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U.S. Supreme Court Update

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U.S. SUPREME COURT UPDATE

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Court Issues One Decision and Receives New Petitions in Cases Involving SALT Matters

*33 On June 21, 2019, the U.S. Supreme Court issued its unanimous decision in *North Carolina Dep't of Rev. v. The Kimberley Rice Kaestner 1992 Family Trust* (Docket No. 18-457), ruling that the presence of in-state beneficiaries alone was insufficient to allow a state to tax trust income that had not been distributed to the beneficiaries where the beneficiaries had no right to demand the income and it was uncertain whether they would ever receive the income.

In addition the Court has received new petitions for certiorari in cases involving state and local tax matters: *Kansler v. Miss. Dep't of Rev.* (Docket No. 18-1485); *McClain v. Sav-On Drugs* (Docket No. 18-1512); and *Chamberlain v. N.Y. Dep't of Tax. and Fin.* and *Edelman v. N.Y. Dep't of Tax. and Fin.* (Docket Nos. 18-1569 and 18-1570).

On June 28, 2019, the Court granted review in one previously reported petition: *Espinoza v. Montana Dep't of Rev.* (Docket No. 18-1195).

The Court also continues its review of a dispute between Delaware and several other states concerning which states have priority rights to claim abandoned, uncashed MoneyGram 'official checks.' The MoneyGram cases set for review are *Delaware v. Pennsylvania*, Case No. 220145, and *Arkansas v. Delaware*, Case No. 220146. As previously reported, the Court has assigned the Honorable Pierre N. Leval, of the U.S. Court of Appeals for the Second Circuit, as Special Master in these cases, tasked with coordinating the taking of evidence and making reports. We will continue to update readers as more details become available.

Lastly, the Court has denied several previously reported petitions involving state and local tax matters since our last update: *Ashland Specialty Co., Inc. v. Steager* (Docket No. 18-1053) on June 17, 2019; *Alabama Dep't of Rev. v. CSX Transportation, Inc.* (Docket Nos. 18-447 and No. 18-612) and *Illinois Central Railroad Co. v. Tenn. Dep't of Rev.* (Docket No. 18-866) on June 24, 2019; and *Bauerly v. Fielding* (Docket No. 18-664) on June 28, 2019.

Court Holds N.C. Unconstitutionally Taxed Income of Out-of-State Trust

On June 21, 2019, the U.S. Supreme Court issued its decision in *North Carolina Dep't of Rev. v. The Kimberley Rice Kaestner 1992 Family Trust* (Docket No. 18-457). Justice Sotomayor delivered the unanimous opinion of the Court, holding that

‘the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it.’

****2** As summarized by the Court, the trust that challenged North Carolina's taxation had its origins approximately 30 years before when Joseph Lee Rice III, a New York resident, formed a trust for the benefit of his children. Mr. Rice decided that the trust would be governed by New York law and he appointed another New York resident as the trustee. ‘The trust agreement provided that the trustee would have ‘absolute discretion’ to distribute the trust's assets to the beneficiaries ‘in such amounts and proportions’ as the trustee might ‘from time to time’ decide.’ On December 30, 2002, the original trust was divided into three share sub-trusts for the benefit of Mr. Rice's children, including his daughter Kimberly Rice Kaestner (‘Kaestner’). The Kimberly Rice Kaestner 1992 Trust (the ‘Trust’ or ‘Kaestner Trust’) was the separate share trust formed for the benefit of Kaestner and her three children, all of whom reside in North Carolina. (Kaestner moved to North Carolina in 1997.) However, the same agreement that controlled the original trust also governed the Kaestner Trust. As noted by the Court, ‘this meant that the trustee had exclusive control over the allocation and timing of trust distributions.’

During the tax years at issue (2005 through 2008), the Trust was subject to New York law and maintained no physical presence in North Carolina, made no direct investments in North Carolina, and held no real property in North Carolina. Rather, the assets held by the Trust consisted of various financial investments, and the custodians of those assets were located in Boston, Massachusetts. In addition, documents and records related to the Trust were kept in New York. The trustee of the Trust was a resident of Connecticut and he decided not to distribute any of the income of the Trust to Kaestner or her children. Nevertheless, the North Carolina Department of Revenue (‘DOR’) assessed tax on the entire amount of income that accumulated in the Trust each year, even though no income was distributed to the North Carolina beneficiaries. The DOR relied on state law that provides that the state may tax any trust ***34** income that ‘is for the benefit of’ a North Carolina resident to impose the tax. The Trust paid the tax under protest, which equaled approximately \$1.3 million, and applied for a refund of the amount paid. North Carolina denied the refund request on February 11, 2011.

