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NOTES

St. Ledger v. Kentucky Revenue Cabinet: The Tax that Would Not Die

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INTRODUCTION

Early this decade, Mr. Herschel St. Ledger, a retired civil engineer and resident of Anchorage, Kentucky, learned that Indiana's intangibles tax¹ had been declared unconstitutional in 1988.² The Marion Superior Court held that the tax unlawfully restricted interstate commerce by providing a commercial advantage to Indiana businesses, the stock of which was exempt from the tax. In response to the ruling, the Indiana General Assembly repealed the tax in 1989.³

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¹ An "intangibles" tax is an ad valorem tax on intangible property, including shares of stock, notes, accounts, bank deposits, patents, copyrights, and trademarks.

² See *Indiana Dep't of State Revenue v. Felix*, 571 N.E.2d 287 (Ind. 1991) (invalidating portions of sections 6-5.1-1-1(2) and 6-5.1-2-1(a) of the Indiana Code exempting people owning stock in Indiana corporations from Indiana's intangibles tax, see IND. CODE §§ 6-5.1-1-1(2) and 6-5.1-2-1(a) (West 1989)).

³ See Ken Berzof, *Tax Attack; Group Plans Court Test of State Intangibles Levy*, THE COURIER-JOURNAL (Louisville, Ky.), July 13, 1990, at C1.

Mr. St. Ledger discussed the demise of the Indiana intangibles tax with several of his friends and decided to challenge Kentucky's intangibles tax. Mr. St. Ledger and his friend, Mr. Harold Miller, also a resident of Anchorage, Kentucky, formed the Kentucky Intangibles Tax Committee in an effort to raise financial support to help defray the costs of litigation.⁴

On July 26, 1990, Mr. St. Ledger and his wife, Nicki, as the class representatives, filed a class action challenging the validity of Kentucky's intangibles tax in Jefferson Circuit Court.⁵ The primary issues were the taxation of bank deposits and shares of corporate stock and the tax's discriminatory effect. Deposits in Kentucky-based financial institutions were taxed at a lower rate than deposits in out-of-state institutions. Similarly, stock holdings in out-of-state companies were subject to the tax while holdings in Kentucky corporations were exempt. The suit alleged that the tax scheme violated the Commerce Clause of the United States Constitution,⁶ the state and federal guarantees of equal protection under the law,⁷ and a provision in the Kentucky Constitution mandating uniformity and equality of taxation.⁸ On October 19, 1995, the Supreme Court of Kentucky invalidated the tax on bank deposits on the ground that it violated the Commerce Clause;⁹ however, the court further held that Kentucky's intangibles tax on shares of corporate stock violated neither the United States nor Kentucky Constitution.¹⁰ This opinion by the Kentucky Supreme Court will be referred to in this Note as "*St. Ledger I.*"

Meanwhile, a similar challenge to North Carolina's intangibles tax had been working its way through the North Carolina courts. The North Carolina Supreme Court held in *Fulton Corp. v. Justus*¹¹ that North Carolina's intangibles tax, which provided preferences to in-state businesses, was not inconsistent with the Commerce Clause of the United

⁴ *See id.*

⁵ For convenience, this Note will follow the lead of the Kentucky courts and refer to the plaintiffs collectively as "St. Ledger."

⁶ U.S. CONST. art. I, § 8, cl. 3.

⁷ *See id.* amend. XIV, § 1; KY. CONST. § 3.

⁸ *See* KY. CONST. § 171. This section provides: "Taxes shall be levied and collected for public purposes only and shall be uniform upon all property of the same class subject to taxation within the territorial limits of the authority levying the tax; and all taxes shall be levied and collected by general laws."

⁹ *See St. Ledger v. Kentucky Revenue Cabinet*, 912 S.W.2d 34, 39 (Ky. 1995) ("*St. Ledger I.*"), *vacated and remanded*, 116 S. Ct. 1821 (1996).

¹⁰ *See id.* at 43; *see also infra* notes 327-32 and accompanying text.

¹¹ *Fulton Corp. v. Justus*, 450 S.E.2d 728 (N.C. 1994), *rev'd sub nom. Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

States Constitution.¹² The United States Supreme Court granted *certiorari* and reversed the decision of the North Carolina Supreme Court. In *Fulton Corp. v. Faulkner*,¹³ a unanimous Court held that the intangibles tax levied in North Carolina discriminated against interstate commerce in violation of the Commerce Clause.¹⁴

Before *Fulton Corp.* was decided, the *St. Ledger* case also went to the United States Supreme Court. Because the effect of the Kentucky intangibles tax scheme was indistinguishable from North Carolina's,¹⁵ the Court's decision in *Fulton Corp.* mandated abolition of the Kentucky intangibles tax insofar as it provided exemptions for in-state companies. Consequently, the United States Supreme Court vacated the Kentucky Supreme Court's decision.¹⁶ On remand, the Kentucky Supreme Court held that the entire tax was invalid because the exemption for in-state companies was not severable from the tax scheme.¹⁷ In determining to what extent refunds would be paid, however, the court rejected the taxpayers' argument that refunds should be available for anyone who paid the tax within two years of the date *St. Ledger I* was filed. Instead, the court held that the limitations period for taxpayer refunds was two years from the date of tax payment, as provided by section 134.590(2) of the Kentucky Revised Statutes.¹⁸ This opinion on remand of the Kentucky Supreme Court will be referred to in this Note as "*St. Ledger II*."

Part I of this Note provides a historical overview of the administration of intangibles tax schemes in Kentucky and other states, focusing primarily on exemptions for in-state companies.¹⁹ Part II of this Note explores the use of the compensatory tax doctrine²⁰ as a defense to an allegation of state tax

¹² See *id.* at 735.

¹³ *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

¹⁴ See *id.* at 327; see also *infra* notes 185-206 and accompanying text.

¹⁵ See *infra* notes 108-09, 159-206, 337 and accompanying text.

¹⁶ See *St. Ledger I*, 116 S. Ct. 1821 (1996), *vacating* 912 S.W.2d 34 (Ky. 1995), *and remanding*.

¹⁷ See *St. Ledger v. Kentucky Revenue Cabinet*, 942 S.W.2d 893, 898 (Ky.) ("*St. Ledger II*"), *cert. dismissed*, 118 S. Ct. 27 (1997); see also *infra* notes 339-41 and accompanying text.

¹⁸ KY. REV. STAT. ANN. [hereinafter K.R.S.] § 134.590(1)-(2) (Michie Supp. 1996).

¹⁹ See *infra* notes 25-112 and accompanying text.

²⁰ A compensatory tax is a tax "designed simply to make interstate commerce bear a burden already borne by intrastate commerce." *Fulton Corp. v. Faulkner*, 516 U.S. 325, 334 (1996) (quoting *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 647 (1994)); see *infra* notes 116-28.

discrimination, concentrating particularly on challenges to state intangibles taxes.²¹ Examining the constitutional challenge to Kentucky's intangibles tax brought by the *St. Ledgers*, Part III of this Note analyzes the Kentucky Supreme Court's holdings in *St. Ledger I* and *St. Ledger II*.²² Part IV of this Note discusses the Kentucky Supreme Court's holding in *St. Ledger II* that section 134.590 mandates a limitations period for taxpayer refunds of two years from the date of tax payment, emphasizing the inherent inequities in this result.²³ After applauding the Kentucky Supreme Court's decision in *St. Ledger II* to strike down the state's intangibles tax, this Note concludes by criticizing the severe limitations that section 134.590 and *St. Ledger II* place on taxpayers' ability to collect refunds.²⁴

I. HISTORICAL OVERVIEW OF KENTUCKY'S INTANGIBLES TAX, THE EARLY CHALLENGES TO THE INTANGIBLES TAX IN KENTUCKY AND OTHER STATES, AND THE MOTIVATIONS FOR EXEMPTING SHARES OF STOCK IN "LOCAL" CORPORATIONS FROM INTANGIBLES TAXATION

A. *History of Kentucky's Intangibles Tax and the Exemption for Stock in "Local" Corporations*

The power to tax intangible property – which can include everything from shares of stock, notes, accounts, and bank deposits to patents, copyrights and trademarks²⁵ – has never been doubted in Kentucky.²⁶ The

²¹ See *infra* notes 113-230 and accompanying text.

²² See *infra* notes 231-350 and accompanying text.

²³ See *infra* notes 351-484 and accompanying text.

²⁴ See *infra* notes 485-87 and accompanying text.

²⁵ See, e.g., K.R.S. § 132.020(2) (Michie Supp. 1996) (listing classes of intangible property subject to taxation).

²⁶ Consider the breadth of the state taxing power as described by the Kentucky Supreme Court:

It is well settled that the power to impose taxes is one so unlimited in force, so searching in extent that the courts scarcely venture to declare that it is subject to any restrictions whatever, except such as rest in the discretion of the authority which exercises it. . . . Nothing but special constitutional limitation upon legislative authority can exclude anything to which the authority extends from the grasp of the taxing power, if the Legislature in its discretion shall select it for revenue purposes. . . . This extends to property whether it be tangible or intangible, and it matters not in what the intangible property consists, whether privilege, corporate franchises, contracts or obligations. It is enough that it is property, which, though

intangibles tax challenged by Herschel St. Ledger was nearly 200 years old.²⁷ The origins of the present-day version of Kentucky's recently invalidated intangibles tax system, and in particular the exemption for investment holdings in corporations,²⁸ can be traced to the 1892 Revenue and Taxation Act.²⁹ Section 4020 of the Act dictated that "[a]ll real and personal estate within this State, and all personal estate of persons residing in this State, and of all corporations organized under the laws of this State, whether the property be in or out of this State . . . shall be subject to taxation . . ."³⁰ Section 4022 of the Act prescribed that "personal estate shall include every other species and character of property – that which is tangible as well as that which is intangible."³¹ Originally, the state levied a uniform tax of \$0.425 per \$100 of value upon such property.³²

intangible, exists, which has value, produces income, and passes current in the markets of the world. To ignore this intangible property or to hold that it is not subject to taxation at its accepted value, is to eliminate from the reach of the taxing power a large proportion of the wealth of the country. Wolfe Co. v. Beckett, 105 S.W. 447, 447-48 (Ky. 1907). Cf. Judy v. Beckwith, 114 N.W. 565, 570 (Iowa 1908) ("Except where limited by some constitutional provision, the power of the state to tax is unlimited.")

²⁷ See Jack Brammer, *Tax on Intangibles Faces Concrete Fight, Critics Say Levy Hurts Business Development, Elderly*, LEXINGTON HERALD-LEADER (Lexington, Ky.), May 17, 1992, at A1. At the time of the *St. Ledger* suit, 22 states still had an intangibles tax on their books, though Kentucky's was the most comprehensive. See *id.* Some states with intangibles tax laws appear not to enforce them. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 18 n.5 to Table 6 (5th ed. 1988). Until the 1980s, Kentucky also had enforcement problems with respect to its intangibles tax. See Brammer, *supra*.

²⁸ See K.R.S. § 136.030(1). The modern version of the exemption, which was first enacted in 1924, see *infra* note 62, can be characterized as exempting from taxation shares held by residents in "local" or in-state corporations, as the exemption applied only if 75% or more of the total corporate property was located and taxed in Kentucky.

²⁹ 1892 Ky. Acts ch. 103. The modern version of the exemption can be traced to 1924. See *infra* note 62.

³⁰ KY. STAT. § 4020 (Carroll 1894). The authors do not substantially examine the Kentucky intangibles tax before 1892, as the historical origins of the current stock exemption can be traced back only as far as the Revenue and Taxation Act of 1892.

³¹ *Id.*

³² See *id.* § 4019. In contrast, the 1996 intangibles tax system imposed disparate tax rates on various types of intangibles. Compare, e.g., K.R.S. § 132.020(1) (imposing a tax of \$0.25 per \$100 of value on shares of stock, notes, and bonds)

Article III of the 1892 Revenue and Taxation Act imposed a franchise tax, essentially a tax on corporate intangible property, on public service corporations.³³ Shares in franchise corporations were not taxed if the corporation paid all taxes on corporate property and franchises.³⁴ Similarly, shares in non-franchise corporations were not taxed provided the corporation paid “the taxes on all its property of every kind.”³⁵ The plain language of these exemptions did not appear to condition their availability on a certain level of the corporation’s entire property being taxed in Kentucky. Despite the clear and precise statutory language, the Kentucky judiciary struggled in applying these exemptions to situations in which a considerable portion of the corporate property was taxed outside Kentucky.³⁶ These

with K.R.S. § 132.020(2) (imposing a tax of \$0.015 per \$100 of value on certain intangibles that do not have a taxable situs outside Kentucky).

³³ See KY. STAT. § 4077 (Carroll 1894); *Commonwealth v. Walsh’s Trustee*, 117 S.W. 398, 399 (Ky. 1909) (“Walsh’s Trustee II”).

Sections 4079, 4080, and 4081 of the Kentucky Statutes governed the determination of the value of a corporation’s franchise. For domestic corporations, the franchise’s value equaled the value of its capital stock less the assessed value of all its tangible property located and taxed in Kentucky. For foreign corporations, the franchise’s value equaled the value of its capital stock employed in Kentucky (a percentage of the total capital stock value based on the percentage of the corporation’s total gross receipts that were attributable to its business in Kentucky, or based on the percentage of the corporation’s total lines that were actually in Kentucky if the corporation was an interstate carrier) less the assessed value of all tangible property located and taxed in Kentucky. See also *id.* at 400.

The Supreme Court of Kentucky consistently interpreted the franchise tax to only apply to “corporations performing a public service.” *Providence Banking Co. v. Webster County*, 57 S.W. 14, 15 (Ky. 1900); see also *Hager v. Louisville Title Co.*, 85 S.W. 182, 182 (Ky. 1905) (“[C]orporations generally are not subject to a franchise tax . . . [and] corporations subject to a franchise tax are such as enjoy a special or exclusive privilege, or a franchise not allowed by law to natural persons, or that perform a public service.”).

³⁴ See KY. STAT. § 4088 (Carroll 1894).

³⁵ *Id.* § 4085; see *Commonwealth v. Steele*, 104 S.W. 687, 688 (Ky. 1907) (construing statute to make shareholders liable for taxation on their shares only if the corporation failed to pay its taxes).

³⁶ See *Commonwealth v. Muir*, 186 S.W. 195, 196 (Ky. 1916) (stating that “endless confusion” had resulted from the application of the exemptions for shares in franchise and non-franchise corporations); *Slater v. Commonwealth*, 179 S.W. 201, 202 (Ky. 1915) (same). Compare *Louisville & Evansville Mail Co. v. Barbour*, 88 Ky. 73, 78-79 (Ky. 1888), with *Commonwealth v. Chesapeake and O. Ry. Co.*, 77 S.W. 186 (Ky. 1903). In *Louisville & Evansville Mail Co.*, the Supreme

early cases also provide a foundation for understanding the development of the current exemption for shares in "local" corporations.

In *Commonwealth v. Walsh's Trustee* ("Walsh's Trustee I"),³⁷ the Commonwealth in 1907 sought to levy the intangibles tax on shares held by a Kentucky resident in Western Union Telegraph Company, a foreign corporation.³⁸ The state conceded that Western Union had properly paid all taxes due Kentucky, including franchise and property taxes.³⁹ However, only one percent of Western Union's property was situated and taxable in Kentucky.⁴⁰ The stockholder argued that this case was controlled by the unambiguous language of the exemption for shares in franchise corporations.⁴¹

The Kentucky Supreme Court disagreed. It determined that the General Assembly intended to tax shares of stock unless the exemption applied.⁴²

Court of Kentucky decided that the General Assembly could not have intended that "both the property of a corporation and the stock of each member of it should be taxed at the same time and for the same purpose" because "though it is not always practicable to make taxation entirely equal and uniform, the [General Assembly had] no power to directly impose double taxation." *Louisville & Evansville Mail Co.*, 88 Ky. at 80. Conversely, in *Chesapeake and O. Ry. Co.*, the Kentucky Supreme Court found it to be "well settled that the capital stock of a corporation, and the shares of stock held by the stockholders, for the purposes of taxation, may be, and generally are, entirely distinct property." *Chesapeake and O. Ry. Co.*, 77 S.W. at 188.

Even before the Revenue and Taxation Act of 1892, Kentucky courts grappled with whether the corporation's property was taxable, the shareholders' stock was taxable, or both. See *Whitaker v. Brooks*, 90 Ky. 63, 75 (Ky. 1890) ("[H]ere the statute plainly says that the corporation shall list its property; and in equally plain terms it provides that, where it is required to do so, the stockholder shall not be required to list his shares for taxation."); see also *Louisville & Evansville Mail Co.*, 88 Ky. at 78-79 ("The main question is whether the specific property of the corporation, consisting of steamboats, or the stock held by its members, was, during the years mentioned, required to be listed and made subject to taxation . . .").

³⁷ See *Commonwealth v. Walsh's Trustee*, 106 S.W. 240 (Ky. 1907) ("Walsh's Trustee I"), *rev'd on reh'r'g*, 117 S.W. 398 (Ky. 1909).

³⁸ See *id.* at 240.

³⁹ See *id.*

⁴⁰ See *id.*

⁴¹ See *id.*; see also *supra* note 34 and accompanying text.

⁴² See *Walsh's Trustee I*, 106 S.W. at 240-41 ("Manifestly the meaning of the statute and the obvious intention of the General Assembly was to recognize the rule that the shares of stock in a corporation were subject to taxation, and should pay

The court concluded that the exemption in section 4088 was ambiguous as to the situation presented,⁴³ and ultimately determined that the General Assembly meant the exemption to apply only when substantially all of the corporation's property was taxed by the state, so as to avoid imposing a double tax by taxing the shares of stock when "all the property of the corporation was in Kentucky, and the taxes paid thereon in Kentucky."⁴⁴

The Kentucky Supreme Court also believed that the stockholder's interpretation of the exemption violated section 171 of the Kentucky Constitution,⁴⁵ which mandated that property within the state territorial limits be uniformly taxed unless specifically exempted by the Constitution.⁴⁶ No constitutional exemption applied to shares of stock.⁴⁷ The court stated that "if [the General Assembly] intended to require only a small part of the personal property subject to taxation to be assessed, as in this case 1 per cent, it clearly had not the power to do it"⁴⁸

their proportion of revenue to the state.").

⁴³ See *id.*

⁴⁴ See *id.* at 241. The Kentucky Supreme Court's interpretation of this "ambiguous" statute was used by the Ohio Supreme Court and ultimately the United States Supreme Court in construing an Ohio stock exemption "which in substance and effect are the same as our statutes on the subject," to apply only where all or substantially all of the corporate property is taxed by the state. *Id.* (discussing *Sturges v. Carter*, 114 U.S. 511 (1885)).

⁴⁵ See *id.* at 242.

⁴⁶ See *id.* Section 171 of the Kentucky Constitution states, "Taxes shall be levied and collected for public purposes only and shall be uniform upon all property of the same class subject to taxation within the territorial limits of the authority levying the tax; and all taxes shall be levied and collected by general laws."

⁴⁷ See *id.* Section 170 of the Kentucky Constitution provides an exclusive list of property exempted from taxation. The Kentucky Supreme Court interpreted the interplay of sections 170 and 171 as clearly imposing a limit on the General Assembly's power to exempt otherwise taxable property. See *id.*

⁴⁸ *Id.* The Kentucky Supreme Court's construction of the statute may have been guided by the General Assembly's apparent rejection of a proposal to amend the exemption in a manner consistent with the stockholder's argument in *Walsh's Trustee I*. A special legislative committee recommended that section 4088 of the Kentucky Statutes be amended to expressly apply to shares in foreign corporations where the corporation pays taxes on its property in either Kentucky or the state of its incorporation. The reasons given for the committee's suggestion were:

A certificate of stock represents in reality an interest in the property owned by the corporation which has been taxed in the hands and in the name of the corporation

Next, in *Commonwealth v. Ledman*,⁴⁹ which followed *Walsh's Trustee I* by less than a week,⁵⁰ the Kentucky Supreme Court addressed whether the exemption for shares in non-franchise corporations applied to foreign corporations "where all of their property is in the state of Kentucky."⁵¹ Despite finding the exemption ambiguous as to the issue, the court concluded the exemption did apply and that its decision was mandated by the uniformity-of-taxation clause embodied in the Kentucky Constitution and the impetus to avoid double taxation in the face of an ambiguous statute.⁵²

The losing shareholder in *Walsh's Trustee I* petitioned the court for rehearing, and in *Walsh's Trustee II*, the Kentucky Supreme Court reversed its earlier judgment and ruled in favor of the shareholder.⁵³ The court noted that the franchise tax taxed the corporation's intangible property (including capital) employed in Kentucky⁵⁴ and interpreted the taxation and exemption scheme adopted by the General Assembly as evidencing its aim to avoid imposing the same tax twice on the same "thing" as well as the same

....

Foreign corporations pay taxes on all property owned [sic] to the States in which they may have been created. Each individual stockholder contributes something towards the payment of this tax, his contribution being the proportion to the number of shares the stock held by him, in that his dividend or profit is decreased by the taxes paid. To compel the resident holder to pay taxes to this State on such stock held by him clearly imposed upon him a double taxation burden and decreases to the extent of the second burden the earning capacity of his investment.

. . . If a resident holder of stock in a foreign corporation is required to pay taxes on the same investment twice, first to the State creating the corporation, and second, to the State of his residence, the State through a mere fiction unjustly places its own citizens at a disadvantage by limiting them in the field of investments and by decreasing the fair return on their investments.

Special Legislative Committee Sits Here, LEXINGTON HERALD-LEADER (Lexington, Ky.), Nov. 18, 1905, at 1. The absence of legislative action on this proposal two years later may have suggested to the Kentucky Supreme Court that the General Assembly did not support this view.

⁴⁹ *Commonwealth v. Ledman*, 106 S.W. 247 (Ky. 1907).

⁵⁰ *See id.*

⁵¹ *Id.* at 250.

⁵² *See id.* Section 171 of the Kentucky Constitution mandates the principle of uniform taxation. *See supra* note 46.

⁵³ *See Walsh's Trustee II*, 117 S.W. 398 (Ky. 1909).

⁵⁴ *See id.* at 399.

property.⁵⁵ The court concluded that the General Assembly believed that the corporation's intangible capital stock and each shareholder's interest in it, while separate and distinct property, were representative of the same thing.⁵⁶

The court then addressed its previous determination in *Walsh's Trustee I* that the stockholder's construction would result in an unconstitutional exemption of taxable property created solely by the General Assembly.⁵⁷ It determined that the exemption technically was not an exemption. Instead, the entire taxing scheme represented the General Assembly's proper exercise of its discretionary authority to tax the full thing once – the corporation's tangible and intangible property – rather than separately and individually taxing the various property interests (that is, the corporation's capital stock and the shareholders' shares).⁵⁸ Considering the clear

⁵⁵ See *id.* The Kentucky Supreme Court backed away from the double taxation characterization it set out in *Walsh's Trustee I*. See *supra* notes 43-44 and accompanying text. In *Walsh's Trustee II*, the court defined classic double taxation as “taxing the same property twice in the same year for the same purpose.” *Walsh's Trustee II*, 117 S.W. at 399. *Walsh's Trustee I and II* did not involve classic double taxation, as the corporation's capital stock (part of its intangible property) and the stockholders' individual shares in that capital stock were considered separate and distinct property. See *id.* However, the apparition of double taxation was raised if the same thing, though technically not the same property, was taxed twice in the same year for the same purpose:

A corporation owns land. All its capital is invested in the land. The corporation owns its capital stock. The shareholders own each their share of capital stock. Each is property. Yet, there is but one thing. When the thing itself is taxed at its full value, every element of it is made to bear the tax. The whole includes all its parts. When the state lays a tax upon the whole, it has made each of its constituent parts contribute to the support of the government.

Id. The court described both types of double taxation as “oppressive” and as working “an inequality that is fundamentally vicious,” and interpreted the taxing scheme as evidencing the General Assembly's attempt to avoid such results. *Id.*

⁵⁶ See *id.*

⁵⁷ See *supra* notes 46-48 and accompanying text.

⁵⁸ See *Walsh's Trustee II*, 117 S.W. at 399-401:

While . . . the General Assembly is prohibited from exempting any property from taxation not specifically exempted by section 170 of the Constitution, it is not required that every phase of property shall be taxed. . . . While it would be permissible without double taxation as that term is used to tax the corporation upon its capital, and the shareholder upon his share . . . , whether the state should resort to that form, or to the simpler one of taxing

language of the exemption and the perceived motivations of the General Assembly in adopting this taxing scheme, the Kentucky Supreme Court upheld the exemption and ruled it was not limited to situations where substantially all of the corporate property was located and taxed in Kentucky.⁵⁹ In 1912, the court extended this holding to the exemption from taxation for shares in non-franchise corporations.⁶⁰

once and at full value the thing which represents the various properties based upon it, is a matter of legislative discretion. . . . The Legislature might have directed the constituents of the franchise to have been assessed separately, as for example, its capital, its surplus, its choses in action. But it has seen proper, instead to group these things into one, and tax the sum.
Id. at 399.

⁵⁹ See *supra* note 28. In considering this system and the exemption employed, the Kentucky Supreme Court noted:

In truth the very requirements of the statutes regulating the proportion of the franchise that is deemed as being owned in Kentucky shows that the Legislature contemplated that any part of it might be owned and enjoyed beyond the jurisdiction of this state, and that the purpose was to tax that only which was here, and that in every instance, without exception, where the franchise and property tax is paid by the corporation, that that settled the bill, and the shareholder need not bother about it.

Walsh's Trustee II, 117 S.W. at 401. The essential holding of *Walsh's Trustee II* was later reaffirmed by the court in *Commonwealth v. Harris*, 118 S.W. 294 (Ky. 1909) (holding where public service corporation pays its franchise and property taxes the stock is not assessed in the hands of the shareholders).

⁶⁰ See *Commonwealth v. Fidelity Trust Co.*, 143 S.W. 1037 (Ky. 1912). The corporation in *Fidelity Trust Co.* was a foreign, non-franchise corporation with substantial property outside of Kentucky that had properly listed and paid taxes on all its property in Kentucky. See *id.* at 1038. The Kentucky Supreme Court noted that it had previously held the section 4085 exemption for shares in non-franchise corporations to apply when all of the foreign corporation's property was located and taxed in Kentucky. See *supra* notes 49-52 and accompanying text (discussing *Commonwealth v. Ledman*, 106 S.W. 247 (Ky. 1907)). The court further noted that any inference in *Ledman* that the exemption required that all of the property of the corporation be located in Kentucky was incorrect and, relying on the analogous case of *Walsh's Trustee II*, the court held the exemption applied if the corporation paid taxes on all of its property within Kentucky even if it had substantial property elsewhere. See *Fidelity Trust Co.*, 143 S.W. at 1039.

In addition, the court questioned the wisdom of the Commonwealth's argument that the exemption was intended to apply only when substantially all of the corporate property was taxed in Kentucky:

The construction claimed [by the Commonwealth] would mean that the Kentucky [corporation], in order that its shares might not be a separate

In 1917, however, the General Assembly expressed its displeasure with the result in *Walsh's Trustee II* and its progeny by consolidating the exemption for shares of stock in a franchise corporation and the exemption for shares in a non-franchise corporation into one provision. The new provision exempted shares held by a resident shareholder in *any* corporation that had one-fourth of its total property in Kentucky if the corporation paid the taxes on such property (including the franchise tax if applicable).⁶¹ In 1924, the General Assembly further restricted the exemption's availability by requiring that at least three-fourths of the corporation's total property be located and taxed within Kentucky.⁶² No reported case addressed the exemption after the 1917 amendments; however, the 1924 amendments resulted in significant litigation.

