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Go Crazy, Folks . . . But Not Too Crazy:¹ California Court Ponders Remedy For Macy's Victory Over San Francisco

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A taxpayer wins its case - the city's tax scheme is held to be unconstitutional – but before getting soaked in victory champagne, let's talk damages. Should the taxpayer receive a refund of all taxes paid under the unconstitutional taxing scheme, or only an amount sufficient to cure the discriminatory effect of the tax? In *Macy's Department Stores Inc. v. San Francisco*,² the California Court of Appeals chose the latter remedy, consistent with the holding of *McKesson Corp. v. Florida Alcohol and Tobacco Div.*³

Unfortunately, the small award of damages is unlikely to deter taxing authorities from enacting unconstitutional tax schemes in the future. If compensatory damages are insignificant, can a case be made for punitives?

Nothing But A Little Pine Tar - San Francisco's Unconstitutional Ordinance

Ordinances in effect between 1995 and 1999 required businesses operating in San Francisco to separately calculate tax liability for payroll expense and gross receipts taxes, and pay the greater of the two. Macy's Department Stores Inc. ("Macy's") filed claims against the city and county of San Francisco for refunds of all taxes paid during the relevant period.

Macy's argued that San Francisco's business tax scheme failed (i) the internal consistency test used to determine whether state or local taxes violate the Commerce Clause of the U.S. Constitution, and (ii) corresponding provisions of the California Constitution. According to Macy's, San Francisco's "tandem tax" could hypothetically discriminate against intercity taxpayers who could be subject to tax under a payroll expense measure in one jurisdiction and under a gross receipts measure in another, unlike a local taxpayer who would pay tax only to San Francisco under only one

¹ "Go crazy, folks! Go crazy!" is one of the famous phrases uttered by the late Jack Buck, St. Louis Cardinals radio broadcasting legend, when Ozzie Smith hit a walk-off home run in Game 5 of the 1985 National League Championship Series. The Cardinals would go on to win the NLCS against the Dodgers, but lose to Kansas City in a heartbreaker World Series. Jack's son, Joe Buck, called the game for FOX last month when the Cardinals won their first World Series Championship since 1982. Go Cards!

² ___ Cal. Rptr. 3d ___, 2006 WL 2960743 (Cal. Ct. App. Oct. 18, 2006).

³ 496 U.S. 18 (1990).

measure. Macy's made no claim that it paid any actual excess taxes under San Francisco's tandem tax scheme.

The trial court held in favor of Macy's, ruling that (i) San Francisco's tandem payroll and gross receipts tax scheme was unconstitutional because it failed the internal consistency test, and (ii) the court was compelled by *General Motors Corp. v. City and County of San Francisco*⁴ to award Macy's a full refund of all local business taxes paid.

When Winning Is Not Enough⁵ - Appellate Court Weighs-In

The appellate court reversed the trial court's award of a full refund, holding that Macy's should receive a partial refund in an amount sufficient to remedy any potential discriminatory burden imposed by the city's tandem tax for the years in question.⁶ The appellate court held that the parameters of state afforded relief are made clear in *McKesson*, which concluded that when a tax scheme is found unconstitutional "only in so far as it operated in a manner that discriminated against interstate commerce," the taxing authority "retains flexibility in responding to this determination."⁷ A taxing authority "may cure the invalidity of the [tax] by refunding to [the taxpayer] the difference between the tax it paid and the tax it would have been assessed were it extended the same [preferential treatment] that its competitors actually received."⁸

The appellate court rejected the trial court's reliance on *General Motors* as providing the definitive measure of a refund. In *General Motors*, the court examined a facially invalid tax enacted by a taxing authority that placed the burden upon the taxpayer to demonstrate double taxation in order to secure a refund. The appellate court distinguished the instant case from *General Motors*, maintaining that it is only the tandem interaction of San Francisco's payroll and gross receipts taxes that violates the commerce clause under the internal consistency test. Both the payroll and gross receipts taxes are valid in isolation. There was no claim that San Francisco's proposed remedy (a partial refund) would not cure the discriminatory effect of the tandem tax scheme, and a full refund is not required because the tax was not beyond the city's power to impose. Accordingly, the appellate court held that San Francisco may limit Macy's tax refund to the amount necessary to remedy any discrimination from the tandem tax. To allow Macy's a full refund of all business taxes paid during the period at issue would place Macy's in a more favorable position than a local taxpayer.