The Trust brought an action in North Carolina state court, asserting that North Carolina violated the U.S. Constitution's Due Process Clause by assessing taxes on undistributed income held by the Trust. The Trust argued that the Trust itself, as opposed to the Trust's beneficiaries, did not have a constitutionally sufficient connection with North Carolina. The state trial court agreed with the Trust's argument, and in a 6-1 decision, the North Carolina Supreme Court affirmed the decision and held that the in-state residence of the Trust's beneficiaries is not a sufficient connection with North Carolina to allow North Carolina to tax the Trust's income.

****3** The state appealed to the U.S. Supreme Court and lost. As explained by the Court, ‘[w]e granted certiorari to decide whether the Due Process Clause prohibits States from taxing trusts based only on the in-state residency of trust beneficiaries.’ Here, the Court ruled in favor of the Trust, but the Court also said that the holding was limited to the facts presented in the case, stating that the Court was not ‘imply[ing] approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to the trust assets differs from that of the beneficiaries here.’

Review Sought of Miss. Refund Claim Denial on Statute of Limitations Grounds

On May 29, 2019, the U.S. Supreme Court received a petition for certiorari in *Kansler v. Miss. Dep't of Rev.*, Docket No. 18-1485, ruling below at [263 So. 3d 641 \(Miss. 2018\)](#). In the case below, the Mississippi Supreme Court held that the Chancery Court of the First Judicial District of Hinds County properly granted summary judgment to the Department of Revenue based on the taxpayers' failed challenge to the state's statute of limitations for claiming a refund, as the ‘statute of limitations is facially nondiscriminatory and has only an incidental effect on interstate commerce, one that is justified by the practical difficulties of tax administration and the State's interest in finality.’

Mississippi's credit for income taxes paid to another jurisdiction.

Mississippi offers a credit to residents for income taxes paid to other states. To claim the credit, a resident must have actually paid the tax to the other state and provide a copy of the income tax return filed with the other state. Mississippi law, however, generally prohibits the resident from recovering overpaid taxes resulting from a credit claimed more than three years after the original tax return was filed. With respect to the credit for taxes paid to another state, Mississippi offers no mechanism or procedure to claim a credit prior to actually paying another state, or to file a protective claim when an audit by another state is imminent and additional tax is likely to be owed.

Background.

While living in New York, Michael Kansler received stock options as part of his compensation from Entergy Corporation. In 2007, Kansler moved to Mississippi and continued to work for Entergy. Kansler and his wife filed Mississippi personal income tax returns for 2008 and 2009, paying taxes on the income from the exercise of stock options and taking the position that the income was only taxable in Mississippi. New York audited the Kanslers' taxes in 2012 regarding the exercise of the stock options, and on December 29, 2014, determined the Kanslers owed additional tax to New York. In January 2015, the Kanslers amended their Mississippi personal income tax returns and claimed a refund of more than \$250,000 based on credits for taxes paid to other states.

The Mississippi Department of Revenue ('DOR') denied the refund because the general three-year statute of limitations period for a refund had expired. The DOR Board of Review and the Mississippi Board of Tax Appeals agreed with the denial of the refund claim. On appeal, both the Chancery Court of the First Judicial District of Hinds County and the Mississippi Supreme Court agreed with the DOR and upheld the denial and determined that the statute of limitations did not violate the Commerce, Due Process, or Equal Protection Clauses of the U.S. Constitution.

****4** According to the Mississippi Supreme Court, the statute of limitations provision should not be judged by the *Complete Auto Transit Inc. v. Brady* test to determine ***35** whether the statute violates the dormant Commerce Clause because the test 'is specifically intended for evaluating the constitutionality of taxes, not state regulations in general.' Rather, the test should be the 'traditional discrimination/*Pike* balancing test, and we find that the discrimination alleged by the Kanslers is 'incidental' to Mississippi's otherwise nondiscriminatory statute of limitations. It therefore must be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.' (As explained by the court below, 'when a state law regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits, this is the *Pike* balancing test. *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970).')

Taxpayer argues *Complete Auto* test should apply.