In the 1926 case of *Shrinkle's Estate v. Kenton County Board of Supervisors*,⁶³ the taxing authority attempted to tax the estate of a resident shareholder for shares in a domestic corporation that had less than half its property located and taxed in Kentucky.⁶⁴ After tracing each of the amendments to the stock exemption, the Kentucky Supreme Court

subject of taxation, must restrict its operations, or rather its property holdings, entirely to the state, and thus be denied the opportunities which thrift and enterprise might give to it by establishing itself in other states as well.

Id. The court also relied on *Walsh's Trustee II* to refute the Commonwealth's argument that the exemption was unconstitutional as a legislative exemption of property from taxation. *See id.* at 1040.

Three years later the Kentucky Supreme Court confronted a situation in which a resident shareholder had directed a non-franchise corporation to hold some property in Kentucky and pay the taxes on it so as to exempt her shares from taxation. *See Slater v. Commonwealth*, 179 S.W. 201, 203 (Ky. 1915). The court found, however, that the exemption applied only when the property was "acquired in good faith, and for the corporate use and purposes." *Id.*

⁶¹ *See* KY. STAT. § 4088 (Carroll 1918). The burden of proof rested with the shareholder to show that one-fourth of the corporation's total property was located and taxed in Kentucky. *See id.*

⁶² *See id.* § 4088 (Carroll 1930). This statute essentially was worded the same way as the modern version of the stock exemption (K.R.S. § 136.010), which existed in substantially the same form for approximately 70 years. The modern statute referred to an exemption from ad valorem taxes and also exempted U.S. and Kentucky government obligations from the calculation of the corporation's total property. *See* K.R.S. § 136.030(1) (Michie Supp. 1996); *see also supra* note 28.

⁶³ *Shrinkle's Estate v. Kenton County Bd. of Supervisors*, 287 S.W. 209 (Ky. 1926).

⁶⁴ *See id.* at 209.

determined that the General Assembly had exercised its discretion to tax both the corporation on its property within the state (including its franchise) and the resident on his shares in the corporation unless three-fourths of the corporation's total property was located and taxed in Kentucky.⁶⁵ Thus, the exemption did not apply.⁶⁶ In summarily disposing of the various double taxation and constitutional arguments made by the shareholder's estate, the court noted that it was well-settled that the General Assembly could tax both the property of the corporation and the property of the shareholders without violating the state or federal Constitution.⁶⁷

In the 1927 case of *Siler v. Board of Supervisors*,⁶⁸ a shareholder made a more developed argument for invalidating the stock exemption. The shareholder argued that not taxing shares in corporations with seventy-five percent of their property in Kentucky, but taxing shares in corporations with less than seventy-five percent of their property in Kentucky, was discriminatory under the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution.⁶⁹ The Kentucky Supreme

⁶⁵ See *id.* at 209-10.

⁶⁶ See *id.* at 209.

⁶⁷ See *id.* at 210. The estate of the shareholder argued that the General Assembly had violated the Kentucky constitutional prohibition against double taxation, as well as the federal Constitution's prohibition against the taking of the shareholder's property without due process of law. See *id.* at 209. The estate also argued that double taxation discriminated against the estate, presumably because the shareholder was taxed on his investments while other shareholders in corporations with at least 75% of their corporate property located in Kentucky would not be so taxed. The Kentucky Supreme Court summarily disposed of all these arguments by reiterating the principle that the capital of the corporation and shares in the corporation are separate and distinct property. See *id.* at 210 (stating that the Commonwealth may tax "the franchise, which includes the capital of the corporation, and [may also tax] the shareholder upon his shares," *Walsh's Trustee II*, 117 S.W. 398, 400 (Ky. 1909)). Unlike the stock exemption in *Walsh's Trustee II*, the section 4088 exemption in *Shrinkle's Estate* unmistakably evidenced the General Assembly's intent to tax both the corporation and the shareholder except in the exempted situation. See *Shrinkle's Estate*, 287 S.W. at 210.

⁶⁸ *Siler v. Board of Supervisors*, 298 S.W. 189 (Ky. 1927).

⁶⁹ See *id.* at 191-92. The other argument presented by the shareholder was that the assessment of the shares at their full value was not a fair and uniform valuation, since the county valued property at only 70% of its full value for assessment purposes. See *id.* at 190. By 1927, Kentucky had amended section 171 of the Kentucky Constitution to allow the General Assembly to classify property for taxation purposes and declare what property would be subject to local taxation. See *id.* Section 4019A-10 of the Kentucky Statutes put intangibles in one class and

Court examined other line-drawing techniques employed by Kentucky and other states in taxation and other areas and noted that all had survived similar equal protection challenges, even those that reached the United States Supreme Court.⁷⁰ It thus concluded that this line-drawing did not constitute unconstitutional discrimination under the Equal Protection Clause.⁷¹

Two years after *Siler*, another challenge to the stock exemption reached Kentucky's highest court. In *Klein v. Jefferson County Board of Tax Supervisors*,⁷² a resident shareholder held stock in a New Jersey corporation that had only one-fourth of its total property located and taxed in Kentucky, and the shares had been assessed at their fair cash value.⁷³ The court again

applied a different tax rate to that property. *See id.* It also exempted intangibles from local taxation. *See id.* By this statute, Whitley County was exempted from taxing intangibles; therefore, any undervaluation of property by the county did not in and of itself ameliorate the fair and uniform assessment of intangibles throughout Kentucky. *See id.* at 191. The shareholder had failed to demonstrate that the undervaluation was so "continuous, persistent, and uniform" as to evidence a scheme by the Commonwealth to allow such undervaluation so that the shareholder would have a colorable claim of discrimination and nonuniformity when his shares were taxed at their full value. *See id.* at 190-91.

⁷⁰ *See id.* Some of the cases the Kentucky Supreme Court relied on involved a forfeiture of land that occurred because the owners had not properly recorded the land for taxation purposes for five consecutive years, an exemption from Kentucky ad valorem taxation on telephone companies if gross receipts were less than \$500, and an exemption of railroads less than 50 miles in length from passenger car heating regulations. *See id.* Since this discrimination is in the social and economic arena, and so would not likely be construed to implicate a fundamental interest or discriminate against a suspect class, the court correctly applied the rational basis test and stated with respect to the protections afforded the taxpayer under the Equal Protection Clause:

The Fourteenth Amendment to the federal Constitution is not a protection in all cases against unwise state legislation. It imposes no fixed rule of taxation upon the states. It protects against such discrimination as amounts to a denial of the equal protection of the law or deprivation of property without due process of law.

Id. at 191.

⁷¹ *See id.* at 191-92.

⁷² *Klein v. Jefferson County Bd. of Tax Supervisors*, 18 S.W.2d 1009 (Ky. 1929), *aff'd*, 282 U.S. 19 (1930).

⁷³ *See id.* at 1010. As in *Siler v. Board of Supervisors*, the shareholder argued that land in the county was assessed at only 70% of its sale value and that assessing his shares at their full sale value violated the uniformity of taxation mandated by

rejected the charge that this line-drawing, by which shares of corporations are taxed only if less than seventy-five percent of their property is in Kentucky, violated the Equal Protection Clause, concluding that given the two extremes of not taxing shares in corporations with no taxable property in Kentucky and taxing shares in corporations with all or substantially all of their taxable property in Kentucky, the General Assembly had made a reasonable compromise.⁷⁴

In 1930, the United States Supreme Court affirmed the Kentucky Supreme Court's judgment in *Klein v. Board of Tax Supervisors*.⁷⁵ The Court reiterated that shareholders and the corporation may both be taxed, though it is not unconstitutional to choose otherwise.⁷⁶ It further noted that to exempt shares from taxation when most or all of the corporation's property was assessed in the state would clearly be "just," though not required, and it found that the line drawn by the Kentucky General Assembly was a reasonable attempt to effectuate that result.⁷⁷ The Court also dismissed the shareholder's argument that the corporation was a mere

the Kentucky Constitution. *See id.* at 1011. The Kentucky Supreme Court dismissed this argument by noting that shares in a corporation and land were different types of property. *See id.* In addition, the assessment of real estate at 70% reflected the county assessment board's judgment that most land was purchased on credit and thus the actual sale price exceeded that for an all-cash sale. *See id.* The court also noted that the shares were only subject to state taxation, not local taxation (a burden that was borne, however, by real estate) and concluded that the classification was "just and reasonable, and [was] clearly such a discrimination as the best interests of society requires." *Id.* at 1012.

⁷⁴ *See id.* at 1011-12. The fact that the General Assembly could have taxed resident shareholders' shares in any corporation irrespective of the location of its taxable property does not mean that failing to tax such shareholders results in discrimination that violates the Equal Protection Clause. *See id.* (discussing and quoting *Hart Refineries v. Harmon*, 49 S. Ct. 188, 188 (1929)).

⁷⁵ *Klein v. Board of Tax Supervisors*, 282 U.S. 19 (1930).

⁷⁶ *See id.* at 23. The Court provided one clue to why shares in a corporation and the corporation's property are different: only the value of the former is affected by rumors. *See id.*

⁷⁷ *See id.* The Court indicated that this case involved "the usual question of degree and of drawing a line where no important distinction can be seen between the nearest points on two sides, but where the distinction between the extremes is plain." *Id.* The Court agreed with the lower court's conclusion that if 90% was reasonable, then 75% must be as well. The lower court believed that the 75% requirement was intended to allow some flexibility so that if only a fraction of a percent of the corporation's property was located outside Kentucky, the shareholder would not lose the exemption. *See Klein*, 18 S.W.2d at 1011.

fiction and that taxation of the shareholder's shares would result in taxing property beyond the state's boundaries if the shares were taxed at their full value, rather than at a percentage reflecting the ratio of the corporate property located in the state to total corporate property.⁷⁸

These cases represent the only challenges to Kentucky's intangibles tax until the *St. Ledger* case.⁷⁹ This historical backdrop provides an understanding of how the exemption developed into its present incarnation. Kentucky, however, was not the only state wrestling with an intangibles tax and its application to shares of stock in a corporation.

B. Other States' Experiences Applying an Intangibles Tax to Shares of Stock

Other states also grappled with the application of an intangibles or property tax to shares of stock and exemptions for investment holdings in in-state companies. Many of the cases that explored this issue were decided in the early part of the century, and most involved a resident shareholder challenging the state's taxation of his shares of stock in a foreign corporation or a corporation with little or no property or business within the state.⁸⁰

⁷⁸ See *Klein*, 282 U.S. at 24. The Court agreed that the corporation may theoretically be a fiction; however, this fiction is treated in the law as if it were a real person and therefore its ownership in property cannot be attributed to its shareholders. The Court stated, "The principle of justice that leads to the exemption that has been dealt with could not be insisted upon as a matter of constitutional right and it is reasonable for the legislature to confine it to well marked cases, rather than press it to a logical extreme." *Id.*

The shareholder's argument of lack of uniformity in taxation was also dismissed by the Court, which stated, "There is nothing in the Fourteenth Amendment that requires land and stock to be taxed at the same rate or by the same tests . . ." *Id.*

⁷⁹ It should be remembered that at the turn of the century and in the early 1900s, the U.S. Supreme Court's jurisprudence regarding the dormant Commerce Clause and its impact on state action that discriminates against interstate commerce was not fully developed. Challenges to intangibles taxation and related exemptions based on the dormant Commerce Clause are analyzed in Part II.B, *infra*.

⁸⁰ See, e.g., *Coca-Cola Co. v. City of Atlanta*, 110 S.E. 730, 736 (Ga. 1922) (upholding Georgia's taxation of residents' shares in foreign corporation even though shares in domestic corporations were exempt from taxation); *In re Greenleaf*, 56 N.E. 295, 296 (Ill. 1900) (concluding Illinois statutes required resident to list his shares in foreign corporations for taxation despite an exemption for shares in domestic corporations, the property of which was taxed by Illinois);

The most common argument against the imposition of a tax on shares of stock was that such taxation constituted impermissible double taxation.⁸¹ This argument took a variety of similar forms. Some shareholders argued that shares of stock were mere representations of the shareholder's claim on the corporation's property.⁸² Others argued the shares derived their value solely from the underlying assets of the corporation.⁸³ The arguments

Judy v. Beckwith, 114 N.W. 565 (Iowa 1908) (concluding Iowa statutes required resident to list his shares in a foreign corporation for taxation despite various exemptions, including one for shares in domestic manufacturing corporations the property of which was taxed in kind by Iowa); *State v. Nelson*, 119 N.W. 1058, 1060 (Minn. 1909) (upholding Minnesota statutes that expressly taxed residents on shares in foreign corporations while exempting from taxation shares in domestic corporations); *Rehkopf v. Board of Equalization of Douglas County*, 141 N.W.2d 462, 470 (Neb. 1966) (upholding Nebraska's intangibles tax scheme, where shares in a foreign corporation were assessed at a substantial value for taxation purposes and shares in domestic corporations were assessed at a miniscule value).

Many of the statutes involved in the cited cases differ from Kentucky's stock exemption in that the latter is not based on the domestic-versus-foreign distinction. The basic assumption, however, remains the same:

The classification in Georgia, whereby the shares of certain domestic corporations are exempt from taxation, and the shares of corporations of other states are liable for taxation, is based upon the assumption that, as a general rule, the assets of domestic corporations are located within this state, and will be returned for taxation, and that the assets of corporations of other states are located without, and are not liable for taxation in this state.

Coca-Cola Co., 110 S.E. at 736.

⁸¹ See, e.g., *Greenleaf*, 56 N.E. at 295 (shareholders alleged that taxation of their shares in foreign corporations with no property in the state constituted double taxation); *Judy*, 114 N.W. at 565 (same); *Nelson*, 119 N.W. at 1060 (same).

⁸² See, e.g., *Greenleaf*, 56 N.E. at 295 (shareholder argued that shares were "mere tokens or evidence of the owner's relative interest in the tangible property owned by the corporation"); *Judy*, 114 N.W. at 567 (shareholders alleged that shares of stock could only in a "very limited and qualified sense . . . be classified as personal property, and are rather merely written evidence" of the shareholder's ownership interest in the property of the corporation).

⁸³ See, e.g., *Coca-Cola Co.*, 110 S.E. at 735 (noting that shares of stock have no "inherent value"); *Rehkopf*, 141 N.W.2d at 468 (same). But see, e.g., *Klein v. Board of Tax Supervisors*, 282 U.S. 19, 23 (1930) (noting that the value of shares in a corporation can be affected by rumors and investor expectations, though the underlying value of the corporate assets cannot similarly be affected).

ultimately boiled down to the claim that shares of stock simply were not property.⁸⁴

The courts regularly rejected these arguments and held that shares of stock were property in their own right despite their “peculiar qualities and characteristics” and “intangible” nature.⁸⁵ The courts often alluded to various characteristics that supported their conclusions that shares of stock were in fact personal property. These characteristics included the shareholder’s power to invoke the state’s authority to recover the stock when wrongfully taken or lost,⁸⁶ the shares’ ability to be the subject of contracts, purchases, or sales,⁸⁷ and the ability of the shares to pass through testacy by bequeath or intestacy by distribution.⁸⁸ In short, shares of stock “have all the qualities of every other character of property”⁸⁹

The shareholders also argued that double taxation existed because the corporate property and the shares of stock were in fact the same property.⁹⁰ The courts repeatedly applied the separate-and-distinct theory to refute this type of argument.⁹¹ The theory posits that the corporation, though a legal fiction, is a person under the law and therefore the owner of the tangible property; the shareholder is the owner only of the shares and while they represent claims on the corporation’s tangible property, they do not represent the ownership of it.⁹² The courts showed little sympathy for the

⁸⁴ *Cf. Eisner v. Macomber*, 252 U.S. 189, 215-19 (1920) (holding that a tax on a totally proportionate stock dividend was not a tax on income because the taxpayer had not derived anything from the dividend; that is, the dividend had not been severed from the taxpayer’s investment and drawn by him).

⁸⁵ *Judy*, 114 N.W. at 567 (noting the “entire unanimity in classifying shares of stock in a corporation as personal property”).

⁸⁶ *See id.*; *Greenleaf*, 56 N.E. at 296.

⁸⁷ *See Rehkopf*, 141 N.W.2d at 468.

⁸⁸ *See id.*; *Judy*, 114 N.W. at 567.

⁸⁹ *Rehkopf*, 141 N.W.2d at 468.

⁹⁰ *See, e.g., Greenleaf*, 56 N.E. at 295 (shareholder argued that taxing the stock was merely “taxing the tangible property a second time”).

⁹¹ *See, e.g., Judy*, 114 N.W. at 567 (noting that the corporation’s capital stock and the shareholder’s share thereof are different property rights); *Greenleaf*, 56 N.E. at 295 (stating “tangible property of a corporation and the shares of stock therein are separate and distinct kinds of property”).

⁹² Consider this discussion in *Judy v. Beckwith*:

A shareholder and the corporation are two distinct persons. Their rights and interests with relation to the property and business are distinct and severable. The corporation is the sole owner of such property, while a share of the capital stock simply entitles the holder to demand his just proportion

plight of shareholders, particularly when their double taxation argument stemmed from the fact that another state, different from the one taxing their stock, had taxed the corporation's tangible property.⁹³ The separate-and-distinct theory successfully and repeatedly dismantled the foundation of any double taxation argument advanced by shareholders.

The shareholders also argued that the legislatures' disparate, and in their view discriminatory, classification of them and their shares as contrasted with shareholders and shares that were exempted from taxation constituted a violation of both the state and the federal Constitutions.⁹⁴ The

of dividends, and, when the corporation is dissolved, to also demand his like proportion of the remnant of assets.

Judy, 114 N.W. at 567; *see also Greenleaf*, 56 N.E. at 295 (noting that the tangible property of the corporation and the shares "belong to different owners - the first being the property of the artificial person, the corporation; the latter the individual owner thereof").

⁹³ This case presents the weakest double taxation argument, since not only does the separate-and-distinct property theory negate the finding that the same property has been taxed twice, but the fact that another state taxes the corporate property negates any finding that the same property has been taxed twice by the same taxing authority or government. Consider the Iowa Supreme Court's response to just such a shareholder claim:

Each state is sovereign within its own territorial jurisdiction, and its power to tax any and all property therein, except such as is in actual transit through it, cannot be taken away, limited, or lessened by the act of the taxing authorities of any other state. . . . When a state finds property within its jurisdiction, it is not necessary, before taxing it, to investigate and ascertain whether any other state has taxed it or asserts the right so to do; and if it happens that two or more jurisdictions have levied a tax upon the same item or description of property for the same period it is not double taxation within the condemnation of the law. A double taxation, obnoxious to the rule, is where the second or additional burden is imposed by the same sovereignty which imposed the first.

Judy, 114 N.W. at 568; *see also State v. Nelson*, 119 N.W. 1058, 1060 (Minn. 1909) (stating the "tax laws of other states have no extraterritorial force").

⁹⁴ *See Coca-Cola Co. v. City of Atlanta*, 110 S.E. 730, 736 (Ga. 1922) (alleging disparate classification violated uniformity of taxation and the Equal Protection Clause); *Rehkopf*, 141 N.W.2d at 466 (stockholder alleging shares in corporations were one class of property that must be taxed uniformly); *Nelson*, 119 N.W. at 1060 (alleging same disparate classification violates state constitutional provisions mandating uniformity and equality of taxation); *Judy*, 114 N.W. at 569 (alleging classification of shares in domestic corporation different than that of foreign corporations violated state constitutional requirement that "all laws must have

shareholders typically alleged that the classification drawn by the legislatures ran afoul of state constitutional provisions requiring uniform taxation and the Equal Protection Clause of the federal Constitution.⁹⁵ Neither argument persuaded the courts, which routinely held the disparate classifications were reasonable as drawn by the legislatures.⁹⁶ The Equal Protection Clause challenges were particularly weak, since the shareholders were not part of a suspect class and the statutes did not impinge upon a

uniform operation”).

⁹⁵ See *supra* note 94.

⁹⁶ In *Rehkopf*, the Supreme Court of Nebraska relied heavily on *Kidd v. Alabama*, 188 U.S. 730 (1903) (involving Alabama’s taxation of shares of stock in foreign but not domestic railroad companies), which ruled against the shareholder’s equal protection claim:

“We say that the state in taxing stock may take into account the fact that the property and franchises of the corporation are untaxed, whereas in other cases they are taxed; and we say untaxed, because they are not taxed by the state in question. The real grievance in a case like the present is that, more than probably, they are taxed elsewhere. . . . No doubt it would be a great advantage to the county and to the individual states if principles of taxation could be agreed upon which did not conflict with each other, and a common scheme could be adopted by which taxation of substantially the same property in two jurisdictions could be avoided. But the Constitution of the United States does not go so far.”

Rehkopf, 141 N.W.2d at 469 (quoting *Kidd*, 188 U.S. at 730).

As to state constitution uniformity requirements, the courts have shown great deference to the state legislatures. Even when the assumptions behind the classification might not hold true, the classifications were not invalidated. See, e.g., *Coca-Cola Co.*, 110 S.E. at 736 (noting that the fact that a foreign corporation will not always have all of its property out of the state, nor will a domestic corporation have all of its property in the state, does not invalidate a classification based on that assumption).

In *State v. Nelson*, the Supreme Court of Minnesota said on this issue:

In the case of a stockholder in a domestic corporation, he is taxed in this state on his interest in the corporation when the corporation pays the tax on its property; but in the case of a foreign corporation, a resident holder of its stock is not and cannot be taxed in this state on his interest in the property of such corporation, except by taxing therein his shares of stock. The result is that each of such stockholders is taxed once, and once only, on his property within the state, and that the statute, eliminating the laws and acts of taxing officers of other states, is equal and uniform in its operation as to persons and property within the state.

Nelson, 119 N.W. at 1060.

fundamental interest.⁹⁷ Resident holders of shares that were not exempted thus faced an insurmountable obstacle in the early part of this century when challenging exemptions on the grounds that such exemptions did not extend to the shares held by them.

C. *The Motivations for Imposing an Intangibles Tax and Providing Exemptions for Stock in "Local" Corporations*

Given the considerable judicial deference to the legislative line-drawing in this area, the question arises as to what motivated state legislatures to draw the lines where they did. Some of the motivating factors proved consequential to the continued existence of these taxation schemes.

Intangibles constitute a form of personal property and their taxation can produce significant revenues – the most basic driving force of any tax.⁹⁸ Although most states that tax intangibles, such as shares of stock, tax them under the separate-and-distinct-property theory,⁹⁹ a majority of the states have refused to tax intangibles altogether.¹⁰⁰ Those states, like Kentucky,

⁹⁷ See *supra* note 74.

⁹⁸ In the *St. Ledger* cases, the Kentucky Revenue Cabinet argued that Kentucky would lose \$30 million per year in revenue if the entire intangibles tax was declared unconstitutional. See Tom Loftus, *Kentucky Tax on Stocks Struck Down, Supreme Court Limits Refunds State Must Pay*, THE COURIER-JOURNAL (Louisville, Ky.), Jan. 31, 1997, at A1 [hereinafter Loftus, *Kentucky Tax on Stocks Struck Down*].

⁹⁹ See *supra* note 25. "There may be sound reasons for this type of double taxation in view of the differences in ownership of the securities and the underlying property, the advantages of incorporation, and the concentration of wealth in corporations and their security holders." HELLERSTEIN & HELLERSTEIN, *supra* note 27, at 204.

¹⁰⁰ The problems created by an intangibles tax probably account for the large number of states' refusal to tax intangibles:

A property tax on intangibles frequently results in substance in a second layer tax on underlying real and tangible personal property, which is itself subject to the same levy. . . .

The virtually insuperable difficulties in ferreting out intangibles by the tax collector, the double taxation problem, and other considerations have caused many fiscal authorities to urge that intangibles be withdrawn from ad valorem taxation altogether, a recommendation which more than a third of the States have adopted. In other States specific intangibles such as bank deposits, mortgages secured by taxed domestic property, and securities of corporations which are otherwise taxed by the State have been exempted

that have taxed intangibles have often created exemptions for shares of stock in what might be described as "local" corporations – domestic corporations or corporations that have most of their property located within the taxing state.¹⁰¹

The impetus for such exemptions has to some extent been the legislative desire to avoid the creation of a double burden by the same taxing authority.¹⁰² Taxing the corporation on its property affects the returns the shareholders receive by reducing the assets available for dividend and residual distribution.¹⁰³ Taxing the shareholders separately on their shares further diminishes their investment return.¹⁰⁴ While clearly less sympathetic when at least one of the burdens has been imposed by another state, the legislatures through these exemptions have attempted to alleviate this perceived injustice when both burdens are imposed by the resident shareholder's state.

The idea that shareholders should bear only their fair share of the "public burden" also appears to have been a motivating factor for these exemptions.¹⁰⁵ If most or all of the corporate property is located and taxed within the state, the legislatures likely believed that the corporation and its resident shareholders had paid their requisite share of the costs for the benefits and protections they receive from the taxing state.¹⁰⁶

Lurking underneath the surface, however, was a third motivating factor for such exemptions: state protection and isolation of truly "local" corporations.¹⁰⁷ Taxation of the shares affects investor

from the property tax.

HELLERSTEIN & HELLERSTEIN, *supra* note 27, at 204-05.

¹⁰¹ See *supra* notes 46-48 and accompanying text.

¹⁰² See *supra* note 48.

¹⁰³ See *supra* note 48.

¹⁰⁴ See *supra* note 48. While the separate-and-distinct theory eliminates the charge of double taxation, the public perception of double taxation still may be significant given the intangible nature of shares of stock and the fact that they derive most of their value from the underlying assets of the corporation.

¹⁰⁵ See *Klein v. Jefferson County Bd. of Tax Supervisors*, 18 S.W.2d 1009, 1011 (Ky. 1929).

¹⁰⁶ See *id.* Presumably the shareholder's share would be represented by the reduced return he receives because all of the corporation's property is taxed.

¹⁰⁷ It should be noted that the effects of this factor were labeled by the Kentucky Supreme Court as "unjust" when the government argued that the original Kentucky stock exemption for non-franchise corporations was intended to apply only where substantially all of the corporate property was located in Kentucky, despite the statute's language to the contrary:

choices.¹⁰⁸ “Local” corporations become more attractive to resident investors than “non-local” corporations by virtue of the tax break offered on such investments.¹⁰⁹ “Local” corporations therefore received an

The construction demanded by the commonwealth, therefore, would lead us to the position that, if a Kentucky manufacturing or trading nonfranchise corporation were, at any time, in the pursuit of its lawful business, to become the holder of any considerable property outside of the state of Kentucky, the holders of its shares of stock would at once have to list same for taxation; whereas, if the corporation should confine its property holdings entirely to Kentucky, its shareholders would not need to list their shares, nor submit to a tax upon them. The Legislature can hardly have meant to create so unjust a condition. The construction claimed would mean that the Kentucky plant, in order that its shares might not be a separate subject of taxation, must restrict its operations, or rather its property holdings, entirely to the state, and thus be denied the opportunities which thrift and enterprise might give to it by establishing itself in other states as well.

Commonwealth v. Fidelity Trust Co., 143 S.W. 1037, 1039 (Ky. 1912); *see also supra* note 60. Ironically, the General Assembly amended the exemptions soon thereafter to achieve the construction that so appalled the Kentucky Supreme Court. *See supra* notes 61-62 and accompanying text.

¹⁰⁸ The Supreme Court of Kentucky noted the effect of Kentucky’s exemption upon investor choice:

First, a potential stockholder who is a Kentucky resident and is contemplating investment in a corporation will find the stock in the corporation whose property is primarily (75% or more) located in the state of Kentucky more attractive than that of a corporation whose property is primarily located outside the state. As a result, and at a minimum, the investor has had his investment decision affected by this tax provision.

St. Ledger I, 912 S.W.2d 34, 42 (Ky. 1995), *vacated and remanded*, 116 S. Ct. 1821 (1996); *see also* *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996) (recognizing that North Carolina’s method of increased taxation of shares of stock in corporations that expand their operations beyond North Carolina affected investor choices); *Brammer*, *supra* note 27 (quoting Herschel St. Ledger’s statement that Kentucky’s intangibles tax “‘improperly influences any person’s investment program’”).

