Journal of Multistate Taxation and Incentives (Thomson Reuters/Tax & Accounting)
Volume 28, Number 9, January 2019

SHOP TALK

Non-Traditional State Tax Litigation: A Look at Four Pending Cases

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State tax litigation traditionally arises in a few standard contexts. Most commonly, state tax litigation follows audit assessments or refund claim denials. Increasingly, however, state tax litigation is arising in other contexts. Perhaps most significantly, tax whistleblower lawsuits have surged over the last 10-15 years in Illinois and New York. Class action attorneys have gotten into the act as well, in some cases filing large class action lawsuits alleging that retailers erroneously collected sales tax from customers.

There are a few cases pending in the courts now that cannot easily be grouped into any of the above categories. One involves four states suing the Treasury Department, alleging that federal tax laws are hampering state sovereign tax authority. Another involves fights between Delaware and numerous other states over which state has the right to take custody of certain unclaimed property. Two cases involve taxpayers who have pro-actively sued an out-of-state tax department in a local court. This article will describe and discuss all four cases, noting the central issues in dispute and explaining how in each case the litigation arose. It will close with some concluding observations.

Four states v. the Treasury Department—$10,000 SALT deduction limitation litigation

Connecticut, Maryland, New York, and New Jersey have filed a lawsuit in federal district court challenging the constitutionality of the $10,000 state and local tax deduction limitation. The limitation, enacted as part of the Tax Cuts and Jobs Act, sets a cap on the amount of state and local taxes a taxpayer can deduct for federal income tax purposes. The lawsuit challenging the $10,000 limitation relies on the Tenth Amendment and the Sixteenth Amendment to the U.S. Constitution.

The Tenth Amendment argument is that the power to tax is a power reserved to the states, allowing states to raise revenue as appropriate to help fund state government. By placing a cap on the amount of state taxes that will be deductible, a disincentive is provided for states to raise taxes, making it harder to fund state government. Under this argument, the limitation encroaches on state sovereign tax authority, restricting what the states can do and undermining the states' right to set their own tax and fiscal policies.

The Sixteenth Amendment argument, similarly, is based on federalism concepts. The argument is that the Sixteenth Amendment itself (which provides for the federal tax power) involved a compromise under which the states agreed to permit federal taxation in exchange for granting a deduction of state taxes against the federal tax. By limiting the SALT deduction to $10,000, the states argue, the compromise is undermined, thereby violating the Sixteenth Amendment (implicit in the argument is that the states would not have agreed to the Sixteenth Amendment if they knew that a state tax deduction cap would be enacted).

Procedurally, the suit was filed in U.S. District Court for the Southern District of New York in July 2018, and not much has happened since then as of this writing.

Delaware v. Pennsylvania and Wisconsin—custody of presumed abandoned MoneyGram checks

In unclaimed property, one of the most fundamental questions is which state has the right to property that has been abandoned. This very question is at the center of a dispute pitting Delaware against numerous states. The stakes are high—estimates are in the hundreds of millions of dollars. One suit was brought by Delaware against Pennsylvania and Wisconsin; the other suit was brought by several states against Delaware.

The legal issue in controversy is which state has superior authority to take custody of presumed abandoned MoneyGram "Official Checks." Should the value of those presumably abandoned checks go to the state where MoneyGram is incorporated (Delaware) or to the states where the checks were purchased (various states)?

Under the priority rules propounded by the U.S. Supreme Court, unclaimed property generally goes to the state of the last known address of the owner based on books and records; if that address is unknown, then the unclaimed property goes to the state of incorporation of the debtor. [1] In the litigation, the last known address of the owners of the checks is unknown, which would generally mean that Delaware gets to take custody of the checks under the Supreme Court's priority rules.

However, Congress enacted a federal statute called the Disposition of Abandoned Money Orders and Travelers Checks Act. [2] Under that statute, sums payable on instruments, and specifically on money orders, traveler's checks and similar written instruments on which a company is liable, are to be reported to the state where the instruments were purchased, rather than to the state of incorporation. [3] Assuming the statute applies, then, the MoneyGram checks should go into the custody of the states where the checks were purchased, not Delaware.

How did Delaware and the states come into conflict over the MoneyGram checks? Pennsylvania audited MoneyGram and, relying on the federal statute cited above, sought the sums payable on over 150,000 MoneyGram checks purchased in Pennsylvania (there is no address for the owners), with a total value of over $10,000,000 for a nine-year period. Pennsylvania learned that the sums payable on the checks had already been reported to Delaware. Pennsylvania then reached out to Delaware and requested the money, and Delaware refused to provide it, leading to litigation being filed.

For its part, MoneyGram is caught in the middle. MoneyGram cannot keep both sides happy (Delaware and the states of purchase want to take custody of the exact same money from the presumably abandoned MoneyGram official checks).

Because this is a lawsuit between states, original jurisdiction lies with the U.S. Supreme Court. The Court must decide whether the federal statute applies or the more general priority rules apply to MoneyGram official checks (assuming a settlement cannot be reached).

Currently, the cases are before a special master (Pierre N. Leval, of the U.S. Court of Appeals for the Second Circuit, who is handling the case management).

Crutchfield v. Massachusetts—a Massachusetts nexus dispute in the Virginia courts

Crutchfield Corp., an online retailer, has filed a complaint for declaratory judgment in Virginia circuit court, asking the court to declare that Crutchfield lacks nexus with Massachusetts and that Massachusetts' economic nexus regulation is invalid and unconstitutional as applied to Crutchfield.