The Kanslers argue that the denial of the refund is a violation of the dormant Commerce Clause. In addition, they argued that the four component tests of *Complete Auto* should be applied more broadly and are applicable in instances involving more than 'taxes.' *Complete Auto* provides that, to avoid violating the dormant Commerce Clause, 'a tax must: (1) be imposed on an activity with a substantial nexus with the taxing state; (2) be fairly apportioned, based on the activity within the taxing state; (3) not discriminate against interstate commerce; and (4) be fairly related to services provided by the taxing state.' With respect to the apportionment prong (and also discrimination prong), the Kanslers contend that the statute must satisfy the 'internal consistency test,' which 'looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with intrastate commerce,' and that here the statute 'fails the internal consistency test because taxpayers with income from other states will suffer more from [Mississippi's] statute of limitations than taxpayers whose income is derived solely from Mississippi.'

Questions presented.

The Kanslers ask the U.S. Supreme Court to consider the following questions:

1. 'Is Mississippi's income tax refund statute of limitation immune *per se* from Commerce Clause scrutiny under *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) and the internal consistency test when it produces actual, undisputed double taxation of its residents' income earned in interstate commerce?'
2. 'Does Mississippi discriminate against interstate commerce by permitting certain residents to recover overpaid income taxes well beyond the normal three-year statute of limitations while denying other residents the same benefit, based exclusively on an interstate element or criteria, when that denial produces actual, undisputed double taxation of residents' income earned in interstate commerce?'
3. 'Does Mississippi violate the Commerce Clause and Due Process Clause of the United States Constitution by failing to afford its resident taxpayers, when audited by a sister state, any pre- or post-deprivation mechanism to preserve their right to claim a credit for taxes paid to other states in order to avoid double taxation of income they earned in interstate commerce?'

Challenge Brought to Calif. Sales Tax Reimbursements

On May 31, 2019, the U.S. Supreme Court received a petition for certiorari in *McClain v. Sav-On Drugs*, Docket No. 18-1512, ruling below at 9 Cal. App. 5th 684 (Cal. 2019), in which customers who paid sales tax reimbursement on purchases they believed to be exempt from sales tax were unable to file suit to compel the retailers' to seek a refund of those reimbursements from the California Department of Tax and Fee Administration. The California Supreme Court rejected the customers' argument that the unavailability of a judicially created remedy violates the Due Process Clause of the U.S. Constitution and that California's tax refund system, by unjustly enriching the state at the expense of consumers, works an unconstitutional taking under the Taking Clause of the U.S. Constitution.

California sales tax structure and purchases at issue.

California imposes its sales tax on the retailer making sales of tangible personal property. Retailers, however, are allowed to collect 'sales tax reimbursement' from the customer, which ultimately places the economic incidence of the tax on the customer. A byproduct of such a *36 tax structure is that the retailer is considered to be the 'taxpayer' authorized to file a tax refund claim under California Rev. & Tax. Code §6902(a). If a retailer pays more sales tax than is due, it may file a refund claim for taxes paid with the California Department of Tax and Fee Administration (the 'Department'). If customers pay excess sales tax reimbursements to the retailer, the retailer must either return the excess to the customer or remit it to the state. There is no statutory remedy for a customer to obtain a refund directly from the Department. However, in *Javor v. State Board of Equalization*, 12 Cal. 3d 790 (1974), the California Supreme Court authorized a customer suit compelling retailers to file claims for refund on behalf of taxpayers who had paid excess tax reimbursement.

As described in the case below, Petitioners, insulin-dependent pharmacy customers, paid sales tax reimbursements on the purchase of glucose test strips and skin puncture lancets from pharmacies, which the Petitioners claim were exempt from sales tax. In California, '[g]lucose test strips and skin puncture lancets furnished by a registered pharmacist . . . in accordance with a physician's instructions' to be used by a diabetic patient are not taxable. However, the Department's position has been that if customers are able to remove the glucose test strips and skin puncture furnishings from the shelf and pay for them without the intervention of a pharmacist, then the sales are subject to tax. Petitioners paid sales tax reimbursements on such purchases.

California courts disallow refund protest.

****6** Petitioners, a class comprised of insulin-dependent pharmacy customers, filed a class action against a group of pharmacies and the Department seeking a refund of sales tax reimbursement paid, for orders compelling the pharmacy defendants to file refund claims against the Department, and for the Department to award refunds to be passed on to customers. Petitioners ultimately argued that to deny consumers a remedy to recover sales tax reimbursement would (1) constitute a public ‘taking’ without just compensation under the Takings Clause of the U.S. Constitution and (2) be a deprivation of property without due process of law under the Due Process Clause of the U.S. Constitution. Both the pharmacy defendants and the Department objected and demurred to the complaint. The trial court sustained the demurrers without leave to amend and the Court of Appeal affirmed noting that ‘the result is not an entirely satisfying one,’ but the California Legislature was best suited to provide a mechanism for refund.