¹⁰⁹ *See St. Ledger I*, 912 S.W.2d at 42. The U.S. Supreme Court in *Fulton Corp.* stated with respect to North Carolina’s similar intangibles tax scheme, “A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents.” *Fulton Corp.*, 516 U.S. at 333.

advantage over “non-local” corporations in competing for investment capital within the state.¹¹⁰

These exemptions also tended to alter “corporate decision making.”¹¹¹ For example, while “local” corporations might be dissuaded from expanding outside the state or feel forced to restrict themselves to in-state expansion for fear of losing their favored investment status in local capital markets, so too may “non-local” corporations be persuaded to become more “local” in order to obtain this favored status.¹¹²

Of the three factors motivating legislatures to exempt from intangibles taxation shares of stock in “local” corporations, the first two were the most relevant and instructive in the early cases that dealt with and ultimately upheld such exemptions. However, the third motivating factor – state isolationism and protectionism – ultimately proved to be the decisive factor.

¹¹⁰ The Kentucky Supreme Court noted:

Companies interested in raising capital through the issuance of stock shares are having potential investors’ decision-making processes affected by this legislation. Companies paying taxes to the state of Kentucky for 75% or more of their property will become more “investment attractive” than those companies that do not. . . .

. . . .

. . . [T]his change in the manner which Kentucky residents invest funds operates in such a way as to “provid[e] a direct commercial advantage to local business.”

St. Ledger I, 912 S.W.2d at 41-42 (quoting *Northwestern States v. Minnesota*, 358 U.S. 450, 459 (1959)).

¹¹¹ *Id.* at 42.

¹¹² *See id.* (raising the spectre that altering corporate decision-making in this artificial way could lead to poor business decisions); *Fulton Corp.*, 516 U.S. at 333 (stating such exemptions tend “to discourage domestic corporations from plying their trades in interstate commerce”); *Commonwealth v. Fidelity Trust Co.*, 143 S.W. 1037, 1039 (Ky. 1912) (noting the restrictive effect on corporate expansion and growth of an exemption from intangibles taxation of shares in only “local” businesses). *But see* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 391-97 (1996) (arguing that state tax incentives are too insignificant to have a substantial effect on business location decisions). The protection of “local” businesses via these exemptions is just one of an immense spectra of location incentives adopted in some form by all of the states. *See id.* at 386 & n.46 (providing examples of tax breaks offered in three states that “reduce capital costs for in-state businesses by providing preferential tax treatment to investors who provide funds to in-state businesses”).

II. *DARNELL TO FULTON CORP.* – STATE LAW SURVEY
OF THE BATTLE BETWEEN THE COMPENSATORY TAX DOCTRINE
AND DISCRIMINATORY STATE INTANGIBLES TAXES

As discussed earlier, states often provide tax incentives and exemptions to benefit local businesses.¹¹³ The Commerce Clause of the United States Constitution¹¹⁴ is a direct grant to Congress to regulate commerce. The United States Supreme Court's interpretation of the negative implications of the Commerce Clause – that is, the dormant Commerce Clause – imposes restrictions on the use of these state tax incentives because no state may “impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.”¹¹⁵ However, a tax that is otherwise discriminatory will pass constitutional scrutiny if it can be classified as a “compensatory tax.” This Part of the Note will discuss cases in which courts struggled with the question of whether to apply the compensatory tax doctrine.

A. *General Discussion and Application of the Compensatory Tax Doctrine*

One of the most fundamental principles permeating constitutional law is captured by the following language from *Fulton Corp. v. Faulkner*, a 1996 United States Supreme Court Commerce Clause decision:

The constitutional provision of power “[t]o regulate Commerce . . . among the several States,” . . . has long been seen as a limitation on state regulatory powers, as well as an affirmative grant of congressional authority. . . . In its negative aspect, the Commerce Clause “prohibits economic protectionism – that is, “regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.”¹¹⁶

¹¹³ See *supra* notes 107-12 and accompanying text.

¹¹⁴ U.S. CONST. art. I, § 8, cl. 3 (“Congress shall have power . . . [t]o regulate Commerce . . . among the several states . . .”).

¹¹⁵ *Maryland v. Louisiana*, 451 U.S. 725, 755 (1981).

¹¹⁶ *Fulton Corp. v. Faulkner*, 516 U.S. 325, 330 (1996) (quoting *Associated Indus. v. Lohman*, 511 U.S. 641 (1994)); see also *Wyoming v. Oklahoma*, 502 U.S. 437, 454-55 (1992) (noting that “[i]t is long established that, while a literal reading evinces a grant of power to Congress, the Commerce Clause also directly limits the power of the States to discriminate against interstate commerce”). The negative Commerce Clause is often referred to as the dormant Commerce Clause.

This negative aspect of the Commerce Clause, in effect, prohibits states from facially discriminating against interstate commerce.¹¹⁷

Courts, however, have long recognized that a facially discriminatory tax might still survive Commerce Clause scrutiny if it is a compensatory tax that “cure[s] the alleged discrimination.”¹¹⁸ A compensatory tax is a facially discriminatory tax on interstate commerce that compensates for an intrastate tax, on a substantially equivalent event, so that there is an equal burden on interstate and intrastate commerce.¹¹⁹ Thus, the compensatory tax doctrine is “a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means.”¹²⁰

In *Oregon Waste Systems v. Department of Environmental Quality Commission*,¹²¹ the United States Supreme Court set forth a three-prong test

¹¹⁷ See *Fulton Corp.*, 516 U.S. at 325 (noting that state laws that facially discriminate against interstate commerce are “‘virtually per se invalid’” (quoting *Oregon Waste Sys. v. Department of Envtl. Quality Comm’n*, 511 U.S. 93 (1994))). In the state taxation context, a law is treated as discriminatory if it “‘tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.’” *Id.* (quoting *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984)).

¹¹⁸ Walter Hellerstein, *Complementary Taxes as a Defense to Unconstitutional Tax Discrimination*, 39 TAX LAW 405, 453 (1986). The United States Supreme Court invoked the compensatory tax doctrine as early as 1869. However, there are not very many judicial opinions considering the doctrine. See *id.* Hellerstein contends that the most powerful justification for the compensatory tax doctrine is constitutional necessity, because the doctrine allows states “to achieve tax equality indirectly when the Constitution prohibits them achieving it directly.” *Id.* Administrative convenience is another common justification for the doctrine. See *id.* at 454.

¹¹⁹ See *Oregon Waste Sys.*, 511 U.S. at 102-03; *Henneford v. Silas Mason Co.*, 300 U.S. 577, 584 (1937) (noting that a discriminatory tax will be upheld if “[w]hen the account is made up, the stranger from afar is subject to no greater burdens as a consequence of ownership than the dweller within the gates”).

¹²⁰ *Oregon Waste Sys.*, 511 U.S. at 102.

¹²¹ *Oregon Waste Sys. v. Department of Envtl. Quality Comm’n*, 511 U.S. 93 (1994). In this case, the operators of solid waste disposal facilities asserted that Oregon’s \$2.50-per-ton surcharge on the in-state disposal of solid waste generated in other states violated the Commerce Clause. The operators complained that the surcharge was discriminatory because only a \$0.85-per-ton fee was imposed on the disposal of waste generated within Oregon. See *id.* Oregon argued that the surcharge was a compensatory tax “necessary to make shippers of such waste pay their ‘fair share’ of the costs imposed on Oregon by the disposal of their waste in

for determining whether a facially discriminatory tax could be upheld as a compensatory tax:

To justify a charge on interstate commerce as a compensatory tax, a State must, as a threshold matter, “identif[y] the [intrastate tax] burden for which the State is attempting to compensate.” Once that burden has been identified, the tax on interstate commerce must be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce. Finally, the events on which the interstate and intrastate taxes are imposed must be “substantially equivalent”; that is, they must be sufficiently similar in substance to serve as mutually exclusive “prox[ies]” for each other.¹²²

The *Oregon Waste Systems* Court noted that under the first prong of the test, general taxes, such as income taxes, could not ordinarily serve as the intrastate burden because it would be almost impossible to determine their amount, given that “general tax payments are often commingled with other general revenues.”¹²³

Furthermore, the *Oregon Waste Systems* Court noted the difficulty in meeting the third prong of the test – the substantially-equivalent-events test. The high Court commented that the most “prototypical example” of substantially equivalent taxable events is the equivalence between the taxation of sales and use of articles of trade. In fact, this is the only situation in which the United States Supreme Court has ever found the existence of substantially equivalent events.¹²⁴ Taxes other than sales and

the State.” *Id.* at 102 (quoting Respondents). The Court held that the \$2.25 surcharge was discriminatory on its face and could not be justified as a compensatory tax because Oregon had failed to identify a charge on intrastate commerce equal to or exceeding the surcharge. *See id.* at 100, 104. Furthermore, Oregon’s levy of taxes on earning income and utilizing Oregon landfills did not involve substantially equivalent events. *See id.* at 104-05. Therefore, the Court found that the statute violated the Commerce Clause. *See id.* at 108.

¹²² *Id.* at 103 (citations omitted). The most modern interpretation of this test is discussed at *infra* notes 188-205 and accompanying text.

¹²³ *Oregon Waste Sys.*, 511 U.S. at 104.

¹²⁴ *See id.* at 105. The Court expressed its hesitancy to “‘plunge . . . into the morass of weighing comparative tax burdens’ by comparing taxes on dissimilar events.” *Id.* (quoting *Tyler Pipe Industries, Inc. v. Washing State Dep’t of Revenue*, 483 U.S. 232, 289 (1961)). One of the first and most important compensatory tax cases was *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937) – the “compensatory use tax” case. At the time of the case, the state of Washington imposed a use tax on

use taxes have been upheld under the compensatory tax doctrine,¹²⁵ but not in recent years and not under the current three-prong test. The Court has rejected substantially-equivalent-events arguments for manufacturing and wholesaling;¹²⁶ the earning of income and the disposing of waste at Oregon landfills;¹²⁷ and the severance of natural resources from the soil and the use of resources imported from other states.¹²⁸ The compensatory tax defense, therefore, is a very narrow defense indeed.

the "privilege of using within this state any article of tangible personal property." *Id.* at 580. However, the statute further provided that the use tax did not apply to "the use of any article of tangible personal property the sale or use of which has already been subjected to a tax equal to or in excess of that imposed by this title whether under the laws of this state or some other state." *Id.* at 580-81 (quoting 1935 Wash. Laws ch. 180). The Silas Mason Company argued that this Washington use tax violated the Commerce Clause. The Court, however, rejected Silas Mason's argument, holding that the use tax was consistent with the Commerce Clause. In its analysis, the Court noted that "[t]he practical effect of a system thus conditioned . . . must be that retail sellers in Washington will be helped to compete upon terms of equality with retail dealers in other states who are exempt from a sales tax or any corresponding burden." *Id.* at 581. The Court further remarked that "[e]quality is the theme that runs through all the sections of the statute," *id.* at 583-84, and "[t]he one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed," *id.* at 584. Therefore, the use tax did not discriminate against interstate commerce.

¹²⁵ See, e.g., *Capitol Greyhound Lines v. Brice*, 339 U.S. 542, 542 (1950) (holding that under the compensatory tax doctrine, a Maryland excise tax on motor vehicles for which titles were issued did not violate the Commerce Clause).

¹²⁶ See *Armco, Inc. v. Hardesty*, 467 U.S. 638, 643 (1984) (holding that since it cannot be determined which part of a manufacturing tax is based on sales and which part is based on manufacturing, a manufacturing tax is not a "proxy" for a gross receipts tax); see also *infra* note 152.

¹²⁷ See *Oregon Waste Sys.*, 511 U.S. at 105 (stressing that since in-state shippers of out-of-state waste are subject to Oregon income taxes, these taxable events are not substantially equivalent).

¹²⁸ See *Maryland v. Louisiana*, 451 U.S. 725, 758-59 (1981). At the time of the case, Louisiana imposed a tax on the "first use" within Louisiana of any gas that was not subject to a severance or production tax imposed by Louisiana or any other state. The first-use tax was challenged on the basis that it discriminated against interstate commerce. The Court agreed with this contention and rejected the state's compensatory tax defense. Since the first-use tax had many credits and exemptions, the Court dismissed the state's argument that the practical effect of the first-use tax was to create equality between the tax burdens borne by gas flowing into Louisiana, whether extracted in Louisiana or off-shore. Therefore, the substantially-equivalent-events test was not met. See *id.* at 759.

B. *Application of Compensatory Tax Analysis to State Intangibles Tax Challenges*

1. *Darnell v. Indiana – 1912 – The History Begins*

*Darnell v. Indiana*¹²⁹ was the first United States Supreme Court case challenging a state intangibles tax statute ostensibly on Commerce Clause grounds¹³⁰ and applying compensatory tax doctrine. In *Darnell*, the state of Indiana brought an action to collect taxes on the stock of a Tennessee corporation. The stock was owned by Darnell, an Indiana resident.¹³¹

Under the applicable Indiana statutes, the state could impose taxes on all shares in foreign corporations, except national banks, owned by inhabitants of the state. In addition, Indiana could levy taxes on all shares in domestic corporations owned by state residents “when the property of the corporations was not exempt or not taxable to the corporation itself.”¹³² In other words, an Indiana resident would not have had to pay taxes on stock owned in a domestic corporation that paid property taxes to the state of Indiana or that owned exempt property.¹³³

Challenging the Indiana taxing scheme, *Darnell* asserted that the statutes violated the Commerce Clause and the Equal Protection Clause.¹³⁴ In particular, Darnell argued before the Supreme Court of Indiana that the tax discriminated “in favor of domestic stocks as against shares in a foreign corporation” because “a resident owning stock in a domestic corporation escape[d] taxation . . . while his next-door neighbor owning shares of stock in a foreign corporation [was] required to pay taxes on his holdings.”¹³⁵ Concluding that the purpose of the taxing scheme was “to require all property to contribute pro rata its share of taxes, and so far as practicable

¹²⁹ *Darnell v. Indiana*, 226 U.S. 390 (1912).

¹³⁰ One of the main issues discussed in this Part is whether *Darnell* was a Commerce Clause case or an Equal Protection Clause case. Ultimately, it was characterized as an equal protection case by the U.S. Supreme Court in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). See *infra* note 206 and accompanying text.

¹³¹ See *Darnell*, 226 U.S. at 397.

¹³² *Id.* The historical intangibles statutes at issue in *Darnell* were located in BURNS’ ANNO. STAT. (Ind.) §§ 10143, 10233, and 10234 (1908). See *Darnell*, 226 U.S. at 397.

¹³³ However, the value of the stock exceeding the value of the corporation’s tangible personal property was taxable. See *Darnell*, 226 U.S. at 397.

¹³⁴ See *id.* at 397-98.

¹³⁵ *Darnell v. Indiana*, 90 N.E. 769, 773 (Ind. 1910), *aff’d*, 226 U.S. 390 (1912).

to avoid double taxation," the Supreme Court of Indiana held that "the tax law of Indiana is not open to the charge of discrimination against stock in foreign corporations, but imposes only just and equal burdens upon all corporate stocks without regard to the place of incorporating or of conducting the corporate business . . . and is accordingly valid."¹³⁶

On appeal to the United States Supreme Court, *Darnell* again alleged that the tax statutes violated the Commerce Clause and the Equal Protection Clause.¹³⁷ The Court, in a very short opinion, affirmed the decision of the Indiana Supreme Court and upheld the statutes, primarily relying on *Kidd v. Alabama*,¹³⁸ a 1903 equal protection

¹³⁶ *Id.* at 774. The Indiana Supreme Court further reasoned:

Domestic corporations are taxed upon all their property The state, in its discretion, might tax the shares of stock in such corporation to the individual owners thereof residing in this state, but it would in a sense be double taxation, and it has not been the policy of this state to do. Shares of stock in a foreign corporation doing business in another state owned and held by a resident of this state are taxed because they have not and cannot be otherwise taxed by this state The fact that the state in which the corporate property may be situated taxes such tangible property in no wise affects the right of this state to tax its own inhabitants upon all their personal property including shares of stock in such foreign corporations.

Id. Finally, the Indiana Supreme Court asserted that *Darnell* was in no position to complain about his property taxes because Indiana residents enjoyed the benefits of Indiana's schools, churches, public accommodations, and governmental protection. *See id.* Interestingly, the Indiana Supreme Court did not mention the compensatory tax doctrine. Rather, it seemed to focus more on the policy against double taxation in justifying the allegedly discriminatory tax.

¹³⁷ *See Darnell*, 226 U.S. at 397-98. *Darnell* also complained that the Indiana statutes did not make an allowance for foreign corporations owning property taxed within Indiana. The Court, however, dismissed this argument because the foreign corporation at issue did not pay any property taxes to Indiana. *See id.* at 398.

¹³⁸ *Kidd v. Alabama*, 188 U.S. 730, 733 (1903) (holding that equal protection of the laws is not denied by Alabama's taxation of railroad stock, because of the exemption of stock in domestic railroads and in others that list substantially all their property for taxation); *see also supra* note 96. The U.S. Supreme Court, employing a rational basis test, concluded there was nothing that would "prevent [Alabama] from taxing stock in some domestic corporations and leaving stock in others untaxed on the ground that it taxes the property and franchises of the latter to an amount that imposes indirectly a proportional burden on the stock." *Kidd*, 188 U.S. at 732. Similarly, in determining whether to tax stock in foreign corporations, the *Kidd* court held that Alabama could take into account whether the property and franchise of the corporation were untaxed since, when corporations are formed in

case.¹³⁹ The *Darnell* Court also noted that the way Indiana taxed “the property of domestic corporations and the stock of foreign ones in similar cases” was “consistent with substantial equality;”¹⁴⁰ yet the Court did not explain its reasoning. In fact, the Court’s opinion is so concise that it is difficult to discern what it meant by using “substantial equality” language. Although the Court relied primarily on equal protection jurisprudence in deciding *Darnell*, the “substantial equality” language it employed is very similar to the language it used much later¹⁴¹ in compensatory tax analysis.¹⁴² Possibly, the Court viewed the intangibles tax as a compensatory tax vis-a-vis the corporate property tax. As will be seen, one of the most contentious issues in modern intangibles tax challenges was whether *Darnell* was a compensatory tax case or an equal protection case.

2. Felix v. Indiana Department of State Revenue – *Darnell Lives On*

After *Darnell*, decades passed without any specific Commerce Clause challenges to state intangibles taxes.¹⁴³ Outside the intangibles tax area, the

other states and their property is located in other states, the only way Alabama could tax anything was to tax the stock held within Alabama. *See id.* Finally, the Court rejected the significance of the ability of other states to tax the property of the foreign railroad corporations, and stated that “[t]he state of Alabama is not bound to make its laws harmonize in principle with those of other states. If property is untaxed by its laws, then for the purpose of its laws the property is not taxed at all.” *Id.*

¹³⁹ *See Darnell*, 226 U.S. at 398. Specifically, the Court stated that “[t]he case is pretty nearly disposed of by *Kidd v. Alabama*, where the real matter of complaint, that the property of the corporation presumably is taxed in Tennessee, is answered.” *Id.* (citation omitted).

¹⁴⁰ *Id.*

¹⁴¹ The three-prong test of *Oregon Waste Sys.* was not set forth until 1994. *See supra* notes 121-28 and accompanying text.

¹⁴² *See infra* notes 156-58 and accompanying text.

¹⁴³ Although there were not any Commerce Clause challenges to state intangibles taxes during this period, there was a state uniformity-of-taxation and equal protection constitutional challenge to the Nebraska intangibles tax statute in 1966. In *Rehkopf v. Board of Equalization*, 141 N.W.2d 462 (Neb. 1966), *see supra* notes 80, 96, the Nebraska Supreme Court held that a statute classifying the stock of a foreign corporation in the hands of a shareholder differently from the capital stock of a domestic corporation did not violate the constitutional provision requiring uniformity or the equal protection component of the Due Process Clause of the Fourteenth Amendment. Central to the court’s holding were its assumption that the

Commerce Clause was being more broadly construed to limit the powers of states. This broad construction of the Commerce Clause began with the analysis of New Deal programs created during the Depression,¹⁴⁴ and resulted in Congress being able to regulate any activity having a substantial effect on interstate commerce, regardless of its local or intrastate nature.¹⁴⁵ The dormant Commerce Clause was also being interpreted broadly to prevent state discrimination against interstate commerce.¹⁴⁶

In the late 1980s, against this background of receding state power under the Commerce Clause, vicious battles pitting the Commerce Clause

property of a corporation gives value to its shares and the importance of the policy against double taxation. *See Rehkopf*, 141 N.W.2d at 467. The Nebraska Supreme Court reasoned that since the corporation's property in Nebraska is taxed to the corporation, the domestic corporation was the "agent for its stockholders for the purpose of payment of any tax which may be due upon its shares of stock." *Id.* at 466. Therefore, a tax law "levying a tax upon the market value of shares in foreign corporations held by citizens of this state, and not levying such a tax upon shares of stock in a corporation in this state where the corporation has paid the full amount of tax upon its property," is a reasonable classification and constitutional. *Id.* at 468. Interestingly, in 1967, the Nebraska legislature repealed the intangibles tax statutes challenged in *Rehkopf*. NEB. REV. STAT. § 77-722, *repealed* 1967 Neb. Laws ch. 498, § 3.

¹⁴⁴ *See United States v. Darby*, 312 U.S. 100 (1941) (upholding the Fair Labor Standards Act of 1938, which prohibited the shipment in interstate commerce of goods produced by employees working for more than the maximum hours or for less than the prevailing rates); *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937) (upholding the National Labor Relations Act of 1935 under the Commerce Clause because a labor stoppage of intrastate manufacturing operations would have a substantial effect on interstate commerce).

¹⁴⁵ *See Wickard v. Filburn*, 317 U.S. 111 (1942) (upholding the Agricultural Adjustment Act of 1938, which placed quotas on wheat, including home-grown wheat, because the more wheat was consumed by farmers personally, the less was bought in commerce; thus, the interstate trade in wheat was implicated and the Commerce Clause was applicable).

¹⁴⁶ *See Boston Stock Exchange v. Tax Comm'n*, 429 U.S. 318 (1977). In *Boston Stock Exchange*, stock exchanges located outside New York challenged an amendment to New York's transfer tax on the basis that it discriminated against interstate commerce. *See id.* at 319-20. As a result of the transfer tax amendment, out-of-state security sales were taxed more heavily than transactions involving a sale within the state. *See id.* at 319. The U.S. Supreme Court held that "because it impose[d] a greater tax liability on out-of-state sales than on in-state sales, the New York transfer tax . . . [fell] short of the substantially even-handed treatment demanded by the Commerce Clause." *Id.* at 332.

against state intangibles taxes began to erupt, particularly in Indiana, North Carolina, Kentucky, Georgia, and Pennsylvania. The first of these battles occurred in Indiana in *Indiana Department of State Revenue v. Felix*.¹⁴⁷

In *Felix*, the Clarkes and Felix ("Taxpayers"), investors in an out-of-state money market fund, challenged the constitutionality of the Indiana Intangibles Tax Act of 1933 under the Commerce Clause.¹⁴⁸ The Taxpayers argued that since the Indiana Intangibles Tax Act applied only to the ownership of the intangibles of out-of-state corporations and exempted the intangibles of Indiana entities, it facially discriminated against interstate commerce and therefore violated the Commerce Clause.¹⁴⁹

The Indiana Superior Court (the trial court) ruled that the Indiana intangibles tax violated the state Constitution¹⁵⁰ and the Commerce Clause of the United States Constitution because it discriminated against Indiana residents with assets in other states.¹⁵¹ On appeal to the Indiana Supreme Court, the Taxpayers argued that the more recent United States Supreme Court cases of *Armco, Inc. v. Hardesty*¹⁵² and *Maryland v.*

¹⁴⁷ *Indiana Dep't of State Revenue v. Felix*, 571 N.E.2d 287 (Ind. 1991).

¹⁴⁸ *See id.* at 288-89. The Taxpayers also contended that the intangibles tax violated the uniformity-of-taxation requirement of the Indiana Constitution, but the Supreme Court of Indiana rejected this contention. *See id.* at 294-95. The Indiana Intangibles Tax Act was historically codified at IND. CODE §§ 6-5-1-1 to 6-5-1-34. As a result of the *Felix* case, however, the legislature repealed the intangibles tax retroactive to November 10, 1988. *See* Pub. L. No. 80-1989, §§ 18-19, 1989 IND. ACTS 912, 919; *see also Refunds Scheduled for Some Hoosiers Who Filed Suit Against Intangibles Tax*, INDIANAPOLIS STAR, Feb. 11, 1992, at B14 (noting "the lawsuit led to the repeal of the tax").

¹⁴⁹ *See Felix v. Indiana Dep't of State Revenue*, 502 N.E.2d 119, 199 (Ind. Ct. App. 1986). Although the Indiana Court of Appeals case did not address the Commerce Clause issues, the Taxpayers' Commerce Clause arguments are clearly laid out there.

¹⁵⁰ The Indiana Superior Court held that the tax violated the uniform taxation provisions in article 10, section 1, of the Indiana Constitution. *See Felix*, 571 N.E.2d at 289.

¹⁵¹ *See id.* at 289-93; *Refunds Scheduled for Some Hoosiers*, *supra* note 148, at B14. This decision prompted the *St. Ledger* case. *See* Introduction, *supra*; Part III, *infra*.

¹⁵² *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984). In *Armco, Inc.*, the taxpayer challenged, on Commerce Clause grounds, the constitutionality of West Virginia's business and operation tax. This tax required persons engaged in the business of selling tangible personal property at wholesale to pay taxes on gross receipts. Local manufacturers were exempt from the gross receipts tax, but they did have to pay a higher manufacturing tax. *See id.* at 639-41. The State argued that the higher

Louisiana,¹⁵³ both of which invalidated state taxes purporting to be compensatory taxes, had implicitly overruled *Darnell*. The Supreme Court of Indiana rejected this argument, stating “[b]ecause state taxes challenged under the Commerce Clause [were] challenged on a case-by-case basis,” it could not infer that *Darnell* was implicitly overruled without the U.S. Supreme Court’s specific direction that intangible taxes were no longer to be construed as “valid compensating [taxes] for in-state property taxes on domestic corporations.”¹⁵⁴

The Taxpayers had attempted, but failed, to distinguish *Darnell* by arguing that its conclusory analysis of “substantially equivalent events” made it an equal protection case.¹⁵⁵ In addition, the Taxpayers argued that the Indiana tax differed from the *Darnell* tax because the *Darnell* tax could have been applied to Indiana intangibles if the property of the domestic corporation was not exempt or not taxable to the corporation itself. In contrast, under the Indiana scheme, domestic shareholders never had to pay the intangibles tax.

The Indiana Supreme Court found this distinction between the two taxes immaterial.¹⁵⁶ Further, the Indiana Supreme Court clearly stated that it viewed *Darnell* as a Commerce Clause decision.¹⁵⁷ Yet, in relying upon

manufacturing tax was a compensating tax for the gross receipts tax, *see id.* at 642, but the Court rejected this argument, holding:

Manufacturing and wholesaling are not “substantially equivalent events” such that the heavy tax on in-state manufacturers can be said to compensate for the admittedly lighter burden placed on wholesalers from out of State. Manufacturing frequently entails selling in the State, but we cannot say which portion of the manufacturing tax is attributable to manufacturing and which portion to sales. The fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of State, and that it is reduced when part of the manufacturing takes place out of State, makes clear that the manufacturing tax is just that, and not in part a proxy for the gross receipts tax.

Id. at 643.

¹⁵³ *Maryland v. Louisiana*, 451 U.S. 725 (1981); *see supra* note 128.

¹⁵⁴ *Felix*, 571 N.E.2d at 292.

¹⁵⁵ The U.S. Supreme Court in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), however, later validated this conclusion. *See infra* note 206 and accompanying text.

¹⁵⁶ *See Felix*, 571 N.E.2d at 292-93.

