COMMON ROADBLOCKS TO REFUNDS: HOW THE STATES TRY TO AVOID PAYING REFUNDS AND WHAT TAXPAYERS CAN DO ABOUT IT.

Francina A. Dlouhy
Faegre Baker Daniels
317-237-1210

I. States That Enact Statutory Prohibitions on Refunds

Often a decision of a court creates refund opportunities for taxpayers. States may sometimes respond to this development by enacting laws prohibiting or limiting refunds based on the court's decision. Consider the following two examples:

A. *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009); *cert. denied* 130 S.Ct. 3324 (May 24, 2010).

1. Ky. Rev. Stat. § 134.580(10)(a) provided:

> "Notwithstanding any provision of the Kentucky Revised Statutes to the contrary:
>
> (a) No money shall be drawn from the State Treasury for the payment of any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return."

2. History of this statutory provision

   a. In 1988, the Kentucky Revenue Cabinet interpreted Kentucky law to prohibit unitary income tax returns by corporate taxpayers, requiring each to file separate returns.

   b. In 1994, the Kentucky Supreme Court ruled that unitary returns were allowed under Kentucky law.

   c. Taxpayers amended returns for previous years and sought refunds.

   d. In 1996, the Kentucky legislature formally abolished filing unitary returns for tax years after 1994.

e. In 2000, the Kentucky legislature enacted the prohibition against refund claims for any tax year before 1995 based on an amended, unitary return filed after December 22, 1994.

f. Therefore, taxpayers with pending refund claims for years 1994 and before were precluded from obtaining refunds.

3. The Kentucky Supreme Court upheld the statute retroactively barring refund claims by the taxpayers based on amended returns filed after the 1994 ruling that unitary returns were allowed. The Court relied on *U.S. v. Carlton*, 512 U.S. 26 (1994), in holding that the retroactive prohibition against refunds satisfied the requirements of due process, because the statute had a rational relation to the legitimate government purpose of raising and controlling revenue. (Ironically, the taxpayers bringing suit in this case to challenge the retroactive prohibition against refunds were the same taxpayers that successfully had challenged the State's previous interpretation that would not allow unitary returns, winning the case in 1994. Thus, these taxpayers had succeeded in overturning the State's old interpretation and complied with the Court's ruling in filing amended returns, only to be denied their refund claims based on the State's later enactment.)

B. Indiana Code § 6-8.1-9-2(c) was adopted by the Indiana General Assembly, as a "legislative reaction" to the *Riverboat Development Inc.* decision, 881 N.E.2d 107 (Ind. Tax Ct. 2008), *trans. denied*. RDI was an S-Corporation commercially domiciled in another state. RDI held a membership interest in an LLC doing business in Indiana. The Indiana Department of Revenue assessed RDI for failure to withhold Indiana income tax on its out-of-state shareholders. The Tax Court held that RDI was not subject to withholding tax liability because it did not have income derived from Indiana sources. Its only income was from its membership interest in the LLC, an intangible sitused outside of Indiana at RDI's commercial domicile. Therefore, under Indiana law, it did not have income from Indiana sources. IC § 6-8.1-9-2(c) was enacted in 2009 to limit refunds based on the RDI case. Note: IC § 6-8.1-9-2(c) is being challenged, not only on due process grounds, but also because it discriminates against taxpayers with commercial domiciles outside of Indiana.

II. Limiting Who Can File A Refund Claim

A state may seek to deny a refund arguing that the party that filed the refund claim is not the proper party to claim the refund under state law. Because state laws are not consistent about which party is authorized to file the refund claim, this issue causes compliance headaches and considerable litigation.

A. Who is the taxpayer?

1. *In the Matter of the Protest of Navajo Refining Company – New Mexico Taxation and Revenue Department (Aug. 31, 2012).* In Navajo Refining, Navajo sought a refund of New Mexico Special Fuel Suppliers Tax and Petroleum Products Loading Fees paid by one of its vendors, Musket. Navajo itself did not remit any of the taxes or fees at issue to the State. The Hearing Officer relied on New Mexico Supreme Court precedent and found that, while technically anyone can claim a refund, a claim is only valid for the amount that the claimant paid to the State. Because Navajo did not pay taxes or fees to the State, a refund claim was not allowed under the plain language of the statute.