The California Supreme Court held that for Petitioners to be entitled to a *Javor* remedy, whereby the California courts would compel the pharmacies to seek a refund on behalf of the Petitioners, the Petitioners must, as a threshold requirement, show a prior legal determination that establishes their entitlement to a refund. In this case, Petitioners had not shown such a legal determination, therefore, the defendant pharmacies would not be forced to file refund claims on behalf of customers.

Question presented.

‘Does a State violate the Due Process Clause and trigger a right to just compensation under the Takings Clause when it permanently escheats private property from an intermediary to itself under a statutory scheme that denies standing to the real parties in interest, including denying them any right to a judicial or administrative procedure by which to reclaim their private property.’

Challenge to the Constitutionality of N.Y.'s Personal Income Tax Scheme

On June 24, 2019, the U.S. Supreme Court received a petition for certiorari in two cases challenging the New York Supreme Court, Appellate Division, First and Third Departments' decisions in *Chamberlain v. N.Y. Dep't of Tax. and Fin.* (Docket No. 18-1569) and *Edelman v. N.Y. Dep't of Tax. and Fin.* (Docket No. 18-1570).¹ In each of the cases below, Connecticut domiciliaries were deemed to be New York statutory residents because they spent more than 183 days in New York, and the New York lower courts upheld the taxation ***37** of their intangible income by New York because it did not amount to double taxation, observing that a credit for taxes is available when the income being taxed is ‘earned’ in the other state.

N.Y.'s personal income tax scheme.

New York taxes the worldwide income, including intangible income, not just of individuals domiciled in New York, but also individuals domiciled elsewhere who maintain a dwelling place in New York and spend more than 183 full or part days of a tax year in New York (i.e., who are a ‘statutory resident of New York’). New York offers a credit for taxes paid to another state if the credit is on ‘income derived from sources within’ that state. With respect to income from intangibles, New York does not offer a credit for taxes paid to another state unless the income is from ‘property employed in a business, trade or profession, carried on’ in the other state.

****7** In each of the underlying cases, the taxpayers were domiciled in Connecticut, but owned a residence in New York and spent more than 183 days in New York during the tax years at issue. After selling their shares of respective companies, the taxpayers each paid full taxes to Connecticut on their worldwide income. The taxpayers each also filed New York tax returns for those years and, after respective audits, were also required to pay tax to New York on the intangible income from the sale of the shares of the companies, even though each had already paid tax to Connecticut on that intangible income.

The taxpayers each filed suit against New York arguing that New York's tax scheme violated the dormant Commerce Clause under the U.S. Supreme Court's decision in *Comptroller of Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015). In *Wynne*, the Court struck down a Maryland tax scheme in which residents were allowed a credit against only a portion of their Maryland taxes (the state taxes but not the county taxes) for income taxes paid to other states. In that decision, the Court held the Maryland tax scheme violated the 'internal consistency test,' which, as discussed above, 'looks to the structure of the tax at issue to see whether its identical application by every state in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.' However, the intermediate state courts rejected the taxpayers' arguments and upheld New York's tax scheme.

N.Y. Court of Appeals dismissed taxpayers' appeal.

In each of the underlying cases below, New York courts held that the New York tax scheme was constitutional. According to the courts, the *Wynne* decision did not abrogate the New York Court of Appeals' prior decision in *Tamagni v. Tax Appeals Tribunal*, 91 N.Y.2d 530 (N.Y. 1998), which upheld the constitutionality of the tax scheme. The New York courts distinguished the present matters from *Wynne*, emphasizing that *Wynne* 'did not involve individuals who faced double taxation on intangible investment income by virtue of being domiciliaries of one state and statutory residents of another' and that 'the income subject to tax in *Wynne* was not intangible investment income, but business income, traceable to an out-of-state source.' The taxpayers appealed to the New York Court of Appeals but the court denied review on the ground that 'no substantial constitutional question [was] directly involved.'

Question presented.

'Whether a state tax scheme that taxes the intangible income of individuals who are domiciled in the State and certain individuals not domiciled in the State, without offsetting credits for taxes paid to another State of domicile, violates the dormant Commerce Clause under this Court's decision *Comptroller of Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015).'

