Journal of Multistate Taxation and Incentives (Thomson Reuters/Tax & Accounting)
Volume 30, Number 2, May 2020

REMEDIES

What to Do with an Unconstitutional Exemption?

A state should generally not be allowed to retroactively eliminate an unconstitutional tax exemption or other tax preference in response to a successful taxpayer challenge.

By MICHAEL SONTAG, STEPHEN JASPER, AND MICHAEL COTTONE

MICHAEL SONTAG and STEPHEN JASPER are members and MICHAEL COTTONE is an associate at Bass Berry & Sims in Nashville, Tennessee.

The Commerce Clause of the U.S. Constitution prohibits states from discriminating against interstate commerce by providing tax exemptions or other tax preferences only to in-state businesses or activities.[1] Put another way, states cannot use tax exemptions and other tax preferences to provide "a direct commercial advantage to local business."[2] Nonetheless, because it is politically easier to fund government by imposing heavier tax burdens on foreign individuals and companies, states sometimes enact discriminatory, unconstitutional tax preferences.

This article considers what happens-and what should happen-when a taxpayer successfully challenges the constitutionality of a discriminatory tax exemption or other tax preference. For future years, states clearly have the ability to eliminate the exemption and subject both in-state and interstate commerce to the same tax burden. For past periods, however, a taxpayer bringing a constitutional challenge typically expects to receive a refund for the difference between the tax it paid and the tax it would have paid had it received the same preferential treatment as its competitors. Taxing authorities have often sought to avoid issuing such refunds. Typically, these states have suggested the proper remedy is to retroactively eliminate the unconstitutional exemption and impose additional tax on the taxpayers that originally received the exemption.

States should not be allowed to do this. For the reasons discussed below, retroactively imposing additional tax on previously exempt or otherwise favored in-state taxpayers rarely, if ever, works to eliminate discrimination. Consequently, a state should generally not be allowed to retroactively eliminate an unconstitutional tax exemption or other tax preference in response to a successful taxpayer challenge. Instead, in the vast majority of cases, the correct result is to provide the taxpayer a refund for the amounts that would not have been paid had it received the same exemption.

Overview of the Law on Remedies for Unconstitutionally Discriminatory Tax Preferences

Beginning with the U.S. Supreme Court's decision in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*,[3] a body of law has developed on the remedies taxpayers are entitled to receive when successfully challenging unconstitutional state tax provisions. In the *McKesson* decision, the Court set forth the foundational principle that a state must provide "meaningful backward-looking relief" to those taxpayers.[4] What qualifies as "meaningful backward-looking relief" has been the subject of a tug-of-war between taxpayers and state revenue departments since the *McKesson* decision was issued, and state courts have reached different results when taxing authorities have attempted to remedy constitutional violations by retroactively eliminating discriminatory tax exemptions or other tax preferences.

The *McKesson* case

In the *McKesson* case, McKesson Corp. claimed that Florida's excise tax on liquor violated the Commerce Clause of the U.S. Constitution because distributors of certain locally produced products received favorable tax rates for which McKesson's alcoholic products did not qualify.[5] McKesson paid Florida's tax at the standard rate and then filed a refund claim, which was denied at the administrative level.[6] McKesson then filed suit in state court seeking (1) injunctive relief against continued enforcement of the discriminatory tax scheme and (2) a refund for the difference between the taxes McKesson paid applying the standard rate and the taxes it would have paid had the reduced rate been applied to the beverages it distributed.[7]

In Florida state court, McKesson prevailed on its constitutional claim. Under the Supreme Court's decision in *Bacchus Imports, Ltd. v. Dias*,[8] Florida's liquor tax regime violated the U.S. Constitution by favoring local industry, and McKesson received prospective injunctive relief that prevented Florida from applying the excise tax's reduced rates in the future.[9] Nonetheless, the Florida Supreme Court ruled that McKesson was

not entitled to any refund of taxes it already paid because of "equitable considerations"-specifically, the fact that the Florida taxing authority relied "in good faith on a presumptively valid statute"-and because the court believed that a refund would provide McKesson a "windfall" by allowing it to recoup taxes that had "likely been passed on" to its customers.[10]

