Attachment A

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LEGAL MEMORANDUM

TO: Senator Chris Romer

FROM: Office of Legislative Legal Services

DATE: April 15, 2009

SUBJECT: Constitutionality of the Income Tax Modification for Colorado Capital Gains[1]

I. Background

For any income tax year, section 39-22-518, C.R.S., allows "a modification, in the form of a reduction of income taxable by the state of Colorado," (hereafter referred to as a state income tax deduction) to a taxpayer who pays state income tax and has income from capital gains earned on either real or tangible personal property located within Colorado that was acquired on or after May 9, 1994, and held for at least five years or the sale of stock or an ownership interest in a Colorado company, limited liability company, or partnership that was acquired on or after May 9, 1994, and held for at least five years.[2]

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[1] This legal memorandum results from a request made to the Office of Legislative Legal Services (OLLS), a staff agency of the General Assembly, in the course of its performance of bill drafting functions for the General Assembly. OLLS legal memorandums do not represent an official legal position of the General Assembly or the state of Colorado and do not bind the members of the General Assembly. They are intended for use in the legislative process and as information to assist the members in the performance of their legislative duties. Consistent with the OLLS' position as a staff agency of the General Assembly, OLLS legal memoranda generally resolve doubts about whether the General Assembly has authority to enact a particular piece of legislation in favor of the General Assembly's plenary power.

[2] Section 39-22-518, C.R.S., also allows a taxpayer who pays state income tax to claim state income tax deductions for an income tax year for capital gains earned on either real or tangible personal property located within Colorado that was acquired before May 9, 1994, or was held for less than five years but at least one year or stock or an ownership interest in a Colorado company, limited liability company, or partnership that was acquired before May 9, 1994, or was held for less than five years but at least one year if the amount of excess state revenues that is required to be refunded pursuant to The Taxpayer's Bill of Rights, section 20 of article X of the state constitution (TABOR), for the fiscal year that ends in the income tax year exceeds a specified amount. For purposes of the federal constitutional legal analysis contained in this memorandum, these state income tax deductions, which are mechanisms for refunding excess state revenues under TABOR and are not expected to be

II. Issue(s) Presented

Does section 39-22-518, C.R.S., violate the Commerce Clause of the United States constitution?

III. Conclusion(s)

Yes, section 39-22-518, C.R.S., appears to violate the Commerce Clause. In *Fulton Corp. v. Faulkner,*[3] the United States Supreme Court held that a North Carolina intangibles tax scheme that resulted in higher taxation of ownership of out-of-state corporate stock relative to taxation of ownership of in-state corporate stock violated the Commerce Clause. Application of the analysis used by the *Fulton* Court to the state income tax deduction allowed by section 39-22-518, C.R.S., which, much like North Carolina's invalidated intangibles tax scheme, results in higher taxation of capital gains derived from out-of-state property and stock relative to taxation of capital gains derived from in-state property and stock, leads to the conclusion that section 39-22-518, C.R.S., probably violates the Commerce Clause.

IV. Analysis

A. The Commerce Clause and differential taxation by a state of in-state and out-of-state property.

1. The Commerce Clause.

Article 1, section 8, clause 3 of the United States constitution contains the Commerce Clause, which states:

> **§ 8. Powers of congress.** The congress shall have power:
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> (3) To regulate commerce with foreign nations, **and among the several states,** and with the Indian tribes. (Emphasis added).

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allowed through at least 2012, are legally indistinguishable from the state income tax deduction authorized for all income tax years. Accordingly, in the interest of brevity, only the state income tax deduction authorized for all income tax years by section 39-22-518, C.R.S., will be considered further in this memorandum.

[3] 116 S. Ct. 848 (1996).

The Commerce Clause establishes federal responsibility for regulation of interstate commerce in two ways: (1) It affirmatively grants Congress power to regulate interstate commerce; and (2) It limits the power of the individual states to regulate such commerce.[4] The element of the Commerce Clause that limits state power is "known as the dormant Commerce Clause" and it "prohibit[s] certain state taxation even when Congress has failed to legislate on the subject."[5]

The purpose of the dormant Commerce Clause is "to serve the Commerce Clause's purpose of preventing a [s]tate from retreating into economic isolation or jeopardizing the welfare of the [n]ation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear,"[6] and it "prohibits economic protectionism -- that is, 'regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.'"[7] Accordingly, "a [s]tate may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the [s]tate,"[8] and "where simple economic protectionism is effected by state legislation, a virtually *per se* rule of invalidity has been erected."[9]

2. Application of the Commerce Clause to differential taxation by a state of in-state and out-of-state property.

For purposes of assessing whether section 39-22-518, C.R.S., violates the Commerce Clause, the most relevant United States Supreme Court case is *Fulton Corp. v. Faulkner.* In *Fulton,* a corporation challenged the constitutionality under the Commerce Clause of a North Carolina statute that: (1) Imposed an intangibles tax on the value of corporate stock owned by North

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[4] *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1335 (1995) (superseded by statute on other grounds).

