations subject to tax in California violated the U.S. Commerce Clause. The trial court required the state to issue a full refund to the taxpayer, and the California Franchise Tax Board (FTB) did not appeal that portion of the decision. The FTB realized 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, and it had already lost the *Ceridian* case (discussed below) in which the court held that the imposition of back taxes on the favored class could not be the appropriate remedy to the extent the statute of limitations was closed for the years in question.

Following the decision in *Farmer Bros.*, however, the FTB began issuing deficiency notices for years not barred by the statute of limitations to those taxpayers who had benefited from the deduction in prior years (*i.e.*, it began imposing back taxes on the favored class). There are several suits pending in California courts with respect to the appropriate remedy for these years not barred by the statute of limitations. The plaintiffs in these cases may pursue several arguments that imposing back taxes on the favored class is not an appropriate remedy. Among other arguments, the taxpayers may argue that:

- imposing back taxes on the favored class will not remedy the discriminatory effect of the dividends received deduction, because such back taxes will not undo the competitive advantages enjoyed by the favored class in prior years, and because the FTB's audit and collection procedures are not sufficiently robust to constitute the type of effort contemplated by *McKesson*;
- state law and sound economic policy require that only the offending language be severed so that the dividends-received deduction remains applicable to all taxpayers; and
- the imposition of back taxes on the favored class may violate California's prohibition on tax increases without a two-thirds approval of the legislature (discussed in greater detail below).

### Imposing Back Taxes—State Law Limitations

In addition to the due process limitations on imposing back taxes on the favored class, state law also may impede the imposition of such taxes. As indicated in the

[38] *Farmer Bros. Co. v. California Franch. Tax Bd.*, 108 Cal. App. 4th 976 (2003), *cert. denied*, No. S117131, 2003 Cal. Tax LEXIS 6515 (Cal. App. 2d Dist. 2003), *cert. denied*, 540 U.S. 1178 (2004).

   ISSN 1078-845X

section above with respect to retroactive apportionment formulas, courts are often precluded from reforming tax statutes in the absence of legislative intervention. Moreover, other state laws may preclude the taxation of the favored class in certain situations.

**Imposing back taxes on the favored class in a discrimination case may be quite difficult to accomplish in practice.**

One example of a case in which a state statute prevented the retroactive taxation of the favored class is *Ceridian. Corp. v. California Franch. Tax Bd.* (*Ceridian*).[39] The court in *Ceridian* held that the deduction permitted for insurance company dividends only to those corporations domiciled in California unconstitutionally discriminated against foreign taxpayers.[40] Because the years at issue fell outside of the FTB's statute of limitations for imposing taxes, the state was precluded from taxing the favored class to remedy the discrimination.[41]

Severability statutes that call for the surgical extraction of only the constitutionally offensive language, as opposed to invalidating the entire statute, also may preclude state taxing authorities from imposing back taxes on the favored class. For example, if a court holds a statute unconstitutional under the U.S. Commerce Clause because the statute provides a deduction to in-state companies that is denied to out-of-state companies, and the offending language in the statute may be severed (thereby leaving the original deduction in place), the state taxing authority would have no statutory power to impose back taxes on the favored class that took advantage of the deduction.

**State constitutions also may prevent retroactive taxation of the favored class.**

State constitutions also may prevent retroactive taxation of the favored class. For example, California's Constitution precludes increases in state taxes without a two-thirds vote of both houses of the Legislature and precludes increases in local taxes without either a majority or two-thirds vote of the electorate, depending on the type of tax.[42] A tax is considered increased if the agency charged with its implementation revises the methodology by which the tax is calculated and the revision results in increased taxes to a taxpayer or property.[43] Because back taxes on the favored class would change the methodology by which the tax was calculated and would result in higher taxes to the favored class, there is a good argument that such taxes would violate the California Constitution. In such a case, the only available remedy may be a refund of the tax. While we are unaware of this argument having been made and/or accepted in any recently published opinion, we believe it to be a strong argument in defense of the state's attempt to impose back taxes on the favored class as the remedy for a discriminatory statute. In this regard, for example, we believe it is a viable argument against the FTB's current approach to the aftermath of the *Farmer Bros.* case.

## State Laws May Limit or Preclude Refunds

State laws may also cut against issuing refunds of unconstitutional taxes in certain circumstances, which by negative implication would favor imposing back taxes on the favored class. In *Annenberg v. Pennsylvania*,[44] the Pennsylvania Supreme Court held that an exemption from personal property taxes discriminated against out-of-state taxpayers because it was applicable only to stock held in entities to which Pennsylvania's capital stock and franchise tax applied. In determining the appropriate remedy for this constitutional violation, the court relied on Pennsylvania's rules with respect to severability, which held that "the provisions of every statute shall be severable."[45] The net result of severing the exemption for stock held in entities to which Pennsylvania's capital stock and franchise tax applied was that the tax applied to *all* stock.[46] The court therefore held that a refund was not necessarily required to provide the meaningful retroactive relief mandated by *McKesson*.[47]

The so-called "pass-on defense" may also limit the ability of courts to issue refunds in discrimination cases in which the state can show that the plaintiff did not ultimately bear the burden of the tax. In *Milwaukee Safeguard Ins. Co. v. Selke* (*Milwaukee Safeguard*),[48] the Illinois Appellate Court held that the "pass-on defense" acted as a bar to the plaintiff's claim for refund of a discriminatory tax. The court indicated that this "pass-on defense" was permitted as a matter of state law.[49] In reaching this result, the Illinois court distinguished its facts from those in *McKesson*.