By the time the *McKesson* case reached the U.S. Supreme Court, the only issue to be decided was the appropriate remedy for McKesson's successful challenge to the unconstitutional tax scheme.[11] Addressing this issue, the Court explained that, when a state requires a tax to be challenged in "a postpayment refund action," the state must "provide meaningful backward-looking relief to rectify any unconstitutional deprivation."[12] Explaining this standard, the Court noted that under certain circumstances-such as when the state lacks the power to impose the tax at issue or the taxpayer is "absolutely immune" from the tax-a refund of previously paid taxes is always required because "no corrective action by the State could cure the invalidity of the tax during the contested tax period."[13] When a tax is unconstitutional because it impermissibly discriminates against interstate commerce, however, the Court found that the state "retains flexibility" to "reformulate and enforce" the tax during the contested tax period in any way that treats taxpayers "in a manner consistent with the dictates of the Commerce Clause."[14]

The Court gave states three options to remedy an unconstitutionally discriminatory tax. First, a state can always cure a discriminatory tax by refunding a taxpayer the difference between the tax it paid and the tax it would have paid had it received the same preferential treatment as its in-state competitors.[15] Second, a state "may assess and collect back taxes" from in-state taxpayers that benefited from preferential treatment during the contested tax period, as long as the state imposed "the retroactive assessment to create in hindsight a nondiscriminatory scheme."[16] Third, a state can combine both of these approaches and offer a partial refund to taxpayers that had been discriminated against and a partial retroactive assessment to favored in-state taxpayers that would, in effect, put both classes on an even playing field.[17]

In presenting these three options, the Court was careful to impose clear limits on a state's ability to remedy unconstitutional discrimination by imposing additional tax for prior periods. As the Court recognized, a state can remedy a discriminatory tax by imposing additional tax on in-state taxpayers that received preferential treatment if-and only if-doing so would not violate "other constitutional restrictions."[18] For example, back taxes cannot be imposed when "the retroactive imposition of a significant tax burden" would be unduly "harsh and oppressive" based on the nature of the tax and the specific circumstances.[19]

In addition, and perhaps more importantly, a state's imposition of additional tax must, in fact, remedy the discrimination. In the Court's words, any retroactive assessment must be calibrated "to create in hindsight a

non-discriminatory scheme," and the remedy must actually reflect "a scheme that does not discriminate against interstate commerce."[20] Although the Court recognized that the remedy is not required to be "perfectly successful," the state must make "a good-faith effort to administer and enforce" its remedy in a way that would eliminate the discrimination.[21] Thus, under the Court's decision in *McKesson*, a remedy for an unconstitutional tax preference must be designed to actually remove the impermissible benefits given to in-state taxpayers and must be carried out in good faith.

State court decisions considering retroactive elimination of unconstitutional tax exemptions

The Court's decision in *McKesson* gave states an opening to refuse to refund discriminatory taxes by promising to retroactively impose additional taxes on favored in-state taxpayers. States took this invitation and, following the decision, have repeatedly sought to remedy discriminatory tax exemptions or other benefits by retroactively eliminating the unconstitutional provisions of the tax, rather than paying refunds.[22] This remedy has received inconsistent treatment in state courts.

State court decisions rejecting retroactive elimination of discriminatory tax exemptions. Some state courts have rejected states' requests to remedy an unconstitutionally discriminatory tax exemption by imposing additional tax on previously favored taxpayers and, instead, required the states to issue refunds. Typically, this has occurred when it is clear that there is some reason additional tax liability cannot be imposed for the prior tax period.

