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Taxpayer Risks and Rewards From Unconstitutional State Tax Legislation

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Tax laws favoring local businesses are like Trader Joe's Speculoos Cookie Butter for state lawmakers -- they can never get enough. The problem is that many of those laws are unconstitutional because they discriminate against interstate commerce. Multistate businesses should monitor those laws for opportunities and hazards. A business taxpayer may be able to take advantage of a tax incentive ostensibly limited to in-state operations, even for out-of-state activity, by using the incentive under the theory that the law violates the commerce clause and the remedy is to expand the law to cover all relevant activity, regardless of where performed.

However, risks exist for business taxpayers complying with the letter of the law by using incentives only for in-state activity. Those taxpayers risk having the incentive completely invalidated, thus retroactively increasing their tax. When business decisions depend on the availability of state incentives, the invalidation and retroactive withdrawal of benefits can leave a bitter taste. Taxpayers with significant dependence on potentially unconstitutional tax incentives must consider the risk for financial statement purposes. Recent history demonstrates that states and taxpayers continue to grapple with the risks and rewards of unconstitutional laws.

I. History of Recent Tax Incentives

The most common form of discriminatory state tax provisions is a law offering tax benefits for conducting specific activities in the taxing state but denying benefits for out-of-state activities. While there is much debate as to where the line is drawn between a valid incentive and a discriminatory tax, there is no debate that the line exists.

The U.S. Supreme Court has made it clear that when this line is crossed, states have a choice of remedies, but those remedies must provide some type of backward-looking relief. A state may retroactively apply the in-state benefit to all taxpayers, retroactively remove the in-state benefit from all taxpayers, or some combination.State revenue departments typically try to avoid expanding the benefit. If the only responsibility of a state revenue department was to protect the state fisc, this might be an appropriate response. However, state revenue authorities must also uphold the state's policy choices and constitutional obligations. The only way to meet those obligations may be to retroactively allow the tax benefit to all taxpayers.

Two recent cases illustrate the resistance of state revenue authorities to apply the discriminatory incentive to all taxpayers, even in the face of judicial or legislative preference to the contrary. In CDR Systems Corp. v. Oklahoma Tax Commission, and *Cutler v. Franchise Tax Board*, Oklahoma and California adopted facially discriminatory legislation to encourage taxpayer investment in the state. In both cases, courts found the laws unconstitutionally discriminated against interstate commerce. And, in both cases, the state revenue authority sought to avoid retroactively expanding the incentive to all taxpayers. By doing so, the state revenue authorities risked punishing the exact class of taxpayers the state legislatures intended to benefit -- the in-state taxpayers.

A. CDR Systems

In CDR Systems, the Oklahoma Tax Commission argued that the court's holding that a state tax incentive was unconstitutional should apply retroactively only to the petitionertaxpayer bringing the case. The Court of Civil Appeals determined that a capital gains deduction unconstitutionally discriminated against out-of-state taxpayers. The deduction in question, found at 68 O.S. section 2358(D), allowed some capital gains earned by selling an Oklahoma company to be excluded from Oklahoma's apportionable corporation income tax base. To qualify as an Oklahoma company, the company must be "an entity whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise."

The appeals court concluded that:

> The capital gains deduction set forth in section 2358(D) discriminates between corporate transactions based on interstate considerations -- in this case, whether the corporate taxpayer is an "Oklahoma company" -- which are facially discriminatory under the Commerce Clause. The law affords Oklahoma companies different treatment than out-ofstate companies for similar taxable events.

Importantly, the appeals court determined that "we do not, by this Opinion, hold section 2358(D) -- and the capital gains deduction provided therein -- to be unconstitutional in its entirety, only those discriminatory distinctions in section 2358(D) between 'Oklahoma' and non-Oklahoma entities."

Thus, the appeals court clearly found that the deduction should be expanded to all taxpayers, regardless of whether the business sold was an Oklahoma company. The appeals court made that conclusion clear by stating that "this leaves section 2358(D) capable of being exercised and applied in a manner both coherent and in accord with the Legislature's intent . . . [to allow the deduction] for qualifying gains." Despite the clear case law prohibiting selective prospectivity, the commission asserted, both before the appeals court and now in its request for review by the Oklahoma Supreme Court, that the ruling should apply retroactively only to CDR and apply prospectively to all other taxpayers.Relying on both Oklahoma and U.S. Supreme Court cases (and common sense that a discriminatory tax cannot be cured prospectively only), the appeals court rejected this position.