⁴ 69 Cal. App. 4th 448 (Cal. 1999).

⁵ When is winning the World Series not enough? ANSWER: when it is won by a team not from New York with an 83-78 regular season record ... but enough from the critics.

⁶ San Francisco appealed the amount refunded to Macy's, but did not appeal the determination that its tax scheme was unconstitutional.

⁷ *McKesson*, 496 U.S. at 39.

⁸ *Id.* at 40.

Cardinal Effort – Can A Case Be Made For Punitives?

At the trial court, Macy's experts argued that a partial refund is bad policy because it would not serve to sufficiently deter local governments from enacting invalid tax measures. Macy's policy arguments were not addressed by the appellate court, but they are worthy of comment here.

In the Respondents' Brief before the appellate court,⁹ Macy argued that a full refund is necessary to serve the weighty policy interests of the United States and California Constitutions in protecting the integrity of interstate and intercity commerce. A remedy that redresses taxation that violates the commerce clause must be sufficient to provide strong disincentives, dissuading taxing authorities from enacting such taxes. A partial refund (i) eliminates the incentives for taxpayers to challenge unconstitutional tax schemes; (ii) directly encourages governmental agencies to engage in unconstitutional conduct; (iii) causes taxpayers and courts to engage in complex and costly factual analysis to determine the "proper" refund; and (iv) incentivizes taxpayers to choose between challenging a tax on internal consistency grounds and obtaining a partial refund, or basing its constitutional challenge on a more difficult or complex constitutional standard that would provide for a complete remedy.

Assuming that the appellate court is correct that *McKesson* restricts the amount of refund to which Macy's is entitled, rather than merely setting the minimum standard of relief, the partial refund fails to act as a deterrent against future unconstitutional tax schemes. Although the appellate court failed to address Macy's public policy concerns, one could imagine the court's response might be that the purpose of a refund is to make taxpayers whole, not to punish taxing authorities.

While one can agree in principle that Macy's should not be placed in a better position than in-city taxpayers, why can't a case be made for punitives? Generally, the answer is that state and local governments generally are immune in state¹⁰ and federal¹¹ court from the imposition of punitive damages, unless immunity is waived. Further, there is legitimate concern over who would bear the ultimate cost of a punitive damage award

⁹ 2006 WL 937615.

¹⁰ See, e.g., Cal. Gov't Code § 818 ("Notwithstanding any other provision of law, a public entity is not liable for damages awarded under Section 3294 of the Civil Code or other damages imposed primarily for the sake of example and by way of punishing the defendant"); *Salinas v. Souza & McCue Constr. Co.*, 424 P.2d 921, 926 (Cal. 1967) ("the levying of punitive damages against a public entity has not been authorized").

¹¹ See, e.g., 11 U.S.C. § 106(a) (State sovereign immunity under the Eleventh Amendment is abrogated for certain federal Bankruptcy Code purposes. While the Bankruptcy Court can award money damages against state and local government agencies, it cannot make an award of punitive damages); *Cox v. State of California Franchise Tax Board*, 2004 WL 2537291 (W.D.Tex. Aug. 10, 2004) (providing that "[g]enerally, states and local government entities are immune from punitive damages under [42 U.S.C. § 1983]. Under the Supreme Court's holding in [*City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247 (1981)], deterrence of constitutional violations is adequately accomplished by allowing punitive damage awards directly against the responsible individuals, rather than the government entities themselves. Thus, while punitive damages may be available 'in a proper case under Section 1983,' they are not available against the Defendant branch of California state government in this case.")

against a taxing authority.¹² But some form of deterrent is needed to address the never ending commerce clause violations by state and local governments. What will stop constitutional violations if the taxing authorities have little if any incentive to behave? If the state courts will not help, maybe U.S. Congress will – after all, it is their constitution that is being abused.■

¹² See, e.g., California Attorney General Opinion 81-506 (May 5, 1982) ("The California Law Revision Commission indicated that it was inappropriate to subject a public entity to liability for punitive damages since such damages are imposed for wrongdoing (oppression, fraud, malice) and the impact falls not on the wrongdoer (public entity or public employee) but upon the innocent taxpayer"); see also, 1 Linda L. Schlueter & Kenneth R. Redden, *Punitive Damages* 194 (4th ed. 2000) (stating that "most courts ... refused to make punitive damages for wrongful acts of agents and employees against public entities" because the cost is imposed on citizens).



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