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# Gone Too Far: Louisiana's Credit Cut Violates Commerce Clause

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In this installment of Tackling SALT, the authors discuss implications of the Supreme Court of Louisiana's decision in *Smith v. Department of Revenue*.

In December 2018 the Louisiana Supreme Court upheld a decision from the 19th Judicial District Court of East Baton Rouge Parish that declared Louisiana Act 109 of 2015 unconstitutional for discriminating against interstate commerce.[1] The act, which amended La. Rev. Stat. 47:33, disallowed an income tax credit to Louisiana residents for taxes paid to another state if that state did not offer a reciprocal credit to its own residents for conducting business and being subject to tax in Louisiana. In addition, the act limited the credit to the amount of tax that would have been paid on the income in Louisiana.[2] This article discusses Louisiana's fiscal climate leading up to the 2015 regular legislative session, examines the ramifications of Act 109 on Louisiana residents with multistate businesses, and considers the implications of the courts' rulings that the act violated the commerce clause of the U.S. Constitution in *Smith v. Department of Revenue*.

## Louisiana's Fiscal Crisis of 2015

Louisiana was facing a $1.6 billion budget shortfall heading into its 2015 regular legislative session. When the session convened April 13, 2015, the budget crisis was the worst the state had seen since the late 1980s, when former Gov. Buddy Roemer inherited a $1 billion deficit caused in part by the drastic nationwide drop in oil prices during the preceding decade. Because of its heavy reliance on the oil and gas industry, Louisiana generates a significant amount of revenue from mineral taxes, and at the height of the 2015 budget crisis some critics placed the blame for the state's financial predicament on another recent oil price downturn. However, many legislators and local economists argued that the deficit had more to do with the state's reliance on unsustainable revenue reserve accounts in recent years. In 2005, before the administration of former Gov. Bobby Jindal, Louisiana benefited from federal recovery funding after hurricanes Katrina and Rita. Around the same time, oil and gas prices experienced a surge, temporarily stimulating the economy and generating mineral tax revenue. The state was also benefiting from high levels of sales tax revenue and gambling proceeds. When Jindal took office at the beginning of the Great Recession in 2008, these accumulated surplus accounts started to be used to fund various state programs, while Jindal's no-tax-increase pledge essentially prevented any revenue-raising legislative changes that could have propped up the draining reserves. Thus, year after year, from 2008 onward Louisiana was spending more money than it was taking in.

[1] *Ivan I. Smith Jr. v. Kimberly L. Robinson, Secretary of the Department of Revenue, State of Louisiana*, 2018-CA-0728 (La. 2018).

[2] La. Rev. Stat. 47:33(A)(4).



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By the start of the 2015 regular session, the state was approaching a major fiscal crisis, and the debate over how to close the funding gap was one of the focal points of the session.

Because of the structure of Louisiana's budget and appropriations process, one of the only ways to significantly reduce state spending without a constitutional amendment is to reduce funds generally allocated to state healthcare and higher education. As a result, many Louisiana residents were concerned that the legislative session would bring further cuts to higher education that the state university system could not handle as per-student funding had fallen more than 40 percent since the start of the recession.[3] Also, healthcare funding was on the budgetary chopping block, with budget proposals failing to provide the funding to maintain the state charity hospital system and neighborhood clinics for uninsured residents. Ultimately, higher education and healthcare were spared from the 2015 budget overhaul by a series of tax cuts and modifications. One of the key features in the Legislature's plan for reversing the deficit was to cut back many credits and deductions by 28 percent for both businesses and individuals. The Legislature enacted these changes without regard to the practical effect the changes might have on taxpayers. The percentage decrease was enacted simply because it was the easiest way to increase revenues and balance the budget. Unfortunately, the cutbacks, which were not substantiated by sound tax policy, had the effect of making reporting and remitting taxes more challenging for both taxpayers and practitioners.