As part of its request for review to the Oklahoma Supreme Court, the commission raises the possibility of the state having to refund tens of millions of dollars of tax. As noted above, case law prohibits a remedy of selective prospectivity. Thus, the only way to avoid paying the alleged refunds (if there really are hordes of taxpayers filling Oklahoma City with amended returns applying the capital gains deduction) is to deny the deduction retroactively and entirely. What the Oklahoma Tax Commission does not mention is what such a denial will cost Oklahomans in unexpected retroactive taxes and interest. Certainly this cost is at least as important as the cost of potential refunds.

B. Cutler

In Cutler, the Court of Appeal of California invalidated a California law which provided for deferral (and sometimes exclusion) of gains from the sale of qualified small business stock (QSBS) to the extent that the taxpayer invested in additional QSBD. The law classified qualified small businesses as those which used "at least 80 percent (by value) of the assets of the corporation . . . in the active conduct of one or more qualified trades or businesses in California." The requirement was not met "for any period during which more than 20 percent of the corporation's total payroll expense is attributable to employment located outside of California." The court invalidated the provision under the commerce clause because the 80 percent property and payroll requirement "favors domestic competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce."

The California Franchise Tax Board responded to Cutler by denying those benefits to the taxpayers who had relied upon them. Because the FTB could not assess further taxes upon companies beyond the statute of limitations, the FTB allowed a refund to the aggrieved parties. However, for the tax years still within the statute of limitations, all taxpayers who reported the exclusion or deferral have or will receive a notice of proposed assessment denying that exclusion or deferral.

In reaction to the FTB's notice, the California State Legislature drafted SB 209. As originally proposed, the bill would have prevented retroactive taxation of taxpayers who received the QSBS deferral or exclusion. However, the version that passed the State Senate would require all taxpayers to pay one-fourth of the tax for years 2008-2012. On August 30 the California State Assembly Appropriation Committee sent the bill to the floor with technical amendemnts.

The Legislature still can't avoid the temptation of creating a benefit for in-state taxpayers, however. SB 209 creates Revenue and Taxation Code section 18153, which waives interest on those taxpayers who would become responsible for paying a retroactive tax. The disfavored taxpayers were responsible for paying those taxes years ago, however, and thus lost the time value of money that the in-state taxpayers enjoyed. The result is that the resident taxpayers received an interest-free loan while nonresidents did not. On September 6 AB 1412, which would eclipse SB 209 by providing the favored taxpayers with the full benefits originally promised them, was introduced.

II. Considerations for Taxpayers

1. In making state location investment decisions, consider both the constitutionality of the incentive offered and the risk that the state revenue agency will revoke the incentive if it is found unconstitutional. In CDR and Cutler, the state revenue authority seems to be an advocate solely of the state fisc and not of good tax policy. That may be shortsighted. If taxpayers find they cannot rely on incentives offered by a state, they may take their business activities to states with less risk. While it might sometimes be expensive for a state to provide retroactive refunds, it is equally true that it may be expensive for some taxpayers to retroactively refund tax incentives on which they relied. For example, in CDR the legislation may have induced a company to establish its headquarters in Oklahoma on the assumption that the company and its owners would have access to the capital

gains deduction upon exiting the business. Now that they have provided the state with income and jobs, the Oklahoma tax commission believes the benefits should be revoked.

2. If the incentive appears to discriminate against interstate commerce, taxpayers should negotiate an alternative remedy with the state before making the investment and before the incentive is challenged.

3. Out-of-state taxpayers should consider taking advantage of potentially discriminatory incentives by applying the incentives to qualifying activities in other states. For example, if a state offers a more advantageous apportionment formula when more than 50 percent of a taxpayer's receipts from technology-related activities occur in the taxing state, a taxpayer engaging in technology activities anywhere should consider using the advantageous apportionment formula on either an original return or as a refund claim on an amended return.

4. Out-of-state taxpayers should consider raising the possibility of a refund claim based on an unconstitutional incentive program as part of the audit negotiation process.

5. Finally, out-of-state taxpayers should carefully monitor the enactment of potentially discriminatory tax incentives in order to timely file protective refund claims.

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