[5] *Id.*

[6] *Id.* at 1335-36.

[7] *Associated Industries of Mo. v. Lohman,* 114 S. Ct. 1815, 1820 (1994) (quoting *New Energy Co. of Ind. v. Limbach,* 108 S. Ct. 1803, 1807 (1988)).

[8] *Armco Inc. v. Hardesty,* 104 S. Ct. 2620, 2622 (1984).

[9] *Philadelphia v. New Jersey,* 98 S. Ct. 2531, 2535 (1978); *see also Fulton,* 116 S. Ct. at 854 (1996) ("State laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.'" (quoting *Oregon Waste Systems, Inc. v. Dept. of Environmental Quality of Ore.*, 114 S. Ct. 1345, 1350 (1994))).

Carolina residents; and (2) Allowed a deduction against a stockholder's liability for the intangibles tax in a percentage equal to the percentage of the total income of the corporation that was subject to North Carolina's corporate income tax.[10] North Carolina determined the percentage of each corporation's total income subject to its corporate income tax by averaging the percentages of the corporation's total sales, payroll, and property located within North Carolina. The resulting effect was that a North Carolina stockholder could offset with a deduction: (1) His, her, or its entire intangibles tax liability for stock issued by a corporation that only had sales, payroll, and property in North Carolina; (2) A lesser percentage of his, her, or its intangibles tax liability for stock issued by a corporation that had only a portion of its total sales, payroll, and property in North Carolina; and (3) None of his, her, or its intangibles tax liability for stock issued by a corporation that had no sales, payroll, or property in North Carolina.

The *Fulton* Court unanimously held that the challenged intangibles tax scheme violated the Commerce Clause. The Court first concluded that the scheme facially discriminated against interstate commerce, declaring that "[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 and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce."[11] The Court also rejected North Carolina's contention that because out-of-state corporations paid only an apportioned amount of North Carolina corporate income tax, which was used in part to fund the maintenance of a capital market so that corporations could sell stock to North Carolinians, the intangibles tax was a compensatory tax imposed to compensate North Carolina for the costs of maintaining that capital market.[12] Finally, the Court,

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[10] The Commerce Clause prohibits states from subjecting business activities "to multiple or unfairly apportioned taxation." *Meadwestvaco Corp. v. Illinois Dept. of Revenue,* 2008 *U.S. LEXIS* 3473, at 15 (April 15, 2008. LEXIS pagination subject to change pending release of the final published version). Accordingly, for the purpose of determining the amount of income tax that a corporation that derives income from more than one state owes to each state, the corporation's income is apportioned between the states from which it derived the income.

[11] 116 S. Ct. at 855.

[12] The compensatory tax doctrine "is fundamentally concerned with equalizing competition between in-staters and out-of-staters," *Fulton,* 116 S. Ct. at 859 n.8, and therefore allows a state to impose a tax on an out-of-state corporation that it does not impose on an in-state corporation only to the extent that the tax equalizes the tax burden between in-state and out-of-state corporations. (*See, e.g., Hinson v. Lott,* 75 U.S. 148, 8 Wall. 148, 19 L. Ed. 387 (1869) (Upholding as a compensatory tax an Alabama tax on each gallon of liquor imported into Alabama in an amount equal to the amount of a tax imposed on each gallon of liquor distilled in Alabama)). Accordingly, the Court has been very reluctant to find general revenue measures to impose "intrastate burdens for purposes of the

noting that "[s]tates may not impose discriminatory taxes on interstate commerce in the hopes of encouraging firms to do business within the [s]tate,"[13] concluded that because the effect of the intangibles tax scheme, "[a]ll other things being equal," was that "a North Carolina investor will probably favor investment in corporations doing business within the State," the scheme "worked an impermissible result."[14]

B. Constitutionality of section 39-22-518, C.R.S., in light of the *Fulton* decision.

1. Standard of review.

The General Assembly has plenary power to enact legislation subject only to express or implied provisions of the Colorado and United States constitutions.[15] "The presumption of constitutionality is rooted in the doctrine of separation of powers" and is based on a premise that the legislature and the executive branches of government "observe and effectuate constitutional provisions in exercising their power."[16] Accordingly, a plaintiff challenging the constitutionality of a statute must prove its unconstitutionality "'beyond a reasonable doubt.'"[17] Notwithstanding the presumption of constitutionality and high burden of proof imposed by the reasonable doubt standard, a court will find a statute to be unconstitutional if "'the conflict between the law and the constitution is clear and unmistakable.'"[18]

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compensatory tax doctrine" because "'[p]ermitting discriminatory taxes on interstate commerce to compensate for charges purportedly included in general forms of intrastate taxation would allow a state to tax interstate commerce more heavily than in-state commerce anytime the entities involved in interstate commerce happened to use facilities supported by general state tax funds.'" *Fulton,* 116 S. Ct. at 856 (quoting *Oregon Waste Systems, Inc. v. Dept. of Environmental Quality of Ore.,* 114 S. Ct. 1345, 1353 n.8 (1994) (internal quotations marks and citation omitted)).