## Credit Limitations as a Means to Reverse the Deficit

The majority of the tax incentive and deduction cuts were temporary provisions due to expire within one to three years after enactment. One of the more significant measures was signed into law under Act 123, which limited some corporate deductions and exclusions, such as net operating losses[4] and the deduction for interest and dividends,[5] for returns filed on or after July 1, 2015.[6] The focus of this article — a modification to the credit for taxes paid to other states — was signed into law under Act 109 on June 19, 2015. Unlike many of the other changes and modifications enacted during the 2015 regular session, this modification did not merely reduce the amount of credit available; rather, it offered an opportunity for Louisiana to update its credit for taxes paid to other states to incorporate language found for this type of credit in many other states.

## Act 109 — The Credit Limitations

Before the changes enacted under Act 109, the Louisiana statutes allowed Louisiana residents a credit for net income taxes imposed by and paid to another state upon income that was also taxable in Louisiana.[7] To be eligible for the credit, the income was required to have been subject to taxation in the other state regardless of the residence or domicile of the taxpayer.[8] Also, the credit was allowed to be claimed only during the same tax period in which the tax liability arose in the other state.[9]

Act 109 added three restrictions to the credit for taxes paid to other states:

1. the credit would be allowed only if the other state provided a credit for Louisiana income taxes paid on Louisiana-source income for its residents;[10]
2. the credit would be limited to the amount of Louisiana income tax that would have been imposed if the foreign-source income had been earned in Louisiana;[11] and

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[3] Center on Budget and Policy Priorities calculation using the Grapevine higher education appropriations data from Illinois State University, enrollment and combined state and local funding data from the State Higher Education Executive Officers Association, and the consumer price index, published by the Bureau of Labor Statistics.

[4] La. Rev. Stat. 47:287.86.

[5] La. Rev. Stat. 47:287.738(F)(1).

[6] The deduction from gross income for NOLs was limited to the lesser of 72 percent of taxable income or 72 percent of the NOL carryforward. The deduction for interest and dividends was limited to 72 percent of the amount otherwise included in gross income.

[7] La. Rev. Stat. 47:33 (effective before July 1, 2015).

[8] La. Rev. Stat. 47:33(A)(1) (effective before July 1, 2015).

[9] La. Rev. Stat. 47:33(A)(3) (effective before July 1, 2015).

[10] La. Rev. Stat. 47:33(A)(4).

[11] La. Rev. Stat. 47:33(A)(5). A later modification to this provision also limited the credit so that it would not be allowed for tax paid on income that is not subject to Louisiana tax. La. Rev. Stat. 47:33(5)(b) (effective June 12, 2018).



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3. the credit would not be allowed for taxes paid to another state that allows a nonresident a credit for the taxes imposed by that state for taxes paid or payable to the state of residence.[12]

The new law took effect July 1, 2015, and applied to all income tax returns filed on or after that date, regardless of the tax year for which the return was filed.[13] The provisions of Act 109 were scheduled to expire July 1, 2018, and any portion of the credit that was disallowed under the new law for tax returns filed after July 1, 2015, for which a valid extension was filed before July 1, 2015, was to be allowed against taxable income in one-third increments during each of the tax years 2017, 2018, and 2019.[14] This mid-calendar-year effective date had many individual taxpayers scrambling to file their extended 2014 income tax returns before July 1, 2015 in an attempt to take advantage of the credit before the new limitations were effective.

Also, on June 12, 2018, after the close of the 2018 Louisiana second extraordinary session, Louisiana enacted Act 6, which further limited the availability of the credit so that it is not allowed for tax paid on income that is not subject to tax in Louisiana.[15] In addition to extending the limitation provisions enacted under Act 109 through June 30, 2023,[16] Act 6 provided that the credit shall not exceed the taxpayer's Louisiana income tax liability, subject to a ratio equal to the proportion of the taxpayer's Louisiana taxable income that is attributable to other states and upon which net income taxes were paid in other states.[17]

Finally, Act 6 provides that for taxes paid on or after January 1, 2018, an individual partner, member, or shareholder who pays another state's entity-level tax that is based solely upon net income included in the entity's federal taxable income shall be allowed a deduction equal to their proportionate share of the entity-level tax paid, to the extent that the individual includes their proportionate share of the related income in their calculation of Louisiana taxable income.[18]