One example is *Ceridian Corp. v. Franchise Tax Board.*[23] In that case, the California Court of Appeal found that California's income tax statutes violated the Commerce Clause by only permitting corporations "commercially domiciled" in the state to deduct certain insurance company dividends and limiting the deduction to dividends "paid from income from California sources."[24] While the taxing authority argued in favor of a "retroactive assessment" as a remedy, the court found that a refund was the only appropriate remedy because the statute of limitations on the tax years at issue had already passed.[25] In other words, retroactive tax collection was impossible under the circumstances and could not provide the constitutionally required relief.[26]

The court's decision in the *Ceridian Corp.* case and other similar decisions accurately reflect the Supreme Court's rationale in the *McKesson* decision. Whenever it is legally impossible to impose retroactive tax-regardless of whether the retroactive tax is prohibited by the U.S. Constitution or state law-a state must provide a refund to a taxpayer that has been discriminated against.

State court decisions allowing retroactive elimination of discriminatory tax exemptions. In contrast, many state courts have allowed states to retroactively eliminate discriminatory tax exemptions or other benefits as a remedy to unconstitutional tax exemptions. Too often, these decisions contain constitutionally suspect reasoning that fails to recognize that a state must actually remedy the discrimination that gave rise to the constitutional challenge in the first place.

For example, in *Annenberg v. Commonwealth*, the Pennsylvania Supreme Court found that a personal property tax exemption violated the Commerce Clause because it, in effect, only applied to stock in Pennsylvania corporations and in foreign corporations doing business in Pennsylvania.[27] Confusingly, the court found that only the *exemption* was discriminatory and that the taxpayer was not entitled to a refund because the imposition of the tax itself was, in the court's view, valid.[28] Of course, this reasoning conflicts with the decision in *McKesson.* To make matters worse, the court simply ordered the taxing authority to "provide a retrospective remedy" without considering whether the taxing authority could, in fact, impose retroactive taxes.[29] On its face, this decision is flawed because it puts the cart before the horse. A refund is the standard remedy to address unconstitutional exemptions because a refund will always eliminate any discrimination the taxpayer experienced. Before a refund can be ruled out as a remedy, it must first be established that the taxing authority can actually remedy discrimination by imposing retroactive taxes.[30]

Similarly, in *Alabama Alcoholic Beverage Control Bd. v. Henri-Duval Winery, LLC*, the Alabama Supreme Court considered the proper remedy for a taxpayer that successfully challenged an excise tax exemption for "native farm wine" produced in Alabama.[31] Ultimately, the court held that "striking" the exemption-and thereby making native farm wine subject to the same excise tax as other wine-was a proper remedy "to cure the constitutional defect in the tax scheme."[32] Effectively, the court denied the taxpayer the benefit of a refund. As in the *Annenberg* case, the court's analysis was fundamentally flawed. Though the court recognized that the discrimination must be cured, it failed to consider whether that was actually possible without a refund.

As these cases demonstrate, state courts can be quick to allow taxing authorities to refuse to provide a refund to taxpayers that bring successful constitutional challenges. Refunding a taxpayer the difference between the tax it paid and the tax it would have paid had it received the same preferential treatment as its competitors is the only certain way to eliminate unconstitutional discrimination in every instance. Accordingly, before a court can rule out a refund, it should first determine whether the alternative remedy proposed by the taxing authority can actually eliminate the discrimination that made the tax scheme unconstitutional.

Can Retroactively Eliminating an Unconstitutional Tax Exemption Provide "Meaningful Backward-Looking Relief"?