¹⁵⁷ *See id.* at 291-93. The court noted: “Eighty years ago, this Court and the United States Supreme Court (in *Darnell*) sustained a virtually identical version of the Indiana intangibles tax against a commerce clause challenge. . . . We find *Darnell* controlling.” *Id.* at 289. It appears that the Indiana Supreme Court viewed

Darnell, which in turn relied upon *Kidd* (an equal protection case), the Indiana Supreme Court arguably overturned *Felix* on tacit equal protection grounds, neither engaging in a detailed compensatory tax analysis nor a Commerce Clause analysis.¹⁵⁸

3. *Fulton Corp. v. Faulkner* – *The Demise of Darnell*

The next significant development in the war between state intangibles taxes and the Commerce Clause occurred in North Carolina, in *Fulton Corp. v. Faulkner*.¹⁵⁹

At the time the case arose, North Carolina imposed an intangibles tax on the value of shares of stock owned by state residents “inversely proportional to the corporation’s exposure to the State’s income tax.”¹⁶⁰ In determining their intangibles tax liability, however, residents were entitled

Darnell as a Commerce Clause/compensatory tax case (as opposed to an equal protection case), since it noted the “substantial equality” language in *Darnell* and commented that under the compensatory tax doctrine, “[t]he ‘substantially equivalent’ events test is still used today to sustain taxes challenged under the commerce clause.” *Id.* at 291 (citing *Ashland Oil, Inc. v. Caryl*, 497 U.S. 916 (1990)). On the other hand, the Indiana Supreme Court stated that the pleadings in *Darnell* revealed the Commerce Clause nature of the case. *See id.* at 292. The *Darnell* Court relied solely on equal protection jurisprudence and did not mention the Commerce Clause/compensatory tax doctrine as a rationale for its decision. Thus, *Darnell* arguably could have been an equal protection case. *See supra* notes 139-42 and accompanying text. As previously noted, the *Darnell* opinion was so concise that it has been difficult for later courts to discern whether the U.S. Supreme Court’s use of the “substantial equality” language truly involved compensatory tax analysis.

¹⁵⁸ *See Felix*, 571 N.E.2d at 287. When the Indiana Supreme Court overturned the Superior Court’s ruling in *Felix* that the tax was legal, the Taxpayers asked the U.S. Supreme Court to hear their case. However, the case eventually settled. As part of the settlement, that appeal was withdrawn, saving the state from a larger refund. *See id.* at 289; *Refunds Scheduled for Some Hoosiers*, *supra* note 148, at B14.

¹⁵⁹ *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). *Fulton* was actually filed after *St. Ledger*; however, *Fulton* got to the U.S. Supreme Court first. The North Carolina intangibles tax challenged in *Fulton* was repealed after the Supreme Court’s decision in *Fulton* without retroactive effect. *See id.* at 328 n.1 (referring to 1995 N.C. Sess. Laws, ch. 41). The former intangibles tax was set out in sections 105 through 203 of the North Carolina General Statutes. *See id.*

¹⁶⁰ *Id.* at 327.

to take a "taxable percentage deduction equal to the fraction of the issuing corporation's income subject to tax in North Carolina."¹⁶¹

Consequently, a corporation doing all of its business in North Carolina would pay corporate income tax on 100% of its income, and the resident shareholders of that corporation's stock would be entitled to a 100% deduction under the North Carolina intangibles tax. In contrast, stock in a corporation doing no business in North Carolina would be taxable on its full value because there would be no percentage deduction.¹⁶² Stockowners of companies doing a portion of their business in North Carolina could ascertain their taxable percentages from a publication of the North Carolina Secretary of Revenue. "In 1990, for example, the Secretary determined the appropriate taxable percentage of IBM stock to be 95%, meaning that IBM did 5% of its business in North Carolina, with the stock held by North Carolina residents being taxable on 95% of its value."¹⁶³

Fulton Corporation ("Fulton") was a North Carolina corporation that held stock in six corporations as of December 31, 1990.¹⁶⁴ Only one of those corporations conducted a portion of its business in North Carolina. Consequently, Fulton paid a significant amount of intangibles taxes to North Carolina for 1990.¹⁶⁵ On May 1, 1991, Fulton filed suit against the North Carolina Secretary of Revenue seeking a refund and a declaratory judgment that the North Carolina intangibles tax violated the Commerce Clause. The Wake County Superior Court granted summary judgment for the Secretary of Revenue.¹⁶⁶

a. Court of Appeals

Fulton then appealed to the Court of Appeals of North Carolina, arguing that the intangibles tax violated the Commerce Clause of the United States Constitution and the Due Process and Equal Protection

¹⁶¹ *Id.* (discussing N.C. GEN. STAT. §§ 105-203). The percentage deduction amount was computed by "applying a corporate income tax apportionment formula averaging the portion of the issuing corporation's sales, payroll, and property located in the state." *Id.* (discussing N.C. GEN. STAT. §§ 105-130.4(i)).

¹⁶² *See id.*

¹⁶³ *Id.* (citing N.C. Dep't of Revenue, Stock and Bond Values as of December 31, at 39 (1990)).

¹⁶⁴ *See* *Fulton Corp. v. Justus*, 430 S.E.2d 494, 496 (N.C. Ct. App. 1993).

¹⁶⁵ *See id.* at 496-97. The actual amount of intangibles taxes paid by Fulton was \$10,884.00, which represented 54% of its stock in the company.

¹⁶⁶ *See id.* at 497.

Clauses of the United States and North Carolina Constitutions.¹⁶⁷ Fulton contended that the intangibles tax violated the Commerce Clause because the percentage deduction aspect of the tax encouraged investors to buy stock in corporations doing business in North Carolina. Therefore, out-of-state corporations could find it more difficult to raise capital in North Carolina, and the trading of stocks in interstate commerce could decline.¹⁶⁸ The court of appeals, explicitly refusing to invoke the compensatory tax doctrine, held that the “portion of the state’s intangibles tax scheme which increases the tax liability for owners of stock in corporations whose business and property is not completely in North Carolina violates the Commerce Clause of the United States Constitution.”¹⁶⁹

The court commenced its analysis by asserting the principle that “[n]o State may, consistent with the Commerce Clause, ‘impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.’”¹⁷⁰ Based on this principle, the court found the intangibles tax facially discriminatory because it encouraged “the development of local business by placing a greater burden on economic activities occurring outside North Carolina than is placed on similar activities within North Carolina.”¹⁷¹

The court then analyzed whether the discriminatory impact of the intangibles tax could be “counterbalanced” by a compensatory tax. The Secretary of Revenue argued that the intangibles tax scheme “compensates for the state’s inability to tax the corporation’s out-of-state property and the income it generates.”¹⁷² Relying on *Armco, Inc. v. Hardesty*,¹⁷³ the court rejected this argument and held that the compensatory tax doctrine could not save the discriminatory aspects of the intangibles tax for two reasons. First, the relationship between property taxes paid by a corporation and intangibles taxes paid by a shareholder, like the relationship between

¹⁶⁷ *See id.*

¹⁶⁸ *See id.* Fulton also argued that “local corporations may be encouraged not to enter interstate commerce in order to avoid the intangibles taxation for their shareholders.” *Id.*

¹⁶⁹ *Id.* at 498-99.

¹⁷⁰ *Id.* at 498 (quoting *Boston Stock Exchange v. State Tax Comm’r*, 429 U.S. 318, 329 (1977)).

¹⁷¹ *Id.* Therefore, in deciding which companies to invest in, taxpayers would not act as if they were in a “no-tax” world.

¹⁷² *Id.* at 499; *see also supra* note 146.

¹⁷³ *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984); *see also supra* note 152 and accompanying text.

manufacturing and wholesaling in *Armco, Inc.*,¹⁷⁴ was too tenuous for the intangibles tax to be classified as compensatory.¹⁷⁵ Second, the intangibles tax (on shareholders) and the property tax (on corporations) were levied on different taxpayers. Therefore, the taxes would not fall on substantially equivalent events.¹⁷⁶

Finally, the North Carolina Court of Appeals rejected the Secretary of Revenue's argument that *Darnell* should be applied because it found the tax in *Darnell* distinguishable from the North Carolina intangibles tax.¹⁷⁷ The court reasoned that in *Darnell*, there was a "one-to-one correlation between *property* tax paid by the corporation and taxes paid by the shareholder on shares owned."¹⁷⁸ In contrast, in North Carolina, the correlation was "between *income* taxed to the corporation and the taxes paid by the shareholders."¹⁷⁹ In North Carolina, income was determined by three factors, and the property factor accounted for only one-fourth of the apportionment formula.¹⁸⁰ Furthermore, the policy against double taxation emphasized in *Darnell* in applying Indiana law was not a fundamental policy in North Carolina tax law.¹⁸¹

b. Supreme Court of North Carolina

The Secretary of Revenue appealed the court of appeals' decision to the Supreme Court of North Carolina, arguing that the North Carolina

¹⁷⁴ See *supra* note 152.

¹⁷⁵ See *Fulton Corp. v. Justus*, 430 S.E.2d 494, 499 (N.C. Ct. App. 1993). The court illustrated the vague relationship between intangibles taxes and property taxes as follows: "under the tax scheme a corporation could pay no property taxes in North Carolina, and the taxable percentage of its stock still be less than one hundred percent because the taxable percentage is computed by multiplying *three* factors: sales, payroll, and property." *Id.*

¹⁷⁶ Further, the court of appeals explained that a tax on gross receipts is not a proxy for a tax on manufacturing: "If a corporation owns no property in North Carolina, the state has no burden of providing protection to the corporation's property and should not be allowed to tax the corporation's stock as proxy for the corporate property." *Id.*; see also *supra* notes 124-28 and accompanying text (noting the difficulty in meeting the substantially-equivalent-events test).

¹⁷⁷ See *Fulton*, 430 S.E.2d at 501.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ See *id.* Sales and payroll are the other two factors that determined income, with the sales factor being "double-weighted." *Id.*

¹⁸¹ See *id.*

intangibles tax did not violate the Commerce Clause.¹⁸² The supreme court agreed with the Secretary of Revenue and reversed the holding that the intangibles tax scheme was consistent with the Commerce Clause.¹⁸³ In its analysis, the North Carolina Supreme Court relied heavily on *Darnell* to sustain the intangibles tax as a compensatory tax. The court noted:

In *Darnell* the [United States] Supreme Court found substantial equality, sufficient to satisfy the Commerce Clause, in taxing the stock of foreign corporations not paying property taxes and taxing the property of domestic corporations. In the instant case the state imposes an intangibles tax on the shares of stock of corporations the amount of which is directly and inversely proportional to the income of the issuing corporation which is taxed in North Carolina. The effect is to reduce the intangibles tax liability for stock held in a corporation to the extent the corporation's income is taxed in this state and to increase the intangibles tax liability on stock held in a corporation to the extent the corporation's income is not taxed in North Carolina. This is the very kind of "compensating" tax scheme the [United States] Supreme Court upheld in *Darnell*.¹⁸⁴

¹⁸² See *Fulton Corp. v. Justus*, 450 S.E.2d 728, 729 (N.C. 1994). *Fulton* also appealed the Court of Appeals' decision to strike only the unconstitutional provisions of the intangibles tax. *Id.*

¹⁸³ See *id.* at 735.

¹⁸⁴ *Id.* at 732. Apparently, the Supreme Court of North Carolina viewed *Darnell* as a Commerce Clause/compensatory tax case. *Fulton* argued (as he did to the court of appeals) that the tax in *Darnell* could be distinguished in two ways from the North Carolina intangibles tax. First, unlike *Fulton*, "Darnell dealt with a property tax on the shareholder that was directly offset by a property tax on the corporation." *Id.* (quoting plaintiffs' brief). Second, "while there might be a relationship between the value of a corporation's stock and the value of its property, the 'relationship between the stock-issuing corporation's North Carolina income tax and the shareholders' North Carolina intangible property tax' is 'vague.'" *Id.* at 733 (quoting plaintiffs' brief). The Supreme Court of North Carolina dismissed *Fulton*'s first contention as an immaterial difference because – unlike the court of appeals – it believed both property taxes and income taxes could offset the intangibles tax in a similar manner. See *id.* at 732. The supreme court also rejected *Fulton*'s second argument because, as demonstrated by economists' reliance on price-earnings ratios, there is a strong relationship (as opposed to a "vague" relationship) between corporate income and the value of a corporation's stock. "Corporate income tax, which is directly proportional to corporate income, affects the amount of . . . dividends," which, in turn, greatly affects the value of the stock. *Id.* at 733.

c. *United States Supreme Court*

After this decision by the North Carolina Supreme Court, Fulton petitioned the United States Supreme Court for a writ of certiorari. The Supreme Court granted the writ and laid *Darnell* to rest by holding that North Carolina's intangibles tax discriminated against interstate commerce in violation of the dormant Commerce Clause.¹⁸⁵ In its analysis, the Court first set forth the general principle that state laws facially discriminating against interstate commerce are "virtually *per se* invalid."¹⁸⁶ It then held that the North Carolina intangibles tax was clearly facially discriminatory because it favored "domestic corporations over their foreign competitors in raising capital among North Carolina residents."¹⁸⁷ It noted, however, that the tax would be constitutional if it were a compensatory tax created to equalize the burdens on interstate and intrastate commerce.¹⁸⁸ It then scrutinized the intangibles tax under the three-prong *Oregon Waste Systems* test to determine if the North Carolina tax could be saved by the compensatory tax doctrine.¹⁸⁹

First, to invoke the compensatory tax defense, a state must describe the intrastate tax burden for which it seeks to compensate. The "intrastate tax must serve some purpose for which the state may otherwise impose a burden on interstate commerce."¹⁹⁰ The North Carolina Secretary of Revenue asserted that the intangibles tax, with its percentage deduction, compensated for the general income tax levied on corporations doing business in North Carolina. The Court rejected this argument, however, stating that "because North Carolina has no general sovereign interest in taxing income earned out of state, . . . the Secretary must identify some in-state activity or benefit in order to justify the compensatory levy."¹⁹¹ The Supreme Court also recognized the "danger of treating general revenue

¹⁸⁵ See *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). This ruling was consistent with the judicial criticisms of *Darnell*, the attempts to distinguish *Darnell*, and the developing Commerce Clause jurisprudence. See *supra* notes 144-58, 172-81 and accompanying text.

¹⁸⁶ *Fulton Corp.*, 516 U.S. at 331 (quoting *Oregon Waste Sys., Inc. v. Department of Env'tl. Quality Comm'n*, 511 U.S. 93, 99 (1994)).

¹⁸⁷ *Id.* at 333. The Court also commented that the tax was facially discriminatory because it discouraged domestic corporations from participating in interstate commerce. See *id.*

¹⁸⁸ See *id.* at 325 (citing *Associated Indus. v. Lohman*, 511 U.S. 641 (1994)).

¹⁸⁹ See *id.* at 332-44; *supra* notes 121-28 and accompanying text.

¹⁹⁰ *Fulton Corp.*, 516 U.S. at 325.

¹⁹¹ *Id.* at 334.

measures,” such as corporate income taxes, as “relevant intrastate burdens for purposes of the compensatory tax doctrine.”¹⁹² This would allow states to tax interstate commerce more heavily “‘anytime the entities involved in interstate commerce happened to use facilities supported by general state tax funds.’”¹⁹³ The Secretary then identified the maintenance of the North Carolina capital markets (which were supported by the corporate income tax) as the relevant in-state activity for justifying a compensatory tax.¹⁹⁴ Since foreign corporations escaped the corporate income tax, the Revenue Secretary reasoned they should have to “pay” for access to the markets through a tax on the value of shares sold.¹⁹⁵ The Supreme Court disagreed, however, because it believed North Carolina provided for the maintenance of its capital markets through its Blue Sky laws, as opposed to the general corporate income tax.¹⁹⁶ Consequently, the tax failed the first prong of the compensatory tax test.

Second, a State invoking the compensatory tax defense must prove that “‘the tax on interstate commerce . . . roughly . . . approximate[s] – but not exceed[s] – the amount of the tax on intrastate commerce.’”¹⁹⁷ The Secretary of Revenue argued that the amounts of the intangibles tax and the corporate income tax could be compared using price/earnings ratios. However, the Supreme Court contended that the Secretary’s suggestion would involve a comparison of “apples to oranges,” and the more proper comparison would be between “the size of the intangibles tax and that of the corporate income taxes component that purportedly funds the capital market.”¹⁹⁸ This comparison was practically impossible to make.¹⁹⁹ The

¹⁹² *Id.* at 326.

¹⁹³ *Id.* at 335 (quoting *Oregon Waste Sys., Inc. v. Department of Env'tl. Quality Comm'n*, 511 U.S. 93, 105 n.8 (1994)).

¹⁹⁴ *See id.* at 336.

¹⁹⁵ *Id.* at 326.

¹⁹⁶ *See id.* Blue Sky laws regulate “who may sell securities in [a state], the procedures that must be followed to do so, and the fees imposed for the privilege.” *Id.*

¹⁹⁷ *Id.* at 336-37 (quoting *Oregon Waste Sys.*, 511 U.S. at 103).

¹⁹⁸ *Id.* at 337. The basis for the court’s “apples and oranges” reasoning was that the general corporate income tax funds several activities, only one of which is the maintenance of capital markets, the Secretary’s only justification for the intangibles tax. In making this comparison, the Supreme Court noted it was suppressing its suspicion that North Carolina funded its capital markets through fees generated by Blue Sky laws. *See id.* at 337-38.

¹⁹⁹ *See id.* at 338. The impossibility results from the fact that corporate income taxes are commingled with funds from other sources before they are earmarked for

Secretary could not prove what portion of the corporate income taxes supported the capital markets, nor whether this amount was greater than the burden placed on interstate commerce by the intangibles tax. Thus, the tax also failed the second prong of the compensatory tax test.²⁰⁰

Finally, a State invoking the compensatory tax defense must prove the taxes fall on substantially equivalent events.²⁰¹ The Secretary of Revenue asserted that North Carolina had “assured substantial equivalence” because of a direct correlation between “the percentage of share value subject to the intangibles tax” and the “percentage of income earned within the state.”²⁰² Furthermore, the Secretary argued that the intangibles tax and the corporate income tax fell on economically equivalent values, and thus on economically equivalent events. The United States Supreme Court, however, disagreed, finding that the intangibles tax was not “functionally equivalent” to the corporate income tax because “equality of treatment [did] not appear when the allegedly compensating taxes [fell] respectively on taxpayers who [were] differently described, as, for example, resident shareholders and corporations doing business out of state.”²⁰³ In addition, the Supreme Court

particular purposes. *See id.*

²⁰⁰ *See id.*

²⁰¹ *See id.* As discussed in Part II.A, *see supra* notes 124-28 and accompanying text, the U.S. Supreme Court has interpreted the “substantial equivalent events” requirement quite narrowly. Basically, the Court has only found the requisite equivalence in the “sales/use tax context,” rejecting equivalence arguments for the “earning of income and the disposing of waste, . . . the severance of natural resources from the soil and the use of resources imported from other states, . . . and the manufacturing and wholesaling of tangible goods.” *Fulton Corp.*, 516 U.S. at 338-39 (citations omitted). In these cases, the high Court held “that the paired activities were not ‘sufficiently similar in substance to serve as mutually exclusive prox[ies] for each other.’” *Id.* at 339 (quoting *Oregon Waste Sys.*, 511 U.S. at 103). The objective of the substantially-equivalent-events requirement is to allow in-state and out-of-state companies “to compete on a footing of equality.” *Id.* at 326.

²⁰² *Fulton Corp.*, 516 U.S. at 326 (citing N.C. GEN. STAT. §§ 105-130.4(i)).

²⁰³ *Id.* The Court did note that a state could get around the “different taxpayer” problem by showing that the actual incidences of the two tax burdens (as opposed to the nominal incidences) are such that the real taxpayers are within the same class. For example, the Secretary could have showed “the economic impact of North Carolina’s corporate income tax is passed through to shareholders of corporations doing business in state in a way that offsets the disincentive imposed by the intangibles tax to buying stock in corporations doing business out of state.” *Id.* at 341. However, the Secretary failed to meet this burden in *Fulton*, and the Court stated that this burden would always be difficult to meet because of such things as the “elasticities of supply and demand,” the market structure, and the

expressed doubt as to whether the corporate income tax was passed directly through to shareholders.²⁰⁴

Therefore, since North Carolina failed to satisfy any of the three requirements needed to establish a valid compensatory tax, the United States Supreme Court found the tax unconstitutional as facially discriminatory.²⁰⁵ The Court concluded that *Darnell* could not save the intangibles tax because *Darnell's* exclusive reliance on *Kidd*, an equal protection case, indicated that *Darnell* should only be viewed as an equal protection case; therefore, it was "no longer good law under the Commerce Clause."²⁰⁶ Therefore, *Fulton* resulted in the complete demise of *Darnell* as a part of Commerce Clause jurisprudence, where before, *Darnell* had only been criticized or distinguished.

4. *The Post-Fulton Corp. Cases – Other than St. Ledger*

This subpart will discuss how state courts, other than Kentucky courts, responded to intangibles tax challenges following the decision in *Fulton Corp.* Kentucky's response to *Fulton Corp.* will be discussed in Part III.

a. *Pennsylvania*

In *PPG Industries, Inc. v. Commonwealth*,²⁰⁷ PPG ("Taxpayer"), a Pennsylvania corporation, appealed a tax resettlement to the Commonwealth Court of Pennsylvania, asserting that the manufacturing exemption to Pennsylvania's capital stock tax violated the Commerce Clause of the United States Constitution.²⁰⁸ The Pennsylvania capital stock tax, applicable to all corporations headquartered in Pennsylvania, provides an

ability of producers and consumers to substitute products. *Id.* Further, courts are not very skilled at evaluating the "relative economic burden" of different taxes. *Id.* at 342 (citing *Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue*, 460 U.S. 575, 589-90 & nn.12-14 (1983)).

²⁰⁴ *See id.* at 343. For example, the actual burden of the tax could be borne by consumers.

²⁰⁵ *See id.* at 344.

²⁰⁶ *Id.* at 345. *Cf. supra* notes 157, 184 and accompanying text (explaining why *Darnell* should be viewed as a Commerce Clause case).

²⁰⁷ *PPG Indus., Inc. v. Commonwealth*, 681 A.2d 832 (Pa. Commw. Ct. 1996).

²⁰⁸ *See id.* at 833. Taxpayer was in the business of manufacturing glass, fiberglass, and paint, and had its corporate headquarters in Pittsburgh. During 1983, the tax year at issue, Taxpayer performed only a portion of its manufacturing in Pennsylvania. *See id.* at 832.

exemption stating that “in determining the relevant apportionment factors the numerator of the property, payroll or sales factors shall not include any property, payroll, or sales attributable to manufacturing, processing, research or development activities in the Commonwealth.”²⁰⁹ Therefore, only manufacturing in the Commonwealth of Pennsylvania can be exempted.

Taxpayer argued that the manufacturing exemption violated the Commerce Clause because it discriminated against interstate commerce in the same way as the percentage deduction in *Fulton Corp.*: it provided a tax exemption for corporations headquartered in Pennsylvania that also manufactured in the state. Thus, Pennsylvania corporations that manufactured in other states were treated less favorably because they did not receive the tax exemption.²¹⁰

The Commonwealth Court of Pennsylvania did not find *Fulton Corp.* controlling because the manufacturing exemption, unlike the exemption in *Fulton Corp.*, did not distinguish between domestic and foreign corporations, and so did not discourage stock ownership of foreign corporations.²¹¹ The commonwealth court found that although the exemption encouraged manufacturing in Pennsylvania, it did so without burdening any interstate transaction because it did not involve any transactions across state lines. Therefore, the manufacturing exemption was upheld.²¹²

²⁰⁹ *Id.* at 833. The manufacturing exemption is located in section 7602(a) of title 72 of the Pennsylvania Statutes. See PA. STAT. ANN. tit. 72, § 7602(a) (West Supp. 1997).

²¹⁰ See *PPG Indus., Inc.*, 681 A.2d at 834-35.

²¹¹ See *id.* at 835. The Pennsylvania court also noted that the manufacturing exemption is not based on any transactions crossing state lines. Rather, the exemption focuses on “how much of the corporate headquarters supports manufacturing within the state.” *Id.*

²¹² See *id.* The Pennsylvania court further noted in support of the manufacturing exemption that the purpose of the exemption is to encourage manufacturing in the state, not to encourage companies to move their headquarters to Pennsylvania. See *id.* at 835 n.7. The authors of this Note agree with the position of the dissent:

The Department’s application of the manufacturing exemption has a discriminatory economic effect on multi-state corporations with a low percentage of manufacturing in Pennsylvania. If a multi-state corporation expands its manufacturing in another state, one of the direct costs of the expansion is an increase in the capital stock tax. Conversely, if a multi-state corporation expands in Pennsylvania the capital stock tax decreases. Not only does the manufacturing exemption provide a positive incentive for

There also have been several recent Commerce Clause challenges to the Pennsylvania County personal property tax. In essence, the personal property tax applies only to the stock of corporations that generate their sole income outside of Pennsylvania and choose not to avail themselves of the Pennsylvania market, because the tax exempts the stock of corporations liable under the Pennsylvania capital stock tax.²¹³

The first challenge was brought by Walter and Leonore Annenberg in *Annenberg v. Pennsylvania*.²¹⁴ The Annenbergs requested injunctive relief

multi-state corporations to increase manufacturing in Pennsylvania, but it penalizes corporations for manufacturing in other states. Thus, the Department's application of the exemption substantially discriminates against out-of-state manufacturing in violation of the Commerce Clause.

Id. at 836. In *Fulton Corp.*, the U.S. Supreme Court found the intangibles tax facially discriminatory, in part because it discouraged domestic corporations from participating in interstate commerce. *See supra* note 187. As the dissent in *PPG-Industries, Inc.* stated, the Pennsylvania manufacturing exemption seems to do exactly that because it penalizes corporations for manufacturing in other states.

²¹³ *See* Christopher J. Hess, Note and Comment, *The Constitutionality of Taxing the "Stranger Within the Gates": The Impact of Fulton v. Faulkner on the Pennsylvania County Personal Property Tax*, 16 J.L. & COM. 233, 240 (1997). The Pennsylvania Personal Property Tax Act reads in pertinent part:

[A]ll personal property . . . is hereby made taxable annually for county purposes, and, in cities coextensive with counties, for city and county purposes, at a rate not to exceed four mills of each dollar of the value thereof . . . [including] all shares of stock in any bank, corporation, association, company, or limited partnership created or formed under the laws of this Commonwealth or of the United States, or of any other state or government, except shares of stock in any bank, bank and trust company, national banking association, savings institution, corporation, or limited partnership, liable to a tax on its shares . . . or the capital stock tax or franchise tax imposed . . . for State purposes.

PA. STAT. ANN. tit. 72, § 4821. The Capital Stock Tax applies to all corporations, foreign and domestic, that are incorporated in Pennsylvania, transact business within Pennsylvania, or receive a license to operate an enterprise within Pennsylvania. *See Hess, supra*, at 239.

