Blog Post

Arizona v. California: A Clear Case of "Passive Aggressiveness" in the State Taxation of Nonresidents

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The State of Arizona has asked the Supreme Court of the United States to hear a challenge to the State of California's taxation of nonresident members of California LLCs and nonresident shareholders of California corporations. The crux of the dispute relates to California's "doing business" tax on all entities that conduct business in the State. The tax is a flat $800 for limited liability companies and is a minimum of $800 for corporations. Arizona asserts that California's aggressive efforts in taxing nonresident passive investors violates the Due Process Clause and the Commerce Clause of the U.S. Constitution. If the Court decides to hear the case, a ruling in Arizona's favor would have an unquestioned impact on the state and local taxation of nonresidents.

The Due Process Clause requires that there be definitive "minimum contacts" between the state and the person, property, or activity it seeks to tax. Arizona argues that where cross-border investment is passive, there are insufficient "minimum contacts" between a nonresident and the in-state business to support California's jurisdiction to tax. In its filed brief, California counters by stating that the "minimum contacts" analysis requires a careful case-by-case review of the relevant facts. For this reason, the action brought by Arizona, California

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maintains, is an ill-suited vehicle for such a Due Process Clause challenge.

Under the Supreme Court's Commerce Clause jurisprudence, a state tax will survive scrutiny if there is a "substantial nexus" between the activity subject to tax and the taxing state and the tax is "fairly related" to the services provided by the taxing state. Arizona claims that California's taxation of nonresident passive investors in California LLCs and corporations violates the Commerce Clause because there is a distinction between the activities of the nonresident passive investor and those of the active California business. California argues that the required Commerce Clause approach, like that of the Due Process Clause, requires a highly-factual examination of each individual case. As a result, California contends that the Court should reject Arizona's request for a bright-line rule.

Assuming that it agrees to hear this case, the Court's recent holdings in *Wayfair v. South Dakota and Kimberley Rice Kaestner 1992 Family Trust* may shape the required constitutional analysis. In *Wayfair,* the Court ruled that the Commerce Clause's "substantial nexus" mandate does not require that a taxpayer be physically present in the taxing state. The Court made clear that substantial nexus exists "when the taxpayer avails itself of the substantial privilege of carrying on business" in the taxing state. On its face, the Court's reasoning in *Wayfair* would tend to support Arizona's Commerce Clause challenge. After all, it cannot be disputed that Arizona-based passive investors in California LLCs and corporations do not "avail [*themselves*] of the substantial privilege of carrying on business" in California.

The focus of the dispute in *Kaestner Trust* was whether North Carolina could tax income earned by a nonresident trust. North Carolina asserted its authority to tax the nonresident trust based solely on the fact that a trust beneficiary resided in the state. The nonresident trust contended that the Due

Process Clause was a bar to the exercise of North Carolina's tax jurisdiction. The Supreme Court unanimously agreed. The Court reasoned that there must be a definitive link between the in-state beneficiary and the trust assets to support North Carolina's efforts to tax the income from such assets.

The Court's holding in *Kaestner Trust* buttresses the arguments made by Arizona in its challenge to California's "doing business" tax. In *Kaestner Trust*, the Court made clear that there must exist a constitutionally-recognizable nexus between the in-state contact and the object of the tax. The mere existence of a contingent economic connection was insufficient to satisfy the Due Process Clause in *Kaestner Trust.* Arizona makes conceptually similar arguments in its filing.

It remains to be seen whether the Supreme Court will accept Arizona's challenge.[1] In the event the Court does entertain argument, however, the resulting holding in the case will undoubtedly have national implications.

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[1] The Court has asked U.S. Solicitor General Noel Francisco to file a brief with his recommendation on whether the Court should hear Arizona's constitutional challenge. The Solicitor General authored a brief in support of South Dakota in Wayfair in which he argued that the Commerce Clause was not a bar to the imposition of the sales tax where the nonresident retailers maintained a "pervasive and continuous virtual presence" in South Dakota. A close reading of the Wayfair decision makes clear that the Court gave great weight to the Solicitor General's arguments. For example, in support of its holding, the Wayfair Court upheld the imposition of the tax based on the "continuous and pervasive virtual presence" of the taxpayers.