The Supreme Court's rationale in the *McKesson* decision has a certain facial appeal, but is it correct? Should states that have enacted discriminatory tax exemptions or other tax preferences be allowed to retroactively impose additional taxes instead of providing the prevailing taxpayer a refund? In the abstract, it makes sense that a taxing authority would be allowed to remedy unconstitutional discrimination by imposing additional tax on previously favored in-state taxpayers. After all, it is the discrimination that is the problem-not the tax itself-and imposing equally high taxes on in-state commerce and out-of-state commerce is not discriminatory. Moreover, no one questions the ability of a state to fix constitutional issues prospectively through legislation. Despite this theoretical appeal, in practice, the situations are few and far between in which a taxing authority could reasonably be expected to effectively eliminate past discrimination by retroactively imposing additional tax on previously favored taxpayers.

Consistently and effectively imposing retroactive tax to remedy past discrimination is nearly impossible

In the vast majority of cases, it is impossible-or nearly so-for states to provide "meaningful backward-looking relief" by retroactively imposing tax to address unconstitutional discrimination. Accordingly, this remedy should be applied sparingly, if at all, in response to a successful challenge to a discriminatory exemption or other tax benefit.

State law will often prevent taxing authorities from imposing back tax to remedy constitutional violations. Most commonly, this occurs due to statutes of limitations. In fact, because it takes several years to receive a final ruling in most jurisdictions, the statutes of limitations will have passed on many of the years at issue in almost all litigation that successfully challenges discriminatory tax exemptions. This is especially true when taxpayers wait until the end of the limitations period approaches to raise the issue by filing their refund claims. Unless the state legislature is willing to change the applicable statute of limitations-and can do so consistent with state and federal constitutional requirements-it is often impossible for a taxing authority to remedy past discrimination by imposing back taxes. Under these circumstances, refunding the taxpayer the difference between the tax it paid and the tax it would have paid had it received the same preferential treatment is the only form of relief that will remedy the constitutional violation.[33]

Even for open tax periods, there is little reason to believe that a taxing authority's proposed remedy of imposing retroactive tax to address past discrimination would work. This is particularly true when entities receiving the benefit of a discriminatory tax have historically not been required to register for or pay the tax at issue. Consider, for example, Tennessee's business tax exemption for manufacturers.[34] In effect, this exemption applies only to taxpayers with manufacturing facilities located in Tennessee.[35] Even if a taxpayer's overall business is manufacturing, it must pay business tax on its gross receipts from sales to Tennessee customers if it manufactures its products at facilities located outside the state. Of course, this exemption is facially suspect under the Commerce Clause.[36]

Assuming this exemption unconstitutionally discriminates against out-of-state manufacturers,[37] it is hard to believe that Tennessee could remedy this discrimination for past periods by imposing business tax on in-state manufacturers. For decades, in-state manufacturers have not been required to pay the business tax, and they cannot be expected to be aware of developments in the tax or to know to come forward and begin paying the business tax. Moreover, because in-state manufacturers are not required to even register for business tax, it would be nearly impossible for the state to track down each taxpayer before the limitations period would expire on back periods.[38]

Even when taxpayers that received discriminatory tax preferences have been required to register and pay some tax, voluntary compliance is unlikely. Assuming these taxpayers know that the taxing authority plans to require them to pay additional tax, taxpayers with any good faith argument that the state cannot retroactively impose tax on them may choose to hold the amount of the tax in reserve and wait to see if they are audited. Because the taxpayers have been paying the tax at issue, the limitations period will generally continue to run.[39] As a result, unless a state has substantial audit resources and also makes remedying the discrimination a top priority, a significant number of taxpayers that received discriminatory benefits would likely escape the additional tax the state claims it will impose to remedy the discrimination.

Moreover, assuming imposing retroactive tax is not prohibited by state law and that the state could feasibly identify and impose additional tax on previously favored taxpayers, there is little ability for taxpayers challenging unconstitutional taxes and the courts to confirm that the states are, in fact, remedying the discrimination at issue. In litigation addressing discriminatory taxes, states have relied on confidentiality statutes and fought to disclose as little information as possible about how taxes are actually enforced.[40] Of course, this makes it impossible to determine whether a state's plan for retroactively assessing additional tax actually works.

