

Possible Outcomes of Successful Challenge to SB 40 Motor Fuel Tax

If the anti-pass through provision in SB 40 is successfully challenged in court, could a refund of the tax be required? What effect could that have on future state budgets?

A Refund of an Unconstitutional Tax Could be Required

It is impossible to predict what remedy will be required by the court in the event a challenge to the Oil Company Assessment is successful. Here are two plausible scenarios, though others may exist:

- 1) The court could find the tax as a whole is unconstitutional, and order a refund of the taxes at issue in the suit, with interest.
- 2) The court could find that only part of the tax is unconstitutional and order a refund of the full amount of taxes at issue or some lesser amount.

Detrimental Effect Possible on Future State Budgets

Even if interest is not considered, the State could be faced with having to refund an amount approaching \$1 billion:

- The Legislative Fiscal Bureau estimates that the Oil Company Assessment will generate approximately \$272 million over the biennium, annualized at \$157 million in the second year.
- Challenges to the tax could last as many as eight years.

If the State chooses not to collect the tax while the law is being challenged, the State still could be faced with a huge refund obligation when the challenge is done:

- If those subject to the tax deposit their tax assessments with the Department of Revenue to prevent having to pay interest in case they lose the challenge, the State is required to pay interest at the rate of nine percent per year on any portion of such a deposit that is later refunded to a taxpayer;
- A nine percent simple interest rate on \$157 million over six years would cost the State nearly \$85 million in interest payments alone.

But does the anti-pass through ban in the gross receipts tax in S.B. 40 violate the U.S. Constitution?

It has been suggested that courts have upheld similar taxes that prohibited oil companies from passing the cost of the taxes on to their customers. The case cited most prominently is a 1988 U.S. Supreme Court case: *Puerto Rico Dept. of Consumer Affairs v. Isla Petroleum Corp.* 485 U.S. 495 (1988). Let's take a look at this case.

In 1986, Puerto Rico imposed an excise tax on oil refiners. Regulations were issued that banned wholesalers from passing the cost of the tax through to retailers. Affected oil companies challenged the regulations as unconstitutional on pre-emption grounds, arguing that the federal Emergency Petroleum Allocation Act (EPAA) pre-empted the state regulations and violated the Supremacy Clause (Art. VI) of the U.S. Constitution.

The Supreme Court found that the Puerto Rico regulations did not violate the Supremacy Clause, absent any federal law preempting state authority. It is important to note that what the Court did not address—and was not asked to address—was whether the tax and regulations violated the *Commerce Clause* of the U.S. Constitution. Indeed, the U.S. Supreme Court has never addressed whether anti-pass through tax provisions such as the one proposed in S.B. 40 violate the Commerce Clause.

How does the Commerce Clause fit into this?

Article I, §8, cl. 3 of the U.S. Constitution provides that Congress has exclusive powers over interstate commerce. One of the principles established by the U.S. Supreme Court is that the Commerce Clause prevents any state from imposing a tax which discriminates against interstate commerce by providing an advantage to local business or by burdening out-of-state business. *See, e.g., Maryland v. Louisiana*, 451 U.S. 725, 753-758 (1981).

While the U.S. Supreme Court has not spoken on the issue whether an anti-pass through prohibition violates the Commerce Clause, at least one lower court has. In 1983, the New York Appellate Division, Third Department, found that such a provision *did* violate the Commerce Clause. In *Shell Oil Co. v. NY State Tax Comm'n.*, 91 A.D.2d 81, 458 N.Y.S.2d 938 (1983), the court held that a gross profits tax with a provision prohibiting oil companies from passing on the costs of the tax to consumers in New York violated the Commerce Clause. The court found that the effect of the pass-through prohibition would be for oil companies to recoup the cost of the New York tax from non-New York purchasers of their products. Because the prohibition would shift the direct burden of the tax from the companies' New York customers onto their out-of-state customers, the taxed oil companies' customers in New York were treated differently than the out-of-state customers. As a result, the court found the provision violated the Commerce Clause of the U.S. Constitution.

The decision was never appealed to the New York Court of Appeals because the legislature repealed the law shortly after this decision. However, the analysis shows how a court might analyze whether an anti-pass through provision violates the Commerce Clause.