The lawsuit was filed in 2017, before the U.S. Supreme Court decided *Wayfair.* Recently, the Massachusetts Department of Revenue has argued that *Wayfair* undermines the constitutional claims in the complaint and renders the suit moot. Crutchfield, however, has sought discovery in the case, including internal documents and emails relating to the drafting, publication, and promulgation of the regulation.

For purposes of this article, the striking thing about the lawsuit is that it is being litigated in the Virginia courts. How is Crutchfield able to have a Massachusetts nexus controversy heard in Virginia state court?

The answer is that Virginia has enacted a statute allowing businesses organized or qualified to do business in Virginia to obtain a declaratory judgment ruling in Virginia circuit court addressing whether another state's sales or use tax nexus assertion produces "an undue burden on interstate commerce" under the U.S. Constitution. [4] A few other states, including New Hampshire, have also contemplated such a statute. The rationale for enacting such a statute is that a local state court will be a friendlier forum for a local business to argue a constitutional issue than will the state courts of the foreign state asserting nexus.

Besides the obvious question of how the Virginia circuit court will decide the case, a more fundamental jurisdictional issue lurks on the constitutionality of statutes authorizing local courts to adjudicate the constitutionality of a foreign state's nexus assertion. It is possible that there will be language in the opinion issued for the next case we will discuss that resolves that issue.

Franchise Tax Board v. Hyatt—tort claims against the FTB in Nevada state court

A case currently before the U.S. Supreme Court poses the question of whether a taxpayer can bring state tort claims in local state court against an out-of-state tax department.

The taxpayer, Hyatt, was a longstanding California resident. He made lots of money licensing fees on technology patents. Effective October 1, 1991, he began filing tax returns as a California nonresident (and a resident of Nevada, which does not impose a personal income tax). The California Franchise Tax Board ("FTB") audited his 1991 tax return and asserted that Hyatt's move to Nevada did not occur until later.

It was not a routine audit. The FTB sent over 100 letters and demands for information, including to third parties such as banks, utility companies, medical providers, Hyatt's attorneys, and other contacts of Hyatt. The FTB also conducted interviews with Hyatt's estranged relatives and requested signed statements from them. Auditors traveled to Nevada and to his past and current addresses seeking information, allegedly peering in windows and rifling through his trash.

At the conclusion of the audit, a $6 million assessment was issued. Hyatt filed two protests challenging the audit results that weaved through the California appeals process for over 11 years, and that involved three different auditors.

In the meantime, while the protests were wending through the California administrative appeals process, Hyatt filed tort claims in Nevada state court, asserting that the FTB must pay damages for negligent misrepresentation, intentional infliction of emotional distress, fraud, invasion of privacy, abuse of process, and breach of a confidential relationship. He sought compensatory and punitive damages from the FTB, and a declaratory judgment that he was a resident of Nevada during the period in question.

A (very) sympathetic Nevada jury awarded Hyatt over $400,000,000 (not a typo) from the FTB. The Nevada Supreme Court set aside most of the claims, but affirmed the portion of the lower-court judgment based on fraud. It then applied a damages cap, leaving Hyatt with substantially less than he had been awarded by the jury.

The U.S. Supreme Court will address whether it was permissible to sue the FTB in Nevada state court at all. Specifically, it will address whether *Nevada v. Hall,* [5] the leading case governing suing one state in another state's courts, should be overruled. Briefly, in *Nevada v. Hall*, the Supreme Court concluded that the State of Nevada could be sued in California state court when a University of Nevada employee driving an automobile owned by Nevada collided with California residents on a California highway. The Court held that neither sovereign immunity nor the full faith and credit clause barred the suit.

As of this writing, oral argument has not been held before the U.S. Supreme Court. While most commentators expect that the Court will overrule *Nevada v. Hall,* there is no telling what the Court will do or exactly how sweeping or narrow its opinion will be. One thing to watch is whether the language in the Court's opinion has any relevance to statutes like the Virginia one discussed above. A broad opinion in the FTB's favor could bar *any* suits involving state tax agencies in out-of-state courts, whereas a more narrow ruling in the FTB's favor might only bar claims for damages, while still allowing for declaratory judgments on legal questions.

Conclusion

With rare exception, the *FTB v. Hyatt* audit being a case in point, state tax controversies tend to be more genteel than commercial business disputes. But state tax litigation no longer consists simply in appealing assessments, filing refund claims, and challenging them if denied. We are now in a world in which tax authorities are suing one another, whistleblowers are challenging alleged tax fraud in state courts, class action plaintiff attorneys are carefully scrutinizing checkout receipts to make sure tax is not erroneously being charged, and, depending on how the U.S. Supreme Court rules in *FTB v. Hyatt*, it may be possible to bring suits against out-of-state tax authorities in local courts. Anyone practicing in the space should keep an eye on the new contexts in which state tax lawsuits are arising, and the ways that state tax authorities are being challenged (and taxpayers are being sued) outside the usual administrative and judicial channels.

[1] *See, e.g., Texas v. New Jersey*, 379 U.S. 674 (1965).

[2] 12 U.S.C. §§ 2501–2503.

[3] 12 U.S.C. § 2503.

[4] *See* Va. Code Ann. § 8.01-184.1.

[5] 440 U.S. 410 (1979).