[13] 116 S. Ct. at 860 (citation omitted).

[14] *Id.*

[15] *People v. Y.D.M.*, 593 P.2d 1356 (Colo. 1979).

[16] *City of Greenwood Village v. Petitioners for Proposed City of Centennial*, 3 P.3d 427, 440 (Colo. 2000).

[17] *E.g., People v. Hickman,* 988 P.2d 628, 634 (Colo. 1999) (quoting *People v. Janousek,* 871 P.2d 1189, 1195 (Colo. 1994)).

[18] *City of Greenwood Village,* 3 P.3d at 440 (quoting *People v. Goddard,* 8 Colo. 432, 437, 7 P. 301, 304 (1885)).

2. Application of *Fulton* analysis to section 39-22-518, C.R.S.

For the purpose of this Commerce Clause analysis, the relevant portions of section 39-22-518, C.R.S., are subsection (1), which allows a state income tax deduction for "income attributable to qualifying gains receiving capital treatment," sub-subparagraphs (2) (b) (I) (A) and (2) (b) (I) (B), which define the term "qualifying gains receiving capital treatment" for purposes of the state income tax deduction allowed by section 39-22-518, C.R.S., for any income tax year,[19] and subparagraph (1) (b) (II) (A), which defines the term "Colorado company, limited liability company, or partnership." These provisions state:

> **39-22-518. Tax modification for net capital gains.** (1) For income tax years commencing on or after July 1, 1995, a modification, in the form of a reduction of income taxable by the state of Colorado, shall be allowed to any qualified taxpayer for the amount of income attributable to qualifying gains receiving capital treatment earned by the qualified taxpayer during the taxable year and included in federal taxable income.
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> (2) For the purposes of this section:
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> (b) (I) "Qualifying gains receiving capital treatment" means the amount of net capital gains, as defined in section 1222 (11) of the internal revenue code, included in any qualified taxpayer's federal income tax return and:
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> (A) **Earned by such qualified taxpayer on real or tangible personal property located within Colorado** that was acquired on or after May 9, 1994, and that has been owned by the qualified taxpayer for a holding period of at least five years prior to the date of the transaction from which such net capital gains arise; or
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> (B) **Earned on the sale of stock or on the sale of an ownership interest in a Colorado company, limited liability company, or partnership** where such stock or ownership interest was acquired on or after May 9, 1994, and has been owned by the qualified taxpayer for a holding period of at least five years prior to the date of the transaction from which the net capital gains arise; or
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> (II) For purposes of this paragraph (b):
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> (A) **"Colorado company, limited liability company, or partnership" means an entity with fifty percent or more of its property and payroll,** as determined in accordance with article IV of the multistate tax compact, section 24-60-1301, C.R.S., **assigned**

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[19] Section 39-22-518 (2) (b) (I) (C) to 39-22-518 (2) (b) (I) (F), C.R.S., provide the different definitions of the term "qualifying gains receiving capital treatment" for the additional state income tax deductions allowed for an income tax year if the amount of excess state revenues that is required to be refunded pursuant to TABOR for the fiscal year that ends in the income tax year exceeds a specified amount. *See supra* note 2.

to locations within Colorado. (Emphasis added).

Applying the analysis that the *Fulton* Court used to invalidate North Carolina's intangibles tax scheme to the state income tax deduction allowed by section 39-22-518, C.R.S., reveals a clear and unmistakable conflict between that statutory section and the Commerce Clause. Like North Carolina's intangibles tax scheme, section 39-22-518, C.R.S., by allowing a deduction only for income earned on "real or tangible personal property **located within Colorado**" or "[e]arned on the sale of stock or on the sale of an ownership interest in a **Colorado** company, limited liability company, or partnership," facially discriminates against interstate commerce. It does so by: (1) Taxing capital gains derived from in-state and out-of-state property and stock differently; (2) Providing an incentive to Coloradans to purchase in-state property and stock instead of out-of state property and stock by increasing the expected return on investment for in-state property and stock only by the amount of the state income tax deduction allowed against any capital gains derived from such in-state property or stock; and (3) Discouraging any "Colorado company, limited liability company, or partnership" from expanding its out-of state operations past the statutory fifty percent threshold that would cause it to lose its "Colorado" status. In sum, like the intangibles tax scheme struck down by the *Fulton* Court, the state income tax deduction allowed by section 39-22-518, C.R.S., appears to violate the Commerce Clause because "[a]ll other things being equal . . . a [Colorado] investor will probably favor investment in corporations doing business within the [s]tate."[20]

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[20] *See supra* note 14 and accompanying text.