## Double Taxation

The law changes set forth in 2015 under Act 109 sparked controversy by creating the potential for double taxation on the income of Louisiana residents with interests in multistate passthrough businesses. Namely, Louisiana residents with income sourced to another state not offering reciprocal credits are taxed twice on the same source of income, because under these circumstances, the provisions of Act 109 disallow the Louisiana credit that would otherwise relieve the burden of double taxation. Following the enactment of Act 109, objections were mounting from Louisiana residents with multistate businesses, particularly those performing work in neighboring Texas. While Texas does not assess an outright "income tax," it does collect an entity-level franchise tax, known as the Texas margins tax, based on gross receipts from business conducted in the state.[19] This entity-level tax is imposed on passthrough entities that are not typically subject to entity-level income taxes. As a result of Act 109, the Louisiana Department of Revenue began denying residents a credit for their share of margins tax paid to Texas, at least in part because of the change in law. In response, taxpayers argued that Act 109 violated the commerce clause, favoring intrastate business over interstate business. Ultimately, the Louisiana Supreme Court heard the case *Smith v. Department of Revenue*[20] to rule on the constitutionality of Act 109.

### *Smith v. Department of Revenue*

The taxpayers in *Smith* were Louisiana residents who owned interests in passthrough entities that transacted business in Louisiana, Texas, and Arkansas.[21] The entities in which the taxpayers had an interest paid the appropriate Texas margins tax assessed on their share of the

[12] La. Rev. Stat. 47:33(A)(6).

[13] La. 2015 H.B. No. 402 section 3(A).

[14] La. 2015 H.B. No. 402 section 3(C).

[15] La. Rev. Stat. 47:33(A)(5)(b).

[16] Act 6, 2018 2nd Extraordinary Session of the Louisiana Legislature.

[17] La. Rev. Stat. 47:33(A)(5)(b).

[18] La. Rev. Stat. 47:33(A)(7).

[19] Tex. Tax Code Ann. section 171.001(a).

[20] *Smith*, 2018-CA-0728.

[21] *Id.*



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Texas-source income.[22] The taxpayers then claimed a credit for the Texas tax on their 2015 Louisiana resident individual income tax return, which included the Texas-source income in the calculation of Louisiana taxable income.[23] The Louisiana Department of Revenue denied the taxpayers' credit claim, contending first that the Texas margins tax was not an income tax for purposes of applying La. Rev. Stat. 47:33, and second, under the provisions of Act 109, that Texas did not offer a reciprocal credit.[24] The taxpayers paid the amount of credit denied under protest and later filed a petition for refund of tax paid under protest.[25]

The language of La. Rev. Stat. 47:33 allows a credit only for net *income* taxes paid to other states. Therefore, the court first set out to determine whether the Texas margins tax was a de facto income tax under the application of the definition in the credit statute. Relying on the appellate court decision in *Perez v. Department of Revenue*,[26] the court held that the term "franchise tax" is not a controlling factor when determining the classification of the tax, and that the Texas tax "is a net income tax imposed by and paid to another state on income also taxable under Louisiana's income tax laws, as required for the application of LSA-R.S. 47:33."[27]

The court then set out to determine the constitutionality of Act 109 under the commerce clause. Using the four-part test to assess the validity of state taxes under the commerce clause established by the U.S. Supreme Court in *Complete Auto Transit Inc. v. Brady*, the court held that Act 109 violated the fair apportionment and discrimination prongs of the *Complete Auto* test.[28] The apportionment test ensures that a state taxes only its fair share of income generated from an interstate transaction, while the discrimination test ensures that states do not impose a tax that discriminates against interstate commerce by providing a direct advantage to local businesses.[29]