²¹⁴ *Annenberg v. Commonwealth*, 686 A.2d 1380 (Pa. Commw. Ct. 1996). Walter Annenberg, former U.S. Ambassador and former chairman of Triangle Publications, Inc. (*T.V. Guide*, *Seventeen*, *The Philadelphia Inquirer*) is a multi-billionaire and highly esteemed philanthropist devoted to educational concerns. *See, e.g.*, William Shawcross, *Turning Dollars Into Change*, TIME, Sept. 1, 1997, at 54; John Birger, *Magazine Matchmaker*, CRAIN'S N.Y. BUS., May 26, 1997, at 31.

and a declaratory judgment that the personal property tax violated the Commerce Clause.²¹⁵ Similarly, in *Stranahan v. Mercer*,²¹⁶ the taxpayers brought a class action lawsuit challenging the constitutionality of the Pennsylvania personal property tax. The commonwealth court has not yet decided the Commerce Clause issues in either of these cases.²¹⁷ Based on the similarities between the Pennsylvania personal property tax and the intangibles tax in *Fulton Corp.*, it appears highly likely that the personal property tax violates the Commerce Clause.²¹⁸

b. *Georgia*

Until recently, Georgia also had an intangibles tax statute that probably violated the Commerce Clause under the *Fulton Corp.* test because it specifically exempted Georgia corporations.²¹⁹ In *Lombard v.*

²¹⁵ See *Annenberg*, 686 A.2d at 1381. Specifically, with respect to corporations not doing business or having a taxable situs within the Commonwealth, the Annenbergs argued that the tax “impairs such corporations’ ability to raise capital in any county that imposes the tax because potential investors in such counties know that any earnings from investment in such stocks will be reduced by the amount of the tax, whereas similar investment in Pennsylvania corporations will not.” *Id.* at 1382.

²¹⁶ *Stranahan v. Mercer*, 697 A.2d 1049 (Pa. Commw. Ct. 1997).

²¹⁷ In *Stranahan*, the Commonwealth Court of Pennsylvania held that a class action could not be employed to obtain individual tax refunds because there was a statutory remedy available. See *id.* In *Annenberg*, the Commonwealth Court of Pennsylvania has only decided procedural issues, such as the facts that the Commonwealth is not an indispensable party and the proper forum is the court of common pleas. See *Annenberg*, 686 A.2d at 1385.

²¹⁸ See Hess, *supra* note 213, at 236 (noting that the personal property tax is clearly facially discriminatory because “it wholly exempts stocks of corporations which engage in any significant Pennsylvania commerce, and conversely, it subjects the shares of stock in out-of-state corporations which do not engage in commerce in Pennsylvania to full taxability,” *id.* at 240). The compensatory tax doctrine would not save the tax because the capital stock tax and the property tax do not fall on substantially equivalent events: the property tax taxes the value of the stock in the hands of a shareholder, see *id.* at 242, while the capital stock tax taxes the income and net worth of the corporation. Therefore, the tax does not fall on identical parties as required by *Fulton*. See *supra* note 203 and accompanying text.

²¹⁹ See Lucy Soto, *Counties Won Some, Lost Some – They Dodged Cuts in Social Services, But Intangibles Tax Repeal Will Hurt*, ATLANTA J. & CONST., Mar.

Collins,²²⁰ Lombard Corporation sued the Commissioner of the Georgia Department of Revenue, asserting the unconstitutionality of the Georgia intangibles tax under the Commerce Clause.²²¹ The tax levied was \$1 for every \$1000 in stocks, bonds, and cash held by an investor in companies based outside Georgia. Investments in Georgia-based companies were not subject to the tax.²²² On March 21, 1996, the Governor signed House Bill No. 6 and House Bill No. 1101, which repealed the Georgia intangibles tax on personal property.²²³ The trial court dismissed *Lombard* as moot because a third party had satisfied Lombard's tax liability, thus leaving the Commerce Clause issue unresolved.²²⁴

C. *The Probable Demise Under Fulton Corp. of Most Intangibles Tax-Exemption Statutes Favoring In-State Businesses Over Out-of-State Businesses*

As a result of *Fulton Corp.*, it is now virtually impossible for states to have intangibles tax statutes with exemptions favoring in-state businesses over out-of-state businesses. The three-prong compensatory tax test articulated by the Supreme Court in *Fulton Corp.* nullified the compensatory tax defense except in the sales/use context and in the rare situation where a state can meet the heavy burden of proving that the taxes fall on substantially equivalent events.²²⁵ Consequently, many states have

22, 1996, at D4.

²²⁰ *Lombard v. Collins*, 480 S.E.2d 47 (Ga. Ct. App. 1997). The *Lombard* case precipitated the repeal of the Georgia intangibles tax, which generated revenue of roughly forty million dollars a year. See Soto, *supra* note 219.

²²¹ The former Georgia intangibles tax was located in GA. CODE ANN. §§ 48-6-20 to 48-6-44. The sections were repealed effective March 21, 1996. See Ga. L. 1996, p. 117, § 6.

²²² See GA. CODE ANN. §§ 48-6-20 to 48-6-23, repealed by Ga. L. 1996, p. 117, § 6.

²²³ See *Lombard*, 480 S.E.2d at 47. House Bill No. 6 became law when the governor signed it. House Bill No. 1101, on the other hand, became law only upon voter approval. This legislation became effective beginning in the tax year 1996. On November 5, 1996, the voters approved the repeal of the intangibles tax in Georgia. See Arthur Brice, *Clinton Wins, GOP Holds House*, ATLANTA J. & CONST., Nov. 6, 1996, at A1.

²²⁴ See *Lombard*, 480 S.E.2d at 47. The Court of Appeals of Georgia agreed that the suit appeared to be moot, but it certified a few questions to the Supreme Court of Georgia regarding the mootness issue. See *id.* at 48-49.

²²⁵ See *supra* notes 185-206 and accompanying text.

surrendered to the Commerce Clause by repealing their intangibles tax statutes, thereby losing significant amounts of revenue.²²⁶

However, states still may have some ability to provide tax incentives encouraging in-state economic development. For example, “to reduce the capital costs for in-state businesses,” California, Colorado, and Delaware currently have statutes that provide “preferential tax treatment to investors who provide funds to in-state businesses.”²²⁷ Furthermore, many states have adopted tax provisions such as investment tax credits, characteristic location incentives, and job credits to attract businesses to their area.²²⁸ To date, none of these provisions have been challenged under the Commerce Clause.²²⁹ Since these tax incentives do appear to favor in-state over out-of-state business activity, it may be only a matter of time before they are challenged under the United States Supreme Court’s anti-discrimination standard.²³⁰ Thus, the modern Commerce Clause era has greatly curtailed

²²⁶ While it is certainly understandable that states would want to provide incentives to encourage economic development within their borders, it must be remembered that our country was built on the principle that states should not be permitted to discriminate against interstate commerce. Otherwise, “the promotion of in-state markets at the expense of out-of-state ones furthers the ‘economic Balkanization’ that our Dormant Commerce Clause jurisprudence has long sought to prevent.” *Fulton Corp. v. Faulkner*, 116 S. Ct. 848, 855 n.3 (1996) (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 325-26 (1979)).

²²⁷ Enrich, *supra* note 112, at 386-87 & n.46 (citing CAL. REV. & TAX CODE § 18152.5 (West Supp. 1994) (exempting 50% of the gains from sales of stock in qualifying in-state small businesses); COLO. REV. STAT. ANN. § 39-22-518 (West Supp. 1995) (waiving the state capital gains tax on the sale of an interest in a Colorado business or property held for at least five years); and DEL. CODE ANN. tit. 30, § 1116 (Supp. 1994) (granting a 15% personal income tax credit for investments in qualifying Delaware businesses)). Although these statutes appear to be facially discriminatory in that they favor local businesses over out-of-state businesses, they have not yet been challenged under the Commerce Clause.

²²⁸ *See id.* at 382-86.

²²⁹ *See id.* at 381. Enrich contends that these incentives have not yet been challenged because “the parties who are ordinarily in a position to bring challenges to state business taxes, namely business taxpayers, have not found it in their interests to attack this particular class of state tax policies.” *Id.* at 408.

²³⁰ *See West Lynn Creamery v. Healy*, 512 U.S. 186 (1994). Enrich concedes that these tax incentives are facially discriminatory. However, he asserts that the Court should employ an antidistortion standard, instead of its traditional discriminatory tax analysis, to evaluate state location incentives. This standard would “judge whether a state tax incentive violates the Commerce Clause by assessing whether that distorts economic decision concerning the location of the

the ability of states to invoke the compensatory tax defense against discriminatory tax legislation. It is against this background that the *St. Ledger* decision emerged.

III. THE *ST. LEDGER* CASE

A. Introduction

As discussed in Part I, before *St. Ledger I*, sixty years passed when there were no legal challenges to the Kentucky intangibles tax.²³¹ While the *Fulton Corp.*²³² case in 1996 sounded a warning bell that Kentucky's intangibles tax might violate the Commerce Clause, many had already begun to challenge its validity by the late 1980s, both in the courtroom and in the political arena. This challenge would ultimately prove successful in 1997 when the Kentucky Supreme Court handed down its final decision in *St. Ledger II*.²³³

B. Post-Klein Developments

1. The Tax Begins to Be Enforced

All was quiet on the intangibles tax front both in the courts and in the legislature for fifty years after *Klein v. Jefferson County Board of Tax Supervisors*.²³⁴ Momentum for an intangibles tax²³⁵ repeal began to build in the late 1980s. The reason for the sudden outcry against a tax that had been around in some form since the Civil War was simple. Until recently, the tax had not been enforced. The state had no way of determining who owed the tax since it did not have clear records of who owned stocks, and

business activity." Enrich, *supra* note 112, at 378.

²³¹ See *supra* notes 25-79 and accompanying text.

²³² *Fulton Corp. v. Faulkner*, 116 S. Ct. 848 (1996).

²³³ See *St. Ledger II*, 942 S.W.2d 893 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

²³⁴ *Klein v. Jefferson County Bd. of Tax Supervisors*, 18 S.W.2d 1009 (Ky. 1929), *aff'd*, 282 U.S. 19 (1930).

²³⁵ The modern form of the intangibles tax was structured as follows. Pursuant to section 132.020(1) of the Kentucky Revised Statutes, individual shareholders were taxed on all corporate stocks. The stocks of corporations with 75% of their taxable property in Kentucky, however, were exempt from this tax pursuant to section 136.030(1).

relied instead upon self-reporting. Unsurprisingly, few Kentuckians actually paid the tax.²³⁶

That all changed in 1987 when the state put the entire tax roll on computers. The state then began to see an increase in intangibles tax receipts. Additionally, Governor Wallace Wilkinson's administration (1987-1991) began sending out notices with tax forms demanding payment of the intangibles tax.²³⁷ Later efforts included a doubling of the number of Revenue Cabinet examiners who tracked the intangibles tax, as well as checking dividends reported on federal tax forms to identify tax liability.²³⁸ By 1995, 112,000 taxpayers were paying the intangibles tax.²³⁹

2. *The Public Reacts*

In response to increased collection of the intangibles tax and the commencement of the *St. Ledger* litigation,²⁴⁰ business groups and economists began speaking out against the tax. They argued that repeal of the intangibles tax would stop many of Kentucky's wealthiest residents, including the early "baby boomers" who were approaching retirement age, from moving to Tennessee or Florida when they retired, because those states do not have income taxes and rely mainly on sales taxes for revenue. Since retirees tend to consume less, they would bear less of a burden of taxation in Tennessee or Florida than would working families. "'Wealthy people see it as a real impediment,'" according to Paul Coomes, a University of Louisville economist.²⁴¹ When these retirees leave, often they take their wealth with them. This wealth could be invested in Kentucky businesses or given to Kentucky foundations. Instead, the intangibles tax effectively bankrolled out-of-state foundations and businesses because Kentucky often did not see the fruit of its wealthy retirees' labor.

In 1992, the Kentucky Economic Development Corporation, a private group composed of business leaders from around the state, urged the repeal of the intangibles tax to improve Kentucky's ability to attract and retain

²³⁶ See Brammer, *supra* note 27, at A12.

²³⁷ See *id.*

²³⁸ See Associated Press, *Intangible Tax Not Gone Yet, So Pay Before You Get Caught, State Warns*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Dec. 28, 1994, at B3.

²³⁹ See *Court Questions State Corporate Stock Tax*, LEXINGTON HERALD-LEADER (Lexington, Ky.), May 21, 1996, at C1.

²⁴⁰ See *infra* notes 242-57 and accompanying text.

²⁴¹ Jim Jordan, *Economist Offers Wish List for State*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Dec. 3, 1996, at B6 (quoting Paul Coomes).

business. According to Ted Broida of Lexington, the group's vice president, the tax impeded business development because it discouraged those who made business-location decisions from wanting to relocate here.²⁴²

Politicians began to make some noise as well. Members of the General Assembly began filing bills that would amend the Kentucky Constitution to abolish the intangibles tax.²⁴³ Starting in 1990 and continuing through the 1994 General Assembly, at least one bill was introduced during each regular session. All of the bills were referred to committee, but none received any consideration.²⁴⁴ The sponsor of one of the bills, Republican Senator Art Schmidt from Cold Spring, echoed the comments of business leaders: "'For anyone with significant wealth, it's silly to live in Kentucky.'"²⁴⁵

²⁴² See Brammer, *supra* note 27, at A1. In 1994, Columbia/HCA, the largest for-profit hospital company in the country and a member of the Fortune 500, moved a wholly owned subsidiary, Health Care Indemnity Inc., and its 40 Louisville employees across the Ohio River into Indiana to escape the intangibles tax. The company paid \$730,000 in tax on intangibles in 1994. See Kyung M. Song, *Columbia Moves Unit to Escape Intangibles Tax*, THE COURIER-JOURNAL (Louisville, Ky.), Dec. 13, 1994, at D10. Columbia/HCA has since moved its entire corporate headquarters to Nashville, Tennessee.

In another example, Vencor, Inc. a Louisville-based health care company that just entered the Fortune 500 in 1997, was forced to restructure its corporate holdings and set up a subsidiary so that its shareholders would be exempt from the tax. See Ken Berzof, *Dire Predictions are Made at Trial on Intangibles Tax*, THE COURIER-JOURNAL (Louisville, Ky.), Mar. 27, 1992, at C1.

²⁴³ Because of the mandate in section 171 of the Kentucky Constitution that all property be taxed, *see supra* notes 45-48, an amendment, in addition to statutory approval, would be required to abolish the intangibles tax.

²⁴⁴ In the 1990 General Assembly, Jon David Reinhardt and Pat Freibert filed House Bill 805. In 1992, intangibles tax repeals were the subject of House Bill 81 filed by Ken Harper, House Bill 290 filed by Dorsey Ridley, House Bill 428 filed by Jon David Reinhardt and Pat Freibert, and Senate Bill 40 filed by Arthur L. Schmidt. During the 1994 General Assembly, Ken Harper and Bill Lear filed House Bill 156 and Jim LeMaster filed House Bill 219. In the Senate, Senator Richard L. Roeding was the primary sponsor of Senate Bill 103 and Senator Joseph U. Meyer sponsored Senate Bill 105, which would have amended the Kentucky Constitution to permit the General Assembly to repeal portions of the tax on certain classes of intangibles.

²⁴⁵ *Tangibly Unfair Tax on Intangible Property Should Be Scrapped*, LEXINGTON HERALD-LEADER (Lexington, Ky.), July 14, 1992, at A6 (quoting state Senator Art Schmidt).

A bipartisan Tax Policy Commission formed by Governor Brereton Jones (1991-1995) recommended the repeal of the intangibles tax in 1995, calling it a "red flag" for executives in companies looking at Kentucky.²⁴⁶ Also in 1995, during the gubernatorial race, all but one of the candidates for Governor told the *Lexington Herald-Leader* that they supported the repeal of the intangibles tax. The lone holdout, then-Lieutenant Governor Paul Patton, called for a comprehensive review of taxes that would include the intangibles tax.²⁴⁷

3. *The 1996 General Assembly*

This momentum prompted the 1996 Kentucky General Assembly to finally consider the repeal of the intangibles tax on stocks. Debate revealed a consensus in favor of amending the Kentucky Constitution to allow the tax to be repealed. Constitutional amendments were proposed in both houses to modify section 170 of the Constitution.²⁴⁸ The House passed such an amendment, but neither bill could get through the Senate.²⁴⁹

Senate Republicans demanded that any amendment, if approved by the voters, actually repeal the intangibles tax.²⁵⁰ Anything less, they argued,

²⁴⁶ KENTUCKY COMMISSION ON TAX POLICY, A BLUEPRINT FOR COMPREHENSIVE REFORM 5-6, 29-30 (Nov. 15, 1995).

²⁴⁷ See *Your Choice: Electing a Governor*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Apr. 2, 1995, at E2.

²⁴⁸ See HB 718, Regular Session (Ky. 1996) (filed by Harry Moberly); SB 113, Regular Session (Ky. 1996) (filed by John "Eck" Rose et al.) (stating that the General Assembly could exempt all or any portion of the intangibles tax on any class of personal property).

²⁴⁹ See *Intangible Property Tax Bill to Die in Committee*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Mar. 22, 1996, at B4.

²⁵⁰ See *id.* Part of the background in this debate was the fact that Republicans had been vastly outnumbered by Democrats in both houses. Recent elections, however, had increased the number of Republicans in the Senate to 17 out of a total of 38. Through alliances with a number of conservative Democrats who could be counted on to support many of their positions, the Republicans began to wield substantial power. Whereas before Republicans could merely slow down legislation, now they could actually stop legislation or force passage of a more favorable bill. The 1996 General Assembly featured many such battles. The intangibles tax battle was probably the most prominent of these. For an analysis of the 1996 General Assembly, see Al Cross, *The 1996 General Assembly; Partisan Sparks Flew from Start to Finish*, THE COURIER-JOURNAL (Louisville, Ky.), Apr. 7, 1996, at D1.

would be mere “subterfuge,” leading the public to believe that the tax had been repealed, when in fact, the General Assembly had only been given the authority to repeal the tax.²⁵¹ With seventeen Republicans in the Senate unwilling to support anything less than an outright repeal, no amendment could pass both houses.²⁵²

Perhaps Senator David Boswell summed it up best: “‘We have failed the people in this commonwealth.’”²⁵³ The inability of the General Assembly to pass a repeal of the intangibles tax left the issue in the hands of the courts, as the *St. Ledger* case proceeded through the system.

C. *St. Ledger Case*

1. *Background*

After the *Klein* decision, no intangibles tax litigation occurred until Herschel St. Ledger filed his class action lawsuit in 1990. St. Ledger was a United States Army Corps of Engineers retiree who resided in Anchorage, a suburb of Louisville. He got his idea to legally challenge the constitutionality of the Kentucky intangibles tax from “some Indiana friends who were laughing at [him] because [he] had to pay the tax.”²⁵⁴ Indiana had recently repealed its intangibles tax after it had been challenged in court.²⁵⁵ Like most Kentuckians, St. Ledger didn’t like the tax. “‘It’s a nuisance tax, [that’s] all it is. It improperly influences any person’s investment program, but especially elderly people whose income is fixed and who depend on investments to help them along.’”²⁵⁶ St. Ledger’s stock holdings in Kentucky-based Louisville Gas & Electric and Humana were exempt from the intangibles tax, but his stock holdings in National City Bank of Cleveland were not.

²⁵¹ See Chad Carlton, *Sharply Divided House Approves Amendment on Tax-Cutting Power*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Mar. 14, 1996, at C1.

²⁵² Constitutional amendments in Kentucky must pass both the House and the Senate with a three-fifths majority to be placed on the ballot. See KY. CONST. § 256 (1892).

²⁵³ *Intangible Property Tax Bill to Die in Committee*, *supra* note 249, at B4 (quoting state Senator David Boswell).

²⁵⁴ Brammer, *supra* note 27, at A1.

²⁵⁵ See *Felix v. Indiana Dep’t of State Revenue*, 502 N.E.2d 119 (Ind. Ct. App. 1986), *rev’d*, 571 N.E.2d 287 (Ind. 1991).

²⁵⁶ Brammer, *supra* note 27, at A1 (quoting Herschel St. Ledger).

St. Ledger, his wife Nicki, and some friends decided to join together to file a class action suit. They founded a group called the Kentucky Intangible Tax Committee, whose members would help to defray the costs of litigation. More than 300 Kentucky residents joined the group.²⁵⁷ St. Ledger sought declaratory and injunctive relief on behalf of himself and others similarly situated and challenged the constitutionality of the corporate shares tax²⁵⁸ as well as the bank deposits tax.²⁵⁹ He personally had

²⁵⁷ *See id.*

²⁵⁸ The courts used the term "corporate shares tax" to refer to the intangibles tax on corporate stock that St. Ledger challenged in his lawsuit. The specific statutes being challenged were the general tax on intangibles, section 132.020(1), and the exemption for companies with at least 75% of their total property in Kentucky, section 136.030(1).

The relevant parts of section 132.020(1) state:

An annual ad valorem tax for state purposes of . . . twenty-five cents (\$0.25) upon each one hundred dollars (\$100) of value of all money in hand, shares of stock, notes, bonds, accounts, and other credits, whether secured . . . or unsecured, except as otherwise provided in subsection (2) of this section . . . shall be paid by the owner or person assessed except as provided in . . . KRS 132.030 . . . and other sections providing a different tax rate for particular property.

K.R.S. § 132.020(1).

The relevant parts of section 136.030(1) state:

The individual stockholders of a corporation shall not be required to list their shares for ad valorem taxation so long as the corporation pays taxes to the State of Kentucky on at least seventy-five percent (75%) of its total property, wherever located. . . . In order to obtain this exemption, the stockholder shall furnish satisfactory proof to the Revenue Cabinet that at least seventy-five percent (75%) of the total property of the corporation as hereinabove specified is taxed in the State of Kentucky.

Id. § 136.030(1).

²⁵⁹ Unlike corporate stock, deposits in Kentucky banks are not exempt from taxation; rather, they are taxed at lower rates pursuant to section 132.030. Out-of-state banks were taxed at the higher rate provided in section 132.020(1). *See supra* note 251. The court referred to this taxing scheme as the Bank Deposits Tax.

The relevant parts of section 132.030 state:

(1) Every person having a deposit in any financial institution, as defined in section 136.500, Kentucky Revised Statutes, on January 1 of any year shall pay an annual tax to the state equal to one-thousandth of one percent (0.001%) upon the amount of the deposit, and no deduction shall be made for any indebtedness

(2) No other tax shall be assessed by the state or any county, city, or other taxing district on the deposits or against the depositor on account of the

deposits in some Kentucky-based savings and loan institutions that were taxed at a lower rate than deposits he had in one out-of-state institution.²⁶⁰ St. Ledger based his claims on the Commerce Clause²⁶¹ of the United States Constitution, the Equal Protection Clause of both the United States Constitution²⁶² and the Kentucky Constitution,²⁶³ and the Classification, Uniformity and Equality of Taxes Provision of the Kentucky Constitution.²⁶⁴ *Klein* stood in the way of all but the Commerce Clause claim, however, and little in the development of Kentucky common law on the subject of the intangibles tax exemption had occurred since *Klein*.²⁶⁵

A different precedent stood in the way of challenges to the bank deposit tax²⁶⁶ based on Fourteenth Amendment due process and equal protection grounds. In *Madden v. Kentucky*,²⁶⁷ the Supreme Court held that the taxpayer could not offer enough evidence to overcome the presumption that the classification in the bank deposit tax was not “hostile and oppressive discrimination.”²⁶⁸ The purpose behind the tax – to compensate for the difficulties and expenses of tax collection in the out-of-state banks²⁶⁹ – was warranted because it was not “hostile and oppressive discrimination against particular persons and classes.”²⁷⁰

Similarly, *Darnell* and the compensatory tax doctrine²⁷¹ stood in the way of the Commerce Clause claim. However, much case law had developed that brought into question the continued validity of *Darnell*.²⁷²

deposits.

K.R.S. § 132.020.

²⁶⁰ See *St. Ledger v. Kentucky Revenue Cabinet*, No. 90-CI-06075, slip op. at 3 (Jefferson Cir. Ky. July 1, 1992).

²⁶¹ U.S. CONST. art. I, § 8, cl. 3.

²⁶² *Id.* amend. XIV, § 1.

²⁶³ KY. CONST. § 3.

²⁶⁴ *Id.* § 171; see text at *supra* note 46.

²⁶⁵ See *supra* notes 75-79 and accompanying text.

²⁶⁶ See *supra* notes 5-10 and accompanying text.

²⁶⁷ *Madden v. Kentucky*, 309 U.S. 83 (1940) (holding that a higher tax rate on out-of-state bank deposits does not violate the Equal Protection and Due Process Clauses of the U.S. Constitution).

²⁶⁸ *Id.* at 88.

²⁶⁹ See *id.* at 89-90.

²⁷⁰ *Id.* at 88.

²⁷¹ See *supra* notes 116-28 and accompanying text (discussing the compensatory tax doctrine in detail).

²⁷² See *supra* notes 143-58 and accompanying text (discussing challenges to *Darnell*).

In fact, in light of those developments, this claim appeared particularly strong. Both taxes clearly discriminated against interstate commerce by applying a lower or zero tax rate on in-state bank deposits and corporate stock, respectively. St. Ledger was prepared to offer the testimony of business leaders and residents about the discriminatory effects of the taxes and how the taxes affected investment decisions.²⁷³ Only the compensatory tax doctrine could save the tax from Commerce Clause challenges. With the status of that doctrine in doubt,²⁷⁴ St. Ledger was confident. He argued that the proper remedy was to strike down both the exemption statutes and the taxes themselves, since the General Assembly contemplated the two statutes as a whole. One would not have been passed without the other.²⁷⁵ To eliminate the exemption would remove the Commerce Clause problem, but it would frustrate the legislative intent because all bank deposits and corporate stock would be subject to the higher rates, a scenario not intended by the General Assembly.²⁷⁶

The Revenue Cabinet obviously relied on the validity of *Klein* and *Darnell*.²⁷⁷ The goal of the higher bank deposits tax on out-of-state bank deposits was to offset the higher collection cost for out-of-state banks, while the goal of the corporate stock tax exemption was to eliminate double taxation. The Cabinet believed that both goals were legitimate and did not violate the Equal Protection Clause, just like the tax challenged in *Klein*.²⁷⁸ The Cabinet argued that *Darnell's* compensatory tax doctrine controlled the Commerce Clause claim. Alternatively, if *Darnell* were held to be no longer valid, the Cabinet argued that only the exemptions should be invalidated. All stocks and bank deposits should be subject to the higher

²⁷³ See *supra* notes 240-47 and accompanying text.

²⁷⁴ See *supra* notes 116-28 and accompanying text (discussing the compensatory tax doctrine in detail).

²⁷⁵ See Appellant's Brief at 7, *St. Ledger v. Kentucky Revenue Cabinet*, 942 S.W.2d 893 (Ky. 1997) (94-SC-468-DG, 94-DC-875-DG, July 18, 1996).

²⁷⁶ See *id.*

²⁷⁷ Initially, the Revenue Cabinet relied on *Klein* only. After the Indiana Supreme Court decision in *Indiana Dep't of State Revenue v. Felix*, 571 N.E.2d 287 (Ind. 1991), see *supra* notes 147-58, the Cabinet began to cite *Darnell*. The Revenue Cabinet also questioned the standing of St. Ledger to bring suit, pointing in particular to the fact that deposits were made and shares were purchased specifically for purposes of the lawsuit. See Appellee's Brief at 3-8, *St. Ledger v. Kentucky Revenue Cabinet*, 942 S.W.2d 893 (Ky. 1997) (94-SC-468-DG, 94-DC-875-DG, Aug. 19, 1996).

²⁷⁸ See Appellee's Brief, *supra* note 277, at 23-24.

tax.²⁷⁹ This would be in keeping with section 170 of the Kentucky Constitution requiring that all property be taxed and would in no way frustrate the intent of the General Assembly, since the tax is designed primarily to raise revenue and not to avoid double taxation.²⁸⁰ The Revenue Cabinet was also prepared to argue that bank deposits were not interstate commerce.²⁸¹ The financial impact of the tax loomed large in the Revenue Cabinet's opposition to the *St. Ledger* claims.