Petition Granted

On June 28, 2019, the U.S. Supreme Court granted certiorari in *Espinoza v. Montana Dep't of Rev.*, Docket No. 18-1195, *38 ruling below at 393 Mont. 446 (2018). The Court will review a decision by the Montana Supreme Court, which held that the Montana tax credit program for qualified education contributions violates Article X, §6, of the Montana Constitution. This provision, entitled 'Aid prohibited to sectarian schools,' prohibits aid used 'for any sectarian purpose or to aid any . . . school . . . controlled in whole or in part by any church, sect, or denomination.'

**8 In response to legislation that allows a tax credit to fund scholarships to private schools, the Montana Supreme Court determined that, by providing a dollar-for-dollar credit against taxes owed to the state, the Legislature is the entity providing aid to sectarian schools in direct violation of the Montana Constitution. Mothers of children who benefited from the scholarship program and who attended religious private schools asked the Court: 'Does it violate the Religion Clauses or Equal Protection Clause of the United States Constitution to invalidate a generally available and religiously neutral student-aid program simply because the program affords students the choice of attending religious schools?'

Petitions Denied

The following previously reported petitions were denied by the Court: *Ashland Specialty Co., Inc. v. Steager* (Docket No. 18-1053) on June 17, 2019; *Alabama Dep't of Rev. v. CSX Transportation, Inc.* (Docket Nos. 18-447 and No. 18-612) and *Illinois*

Central Railroad Co. v. Tenn. Dep't of Rev. (Docket No. 18-866) on June 24, 2019; and *Bauerly v. Fielding* (Docket No. 18-664) on June 28, 2019.

In *Ashland Specialty Co., Inc. v. Steager* (Docket No. 18-1053), ruling below at [818 S.E.2d 827 \(2018\)](#), the Court had been asked to review a West Virginia Supreme Court of Appeals decision concluding that a penalty, imposed on a taxpayer for selling brands of cigarettes not on the West Virginia Tax Commissioner's list of cigarettes that could be lawfully sold in West Virginia, was not an abuse of discretion, should not be canceled or reduced, and did not violate the Excessive Fines Clause of the West Virginia Constitution or the Eighth Amendment of the U.S. Constitution.

In *Illinois Central Railroad Co. v. Tenn. Dep't of Rev.* (Docket No. 18-866), ruling below at [748 Fed. Appx. 26 \(6th Cir. 2018\)](#), the Court had been asked to review a decision by the U.S. Court of Appeals for the Sixth Circuit holding that Tennessee did not violate the U.S. Constitution by imposing a sales tax on the fuel purchases of railroad carriers while exempting the fuel purchases of motor carriers.

In *Alabama Dep't of Rev. v. CSX Transportation, Inc.* (Docket No. 18-447), ruling below at [CSX Transportation, Inc. v. Alabama Dep't of Rev., 888 F.3d 1163 \(11th Cir. 2018\)](#), the Court was asked to review the Eleventh Circuit's holding that the Alabama sales tax, which applies to diesel fuel purchases by rail carriers but not diesel fuel purchases by motor or water carriers, constituted a tax that impermissibly discriminates against rail carriers under §11501(b)(4) of the Railroad Revitalization and Regulatory Reform Act of 1976 (the '4-R Act').

In *Bauerly v. Fielding* (Docket No. 18-664), ruling below at [916 N.W.2d 323 \(Minn. 2018\)](#), the Court had been asked to review a Minnesota Supreme Court decision that held that Minnesota's resident trust classification violated both the federal and Minnesota Due Process Clauses, as applied to four Minnesota trusts, because (1) the state lacks sufficient contacts with the trusts and (2) there is no rational relationship between the income the state seeks to tax and the protections and benefits conferred by the state.

****9** The Court ruled in favor of the Trust, but the Court also said that the holding was limited to the facts presented in the case.

Mississippi law, however, generally prohibits the resident from recovering overpaid taxes resulting from a credit claimed more than three years after the original tax return was filed.

Customers who paid sales tax reimbursement on purchases they believed to be exempt from sales tax were unable to file suit to compel the retailers' to seek a refund of those reimbursements from the California Department of Tax and Fee Administration.

The taxpayers argue that New York's tax scheme violates the dormant Commerce Clause under the U.S. Supreme Court's decision in *Comptroller of Treasury of Maryland v. Wynne*.

The Court will review a decision by the Montana Supreme Court, which held that the Montana tax credit program for qualified education contributions violates the Montana Constitution.

Footnotes

- 1 The authors' law firm, Hodgson Russ LLP, has been engaged to represent the taxpayers in these matters and filed the petitions for certiorari at issue before the Court.