Allowing states to avoid refunds by promising to retroactively impose tax creates bad incentives

Beyond being nearly impossible to effectively execute in most circumstances, allowing a taxing authority to avoid issuing refunds by promising to retroactively impose tax creates a number of negative incentives that should be avoided.

As an initial matter, the same incentives that lead states to pass discriminatory exemptions in the first place also discourage taxing authorities from diligently pursuing back liability from in-state taxpayers. There is a reason that, with each year that passes, we continue to see constitutional challenges to state and local taxes: States continue to pass tax statutes that discriminate against interstate commerce in favor of in-state businesses and activities. The politicians that enact tax legislation balance many needs and desires, among them the need to fund the government and the desire to avoid angering voters by increasing taxes. The urge to solve both of these problems by placing as much of the tax burden as possible on "outsiders" is often too strong for lawmakers to resist. This same incentive could apply to taxing authorities that might be less likely to vigorously impose additional tax liability on in-state taxpayers. It is at least questionable whether the taxing authorities would diligently pursue back liability from these in-state taxpayers.

If the taxing authorities do not actually remedy past discrimination by imposing additional tax, there is no one else who will ensure that the discrimination is actually eliminated. In the context of litigation, the taxpayer would normally be expected to ensure that the taxing authority lives up to its obligations. If that taxpayer's refund claim is denied, however, any real incentive the taxpayer has to monitor the taxing authority's activities essentially disappears because any benefit the taxpayer would receive from the imposition of additional taxes on others is less significant. Moreover, without input from opposing parties, courts are poorly equipped to monitor tax collection efforts. Practically, no one will make sure a taxing authority follows through on its promise to impose tax retroactively.

Finally, allowing a taxing authority to avoid issuing refunds by promising to retroactively impose tax simply encourages states to pass tax exemptions and other tax preferences of questionable constitutionality. If a state knows that, when a questionable provision is challenged, the government will, at worst, simply get a "do over" and be able to impose the tax as though the provision never existed, there would be little to discourage the government from attempting to benefit in-state interests by discriminating against interstate commerce. Likewise, if taxpayers cannot get meaningful relief in the form of a tax refund, they will have significantly less incentive to bring a meritorious constitutional challenge in the first place. Obviously, constitutional remedies should be designed to discourage constitutional violations, not encourage them.[41]

Conclusion

States have "flexibility" and are not required to be "perfectly successful" in remedying past discrimination, but the Supreme Court's decision in *McKesson* promises "meaningful backward-looking relief" to taxpayers that bring a successful constitutional challenge to a discriminatory tax regime.[42] Allowing states to remedy the unconstitutional regime by retroactively imposing additional tax will almost never satisfy this requirement.

At a minimum, states should be required to (1) affirmatively demonstrate that their plan to retroactively impose additional taxes will remedy past discrimination in fact, rather than simply in theory, and (2) provide access to information that will allow taxpayers and courts to scrutinize the extent to which the discrimination has been remedied. If the state cannot articulate a feasible plan for remedying the discrimination and allow its processes to be scrutinized, it should be required to refund the prevailing taxpayer the difference between the tax it paid and the tax it would have paid had it received the same preferential treatment as its competitors. Otherwise, there is no way to guarantee that the states will actually provide "meaningful backward-looking relief" as constitutionally required.

[1] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[2] *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268 (1984).

[3] 496 U.S. 18 (1990).

[4] *Id.* at 31.

[5] *Id.* at 22-23. Specifically, Florida law provided significantly reduced excise tax rates and other preferential treatment to beverages that were manufactured from citrus or other agricultural crops commonly grown within Florida and used to produce alcoholic beverages in the state. *Id.*

[6] *Id.* at 23-24.

[7] *Id.* at 24-25.

[8] 468 U.S. 263, 273 (1984) (finding unconstitutional Hawaii's liquor tax exemptions for okolehao (a spirit made from an indigenous Hawaiian plant) and pineapple wine).

