Interstate Commerce Initiative

NTUF
NATIONAL TAXPAYERS UNION FOUNDATION

Issue Brief

MAY 15, 2019

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California's "Doing Business" Tax Should Face High Court Scrutiny

Introduction

For years, California has been operating a tax scheme that amounts to little more than a cash grab from residents of neighboring states. Now, the Supreme Court has a chance to put an end to it.

In its endless search for more revenue, California has invented a new and innovative way to tax the residents of another state. More specifically, California assesses a minimum $800 "doing business" tax to Arizona-based passive investors in LLCs that have an ownership share in a California company. They enforce this by sending extraterritorial and extrajudicial seizure notices to banks, ordering them to take money from the Arizona resident's account or cough up the cash themselves.

Arizona is seeking to file suit against California in the U.S. Supreme Court arguing that the levies overstep their bounds and encroach on Arizona's ability to tax and regulate the conduct of their own residents. NTUF filed an amicus brief in support of Arizona's motion, arguing that California's conduct violates both due process and commerce clause limits on state power. The Supreme Court will now consider whether to grant Arizona's motion, which would set the stage for a rare state-on-state battle at the high court.

Background

California, like many states, has a franchise tax on businesses that operate within the state. In 2011, the statute governing this tax was amended to clarify that the franchise tax applied to any business that exceeded certain sales, property, or payroll taxes within the state of California.

California's Franchise Tax Board (FTB) interpreted these amendments broadly, however. The FTB determined that not only were out-of-state limited liability companies (LLCs) that operated within California liable for the franchise tax, but LLCs that had a passive investment by definition means that the investor is *not* "doing business" in California, and that legal precedent underscores the notion that passive investment alone doesn't constitute sufficient basis for imposing tax obligations, the FTB persists in enforcing California's "doing business" tax on out-of-state passive investors.

The FTB has gone to great lengths to enforce its interpretation. They have issued seizure notices to multistate banks instructing them to extract funds from Arizona residents' accounts or else face seizure themselves. Adding insult to injury, the FTB often tacks fines on top of the actual tax liability when it has to resort to bank seizures to retrieve its ill gotten gains. Arizona Attorney General Mark Brnovich cited the example of PW5S, an Arizona LLC that found itself targeted for this tax. When PW5S refused to pay the illegal tax, California's FTB issued seizure orders to Wells Fargo for more than $12,600, well above the $800 tax assessment. Wells Fargo also tacked on $125 fees each time it received a seizure order.

These seizures make a mockery of due process. No court order is necessary under California law for the FTB to issue a seizure notice, and the targeted businesses are not allowed to challenge the seizure in court under California law.

Key Facts:

California assesses its "doing business" tax on with only tangential connection to the state.

This tax scheme violates both the 14th Amendment's due process clause and the interstate commerce clause of the constitution.

Without Supreme Court review, those affected by this scheme will have no recourse.

Making Mincemeat of Due Process

It's not the first time that other states have had to ask the Supreme Court to step in to rein in the overly aggressive practices of the FTB. The Court has already heard oral arguments in the case of *Franchise Tax Board of California v. Hyatt*, a case in which inventor Gilbert Hyatt moved from California to Nevada yet found himself hounded by California's FTB.

Alleging that Hyatt lied about the date of his move, FTB auditors went through Hyatt's garbage at his Nevada home, leaked his Social Security number to reporters, and enlisted his estranged family to testify against him. Eventually Hyatt had enough, suing California for damages. Hyatt won, but was before the Supreme Court this year again on another appeal. California did not contest that it engaged in these unwarranted behaviors, simply that Hyatt did not have the right to sue California in Nevada courts.

The Supreme Court ultimately ruled in California's favor, but in doing so it put businesses in a difficult situation. By limiting their ability to sue in their own state's courts, the Court leaves them with just one unenviable option: submitting themselves to the jurisdiction of a state with which they have no other connection. This effectively requires them to relinquish one right in order to vindicate another. This inability to secure meaningful relief at the state level is a key reason why this particular case is being brought at the Supreme Court level.

When businesses have challenged the FTB in California courts, they have found a sympathetic ear. The most significant challenge to the "doing business" tax came from Swart Enterprises, an Iowa-based business. In *Swart Enterprises v. California Franchise Tax Board*, the California Court of Appeals ruled that Swart was not "doing business" in California when it held only a 0.2 percent passive investment in a California LLC managed by a professional manager, not shareholders.

California's FTB decided to engage in a bit of malicious compliance, however. Rather than taking the appeals court's ruling as the clear rebuke of its behavior that it seemed to be, the FTB determined that it would exempt businesses that fit only the exact same set of circumstances. Out-of-state LLCs are now exempted from the franchise tax if the investment they have in a California business is under 0.2 percent, the California business is manager-managed, and the California business did not transition to being manager-managed after the *Swart* decision. If an out-of-state LLC fails any of these three requirements (two of which are entirely arbitrary and specific to the *Swart* decision), the FTB still considers them liable for the "doing business" tax.

Interstate Commerce Violations

In addition to the flagrant due process violations, California's conduct also fails the commerce clause test that limits state taxation of interstate commerce. Though the Supreme Court unfortunately expanded the power of states to do so in the case of *South Dakota v. Wayfair*, there are significant limits in other case law that would clearly compel a court to rule in Arizona's favor should their case be heard.

More specifically, California's "doing business" tax clearly violates the so-called *Complete Auto* test, named after a 1977 Supreme Court case in which the majority laid out a four-part test to determine the constitutionality of a tax under the commerce clause. To avoid offending the Commerce Clause, the ruling established that a state tax must apply to an activity with a substantial nexus with the taxing state, be fairly apportioned, not discriminate against interstate commerce, and be fairly related to the services the state provides.

California's cross-border "doing business" tax fails all four parts of the *Complete Auto* test. The activity in question has no substantial nexus with the state, because passive investment does not constitute business activity in the first place. The tax is not fairly apportioned because it does not vary based on degree of ownership or activity. It is discriminatory in nature, targeting out-of-state passive investors for more complex and burdensome tax treatment than in-state equivalents. And finally, it is not fairly related to services provided by the state because an out-of-state passive investor receives no services from California at all.

Conclusion

California is, by virtue of its size and its status as a high-tax state, one of the most aggressive repeat offenders in launching cross-border tax and regulatory schemes. In 2010, California's state legislature expanded a state ballot initiative that required chicken farmers to provide egg-laying chickens with a certain amount of space — once expanded, the regulation applied to out-of-state sellers into California as well. Given the size of California's market, this rule amounted to California regulating egg farmers in states around the country. Though over a dozen states filed suit against California's egg regulation, the Court refused to grant the case a hearing.

Though the Court passed on the opportunity to check California's aggression in that case, *Arizona v. California (2019)* could an opportunity to establish clearer limits on cross-border reach by states. This time, the Supreme Court should take the case in order to give the issues a proper hearing at the highest levels. In doing so, Justices could help to redefine federalism and state sovereignty for the 21st century.

About the Authors

Andrew Moylan and Andrew Wilford lead the Interstate Commerce Initiative at the National Taxpayers Union Foundation (NTUF), a project which seeks to protect taxpayers from the pernicious effects of states attempting to exercise power outside their borders. NTUF is a non-partisan research and educational organization that shows Americans how taxes, government spending, and regulations affect them.

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