2. Financial Impact of Tax

Throughout the trial, it was difficult to determine precisely the potential financial impact of the *St. Ledger* case on Kentucky. The most cited figure was that \$25 million was generated annually by the Corporate Shares Tax.²⁸² The Revenue Cabinet obviously had a strong financial interest in keeping this revenue flowing into the state's general fund. Of far greater concern, however, was the amount of refunds, if any, that the courts might grant to those Kentuckians who had already paid the tax.²⁸³

This amount was dependent upon a number of factors. The obvious first factor was the number of years for which the state would allow taxpayers to claim refunds.²⁸⁴ If the filing of the *St. Ledger* suit constituted an application for refund for all taxpayers, as *St. Ledger* argued, then refunds would have to be paid back to 1988.²⁸⁵ An internal Finance Cabinet memorandum estimated that this would generate \$320 million in refund claims.²⁸⁶ The state's rainy day fund contained about \$200 million dollars

²⁷⁹ See *id.* at 26-31.

²⁸⁰ See *id.* at 53.

²⁸¹ The Revenue Cabinet relied upon section 287.030(3) of the Kentucky Revised Statutes, which states that non-Kentucky banks may not transact any banking business in Kentucky except to lend money. Thus, banks and bank deposits are local in nature. See *id.* at 9.

²⁸² See Memorandum, Consensus Forecasting Group, Kentucky Office of Financial Management and Economic Analysis, *Fiscal Impacts of Selected Legislation* (Mar. 12, 1996).

²⁸³ The return of previously paid taxes plus interest would have a much larger impact on the state's general fund. Estimates ranged from \$208 to \$320 million. See *id.* at 3.

²⁸⁴ See K.R.S. § 134.590 (Michie Supp. 1996). The period for which refunds would be available was disputed in litigation, however. See *infra* notes 351-484 and accompanying text..

²⁸⁵ See *infra* notes 351-484 and accompanying text.

²⁸⁶ See Memorandum, Consensus Forecasting Group, *supra* note 282, at 3.

at the time.²⁸⁷ A second factor affecting the potential amount of refunds was whether or not the state had to pay interest on the refunds. The internal Finance Cabinet memorandum assumed interest would have to be paid. A final factor would be the refund procedure. If taxpayers were automatically given refunds, more money would have to be paid out than if taxpayers had to be proactive and file claims.²⁸⁸ Regardless of the exact dollar amount, the financial stakes were significant for the state.²⁸⁹

3. St. Ledger I

a. Circuit Court – “A Ruling Neither Side Really Asked for”²⁹⁰

After a bench trial that featured testimony from many prominent business leaders on behalf of St. Ledger as well as an amicus curie brief filed by the Kentucky Chamber of Commerce,²⁹¹ on July 1, 1992 the Jefferson Circuit Court found that the exemption statute was so “obviously unenforceable as written”²⁹² and so “incomplete or conflicting in pro-

²⁸⁷ See Tom Loftus, *Deal Settles Intangible-Tax Case; First Refunds May Go Out in 2 Weeks*, THE COURIER-JOURNAL (Louisville, Ky.), Sept. 11, 1997, at A1 [hereinafter Loftus, *Deal Settles Intangible-Tax Case*]. The rainy day fund is a discretionary fund for fiscal emergencies.

²⁸⁸ See *infra* notes 351-484 and accompanying text.

²⁸⁹ The final settlement included the approximate figures of \$143 million in refunds plus \$40 million in interest. See Agreed Judgment of Satisfaction and Resolution at 6, *St. Ledger v. Kentucky Revenue Cabinet*, No. 90-CI-06075 (Jefferson Circuit Court, Sept. 10, 1997).

²⁹⁰ Ken Berzof, *Judge Rejects Tax Exemption for Investors in State's Firms*, THE COURIER-JOURNAL (Louisville, Ky.), July 3, 1992, at A1 (describing St. Ledger attorney's characterization of the Jefferson Circuit Court's ruling).

²⁹¹ The Chamber of Commerce joined St. Ledger on behalf of its 3000 member businesses based or operating in Kentucky. See Brief of Amicus Curiae, Kentucky Chamber of Commerce at vi., *St. Ledger v. Kentucky Revenue Cabinet*, 942 S.W.2d 893 (Ky. 1997) (94-SC-468-DG, 94-SC-875-DG, Sept. 18, 1996). The Chamber of Commerce was concerned that the Revenue Cabinet's position that the corporate share tax should extend to all corporate stock would “severely and adversely impact (if not destroy) Kentucky's business and investment community.” *Id.* at 14. Its arguments were similar to those of the taxpayers in support of the position that the entire statute was unconstitutional. On the issue of refunds, the Chamber supported the limitation of refunds to two years. See *id.*

²⁹² *St. Ledger v. Kentucky Revenue Cabinet*, No. 90-CI-06075, slip op. at 11-12 (Jefferson Cir. Ct. July 1, 1992).

visions²⁹³ that it was void. To assist taxpayers in preparing their returns, the Revenue Cabinet had provided taxpayers with a list of in-state, and thus exempt, corporations. Because such a list was not provided for by statute, the circuit court found the state had exceeded its statutory authority. Yet, without such a list, it would be impossible for the taxpayer to pay the corporate shares tax,²⁹⁴ thus, the corporate shares tax exemption was found to be unenforceable as written. The circuit court's decision did not reach the Commerce Clause claims, although it noted the corporate shares tax "significantly impact[ed] interstate commerce."²⁹⁵ This ruling meant that *all* stock would be taxed at the higher rate, since only the exemption was ruled unconstitutional, not the entire taxing scheme.

The Jefferson Circuit Court further found that the bank deposits tax violated the Commerce Clause and was unconstitutional.²⁹⁶ It found no evidence to support the Revenue Cabinet's claim that a higher rate on out-of-state bank deposits was needed to offset the higher cost of collection of the tax.²⁹⁷ Thus, out-of-state bank deposits were to be taxed in the same manner as in-state bank deposits.²⁹⁸ Attorneys for St. Ledger described this ruling as "'winning the battle but losing the war,'" since everyone now had to pay a higher rate of taxes on stock.²⁹⁹

*b. Court of Appeals – "Bank Accounts, by There [sic] Very Nature, Do Not Fall into the Category of Interstate Commerce"*³⁰⁰

A three-judge court of appeals panel in May 1994 reversed the circuit court's ruling on the corporate shares tax, finding the statute enforceable as written.³⁰¹ The court of appeals noted that if the Revenue Cabinet could compile a list of exempt corporations by obtaining information directly from those corporations, their shareholders could as well. Thus, the court of appeals reasoned, the statute did not place an unenforceable burden on the taxpayers since they could get their own information or use the

²⁹³ *Id.*

²⁹⁴ *See id.* at 6-7.

²⁹⁵ *Id.* at 5.

²⁹⁶ *See id.* at 12.

²⁹⁷ *See id.* at 9.

²⁹⁸ *See id.* at 10-11.

²⁹⁹ Berzof, *supra* note 290, at A1 (quoting one of St. Ledger's attorneys).

³⁰⁰ St. Ledger v. Kentucky Revenue Cabinet, No. 92-CA-2688-MR, slip op. at 21 (Ky. Ct. App. May 20, 1994).

³⁰¹ *See id.* at 16, 21.

Revenue Cabinet's information.³⁰² Moreover, the court of appeals found the service offered by the Revenue Cabinet did not exceed its statutory authority; rather, the Cabinet's listing of exempt corporations merely assisted taxpayers in determining their liability.³⁰³

This line of reasoning made sense. Taxpayers must rely upon information from their employers to determine wages paid and taxes withheld.³⁰⁴ They also may rely on the Internal Revenue Service's listing of organizations that qualify as non-profit³⁰⁵ to determine if they may take a charitable deduction.³⁰⁶ Courts have not found reliance on such lists of information to represent the kind of burden on the taxpayer that would render the respective statutes unenforceable.

The court of appeals then proceeded to resolve two claims with respect to the corporate shares tax not addressed by the circuit court. The first claim was that section 136.030(1) violated both the Kentucky and federal Constitutions' Equal Protection Clauses and section 171 of the Kentucky Constitution concerning uniformity, equality, and classification of taxes, because it discriminated between in-state and out-of-state corporations.³⁰⁷ This claim failed because the justices found *Klein*³⁰⁸ controlling on this issue. *Klein* upheld the validity of the statute as a reasonable attempt to alleviate double taxation.³⁰⁹

Finally, the court of appeals addressed the Commerce Clause claim. The court held that the intangibles tax did in fact discriminate against interstate commerce by exempting from taxation the shares of in-state corporations.³¹⁰ The court, however, held that the compensatory tax

³⁰² See *id.* at 7.

³⁰³ See *id.*

³⁰⁴ See 26 C.F.R. § 31.6051-1(a) (1997) (governing employer wage statements for employees).

³⁰⁵ See I.R.C. § 501(c)(3) (1994).

³⁰⁶ See 26 C.F.R. § 601.201(n)(3)(iii)(a). In Publication No. 78, the Internal Revenue Service ("I.R.S.") set forth a "Cumulative List of Organizations described in section 170(c) of the Internal Revenue Code of 1954," a list of non-profit organizations the I.R.S. continues to use in issuing ruling or determination letters relied upon by taxpayers.

³⁰⁷ See *St. Ledger v. Kentucky Revenue Cabinet*, No. 92-CA-2688-MR, slip op. at 8 (Ky. Ct. App. May 20, 1994).

³⁰⁸ See *Klein v. Jefferson County Bd. of Tax Supervisors*, 18 S.W.2d 1009 (Ky. 1929); see also *supra* notes 72-78 and accompanying text.

³⁰⁹ See *Klein*, 18 S.W.2d at 1012.

³¹⁰ See *St. Ledger*, No. 92-CA-2688-MR, slip op. at 11-12.

doctrine³¹¹ saved such a tax from unconstitutionality.³¹² Citing *Darnell*,³¹³ the court of appeals held that a tax on out-of-state corporate stock was constitutional because elimination of double taxation was a justifiable and legitimate burden on interstate commerce,³¹⁴ and observed that it “[knew] of no other practical way of equalizing the impact upon interstate commerce, and, at the same time, preventing what essentially amount[ed] to double taxation.”³¹⁵

One “other practical way,” of course, did exist: The General Assembly could repeal the entire statute. Furthermore, the court of appeals’ reliance on *Darnell* was extremely questionable in light of the extensive development of the compensatory tax doctrine in the years since 1912, as the United States Supreme Court’s decision in *Fulton Corp.* demonstrated. Even though *Darnell* had not been explicitly overruled, more recent Supreme Court cases, such as *Boston Stock Exchange v. State Tax Commission*,³¹⁶ *Armco, Inc. v. Hardesty*,³¹⁷ and *Maryland v. Louisiana*,³¹⁸ which rejected the compensatory tax doctrine for the challenged taxes, indicated that *Darnell*’s holding and analysis were, at best, questionable.³¹⁹

On the issue of the bank deposits tax, the court of appeals also reversed the circuit court, holding that bank deposits, by their very nature, were not interstate commerce, and focused narrowly on the statutory requirement in section 287.030(3) that out-of-state banks could conduct no banking business other than lending money.³²⁰ Thus, the court concluded that Kentucky banks were “local in nature and not national.”³²¹

³¹¹ See *id.* at 13-16; see also *supra* notes 116-28 and accompanying text.

³¹² See *St. Ledger*, No. 92-CA-2688-MR, slip op. at 13.

³¹³ *Darnell v. Indiana*, 226 U.S. 390 (1912); see *supra* notes 129-42 and accompanying text. The U.S. Supreme Court in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), however, asserted that *Darnell* should be seen mainly as an equal protection case. See *id.* at 345-46.

³¹⁴ See *St. Ledger*, No. 92-CA-2688-MR, slip op. at 16.

³¹⁵ *Id.*

³¹⁶ *Boston Stock Exchange v. State Tax Comm’n*, 429 U.S. 318 (1977).

³¹⁷ *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984).

³¹⁸ *Maryland v. Louisiana*, 451 U.S. 725 (1981).

³¹⁹ See *supra* notes 128, 143-54 and accompanying text.

³²⁰ Section 287.030(3) reads:

No bank incorporated under the laws of another state or national bank having its principal place of business outside this state shall transact any banking business in this state except to lend money

K.R.S. § 287.030(3) (Michie 1996).

³²¹ *St. Ledger*, No. 92-CA-2688-MR, slip op. at 19.

That might have been true early in this century, but by the 1990s it was clearly not the case. Many of Kentucky's biggest banks had been purchased by out-of-state bank holding companies and so were not "local in nature."³²² In fact, many community activists in Kentucky have complained that such purchases by out-of-town banks cause local deposits to leave the local market and be invested in the bank's other markets.³²³ Furthermore, ATM networks like Cirrus enable bank customers to withdraw money from their bank accounts, not only in another state but also in another country. Finally, the federal government recognizes the interstate nature of bank deposits by insuring all deposits in banks and savings and loans up to \$100,000.³²⁴

In holding that bank deposits were not interstate commerce, the Kentucky Court of Appeals ignored a long line of Commerce Clause cases that broadly defined interstate commerce.³²⁵ For example, the United States Supreme Court as far back as 1903 held that lottery tickets were interstate commerce, even though they could be sold only in the state authorizing them.³²⁶ Lottery tickets are analogous to bank deposits. Anyone, even a

³²² See, e.g., Toya Richards Hill, *Liberty National Bank, Bank One to Merge*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Aug. 5, 1994, at C7; Jim Jordan, *Fifth Third, Provident Making Plans to Join Highly Competitive Lexington Banking Market*, LEXINGTON HERALD-LEADER (Lexington, Ky.), July 8, 1991, at D1.

³²³ See *Housing Groups Oppose Area Bank Merger*, THE COURIER-JOURNAL (Louisville, Ky.), Nov. 20, 1997, at D1.

³²⁴ See 12 U.S.C. § 1821 (1995).

³²⁵ See *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1, 37 (1937) ("Although activities may be intrastate in character when separately considered, if they have such a close and substantial relation to interstate commerce that their control is essential or appropriate to protect that commerce from burdens and obstructions, Congress cannot be denied the power to exercise that control.") (citing *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935)); *Carter v. Carter Coal*, 298 U.S. 238, 298 (1936) ("As used in the Constitution, the word 'commerce' is the equivalent of the phrase 'intercourse for the purposes of trade,' and includes transportation, purchase, sale, and exchange of commodities between the citizens of the different states. And the power to regulate commerce embraces the instruments by which commerce is carried on. . . . [T]he phrase 'Commerce among the several states' was defined as comprehending 'traffic, intercourse, trade, navigation, communication, the transit of persons, and the transmission of messages by telegraph, - indeed, every species on commercial intercourse among the several states.'" *Id.* at 298 (citations omitted)); *Champion v. Ames*, 188 U.S. 321, 326 (1903) ("[T]he carrying from state to state of lottery tickets constitutes interstate commerce.").

³²⁶ See *Champion*, 188 U.S. at 326.

non-resident, can buy lottery tickets as long as she is in a state that permits their sale. If she is the lucky winner, she can take her winnings back to her state of residence. Similarly, anyone can make a deposit in any bank and be paid interest on her deposit. If she desires, she may withdraw her funds and use them in any state that she chooses. Therefore, the court of appeals' statement that banking in Kentucky is purely "local in nature" was plainly wrong. This effort to so narrowly construe section 287.030(3) demonstrated the lengths to which the Revenue Cabinet and the courts were willing to go to defend such a blatantly unconstitutional statute.

*c. Kentucky Supreme Court –
“ ‘If We Were Going to Lose One of Them,
This Is the One to Lose’ ”³²⁷*

On October 19, 1995, the Kentucky Supreme Court in *St. Ledger I* affirmed the decision of the court of appeals upholding the corporate shares tax but reversed its decision as to the bank deposits tax. Like the court of appeals, in upholding the corporate shares tax, the Kentucky Supreme Court found both *Klein* and *Darnell* to be controlling.³²⁸ The supreme court, however, not surprisingly, recognized the flaw in the court of appeals' analysis of the bank deposits tax, holding that bank deposits are an instrument of interstate commerce. Pointing to a United States Supreme Court case that held that investment funds, like bank deposits, are interstate commerce,³²⁹ the Kentucky Supreme Court held that because the tax created an advantage for Kentucky banks at the expense of out-of-state banks, it clearly violated the Commerce Clause.³³⁰ The court made no attempt to save the tax by applying the compensatory tax doctrine of *Darnell*. On the issue of refunds, the Kentucky Supreme Court agreed with

³²⁷ Jack Brammer & Chad Carlton, *Tax on Money Outside Kentucky Loses in Court But Ruling Lets Intangible Tax on Corporate Stocks Continue*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Oct. 20, 1995, at A1 (quoting Alex Rose, a Revenue Cabinet official).

³²⁸ See *St. Ledger I*, 912 S.W.2d 34, 39-40 (Ky. 1995) (noting that the compensatory tax doctrine saved the corporate stock tax from Commerce Clause challenges and that the classification was a reasonable way of alleviating the burden of double taxation), *vacated and remanded*, 116 S. Ct. 1821 (1996), *on remand*, 942 S.W.2d 893 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

³²⁹ See *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 331 (1977).

³³⁰ See *St. Ledger I*, 912 S.W.2d at 40, 43.

the circuit court that refunds of taxes paid for the period beginning two years before the date the lawsuit was filed and ending with its conclusion (pursuant to section 134.590) should be paid. The court also awarded St. Ledger attorney fees for the costs and fees pertaining to the challenge to the bank deposits tax.³³¹

While recognizing the obvious – that bank deposits are interstate commerce – the Kentucky Supreme Court still relied on the outdated application of the compensatory tax doctrine of *Darnell* in upholding the constitutionality of the tax on corporate stock.³³² Neither party was completely pleased with the results. St. Ledger wanted to appeal the corporate shares tax decision, while the Revenue Cabinet wanted to appeal the bank deposits tax decision.

4. St. Ledger II – “*It’s Finally Happened*”³³³

In 1996, the United States Supreme Court in *Fulton Corp.* held the North Carolina intangibles tax unconstitutional.³³⁴ In doing so, it overruled *Darnell*, holding that the compensatory tax doctrine could not save the tax from invalidation under the Commerce Clause. This decision had clear ramifications for Kentucky’s corporate shares tax, since the Kentucky Supreme Court had relied on the validity of *Darnell* for its holding in *St. Ledger I*,³³⁵ which had upheld Kentucky’s intangibles tax and exemption. The Kentucky intangibles tax scheme was similar in effect to the one ruled unconstitutional in *Fulton Corp.*³³⁶ Thus, in *St. Ledger II*, the remaining issues were whether to sever the exemption from the corporate shares tax or strike down the whole tax scheme; for what length of time, if any, taxpayers were entitled to refunds; and whether the court should award attorney fees and costs.³³⁷

³³¹ See *id.* at 43.

³³² See *id.*

³³³ Loftus, *Kentucky Tax on Stocks Struck Down*, *supra* note 98, at A1.

³³⁴ See *supra* notes 159-206 and accompanying text.

³³⁵ *St. Ledger I*, 912 S.W.2d 34 (Ky. 1995), *vacated and remanded*, 116 S. Ct. 1821 (1996).

³³⁶ The North Carolina taxing scheme called for the tax rate to be proportional to the amount of taxes paid to the state by the corporation. Compare K.R.S. §§ 136.030(1), 132.020 (Michie Supp. 1996) with N.C. GEN. STAT. § 105-203 (1996). See also *supra* note 159.

³³⁷ See generally *St. Ledger II*, 942 S.W.2d 896 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997). The bank deposits tax ruling was left standing upon the Kentucky

In addressing the first issue, the Kentucky Supreme Court decided to strike down the entire corporate shares tax.³³⁸ The court determined that the entire tax was designed to eliminate double taxation and that striking only the exemption would result in taxation of both a corporation and its shareholders, a "direct contravention of the expressed intent of the General Assembly."³³⁹ Invalidating only the exemption would in effect result in the creation of a new tax by the judiciary, a violation of the separation-of-powers doctrine since only the legislative branch had the power to create a tax.³⁴⁰

The court also ruled that the filing of *St. Ledger I* in 1990 did not constitute notice to taxpayers and that taxpayers were only entitled to refunds dating from two years before filing an application pursuant to section 134.590(2).³⁴¹ Further, it denied *St. Ledger's* request for payment of any attorneys' fees and costs, calling the Revenue Cabinet's reliance upon *Darnell* justifiable.³⁴²

Taxpayers across the Commonwealth were ecstatic about the court's main conclusion striking down the corporate shares tax. *St. Ledger*, however, still wanted to appeal the court's rulings concerning refunds and attorneys' fees, while the Revenue Cabinet wanted to appeal the invalidation of the corporate shares tax and the decision that interest was owed on the tax refunds.³⁴³ Finally, on September 10, 1997 the parties reached a settlement agreement.³⁴⁴ Refunds would be available for a two-year period, as held in *St. Ledger II*. Interest would be payable on these refunds.³⁴⁵

Supreme Court's denial of rehearing.

³³⁸ See *id.* at 898.

³³⁹ *Id.* at 897. Of course, in *Klein v. Jefferson County Board of Tax Supervisors*, 18 S.W.2d 1009, 1010-12 (Ky. 1929), the court had stated that taxing a corporation and its shareholders was not double taxation.

³⁴⁰ See KY. CONST. § 28 (Separation-of-Powers Clause).

³⁴¹ See Part IV for further discussion.

³⁴² See *St. Ledger II*, 942 S.W.2d at 903. Calling it unjustifiable, of course, would have called into question the court's earlier decision in *St. Ledger I*.

³⁴³ See Loftus, *Deal Settles Intangible-Tax Case*, *supra* note 287, at A1. *St. Ledger* filed a petition for writ of certiorari with the U.S. Supreme Court. See *St. Ledger v. Kentucky Revenue Cabinet*, filed July 21, 1997 (97-127). The petition was dismissed upon settlement on Sept. 22, 1997. See *St. Ledger v. Kentucky Revenue Cabinet*, 118 S. Ct. 27 (1997).

³⁴⁴ See Agreed Judgment of Satisfaction and Resolution, *St. Ledger v. Kentucky Revenue Cabinet* (No. 90-CI-06075) (Jefferson Cir. Ct. Sept. 10, 1997).

³⁴⁵ See *id.* at 4.

Attorneys' fees equal to six percent of the tax to be refunded³⁴⁶ were to be paid to St. Ledger's attorneys. Both sides agreed to drop further appeals.³⁴⁷

Thus, the tax that would not die finally did. Unfortunately, Herschel St. Ledger died in 1996 before the conclusion of the litigation bearing his name.³⁴⁸ Hal Miller, one of the members of the Kentucky Intangible Tax Committee commented, "It's too bad Herschel isn't around to celebrate with us." But Miller added: "I'm glad it's over. We've been vindicated, and I think we did a real service for the taxpayers."³⁴⁹ Despite the celebration, Miller and other members of the group are still bitter. "They dragged this case out for years and were rewarded for doing so in the end because the courts limited the amount of refunds they have to pay."³⁵⁰

IV. TAXPAYERS WERE NOT ENTITLED TO A BROAD WINDOW OF OPPORTUNITY IN WHICH TO FILE APPLICATIONS FOR REFUNDS

St. Ledger's victory was diminished for Kentucky taxpayers who had paid the intangibles tax but had not filed an application for refund within two years from the date their payments were made. While in an earlier case³⁵¹ the Kentucky Supreme Court had held that Kentucky's statute providing for refunds of taxes paid under an unconstitutional statute³⁵² applied retroactively, in *St. Ledger* the court limited refunds to taxpayers who filed applications within two years from the date their tax payments had been made.³⁵³ In so doing, the court created two classes of property

³⁴⁶ Attorneys' fees totaled approximately \$8.5 million. *See id.* at 5.

³⁴⁷ *See id.* at 6.

³⁴⁸ *See Loftus, Deal Settles Intangible-Tax Case, supra* note 287, at A1.

³⁴⁹ *Id.* (quoting Hal Miller).

³⁵⁰ *Id.* (quoting Hal Miller).

³⁵¹ *See Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329, 331 (Ky. 1994) (noting that federal law was irrelevant regarding whether refunds for taxes paid pursuant to an unconstitutional law should be retroactively paid because, as a matter of state law, section 134.590 mandates refunds). Although *Gossum* was decided during the course of the *St. Ledger* litigation, the Kentucky Supreme Court noted that by enacting section 134.590, the Commonwealth had consented to retroactively refund taxes paid under unconstitutional statutes. *See id. Cf., e.g., Department of Revenue v. Jack Cole Co.*, 474 S.W.2d 70, 73 (Ky. 1971) (stating that section 134.590 "simply requires the Department of Revenue to refund taxes paid under a statute 'held unconstitutional'").

³⁵² *See* K.R.S. § 134.590(2).

³⁵³ *See St. Ledger II*, 942 S.W.2d 893, 900 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997) (holding that the limitations period for taxpayer refunds was two years from

owners:³⁵⁴ the well-advised who were informed of the need to file refund claims early in the course of the *St. Ledger* litigation,³⁵⁵ and those who either relied upon the litigation as their application for refund or who did not know they needed to file for a refund.³⁵⁶ Refunds for the well-advised could extend as far back as 1988, while in contrast, refunds for the less-experienced would likely be limited to only two years of tax payments,³⁵⁷ since the less-experienced might have been unaware of the constitutional challenge or the need to act.³⁵⁸ In both classes, the financially savvy and the financially unsophisticated, the tax disproportionately affected senior citizens living on fixed incomes from retirement investments,³⁵⁹ an effect that would not necessarily be remediated for those financially savvy enough to have been filing returns since *St. Ledger* first filed suit.³⁶⁰ A legislative fix was needed, but a legislative fix was not to be found.³⁶¹

the date of tax payment, as laid out in section 134.590(1)-(2)).

³⁵⁴ See *id.* at 903 (Graves, J., concurring in part and dissenting in part).

³⁵⁵ Refunds for the financially savvy intangible property owners could extend as far back as 1988, provided a taxpayer filed an application for refund with the Department of Revenue in 1990. See K.R.S. § 134.590(2); see also *St. Ledger II*, 942 S.W.2d at 903 (Graves, J., concurring in part and dissenting in part) (noting that the “wealthy, better informed, and publicly served class will receive refunds back to 1988”).

³⁵⁶ See K.R.S. § 134.590(2).

³⁵⁷ See *id.*

³⁵⁸ See *St. Ledger II*, 942 S.W.2d at 903 (Graves, J. concurring in part and dissenting in part).

³⁵⁹ See *Brammer*, *supra* note 27, at A1. State Representative Dorsey Ridley said about the tax, “I’m hearing from a lot of people, especially senior citizens, who have set up nest eggs for their retirements and are seeing them being raided.” *Id.* (quoting Dorsey Ridley). Herschel St. Ledger agreed, noting that the tax worked a much greater hardship on “elderly people whose income is fixed and depend on investments to help them along.” *Id.* (quoting Herschel St. Ledger). The majority of the citizens comprising the Kentucky Intangible Tax Committee, formed by *St. Ledger* to fight the tax, were senior citizens. See *id.*

³⁶⁰ As between seniors citizens who filed refund claims early in the litigation and those who did not file, however, the effect would be somewhat lessened. Seniors citizens, as well as other taxpayers who paid the intangibles tax outside the permitted refund period, would never be able to recover the full amount of unconstitutional taxes collected.

³⁶¹ See *supra* notes 243-53 and accompanying text.

A. *Taxpayers Argue that Meaningful Relief Must Be Broader than that Accorded by Section 134.590(2)*

1. *Due Process Did Not Require an Extension of Time to File an Application for Refund*

The most important problem for *St. Ledger* was proving how far back refunds would be allowed. *St. Ledger* argued that under section 134.590(6), “where the amount of taxes due is in litigation”³⁶² taxpayers should have two years from the date the amount is determined (that is, in *St. Ledger*, when the lawsuit was resolved) to file their applications for refund.³⁶³ The Revenue Cabinet, on the other hand, successfully argued that even if *St. Ledger* were entitled to a refund, under section 134.590(2) he could only receive one if he had applied for it within two years of having paid the intangibles tax.³⁶⁴ Unfortunately, one of the great ironies of section 134.590(2) is that a taxpayer may receive very little redress from a taxing statute being declared unconstitutional. Because section 134.590(2),³⁶⁵ which pertains to refunds when state statutes are held unconstitutional, prohibits refunds unless the taxpayer applies within two years of paying the tax, many taxpayers would stand to lose significant amounts of money if they were ignorant of the *St. Ledger* lawsuit and had not taken action to preserve their rights. The statute does not toll for lack of notice,³⁶⁶ nor can amended returns revive the time period for filing once it has expired.³⁶⁷ Even assuming a taxpayer applied for a refund on grounds of unconstitutionality before the *St. Ledger* suit was filed, her application still might have been rejected by the Revenue Cabinet two years after the date her tax payment was made.³⁶⁸ But the greater difficulty for most taxpayers to overcome was that they simply did not know the intangibles tax was being challenged, so they had no reason to know that it was important for them to file a refund application. Doubtless, many of those who knew of the

³⁶² K.R.S. § 134.590(6) (Michie Supp. 1996).