The U.S. Supreme Court in *McKesson* refused to apply the pass-on defense because, in discrimination cases, the taxpayer is injured vis-à-vis its competition even if it is able to pass the tax on to its customers, be-

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[39] *Ceridian Corp. v. California Franch. Tax Bd.*, 85 Cal. App. 4th 875 (2000).

[40] *Id.* at 888.

[41] *Id.* at 889. The state also relied on a statutory provision that expressly required the imposition of back taxes on the favored class to remedy unconstitutional taxes. *Id.* at 888-889. The trial court rejected the application of that statute as being applicable only to banks, and the Court of Appeal failed to reach the issue after holding that the statute of limitations barred the imposition of back taxes. *Id.* Had the statute of limitations not run, however, the state statute may have dictated the result in the case, assuming it did not violate due process and applied to the facts of the case.

[42] Cal. Const. art. XIIIA, §3; art. XIIIC, §2.

[43] *See* Cal. Const. art. XIIIA, §3; *AB Cellular LA LLC v. City of Los Angeles*, 150 Cal. App. 4th 747 (2007) (citing Cal. Govt. Code §53750(h)(1)(B)).

[44] *Annenberg v. Pennsylvania*, 562 Pa. 581 (2000).

[45] *Id.* at 594.

[46] *Id.* at 597.

[47] *Id.* at 605.

[48] *Milwaukee Safeguard Ins. Co. v. Selke*, 324 Ill. App. 3d 344.

[49] *Id.* at 351.

cause it will presumably suffer from lower sales.[50] As noted in *Milwaukee Safeguard*, however, the U.S. Supreme Court in *McKesson* left open the possibility of a state law pass-on defense by conditioning its holding that the defense did not apply on a finding that the Florida Supreme Court did not rely on an express ''pass-on defense,'' but rather attempted to apply such a defense based on general equitable principles.[51] Thus, if the jurisdiction in which the tax is imposed recognizes a pass-on defense, this may preclude refunds in discrimination cases even though the taxpayer is still injured by the discriminatory tax in its competitive position with respect to the favored taxpayers.

In our view, the ''pass-on defense'' raises numerous additional concerns, including constitutional and policy issues. Unfortunately, addressing these concerns would require a long discussion beyond the scope of this article.

## The Interaction of Sound Policy And the Practical Application Of *McKesson*

Absent any of the due process or state law impediments to a court's ability to fashion remedies for unapportioned or discriminatory taxes, courts should consider the policy implications of the potential remedies in determining the appropriate remedy. Permitting states and local jurisdictions to apply retroactive apportionment formulas or to impose back taxes on the favored class provides perverse incentives for states to impose unconstitutional taxes, encourages unnecessary litigation, and strips taxpayers of their incentives to bring meritorious claims against unconstitutional taxes. The discussion below is not meant to argue or imply in any way that states and local jurisdictions always have perverse intentions, but the incentives created by allowing certain types of state action in lieu of true and effective retroactive remedies are cause for serious concern.

Permitting taxing jurisdictions to apply retroactive apportionment formulas creates incentive to promulgate unconstitutional taxes. Allowing retroactive apportionment formulas permits taxing jurisdictions to enact unapportioned taxes, hoping perhaps that if a taxpayer challenges the tax, the taxpayer will be unable to meet its burden of proof under the retroactive apportionment formula, thus allowing the state to avoid payment of any refund. And even if a taxpayer successfully challenges the unapportioned tax and is able to meet its burden of proof, the taxing jurisdiction will be no worse off than it would have been had it apportioned the tax in the first instance.

**The incentives created by allowing certain types of state action in lieu of true and effective retroactive remedies are cause for serious concern.**

Allowing the imposition of back taxes on the favored class as the remedy for a discriminatory tax creates even stronger incentives for taxing jurisdictions to enact discriminatory taxes. For example, if a state enacts a discriminatory tax, and the court permits the state to remedy that discrimination by imposing further taxes on the favored class, the state essentially is receiving a windfall for having implemented an unconstitutional tax. Moreover, imposing this tax on the favored class is almost certain to result in additional litigation that may last for many years, which results in a significant waste of money and time on both sides of the litigation and also of judicial and administrative resources.

In addition to the incentives provided to states to impose unconstitutional taxes and the unnecessary litigation imposing such taxes may create, applying retroactive apportionment formulas and imposing back taxes on the favored class will discourage taxpayers burdened by unconstitutional taxes from bringing meritorious suits. Taxpayers are unlikely to bring suits to challenge taxes if they are not provided with a refund of the taxes they paid under the unconstitutional scheme.

The various permutations that arise in the context of remedies for unconstitutional taxes as a result of varying state laws, varying interpretations of federal due process requirements, and varying factual circumstances often make it difficult to predict the remedy a court will award to a taxpayer successfully challenging an unconstitutional tax. However, because the state and federal laws governing the appropriate remedy for unconstitutional taxes are often flexible, we hope that courts will take the policy considerations described above into account in determining the remedy to apply.



[50] *McKesson*, 496 U.S. at 48-49.
[51] *Id.* at 49, n. 34; *see also Milwaukee Safeguard*, 324 Ill. App. 3d at 350-51.