[9] *See Div. of Alcoholic Beverages & Tobacco, Dep't of Bus. Regulation v. McKesson Corp.*, 524 So. 2d 1000, 1002, 1005, 1010 (Fla. 1988).

[10] *Id.* at 1010-11.

[11] *See McKesson*, 496 U.S. at 31 ("It is undisputed that the Florida Supreme Court, after holding that the Liquor Tax unconstitutionally discriminated against interstate commerce because of its preferences for liquor made from 'crops which Florida is adapted to growing,' acted correctly in awarding petitioner declaratory and injunctive relief against continued enforcement of the discriminatory provisions.").

[12] *Id.*

[13] *Id.* at 39.

[14] *Id.* at 39-40.

[15] *Id.* at 40.

[16] *Id.*; *see also Iowa-Des Moines Nat. Bank v. Bennett*, 284 U.S. 239 , 247 (1931) ("It may be assumed that all ground for a claim for refund would have fallen if the state, promptly upon discovery of the discrimination, had removed it by collecting the additional taxes from the favored competitors. By such collection the petitioners' grievances would have been redressed; for these are not primarily overassessment.").

[17] *McKesson*, 496 U.S. at 40.

[18] *Id.*

[19] *Id.* at 40 n.23. In practice, this is often a relatively easy requirement to meet. *See, e.g.*, *United States v. Carlton*, 512 U.S. 26, 32-33 (1994). It should be noted, though, that states often have more stringent constitutional standards with respect to retroactive tax legislation. *See, e.g.*, *Stranburg v. Panama Commons, LP*, 160 So. 3d 160, 162 (Fla. Dist. Ct. App., 1st Dist. 2015).

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

[21] *Id.* at 40 n.23.

[22] In addition to the federal constitutional component of the analysis, whether a court can retroactively eliminate an unconstitutional provision of a statute presents state law issues-at least in the absence of a legislative enactment retroactively eliminating the provision. *See, e.g.*, *Chapman v. Comm'r of Revenue*, 651 N.W.2d 825, 836 (Minn. 2002).

[23] 102 Cal. Rptr. 2d 611, 616-17 (2000), *as modified on denial of reh'g* (Jan. 18, 2001).

[24] *Id.* at 616-17.

[25] *Id.* at 621.

[26] *Id.*

[27] 757 A.2d 338, 341 n.4, 346 (Pa. 2000).

[28] *Id.* at 352.

[29] *Id.*

[30] *See McKesson*, 496 U.S. at 51 (noting that the remedy must "cure any unconstitutional discrimination against interstate commerce during the contested tax period").

[31] 890 So. 2d 70, 72 (Ala. 2003).

[32] *Id.* at 80.

[33] *See McKesson*, 496 U.S. at 39-41, 51.

[34] Tenn. Code Ann. §67-4-708(3)(C); Tenn. Code Ann. §67-4-712(e).

[35] *See* Tenn. Code Ann. §67-4-712(b)(2) (requiring a business to be primarily engaged in manufacturing products "from a location or outlet subject to ad valorem taxation" under Tennessee's property tax statutes to qualify for the exemption).

[36] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 , 279 (1977); *see also Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 , 268 (1984) (noting that the Commerce Clause prevents states from imposing discriminatory taxes that provide "a direct commercial advantage to local business").

[37] Cases challenging the exemption are currently pending.

[38] Tenn. Code Ann. §67-4-706(a).

[39] *See, e.g.*, Cal. Rev. & Tax. Code §6487; N.Y. Tax Law §1083; Tenn. Code Ann. §67-1-1501(b).

[40] *See, e.g.*, Tenn. Code Ann. §67-1-1702(a).

[41] *See Collins v. Virginia*, 138 S. Ct. 1663, 1680 n.6 (2018).

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

© 2020 Thomson Reuters/Tax & Accounting. All Rights Reserved.