³⁶³ *St. Ledger II*, 942 S.W.2d at 898-99.

³⁶⁴ See Appellant’s Brief, *supra* note 275, at 23-24.

³⁶⁵ “No refund shall be made unless an application for refund is made within two (2) years from the time payment was paid.” K.R.S. § 134.590(2).

³⁶⁶ See *infra* note 468.

³⁶⁷ See *infra* notes 387-88 and accompanying text.

³⁶⁸ See K.R.S. § 134.590(2). Cf. *Griggs v. Dolan*, 759 S.W.2d 593, 596 (Ky. 1988) (discussing section 134.590(6)). It is unclear what the effect of a rejected application would be.

class action considered it to be their “clear and certain remedy.”³⁶⁹ But even if they knew about the lawsuit, it did not necessarily alert them to the need to file for a refund.

St. Ledger, therefore, argued that section 134.590(6) preserved the taxpayers’ right to go back and file refund applications at least to the date the lawsuit was filed, once the unconstitutionality of the statute had been determined.³⁷⁰ To support this argument, St. Ledger asserted that the Kentucky Supreme Court in *Griggs v. Dolan*³⁷¹ and *Barrett v. Reynolds*³⁷² did not distinguish among taxing entities in applying section 134.590(6) (which governs refunds by all taxing entities *other than* the Revenue Cabinet³⁷³) and that both cases “adhered to the principle that a taxpayer must have sufficient time after the holding of unconstitutionality within which to make the ‘paper’ application for refunds of taxes paid within two

³⁶⁹ See *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 495 U.S. 18, 32 (1990) (quoting *Atchison, T. & S.F.R. Co. v. O’Connor*, 223 U.S. 280, 285 (1912)).

³⁷⁰ See *St. Ledger II*, 942 S.W.2d 893, 899 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997); Appellant’s Brief, *supra* note 275, at 21.

³⁷¹ *Griggs v. Dolan*, 759 S.W.2d 593 (Ky. 1988). In this class action, taxpayers sought review on matters relating to an unconstitutional method of 1981 farm tax assessment by the Fayette County property valuation administrator. The court noted three stages to the litigation. In *Dolan v. Land*, 667 S.W.2d 684 (Ky. 1984), “Chapter I,” the method used was declared unconstitutional. See *Griggs*, 759 S.W.2d at 594. “Chapter II” was *Board of Educ. v. Taulbee*, 706 S.W.2d 827 (Ky. 1986), in which the court decided that the taxpayers needed to apply for refunds individually, and that they could not recover refunds from the Board of Education for 1981 because it had not been a party to the litigation. See *Griggs*, 759 S.W.2d at 594. “Chapter III” was *Griggs v. Dolan*, wherein the Kentucky Supreme Court construed section 134.590(6) to mean that the outer time limit in which the taxpayers could apply for refunds was two years from the date their litigation ended. See *id.* at 596.

³⁷² *Barrett v. Reynolds*, 817 S.W.2d 439 (Ky. 1991). This case involved a challenge to the method used by the Owsley County property valuation administrator to reassess farm and commercial property. *Barrett* held, as did *Griggs*, see *supra* note 371, that under section 134.590(6), the outer time limit for applying for a tax refund stemming from a suit challenging a local taxing entity’s assessment is two years from the final judgment. See *Barrett*, 817 S.W.2d at 441-42.

³⁷³ See *Taulbee*, 706 S.W.2d at 829. Section 134.590(6) applies to city, urban-county, county, school district, or special district ad valorem taxes. See K.R.S. § 134.590(3). Arguably, however, the local applicability of section 134.590(6) is unclear from the text. See Appellant’s Brief, *supra* note 275, at 18-32.

years prior to the filing of the action.³⁷⁴ Thus, limiting taxpayers to filing for refunds within two years of their tax payments—rather than within two years from conclusion of the litigation—would be tantamount to switching tax refund procedures midstream, and would violate due process.³⁷⁵ Moreover, St. Ledger argued that federal due process mandates under *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*³⁷⁶ required the same time extension (two years from the conclusion of litigation) to be applied under section 134.590(2).³⁷⁷

Conversely, the Revenue Cabinet argued first that taxpayers were not entitled to *any* retroactive relief, and alternatively, if they were, only to the two years permitted by section 134.590(2).³⁷⁸ In review of these arguments, the Kentucky Supreme Court rejected out-of-hand the notion that section 134.590 provided anything less than retroactive relief, noting that “KRS 134.590 requires some type of [retroactive] refund as a matter of state law,

³⁷⁴ Appellant’s Brief, *supra* note 275, at 23-24.

³⁷⁵ See *id.* at 31-32. St. Ledger believed such “bait and switch” remedies, *id.* at 32, violated due process requirements laid out in *Reich v. Collins*, 513 U.S. 106 (1994), where the U.S. Supreme Court held that Georgia could not provide a post-deprivation tax refund statute, then declare its remedy did not exist after taxpayers had paid disputed taxes, successfully challenged them, and applied for a refund. See *id.* at 111.

³⁷⁶ *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 495 U.S. 18 (1990).

³⁷⁷ See St. Ledger II, 942 S.W.2d 893, 901 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997); Appellant’s Brief, *supra* note 275, at 23-24.

³⁷⁸ See Appellee’s Brief, *supra* note 277, at 44-50. Later, the Revenue Cabinet conceded that section 134.590 applied retroactively. See *St. Ledger II*, 942 S.W.2d at 898-99. In arguing for no retroactive relief, the Revenue Cabinet pressed for application of the test set out in *Chevron Oil Co. v. Hudson*, 404 U.S. 97, 106-08 (1971), which was that a decision should not be retroactively applied if on the whole it establishes a new principle of law, if retroactive application would retard the operation of the new law, and if retroactive application would cause injustice or hardship. *Chevron Oil Co.* has been heavily criticized and impliedly overruled. See *Reynoldsville Casket Co. v. Hyde*, 514 U.S. 749, 752-54 (1995) (noting that reliance on a prior federal law that is overruled – “a reliance of the same kind and degree as that involved in *Chevron Oil*” – does not warrant refusing to retroactively apply the new rule of law); *Harper v. Virginia Dep’t of Taxation*, 509 U.S. 86, 97 (1993) (stating “‘an opinion announcing a rule of federal law normally is properly understood to have followed the normal rule of retroactive application’” (quoting *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529, 539 (1991))).

independent of [federal] due process requirements.³⁷⁹ Moreover, the court noted that the Revenue Cabinet had finally conceded this point.³⁸⁰

Key to the court's thinking on both the retroactivity and due process issues was its decision in *Kentucky Revenue Cabinet v. Gossum*,³⁸¹ issued during the pendency of *St. Ledger*. In *Gossum*, federal retirees brought a class action lawsuit seeking a refund of taxes assessed under an unconstitutional Kentucky statute³⁸² that had taxed a portion of federal retirement annuities but exempted *all* state retirement annuities.³⁸³ *Gossum* unequivocally stated that "inasmuch as the Commonwealth [had] consented by statute to refund taxes paid under an unconstitutional provision," the Revenue Cabinet's position in *St. Ledger* against retroactivity³⁸⁴ was moot.³⁸⁵

But the assurance of retroactive application did not guarantee *St. Ledger* full refunds of unconstitutionally collected taxes. Section 134.590(2) stated that no refunds would be made under a tax statute held unconstitutional unless an application for refund was made within two years from the date the tax payment had been made.³⁸⁶ The Kentucky Supreme Court was not persuaded by *St. Ledger*'s arguments that meaningful backward-looking relief³⁸⁷ could be found only if the suit had tolled section 134.590(2)'s time limit for filing refund applications or the

³⁷⁹ *St. Ledger II*, 942 S.W.2d at 899 (discussing *McKesson Corp.*, 496 U.S. at 31).

³⁸⁰ *See id.* at 898-99.

³⁸¹ *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329 (Ky. 1994).

³⁸² The statute, section 141.021, was repealed by the Kentucky legislature after the United States Supreme Court found that a similar statute, section 206.301(1)(f) of the Michigan Compiled Laws, violated intergovernmental tax immunity under the U.S. Constitution. *See Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 810-17 (1989); MICH. COMP. LAWS ANN. § 206.301(1)(f) (West Supp. 1988).

³⁸³ *See Gossum*, 887 S.W.2d at 331.

³⁸⁴ The Kentucky Supreme Court noted that, regardless of the *Chevron Oil* factors, *see supra* note 378, *David v. Michigan* and *Harper v. Virginia Dep't of Taxation* unambiguously required retroactive application. *See Gossum*, 887 S.W.2d at 332 (discussing the leading case, *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993) ("The legal imperative 'to apply a rule of federal law retroactively after the case announcing the rule has already done so' must 'prevail over any claim based on a *Chevron Oil* analysis.'" *Id.* at 98 (paraphrasing *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529, 540 (1991))).

³⁸⁵ *Gossum*, 887 S.W.2d at 331 (citing K.R.S. § 134.590(2)).

³⁸⁶ *See* K.R.S. § 134.590(2).

³⁸⁷ *See* Appellant's Brief, *supra* note 275, at 12-31.

time limit of section 134.590(6) was applied two years from the end of litigation.³⁸⁸ St. Ledger's argument that a much larger "window of opportunity" for the taxpayers to request relief was mandated in order to meet fundamental federal due process requirements did not avail.³⁸⁹ Moreover, the court refused to apply the extended limitations period of section 134.590(6), holding that as far back as *Taulbee*,³⁹⁰ it had "distinguishe[d] that the Revenue Cabinet [should] refund under K.R.S. § 134.590(2) and that K.R.S. § (3), (4), (5), and (6) [apply] to the refund of all other taxing districts."³⁹¹ The court further stated that section 134.590(6) could not properly be interpreted by analogy to section 134.590(2) since the former applies to litigation about the *amount* of taxes owed, rather than litigation over the constitutionality of a exemption: "[T]he amount of taxes due is not an item of litigation. It is an issue of all the tax or none of the tax."³⁹²

St. Ledger's failed "window of opportunity" argument was based on *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*. In *McKesson Corp.*, the United States Supreme Court held that the Due Process Clause of the United States Constitution required retroactive relief as a post-deprivation remedy to taxpayers who paid taxes under a Florida

³⁸⁸ See *St. Ledger II*, 942 S.W.2d 893, 898-902 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997); Appellant's Brief, *supra* note 275, at 22-26.

³⁸⁹ *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990). In *McKesson Corp.*, Florida liquor distributors challenged a state excise tax that provided tax reductions for beverages made from Florida citrus, grapes, and cane sugar, then bottled in Florida. See *id.* at 22-24. Like Kentuckians challenging the intangibles tax, see *St. Ledger II*, 942 S.W.2d at 893, the Florida liquor distributors could not refuse to pay their excise taxes without being subject to fines, nor could they refuse to pay taxes while challenging its constitutionality, see *McKesson Corp.*, 496 U.S. at 31. Unlike Kentucky, however, once the tax had been declared unconstitutional, Florida refused to refund *any* taxes paid or provide *any* post-deprivation remedy. See *id.* at 26. The United States Supreme Court held that federal due process protections required Florida to provide some form of retroactive relief, specifically holding that Florida was required to refund taxes because it was too late for "prompt injunctive relief" to have had any effect. *Id.* at 41-43.

³⁹⁰ *Board of Educ. v. Taulbee*, 706 S.W.2d 827, 829 (Ky. 1986).

³⁹¹ See *St. Ledger II*, 942 S.W.2d at 901.

³⁹² *Id.* In so ruling, the Kentucky Supreme Court foreclosed any equal protection arguments that the two statutes treated two similar classes of taxpayers differently. Cf. *Reynoldsville Casket Co. v. Hyde*, 514 U.S. 749, 755-57 (1995) (stating in dicta that the cure for differential tax treatment among similar taxpayers would be either to similarly burden or similarly unburden both groups).

statute later determined to be invalid.³⁹³ But the Supreme Court also noted that providing retroactive relief could “undermine the State’s ability to engage in sound fiscal planning”³⁹⁴ and to address this problem permitted states to impose procedural requirements, including short statutes of limitations, on post-deprivation remedies.³⁹⁵ The taxpayers in *McKesson Corp.* actually received broad relief because Florida had refused to provide *any* pre-deprivation or post-deprivation remedies for unlawful tax assessments.³⁹⁶

Thus, to meet St. Ledger’s due process challenge, the Revenue Cabinet needed only to argue section 134.590(2) in rebuttal. St. Ledger would receive relief through a tax refund, but he would not receive relief to the extent he had hoped for. As *McKesson Corp.* noted, due process does not require complete relief. A state may impose any number of procedural protections designed to “secure the State’s interest in stable fiscal planning when weighed against its constitutional obligation to provide relief for an unlawful tax.”³⁹⁷ Thus, while the Commonwealth’s tax “scheme [was] pointedly designed to coerce taxpayers into remitting taxes before challenging any liability,”³⁹⁸ its post-deprivation remedies, though limited, met the fundamental due process concerns of *McKesson Corp.*³⁹⁹ The Kentucky Supreme Court did not address the notion that a “bait and switch” of remedies had occurred.⁴⁰⁰

While this statutory construction is the legally correct one, it does not provide much justice for the many Kentucky taxpayers who relied on the *St. Ledger* lawsuit to vindicate their claims to refunds of taxes wrongfully collected. Without a doubt, section 134.590(2) requires refund applications to be filed within two years from date of payment. Also without a doubt, taxpayers relied on the *St. Ledger* suit – and justifiably so – to preserve their

³⁹³ See *McKesson Corp.*, 496 U.S. at 44-45.

³⁹⁴ *Id.* at 44.

³⁹⁵ See *id.*

³⁹⁶ See *id.* at 51 (noting that Florida was free to choose any form of relief that comported with federal requirements, “ranging from a refund of the excess taxes paid . . . to an offsetting charge to previously favored distributors, that [would] cure any unconstitutional discrimination against interstate commerce during the contested tax period”).

³⁹⁷ *Id.* at 45.

³⁹⁸ *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329, 333 (Ky. 1994).

³⁹⁹ As previously discussed, in Kentucky such refunds are required “as a matter of state law, independent of due process requirements.” *St. Ledger II*, 942 S.W.2d 893, 899 (Ky. 1997).

⁴⁰⁰ See *id.* at 899-901.

claims. This is particularly troubling given that the Revenue Cabinet is under no obligation to inform taxpayers when taxing statutes are challenged.⁴⁰¹ The only early public notice the Revenue Cabinet gave was not really public notice at all: in its March 1993 *Kentucky Tax Alert* (a publication largely directed at CPAs and other tax professionals), the Revenue Cabinet advised that protective refunds should be filed regarding “the exemption from intangible tax of stock owned by *in-state corporations*,”⁴⁰² hardly an accurate description of the *St. Ledger* litigation. So the end result of *St. Ledger* was that the general public did not receive public notice that the Commonwealth was taxing them unconstitutionally, and a member of the general public did not receive a refund of wrongfully paid tax money unless he or she filed an application for a refund of taxes he or she did not know were improperly collected. In simple terms, Kentucky taxpayers found themselves to be in the proverbial catch-22.⁴⁰³

2. *The Filing of the Lawsuit Should Have Constituted an “Application” for Relief*

St. Ledger then argued that, if section 134.590(6) did not allow taxpayers to file their applications for refund up to two years after the conclusion of the litigation, then in order to afford them “meaningful, backward-looking relief,”⁴⁰⁴ both due process⁴⁰⁵ and issue preclusion⁴⁰⁶

⁴⁰¹ See *supra* note 439.

⁴⁰² Appellant’s Brief, *supra* note 275, at 8 (quoting Kentucky Revenue Cabinet, *Kentucky Tax Alert*, Vol. 12, No. 2 (Mar. 1993)) (emphasis added).

⁴⁰³ “There was only one catch . . . and that was Catch-22.” JOSEPH HELLER, *CATCH-22* (frontispiece) (Simon and Schuster 1961); see also *id.* at 397-99, 411-19.

⁴⁰⁴ See Appellant’s Brief, *supra* note 275, at 24.

⁴⁰⁵ See *id.* at 12-13.

⁴⁰⁶ See *id.* at 13-14. The taxpayers argued that the broader relief permitted in *St. Ledger I* regarding refunds of the bank deposits tax should be applied to refunds of the corporate shares tax, since the same statute, section 134.590, imposed both taxes. See *id.* at 14. In *St. Ledger I*, the Kentucky Supreme Court agreed with the Jefferson Circuit Court’s holding that the taxpayers could apply for tax refunds under section 134.590. See *St. Ledger I*, 912 S.W.2d 34, 43 (Ky. 1995), *vacated and remanded*, 116 S. Ct. 1821 (1996). Problematic was the circuit court’s ruling that the taxpayers were eligible for refunds on taxes paid from July 24, 1988 forward. See Appellant’s Brief, *supra* note 275, at 14 (citing circuit court’s order). Thus, the taxpayers in *St. Ledger II* reasoned that, based on the Kentucky Supreme Court’s seeming affirmation of the circuit court’s order in *St. Ledger I*, they

required that the filing of the *St. Ledger* lawsuit either constituted the required statutory application for refund⁴⁰⁷ under section 134.590, “or at least preserve[d] the right . . . to file an application” for the entire class of taxpayers.⁴⁰⁸ Thus, St. Ledger asserted that the Commonwealth was obligated to refund tax payments as far back as 1988, two years before the lawsuit was first filed.⁴⁰⁹ Moreover, St. Ledger believed that the Revenue Cabinet had been put on notice by the filing of the lawsuit, and that, in the absence of a statutory procedure for the filing of a refund application, the lawsuit should have sufficed.⁴¹⁰

In arguing for a preserved right to file an application, St. Ledger relied heavily upon *Department of Revenue v. Jack Cole Co.*,⁴¹¹ and on the dissent in *Board of Education v. Taulbee*,⁴¹² which was partially adopted by the

likewise should be able to apply for intangibles tax refunds back to July 24, 1988 under the law-of-the-case doctrine (or issue preclusion). See *St. Ledger II*, 942 S.W.2d 893, 899 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997). The law-of-the-case doctrine, however, requires courts to be bound by their earlier conclusions of law when deciding subsequent appeals. See *Inman v. Inman*, 648 S.W.2d 847, 849 (Ky. 1982) (holding that when an issue of law has been decided in a previous appeal, that decision precludes the issue’s reconsideration on a second appeal; otherwise, “litigation would be interminable, and a decision of the appellate court, which is supposed to put the issue to rest between the same parties, would only be a starting point for new litigation”). In *St. Ledger II*, however, the Kentucky Supreme Court was not revisiting a previously decided issue of law (the bank deposits tax); it was re-examining a different constitutional challenge, that of the challenge to the corporate shares tax. Thus, the law-of-the-case doctrine was irrelevant. See *St. Ledger II*, 942 S.W.2d at 899.

⁴⁰⁷ See Appellant’s Brief, *supra* note 275, at 19-22. Section 134.590(2) states that the Department of Revenue shall not refund taxes paid under a tax statute that has been held unconstitutional unless “an application for refund is made within 2 (two) years from the time payment was made.”

⁴⁰⁸ *Id.* at 21 (citing *Department of Revenue v. Jack Cole Co.*, 474 S.W.2d 70 (Ky. 1971)). Appellants argued that “the filing of a lawsuit challenging the constitutionality of a taxing statute either constitutes the filing of an application or preserves the right of a taxpayer to file an application for refund of taxes paid within two years prior to the filing date of that litigation.” *Id.*

⁴⁰⁹ St. Ledger filed suit in 1990. See Chris Nolan, *State Poised for Possible Tax Hike: Revenue Cabinet Argues Stock Tax Should Apply to Kentucky Companies*, THE KENTUCKY GAZETTE (Lexington, Ky.), July 9-15, 1996.

⁴¹⁰ See Appellant’s Brief, *supra* note 275, at 21.

⁴¹¹ *Department of Revenue v. Jack Cole Co.*, 474 S.W.2d 70, 73-74 (Ky. 1971).

⁴¹² *Board of Educ. v. Taulbee*, 706 S.W.2d 827 (Ky. 1986).

Kentucky Supreme Court in *Griggs v. Dolan*.⁴¹³ In *Department of Revenue v. Jack Cole Co.*, the Jack Cole Company ("Company") applied for refunds for fuel taxes paid on fuels bought in Kentucky but used in the Company's motor vehicles operating outside the state. The Company filed suit and, by mutual agreement with Ashland Oil & Refining Company, let its suit "languish" until the resolution of the Ashland Oil litigation that resulted in the tax being declared unconstitutional.⁴¹⁴ At that time, the Company sought to recover its tax refund under section 134.590(1)-(2), which governs refunds of taxes paid into the State Treasury pursuant to statutes subsequently held unconstitutional.⁴¹⁵

Because section 134.590(1)-(2) did not provide a procedure for filing an application for refund of taxes under an unconstitutional statute, the Revenue Cabinet was required to calculate refunds from the date the Company first formally requested a refund *on the grounds of unconstitutionality*: the date the lawsuit was filed.⁴¹⁶ Although under the taxing statute, the Company had other applications for refunds filed on forms provided by the Revenue Cabinet, the forms did not constitute an application for refund because "they were not calculated to initiate a decision by the [Revenue Cabinet] on the issue of the right to refund on the basis of unconstitutionality of the statute."⁴¹⁷ The filing of the Company's appeal

⁴¹³ *Griggs v. Dolan*, 759 S.W.2d 593 (1988). Neither *Griggs* nor the *Taulbee* dissent suggested that the taxpayers were entitled to refunds without filing individual applications with the appropriate administrative agency. *See id.* at 597; *Taulbee*, 706 S.W.2d at 832 (Leibson, J., dissenting). *Griggs* did, however, note that section 134.590(6) provided enough time for taxpayers to seek refunds after the unconstitutionality of an assessment was established. *See Griggs*, 759 S.W.2d at 596.

⁴¹⁴ *See Jack Cole Co.*, 474 S.W.2d at 71-72; *Kentucky Dep't of Revenue v. Ashland Oil & Refining Co.*, 449 S.W.2d 904 (Ky. 1970).

⁴¹⁵ Section 134.590(1)-(2) states as follows:

(1) When it appears to the appropriate agency of state government that money has been paid into the State Treasury for ad valorem taxes when no taxes were in fact due *or for taxes of any kind paid under a statute held unconstitutional*, the agency of state government which administers the tax shall refund the money, or cause it to be refunded, to the person who paid the tax

(2) *No refund shall be made unless an application for refund is made within two (2) years from the time payment was made*

K.R.S. § 134.590(1)-(2) (Michie Supp. 1996) (emphasis added).

⁴¹⁶ *See Jack Cole Co.*, 474 U.S. at 74.

⁴¹⁷ *Id. Cf., e.g.*, 103 KY. ADMIN. REGS. 1.010 (1997) (providing that taxpayers must file written protests of assessments to pursue an administrative proceeding to

on the ground of unconstitutionality was the application for refund.⁴¹⁸ Consequently, the Kentucky Supreme Court ordered a refund of taxes paid two years before the date of filing, or for about seven years.⁴¹⁹ Thus, under the *Jack Cole Co.* standard, St. Ledger would have been entitled to refunds from 1988 to the present.

Although *Jack Cole Co.* was brought under section 134.590(1)-(2), it was not a class action suit. Where class actions like *St. Ledger* have been filed, the judgment of the Kentucky Supreme Court, albeit, regarding the sister statute section 134.590(6), which applies only to local ad valorem tax refunds,⁴²⁰ has been that a protective claim must be filed by each class member individually.⁴²¹ Thus, the Revenue Cabinet disputed that filing any lawsuit could ever constitute an "application" for purposes of section 134.590(2),⁴²² arguing instead that the statute required applications for tax refunds to be made individually.⁴²³ Citing *Board of Education v. Taulbee*,⁴²⁴ and analogizing to sections 134.590(6) to 134.590(2),⁴²⁵ the Revenue Cabinet contended that St. Ledger's lawsuit was not a refund application nor did it retroactively preserve the Taxpayers' applications for refunds until the lawsuit concluded.⁴²⁶

Taulbee dealt with a successful class action suit challenging the constitutionality of school tax assessments under section 134.590(6), rather than the state ad valorem refund statute, section 134.590(2). In it, the Kentucky Supreme Court held that "original litigation over the constitutionality of the assessment in itself" would not authorize an automatic refund because the statute was not self-executing.⁴²⁷ *Taulbee* required

determine the correctness of the assessment).

⁴¹⁸ See *Jack Cole Co.*, 474 S.W.2d at 71, 73-74.

⁴¹⁹ See *id.*

⁴²⁰ See *Board of Educ. v. Taulbee*, 706 S.W.2d 827, 829 (Ky. 1986).

⁴²¹ "[The Kentucky Supreme Court] has specifically held that a class action relief is not available for the refund of taxes." See *id.* at 828 (citing *Swiss Oil Corp. v. Shanks*, 270 S.W. 478 (Ky. 1925), in which, under an earlier statute similar to section 134.590, the Kentucky Supreme Court held that the Swiss Oil Corporation could not sue on behalf of all other oil producers for a refund of taxes under the graduated occupational tax statute that Swiss Oil was challenging as invalid).

⁴²² See Appellee's Brief, *supra* note 277, at 50-51.

⁴²³ See *id.* (citing *Taulbee*, 706 S.W.2d at 829).

⁴²⁴ *Board of Educ. v. Taulbee*, 706 S.W.2d 827 (Ky. 1986).

⁴²⁵ Section 134.590(2) does not extend the time for filing an application.

⁴²⁶ See Appellee's Brief, *supra* note 277, at 50-51.

⁴²⁷ *Taulbee*, 706 S.W.2d at 829. The Kentucky Supreme Court noted: Obviously, the only way a statute can be held unconstitutional is when

applications for refunds to be made individually.⁴²⁸ The *Taulbee* plaintiffs, therefore, were not entitled to automatic refunds by virtue of their lawsuit.⁴²⁹

Regrettably, neither *Jack Cole Co.* nor *Taulbee* shed much light on how to apply for a refund to the Revenue Cabinet when the constitutionality of a taxing statute is being challenged. Neither subsection (2) nor (6) of section 134.590 provides guidance. The Revenue Cabinet's rules in the Kentucky Administrative Code are likewise silent on this issue.⁴³⁰ Notice to the Department seems to be an important element; that is why an individual lawsuit should suffice.⁴³¹ Yet something more individual than being a party to a class action lawsuit is required.⁴³² Oral protests are not enough.⁴³³ Filing an amended tax return outside the two-year limitation period with a refund request does not suffice,⁴³⁴ nor does it overcome section § 134.590(2)'s two-year statute of limitations.⁴³⁵ Third-party refund

a court makes such a decision. The filing of a lawsuit does not automatically entitle a plaintiff to a refund without further action

. . . .

The original litigation over the constitutionality of the assessment in itself does not automatically authorize a refund. K.R.S. 134.590(6) is not self-executing. Application for refund must be made individually.

Id.

⁴²⁸ *See id.*

⁴²⁹ *See id.*

⁴³⁰ The Department of Revenue has issued no rules governing such applications, although an administrative regulation governs protest of tax assessments under the taxing statute. *See* 103 KY. ADMIN. REG. 1:010.