In reviewing the fair apportionment prong of *Complete Auto*, the court noted that fair apportionment requires both internal and external consistency.[30] The internal consistency test requires a review of a tax's structure to determine whether an identical application in every state would disadvantage interstate commerce as compared with intrastate commerce.[31] External consistency, on the other hand, focuses on the "economic justification" of a state's claim to the value it taxes.[32] The court also stated that the "threat of real multiple taxation . . . may indicate a State's impermissible overreaching" regarding the external consistency test of the fair apportionment prong of *Complete Auto*.[33] The court agreed with the taxpayers' argument that Act 109 failed to fairly apportion the tax according to each state's relation to the income, and therefore created the potential for double taxation on the income, failing the external consistency test.[34]

Next, the court investigated Act 109 under the discrimination prong of *Complete Auto*.[35] The taxpayers argued that Act 109 discriminated against interstate commerce because of the requirement that a reciprocal credit exist for the credit to be allowable.[36] This requirement would, in the taxpayers' case, essentially lead to double taxation of Texas-source income; since Louisiana

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Perez v. Secretary of the Louisiana Department of Revenue and Taxation*, 731 So. 2d 406 (La. Ct. App. 1999). Since the inception of the Texas margins tax, states and taxpayers have often disagreed over whether the margins tax, which is imposed not on individuals but on entities, including passthrough entities, is a creditable tax for states with laws similar to Louisiana's. Interestingly, however, Louisiana had addressed the issue of whether the Texas tax was a creditable tax for purposes of La. Rev. Stat. Ann. 47:33 in 1999 in *Perez*. In that case, the Louisiana appellate court ultimately held that for the Texas margins tax paid by an S corporation, a credit was allowed for the individual on his Louisiana income tax return because the margins tax is a net income tax and the income in question was also taxable in Louisiana. The Louisiana Department of Revenue acquiesced to this treatment in 2003. La. Statement of Acq. No. 03-001 (Sept. 10, 2003). Despite that acquiescence, after the passage of Act 109 continuing through *Smith*, the Department of Revenue reverted to its prior position that the Texas margins tax was not an income tax.

[27] *Smith*, 2018-CA-0728, *citing Perez*, 731 So. 2d.

[28] *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

[29] *Smith*, 2018-CA-0728.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*



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would not allow a credit for the Texas margins tax, the taxpayers' Texas-source income would be subject to income tax in both Texas and Louisiana. Taxpayers also argued that the provision in Act 109 that limited the credit to the amount of Louisiana income tax a taxpayer would have paid also discriminated against interstate commerce because essentially some portion of a taxpayer's out-of-state income may always be taxed twice.[37] Because of these factors, and relying on the Supreme Court's *Comptroller of the Treasury of Maryland v. Wynne*,[38] the court found that Act 109 discriminated against interstate commerce by creating double taxation of interstate income while preventing double taxation of intrastate income.[39] In failing these two prongs of the *Complete Auto* test, Act 109 was determined to be unconstitutional by violating the commerce clause of the U.S. Constitution.[40]

In February 2019 the Department of Revenue filed an application for a rehearing of the court's opinion to consider the severability of the subparts of Act 109.[41] During the rehearing, the court determined that only one part of Act 109, the part that disallowed the credit if the other state did not provide for a reciprocal credit, violated the commerce clause, as opposed to the entirety of the act being unconstitutional.[42] Thus, the portion of Act 109 that limited the credit to the amount of income tax that would have been imposed by Louisiana was deemed constitutional and is still in effect.[43] As a result, after the final decision in *Smith*, credits for taxes paid to other states will be allowed regardless of whether the other state has a similar credit, but the credit will still be limited to the amount of tax that would have been paid if the income had been earned only in Louisiana.

### Unconstitutional? Not in Other States

The holding in *Smith* was surprising for a number of reasons. First, though the checks and balances of a federal system of government give the power to determine constitutionality of laws to the judicial branch, the judicial branch's finding of unconstitutionality for a duly passed law is, in itself, a fairly rare occurrence. However, the most surprising thing about the initial Louisiana Supreme Court decision was the fact that many other states have similar laws in terms of limiting the credit to the tax that would have been imposed by the resident state on the credited income.[44] Thus, commentators were generally surprised by the breadth of the initial ruling on constitutionality. However, the court soon modified its position upon rehearing and limited the unconstitutional ruling to the portion of the law that disallowed the credit if the other state did not provide a similar credit for Louisiana income taxes paid. The revision of the first decision in *Smith* brought Louisiana back in line with other states' treatment of the exceedingly common credit for taxes paid to other states.