⁴³¹ *See* Department of Revenue v. Jack Cole Co., 474 S.W.2d 70, 73-74 (Ky. 1971).

⁴³² *See Taulbee*, 706 S.W.2d at 829; St. Ledger II, 942 S.W.2d 893, 901 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

⁴³³ *See* McNeely v. Kentucky Revenue Cabinet, 1996 WL 391209, *1 (Ky. Bd. Tax App., July 10, 1996).

⁴³⁴ *See id.* Mr. McNeely had paid state income tax on part of his federal retirement annuity income. After *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329 (Ky. 1994), *see infra* notes 386-90 and accompanying text, his first written request for refund was made on May 5, 1989; therefore, he could not receive refunds further back than May 4, 1987. To overcome the time limits of section 134.590(2), Mr. McNeely filed amended income tax returns for the years 1981 to 1985 and included a refund request with each return. The Revenue Cabinet declined to count his amended returns as proper applications for refund. *See McNeely*, 1996 WL 391209, at *1.

⁴³⁵ *See McNeely*, 1996 WL 391209, at *1.

requests pass muster with the Revenue Cabinet.⁴³⁶ Yet *St. Ledger II*, while noting that the issue of what constitutes a sufficient tax refund application was raised,⁴³⁷ did nothing to resolve the problem, focusing instead on which statute of limitations applied to refunds.

Perhaps it is not a matter that can be resolved by the Kentucky Supreme Court; rather, it should be resolved through rulemaking by the Revenue Cabinet. The irony is that, because taxpayers in *St. Ledger* did not know how (or when) to file an application, “their legal rights were cut off” when they were required to apply to the Revenue Cabinet while the unconstitutionality of the taxing statute was being litigated.⁴³⁸ Moreover, taxpayers in general may or may not have notice of such lawsuits, depending on their sophistication and access to financial planners and accountants. The Revenue Cabinet is under no obligation to notify the public of pending lawsuits challenging the constitutionality of taxing statutes.⁴³⁹ Yet the Cabinet is uniquely equipped by virtue of its computer

⁴³⁶ According to the Kentucky Society of Certified Public Accountants, “If the requester is a bank trust department, broker, agent, executor/administrator, attorney-in-fact, or an authorized legal representative of the taxpayer,” third-party refund requests will be honored. Other third-party requests may be considered adequate by the Revenue Cabinet to “trigger” the refund claim. Kentucky Society of Certified Public Accountants, *Intangibles Tax Update* (visited Oct. 30, 1997) <<http://www.kycpa.org/intangib.htm>>.

⁴³⁷ See *St. Ledger II*, 942 S.W.2d at 899-900.

⁴³⁸ See *Board of Educ. v. Taulbee*, 706 S.W.2d 827, 832 (Ky. 1986) (Leibson, J., dissenting).

⁴³⁹ Statutory notice requirements regarding matters affecting taxpayers’ substantial interests abound, but there are none in this area. Case law does not appear to direct that notice be given, either. See, e.g., K.R.S. § 131.181 (Michie Supp. 1996) (requiring Cabinet to provide notice of delinquency to taxpayers who hold coal mining licenses that their licenses are in danger of revocation); *id.* § 132.310 (stating the Cabinet shall provide notice of assessments on property that taxpayers failed to list for assessment); *id.* § 133.160 (Michie 1991) (requiring the Cabinet to provide notice to taxpayers when planning to raise property assessments); *id.* § 134.420 (Michie Supp. 1996) (mandating that Cabinet must provide notice of tax liens to taxpayers); *id.* § 138.880 (requiring Cabinet to send notice to taxpayers of assessments on illegal drugs seized by law enforcement); *id.* § 139.680 (Michie 1991) (stating that Cabinet must give notice to purchasers of business or stock of personal tax liability if they fail to withhold purchase price); *id.* § 144.130 (Michie Supp. 1996) (requiring Cabinet to give immediate notice of determination of tax credit applications of certificated air carriers); *id.* § 211.392 (Michie 1995) (requiring Cabinet to give notice and opportunity for conference prior to certificate modification or revocation to fluidized bed combustion technology tax exemption

ized cross-indexes to know the identity of each taxpayer and the amount of each tax wrongfully paid, whether a lawsuit challenging a taxing statute's constitutionality is an individual suit or a class action.⁴⁴⁰ Although the deck appears stacked against individual taxpayers who have much to lose (particularly given the short time frame allowed to apply for refunds), it is doubtful that the problem of what constitutes an application can be resolved by the Supreme Court; rather, the Revenue Cabinet should resolve it through rulemaking, specifying a procedure to be followed under section 134.590(2).

B. The Protected Class that Wasn't

Thus, even though section 134.590(b) provided retroactive relief and federal due process concerns were addressed, limiting financial recovery to two years from the date each taxpayer individually filed an application for tax refund – instead of two years from the date the lawsuit was filed or

certificate holders); *id.* § 224.01-310 (requiring notice and an opportunity for hearing before revocation of pollution control tax exemption certificate modification or revocation); *id.* § 247.920 (Michie 1994) (requiring notice and opportunity for hearing to be given to the Coal Marketing and Export Council before issuance to taxpayer of alcohol production tax exemption certificate, and requiring notice to taxpayer and the Coal Marketing and Export Council before certificate modification or revocation).

The Revenue Cabinet did not publish notice of the need for taxpayers to file protective claims to preserve their refunds until March 1993 in the *Kentucky Tax Alert*, almost three years after the initial litigation had been filed. *See* Kentucky Revenue Cabinet, *Kentucky Tax Alert*, Vol. 12, No. 2 (Mar. 1993). The *Kentucky Tax Alert* is not a general circulation publication and is sent primarily to professionals; thus, the class of those receiving notice was small. Moreover, the March issue misleadingly advised that the statutory provision being challenged governed “the exemption from intangible tax of stock owned by in-state corporations.” *Id.* at 1; *see also* Appellant’s Brief, *supra* note 275, at 8. Previous issues had discussed *St. Ledger* (*see, e.g.*, Kentucky Revenue Cabinet, *Kentucky Tax Alert*, Vol. 11, No. 8 (Aug. 1992)), but had advised taxpayers to “continue to pay taxes under existing law as they have in previous years,” without advising them of the need to file protective claims to preserve their right to potential refunds. *See id.*

⁴⁴⁰ *See* Brammer, *supra* note 27. Although the intangibles tax had been on the books for 178 years, the Revenue Cabinet had never bother to enforce it until the state computerized its tax roll in 1987, cross-referencing tax returns with tax investments. *See supra* notes 236-38.

two years after it was resolved – created two classes of taxpayers. In the words of Justice Graves:

[I]t is likely the more wealthy, better informed, and better publicly served class will receive refunds back to 1988. However, unsophisticated, intangible property owners . . . will be limited to two years. . . . This will be perceived as a basic inequity that privileges the wealthy and penalizes the less fortunate. Also, all Kentucky taxpayers will be billed to repay a small privileged class.

....

If a private citizen had behaved in such a confiscatory manner in appropriating under color of a law a constitutionally challenged entitlement, he would be arrested for failure to make required disposition of property.⁴⁴¹

But the Commonwealth of Kentucky does not behave in the way “it mandates its citizens to behave.”⁴⁴² And the Equal Protection Clause of the United States Constitution does not protect those injured from wealth-based class distinctions very well, particularly when the class distinctions are between groups of people with varying degrees of wealth (as opposed to those who are poor and those who are wealthy).⁴⁴³ Further, equal protection

⁴⁴¹ *St. Ledger II*, 942 S.W.2d at 903 (Graves, J., dissenting).

⁴⁴² *Id.* (Graves, J., dissenting).

⁴⁴³ The United States Supreme Court has consistently refused to treat wealth-based classifications as suspect under the Equal Protection Clause. Wealth classifications do not activate heightened scrutiny and its protections – at least without being linked to a clearly fundamental right like voting, for example. *See, e.g., Lewis v. Casey*, 116 S. Ct. 2174, 2185 (1996) (stating that a prison’s policy of restricting access to the prison law library and legal assistance for indigent prisoners in lock-down did not violate equal protection, even where the delays caused by the restrictions resulted in actual injury); *Kadrmas v. Dickinson Pub. Schs.*, 487 U.S. 450, 457-61 (1988) (holding that a North Dakota statute that permitted school bus districts to charge a user fee for bus transportation did not unconstitutionally place greater obstacles to education on the poor than on the wealthy); *San Antonio Indep. Sch. Dist. v. Rodriguez*, 411 U.S. 1, 28-29 (1973) (stating that children who received poorer quality education due to lack of family wealth and its impact on school funding did not have a constitutional complaint; only if children were completely deprived of schooling would equal protection under a wealth-based classification be invoked); *James v. Valtierra*, 402 U.S. 137, 141-42 (1971) (holding that wealth classifications did not invoke heightened scrutiny and upholding a constitutional amendment preventing low-income housing

challenges to state tax refund statutes have fared poorly,⁴⁴⁴ largely because wealth-based classifications are subject to the lowest level of scrutiny⁴⁴⁵ and because it is difficult to categorize those receiving an unfair tax refund as a suspect class⁴⁴⁶ for purposes of equal protection review.

For example, in *American States Insurance Co. v. Michigan Department of Treasury*,⁴⁴⁷ taxpayers who had successfully challenged an unconstitutional retaliatory tax in the Insurance Code were precluded from obtaining some tax refunds due to the ninety-day time period allotted for filing for refunds of taxes paid under taxing statutes found to be unconstitutional.⁴⁴⁸ They argued that section 205.27a(6) of the Michigan Compiled laws violated the Equal Protection Clause of the United States Constitution because it treated the "preemption claimants," taxpayers whose claims for refunds stemmed from a state statute being preempted by the federal

from being built in any community that did not vote to have it built); *Harper v. Virginia Bd. of Elections*, 383 U.S. 663, 666-68 (1966) (striking poll tax because it drew lines on the basis of wealth and property).

⁴⁴⁴ See, e.g., *Axtell v. United States*, 860 F. Supp. 795, 801-02 (D. Wyo. 1994) (stating that federal tax statute did not create a suspect class of taxpayers who received correctly addressed notices of deficiency simply because it provided a three-year statute of limitations for making tax assessments against those who received misaddressed notices of tax deficiency, but only a two-year statute of limitations against those who received properly addressed notices); *Hundert v. Bieszczat*, 526 F. Supp. 1051, 1054-55 (N.D. Ill. 1981) (holding that Illinois tax system, which (after a lawsuit) only refunded excessive taxes to taxpayers who filed under protest, did not create a suspect class of the non-protesting taxpayers because Illinois had many rational reasons for its conduct, including the administrative complexity of figuring out who was entitled to refunds); *Fierro & Sons, Inc. v. Division of Revenue*, 1988 W.L. 109306, *2 (Del. Super. Ct) (finding that tax statute limiting taxpayers to three years to file for a refund for taxes erroneously paid while allowing the state an additional time period did not make the taxpayers a suspect class).

⁴⁴⁵ See, e.g., discussion at *supra* note 70.

⁴⁴⁶ See *American States Ins. Co. v. Michigan Dep't of Treasury*, 560 N.W.2d 644, 648 (Mich. Ct. App. 1996).

⁴⁴⁷ *American States Ins. Co. v. Michigan Dep't of Treasury*, 560 N.W.2d 644 (Mich. Ct. App. 1996).

⁴⁴⁸ See *id.* at 648. The Michigan statute provided: "[A] claim for refund based upon the validity of a tax law based on the laws or the constitution of the United States or the state constitution of 1963 shall not be paid unless the claim is filed within 90 days after the date set for filing a return." MICH. COMP. LAWS § 205.27a(6) (West Supp. 1997).

Constitution or a federal law,⁴⁴⁹ differently than other taxpayers who sought and were able to receive tax refunds.⁴⁵⁰ In order for the preemption claimants to establish an equal protection violation, they would have had to show that they were part of a suspect class and that the statute of limitations to which they objected impinged upon a fundamental constitutional right.⁴⁵¹ The preemption claimants could not establish that they were a protected class, since they did not belong to a group “‘saddled with such disabilities, or subjected to such a history of purposeful unequal treatment, or relegated to such a position of political powerlessness as to command extraordinary protection from the majoritarian political process.’”⁴⁵² The Michigan court found that the taxpayers were a “‘large, diverse and amorphous class, unified only by the common factor that the Insurance Code [had] been declared invalid.’”⁴⁵³ Moreover, the right they sought to vindicate, the right to a tax refund, was not a fundamental right.⁴⁵⁴ Since the preemption claimants were neither part of a suspect class nor vindicating a fundamental right, they were only entitled to a review of their claims under the rational relationship test,⁴⁵⁵ and as long as a governmental entity has some rational basis for making the class distinction, it will stand.⁴⁵⁶ Here, Michigan limited preemption claimants’ refunds because their claims applied to large groups of people, and thus would have a tremendous impact on Michigan’s revenue if refunds were not limited.⁴⁵⁷ The Michigan Court of Appeals, therefore, rejected the preemption taxpayers’ claim on the basis that protecting the state’s treasury was a legitimate state purpose.⁴⁵⁸

Similarly, what state purpose could be more compelling than protecting the Commonwealth of Kentucky’s “fiscal security” when a tax scheme is declared unconstitutional, through limiting the amount of time during

⁴⁴⁹ See *American States Ins. Co.*, 560 N.W.2d at 646.

⁴⁵⁰ See *id.* at 648.

⁴⁵¹ See *id.*

⁴⁵² *Id.* (quoting *San Antonio Indep. Sch. Dist. v. Rodriguez*, 411 U.S. 1, 28 (1973)).

⁴⁵³ *Id.* (quoting *Rodriguez*, 411 U.S. at 28).

⁴⁵⁴ See *id.* at 649 (citing *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329 (Ky. 1994)).

⁴⁵⁵ See *id.* at 648-50.

⁴⁵⁶ See *id.* at 650. Cf. *St. Ledger II*, 942 S.W.2d 893, 901 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

⁴⁵⁷ See *American States Ins. Co.*, 560 N.W.2d at 650.

⁴⁵⁸ See *id.*

which refunds can be claimed?⁴⁵⁹ It was undisputed that “refunds under an unconstitutional statute [would] involve multitudes of taxpayers and millions of dollars.”⁴⁶⁰ While allowing only two years of refunds under section 134.590(2) would still likely cost the Commonwealth \$208 million⁴⁶¹ in refunds, providing refunds to taxpayers from 1988 forward might have cost Kentucky nearly \$320 million in refunds.⁴⁶² The refunds of wrongly collected taxes, however, need not have “cost”⁴⁶³ the Commonwealth anything because St. Ledger had sought an injunction after the case was filed in 1990 to place the monies collected by the Revenue Cabinet in escrow pending the outcome of the litigation.⁴⁶⁴ In fact, the United States Supreme Court in *McKesson Corp.* suggested that placing challenged tax payments into an escrow account would be an excellent accounting device by which a state could “predict with greater accuracy the availability of undisputed treasury funds.”⁴⁶⁵ St. Ledger “moved the trial court for a temporary injunction requiring [the] Revenue Cabinet to escrow into a separate, interest-bearing account, all monies collected from the Corporate Shares Tax during the pendency of the action.”⁴⁶⁶ St. Ledger, however, was unsuccessful in this attempt to protect taxes paid for future refunds.⁴⁶⁷

What has been created, therefore, is a way for the Commonwealth to behave in a highly confiscatory manner, but legally get away with it. This is not unlike a person on a crowded street who falls victim to a pickpocket,

⁴⁵⁹ See *St. Ledger II*, 942 S.W.2d at 900 (citing *Gossum*, 887 S.W.2d at 335).

⁴⁶⁰ *Id.*

⁴⁶¹ Interestingly, the amount of money in the Commonwealth’s “rainy day” or budget reserve trust fund was about \$200 million. See Tom Loftus, *U.S. Supreme Court Ruling May Cost State \$200 Million*, THE COURIER-JOURNAL (Louisville, Ky.), May 21, 1996, at A1 [hereinafter Loftus, *U.S. Supreme Court Ruling May Cost State \$200 Million*].

⁴⁶² See Memorandum, Consensus Forecasting Group, *supra* note 282.

⁴⁶³ Ultimately, to help pay for intangibles refunds and to raise monies for a \$100 million increase in funding for higher education, the Commonwealth sold \$200 million worth of tax and revenue anticipation notes. See Jim Molis, *Kentucky Lawmakers Authorize Debt for Capital Projects, Easing Cash Flow*, THE BOND BUYER, June 10, 1997.

⁴⁶⁴ See Loftus, *U.S. Supreme Court Ruling May Cost State \$200 Million*, *supra* note 461.

⁴⁶⁵ *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 45 (1990).

⁴⁶⁶ Appellant’s Brief, *supra* note 275, at 30.

⁴⁶⁷ See *St. Ledger II*, 942 S.W.2d 893 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

discovering the theft hours later. When he reports the crime to the police, he is informed that all thefts must be reported at the time of the theft, or within an hour of it. He explains that, had he *known* he was being robbed, he certainly would have reported it immediately. In fact, he did call the police soon as he discovered the wallet missing. This plea, however, falls on deaf ears. Imagine as well that he actually locates the thief on his own, still possessing the wallet, but because in the meantime the thief has used the money to pay back rent, the police are unwilling to press charges.⁴⁶⁸ This is the same as saying that while a “[s]tate’s interest in financial stability does not justify a refusal to provide relief,”⁴⁶⁹ it does justify procedural restrictions that assure minimal disruption to the state’s coffers. The right to recover a tax refund is not a fundamental right.⁴⁷⁰ Thus, the Commonwealth may collect a discriminatory tax, deliberately refuse to protect those funds while in litigation, then plead that it would deplete the state coffers to return what it wrongfully took in the first place. “It is obvious that the Commonwealth is using its superior position of power to an unfair advantage because if someone does not file a claim, the Commonwealth will be able to keep some of what it forcibly and illegally took.”⁴⁷¹ Such behavior should not be rewarded; the General Assembly should step in to correct what it previously permitted, either by amending the statute to allow refund applications to be filed back to 1988, or at a minimum by extending the period of refund.⁴⁷²

⁴⁶⁸ For many other types of claims, the statute of limitations is tolled by lack of notice. The limitations period for several statutory claims does not begin to run until the date from which the injury was discovered or reasonably should have been discovered. *See, e.g.*, K.R.S. § 413.130(3) (Michie 1992) (fraud or mistake); *id.* § 413.140(1)(e) & (2) (claims for medical malpractice); *id.* § 413.245 (professional service malpractice actions). *Cf. Ingersoll-Rand Co. v. Whittaker*, 883 S.W.2d 514, 515-16 (holding that employee who did not receive notice from his employer that it was terminating his temporary total disability benefits was entitled to tolling of the statute of limitations for filing his claim). *But see Lashlee v. Sumner*, 570 F.2d 107, 110 (6th Cir. 1978) (holding that under Kentucky law, the fact that a plaintiff did not learn of a libelous report against him until several months after its publication did not toll the period of limitations provided by section 413.140(1)(d)).

⁴⁶⁹ *McKesson Corp.*, 496 U.S. at 50.

⁴⁷⁰ *See American States Ins. Co. v. Michigan Dep’t of Treasury*, 560 N.W.2d 644, 649 (Mich. Ct. App. 1996) (citing *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329 (Ky. 1994)).

⁴⁷¹ *St. Ledger II*, 942 S.W.2d at 902 (Graves, J., dissenting).

⁴⁷² Justice Graves believed that the refund period should be extended back to 1988 to provide meaningful retroactive relief under *McKesson Corp.* *See id.* at 903

C. *Solutions Provided by Other States*

It is evident that Kentucky's approach is unfair and unjust to those unlawfully deprived of income from investments through the unconstitutional corporate shares tax, then lawfully deprived of refunds through section 134.590(2). But have other states done better by their citizens? Unfortunately, the answer is sometimes yes, sometimes no. Although relief under section 134.590(2) is limited to instances where taxpayers can file an application for refund within two years of their last tax payment, that limited relief is more generous than what many states allow.

For example, as noted in *McKesson Corp.*, until ordered to do so by the United States Supreme Court, Florida provided *no* relief, either pre- or post-deprivation, to taxpayers under its unconstitutional excise tax.⁴⁷³ Michigan, as noted above, provided that in order to seek a refund under an unconstitutional tax, claimants had to protest within ninety days after filing a return.⁴⁷⁴ Examples of shorter time frames abound: in Missouri, a protest is required at the time of payment;⁴⁷⁵ in North Carolina, thirty days after tax payment.⁴⁷⁶ But legislators in North Carolina believed the state had a

(Graves, J., dissenting).

⁴⁷³ See *McKesson Corp.*, 496 U.S. at 51.

⁴⁷⁴ See *American States Ins. Co.*, 560 N.W.2d at 646.

⁴⁷⁵ See MO. ANN. STAT. § 139.031(1) (West Supp. 1998) ("Any taxpayer may protest all or any part of any taxes assessed against him, except taxes collected by the director of revenue of Missouri. Any such taxpayer desiring to pay any taxes under protest shall, at the time of paying such taxes, file with the collector a written statement setting forth the grounds on which his protest is based."); *American States Ins. Co.*, 560 N.W.2d at 647 (citing *Jenkins v. Missouri*, 962 F.2d 762, 766 (8th Cir. 1992)).

⁴⁷⁶ See N.C. GEN. STAT. § 105-267 (1997). This statute states:

No court of this State shall entertain a suit of any kind brought for the purpose of preventing the collection of any tax imposed in this Subchapter. Whenever a person has a valid defense to the enforcement of the collection of a tax, the person shall pay the tax to the proper officer, and that payment shall be without prejudice to any defense of rights the person may have regarding the tax. At any time within the applicable protest period, the taxpayer may demand a refund of the tax paid in writing from the Secretary and if the tax is not refunded within 90 days thereafter, may sue the Secretary in the courts of the State for the amount demanded.

See also *American States Ins. Co.*, 560 N.W.2d at 647 (citing *Swanson v. North Carolina*, 441 S.E.2d 537, 545 (N.C. 1994)).

“‘moral obligation to pay everybody,’”⁴⁷⁷ even though estimates of liability for refunds ranged from \$300 million to over \$500 million.⁴⁷⁸ The legislature changed the deadline for filing an application for a tax refund from thirty days to a year from the date of payment.⁴⁷⁹ Even though North Carolina’s legislature acted to rectify the perceived injustice of a short time frame for requesting tax refunds, North Carolina’s extended one-year refund period is still shorter than Kentucky’s two-year period.

On the other hand, a few other states go beyond section 134.590(2) in the relief they offer. Pennsylvania allows taxpayers to file a claim for refund of taxes collected under an unconstitutional statute within three years of payment or *settlement* of the taxes due.⁴⁸⁰ California⁴⁸¹ allows refund claims to be filed four years from the date any constitutional amendment is passed to rectify unconstitutional taxing statutes. Florida

⁴⁷⁷ Christopher McEntee, *Trends in the Region: School Bond, Tax Liability Issues Preoccupy North Carolina*, THE BOND BUYER, May 2, 1996, available in 1996 WL 5638030 (page numbers unavailable on-line) (quoting North Carolina Senate Appropriations Committee member Gerald Blackmon).

⁴⁷⁸ See *id.*

⁴⁷⁹ See Danny Johnson, *N.C. Tax Changes May Benefit Your Firm*, THE BUS. J., Nov. 18, 1996, available in 1996 WL 11865126 (page numbers unavailable on-line).

⁴⁸⁰ See 1997 Pa. Legis. Serv. 1997-7 (House Bill 134), available in Westlaw, PA. LEGIS. 1997-7, to be codified at 72 PA. CONST. STAT. ANN. § 3003.1. This law provides:

When any tax or other money has been paid to the Commonwealth under a provision of this act or any other statute subsequently held by final judgment of a court of competent jurisdiction to be unconstitutional or under an interpretation of such provision subsequently held by such court to be erroneous, a petition for refund may be filed with the department either prior or subsequent to such final judgment but must be filed within three years of the payment of which a refund is requested, or within three years of the settlement of such taxes or other moneys due the Commonwealth, whichever period last expires.

⁴⁸¹ See CAL. REV. & TAX. CODE § 5096.5 (West Supp. 1998). This statute states:

Any taxes paid which were not erroneously or illegally collected under the law as it existed at the time of collection, but for which an exemption is provided by a retroactive constitutional amendment, shall be refunded after compliance with the provisions of this article, except that the claim for refund may be filed at any time within four years after the date such amendment became effective, or the date that this section became effective, whichever is later.

allows three to five years, depending on when the claim to a refund accrued.⁴⁸² Virginia provides that refund applications are to be filed (on specific forms) within three years of the date the tax is assessed.⁴⁸³ Clearly, other states see longer time frames as being the most reasonable way to approach tax refunds where an unconstitutional tax has been stricken. At a minimum, the Kentucky General Assembly could extend the period of refund, so that Kentucky taxpayers could recoup a larger portion of their loss.⁴⁸⁴ It is, after all, only fair.

CONCLUSION

Following the United States Supreme Court's decision in *Fulton Corp.* and subsequent vacation of *St. Ledger I*, the Kentucky Supreme Court was wise to hold that the exemption provided for stock of in-state companies was not severable from Kentucky's intangibles tax scheme. A contrary holding would have transgressed Kentucky's long-accepted public policy against double taxation, contravened the clear legislative intent that the Kentucky intangibles tax avoid subjecting corporate shareholders to double

⁴⁸² See FLA. STAT. ANN. § 215.26(2) (West Supp. 1998). The statute provides: Application for refunds as provided by this section must be filed with the Comptroller, except as otherwise provided in this subsection, within 3 years after the right to the refund has accrued or else the right is barred. Except as provided in chapter 198 and s. 220.23, an application for a refund of a tax enumerated in s. 72.011, which tax was paid after September 30, 1994, must be filed with the Comptroller within 5 years after the date the tax is paid.

⁴⁸³ See VA. CODE ANN. § 58.1-1824 (Michie 1997). This statute provides: Any person who has paid an assessment of taxes administered by the Department of Taxation may preserve his judicial remedies by filing a claim for refund with the Tax Commissioner on forms prescribed by the Department within three years of the date such tax was assessed. Such taxpayer may, at any time before the end of one year after the date of the Tax Commissioner's decision on such claim, seek redress from the circuit court under § 58.1-1825. The Tax Commissioner may decide such claim on the merits in the manner provided in § 58.1-1822 for appeals under § 58.1-1821, or may, in his discretion, hold such claim without decision pending the conclusion of litigation affecting such claim. The fact that such claim is pending shall not be a bar to any other action under this chapter.

⁴⁸⁴ Justice Graves thought the refund period should be extended to 1988 at minimum. See *St. Ledger II*, 942 S.W.2d 893, 903 (Ky.) (Graves, J., dissenting), cert. dismissed, 118 S. Ct. 27 (1997).

taxation, and amounted to an unconstitutional encroachment upon legislative authority.⁴⁸⁵

The result in *St. Ledger II*, however, greatly limited the taxpayers' victory in *St. Ledger I*. The Kentucky Supreme Court's decision, albeit restricted by the mandates of section 134.590,⁴⁸⁶ unjustly discriminates against inexperienced intangible property owners, particularly many senior citizens living on fixed incomes from retirement investments.⁴⁸⁷

To alleviate *St. Ledger II*'s discriminatory result in favor of the wealthier and more sophisticated investors, the Kentucky General Assembly should affirmatively act to provide a better opportunity for less savvy investors to recoup their losses. An extension of the time frame within which a refund application may be filed would afford such an opportunity. Until more affirmative relief is provided, the taxpayer victory in *St. Ledger I* will remain hollow for the many Kentucky taxpayers who were subjected for years to Kentucky's illegal intangibles tax.

⁴⁸⁵ See *supra* notes 339-41 and accompanying text.

⁴⁸⁶ See *supra* notes 362-92 and accompanying text.

⁴⁸⁷ See *supra* notes 354-60 and accompanying text.