### How to Get My Refund? Another Wrinkle

As discussed above, Act 109 and its modifications to the credit for taxes paid to other states were passed in June 2015 and were effective from July 1, 2015, until the decision on constitutionality was reached in December 2018. Since the law was declared unconstitutional, many taxpayers and tax practitioners scrambled to file claims for refunds for tax year 2014 before December 31, 2018, for any tax returns affected by the midyear law change in 2015.[45] However, because of a provision in Louisiana law in effect at the time that required that original tax payments be made under protest in order to recover them, taxpayers were also urged to file a claim against

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[37] *Id.*

[38] *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015) (holding that Maryland's crediting scheme, which allowed residents a credit against the state portion of its income tax, but not the local portion, violated the commerce clause by failing the internal consistency test because if every state had Maryland's income tax structure, intrastate commerce would receive a tax benefit as opposed to interstate commerce).

[39] *Smith*, 2018-CA-0728.

[40] *Id.*

[41] *See Smith*, 2018-CA-0728.

[42] *Id.*

[43] *Id.*

[44] *See, e.g.*, Ga. Code Ann. 48-7-28 (stating that the credit cannot exceed the tax that would be payable to Georgia on a like amount of taxable income); and Miss. Code Ann. 27-7-77(2) (stating that the credit may not exceed the amount computed by applying the highest Mississippi rates to the net taxable income reported to the other state).

[45] In Louisiana, no refund or credit for overpayment shall be made unless a claim for a credit or refund has been filed with the secretary of the Department of Revenue within three years from December 31 of the year in which the tax was due. La. Rev. Stat. 47:1623(A). Thus, all claims for refund for the 2014 tax year, for which tax payments were due in 2015, were due by December 31, 2018.



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the state with the state tax adjudicatory body, the Louisiana Board of Tax Appeals.[46] As a result, at the end of 2018, there was a flurry of activity related to the *Smith* decision. Since then, however, the law on the availability of refunds of overpayments has been changed so that now refunds are available in cases when the overpayment was caused by an unconstitutional law.[47] Thus, a payment under protest and subsequent recovery suit are no longer required in the instance when recovery is based on the unconstitutionality of a tax law. Taxpayers and tax practitioners are still awaiting guidance from the Louisiana Department of Revenue on how this new law change may affect the procedure to claim refunds related to the *Smith* decision and the unconstitutionality of Act 109.

## Conclusion

In the summer of 2015 Louisiana confronted its ongoing budgetary struggles. The Legislature tried to manage the state's fiscal issues through various revenue-raising measures, including modifications to the credit for taxes paid to other states. Unfortunately, the Legislature did not foresee the impact the changes would have on the predictability and stability of the Louisiana tax laws, especially for taxpayers who had historically claimed the credit for taxes paid to other states, particularly in Texas. Ultimately, this situation led to the Louisiana Supreme Court declaring the modifications to the credit for taxes paid to other states unconstitutional. This unconstitutionality led to a whole host of other issues in tax administration for taxpayers, as uncertainty still remains, nearly a year later, on how best to claim refunds for overpaid taxes relating to the unconstitutional changes made in Act 109. Now, taxpayers are still left wondering when, and how, they may ever recover amounts rightly theirs because of unconstitutional tax laws. ■

[46] *See* La. Rev. Stat. 47:1621(B)(10) (effective until June 18, 2019). Under this version of the statute, refunds of overpayments were allowed only in specific situations, which did not include situations in which the law was later found to be unconstitutional.

[47] *See* La. Rev. Stat. 47:1621(b)(10) (effective June 18, 2019).


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