2. *Letter Ruling No. LR 7077 – Missouri Department of Revenue (Apr. 13, 2012).* A manufacturer collected and remitted sales tax on sales to its customers. The manufacturer filed a refund claim on the basis of a sales tax exemption, stating that it would hold any refund in trust for its customers. Under Missouri law, the proper party to file and receive a refund is the party legally obligated to remit the tax to the state. Thus, the manufacturer was entitled to submit the claim.

3. *RCN Telecom Services, Inc. f/k/a Freedom New York, LLC v. Director – New Jersey Tax Court (June 14, 2010).* Freedom New York, LLC ("Freedom"), previously did business under the name of RCN Telecom Services, Inc. ("RCN"). RCN had purchased the equipment at issue and paid sales tax, with Freedom eventually filing a sales tax refund claim based upon an overlooked sales tax exemption. The relevant issue before the Court was which entity was the proper refund claimant. The Court ruled that Freedom, f/k/a RCN, the "customer," was the proper claimant. The Court also reached its decision despite the fact that RCN's related entity, RCN Operating Services, actually remitted payment to vendors.

4. *Taczanowski, DTA No. 821740 – New York Division of Tax Appeals (May 21, 2009).* Petitioner claimed that she was entitled to a refund of New York sales tax because, among other things, there was a seizure of her bank account and a tax levy served on her bank after allegedly improper notice was provided to her by the State. However, the levy was closed without payment and another person, a responsible officer for the business, ultimately made payment for the outstanding sales tax liability. The Tribunal denied petitioner's claim on the basis that she "did not pay the taxes which are the subject of the refund claim."

5. *Decision No. 07-0159 RC – West Virginia Office of Tax Appeals (Feb. 15, 2008).* Petitioner operated a country club and golf course and improperly collected Consumer Sales and Service Tax on the membership dues paid

by its members. One of the issues in the appeal was whether petitioner was entitled to the refund of overpaid tax without evidence of an assignment of members' refund claims to the petitioner. The ALJ ruled against the petitioner, stating that under the controlling statutes, the proper party to file a refund claim under that state's law is the party who actually paid the tax with his own funds, and not the party who collected it.

B. Filing As An Agent

1. *J-W Power Co. v. State ex rel Department of Revenue and Taxation – Louisiana Supreme Court (Mar. 15, 2011).* J-W Power Co. collected sales tax on compression services (treated as a taxable lease of equipment) and paid the tax to the State under protest. In its protest, J-W failed to mention any of the parties (some were related, some unrelated) from which the tax was collected. The Department then argued that J-W was not the taxpayer and was not properly entitled to a refund. The trial court ruled in favor of the Department, but the appellate court reversed, finding that there was no rational basis for refusing to allow a party to sue through his agent, as long as the agent complies with statutory requirements. The Supreme Court affirmed the appellate court, stating that although only the affiliates (actual purchasers) had a true interest in the refund claim, a duly authorized agent could bring a claim on their behalf. The Department also lost its argument that, because tax laws are *sui generis*, agency principles from other areas of law cannot be applied.

2. *AT&T Corp. v. Commissioner – Minnesota Tax Court (Jan. 7, 2004).* Under Minnesota's capital equipment sales/use tax exemption, applications for refund must be filed by the purchaser of the equipment and not the vendor who remitted the tax. In AT&T Corp., the purchaser and proper refund claimant was US WEST. However, the application for refund was filed on the vendor's letterhead, providing the TIN of the vendor as well. The refund claim was ultimately denied on the basis that the refund was not made by the purchaser as required by Minnesota law.

C. A variation of the issue of who can claim the refund arises in the property tax area, where the right to a refund often turns on who owns the property.

1. *First Union National Bank of Florida v. Lee Co. Commission – Supreme Court of Alabama (June 30, 2011).* The mortgagee-redeemer of residential property applied for a property tax refund of additional money collected at tax sale. The Court explained that the true owner is the party entitled to file a refund because the owner is the party against whom property taxes are assessed. Therefore, the delinquent property owner, and not the mortgagee-redeemer, was entitled to any extra funds remaining post-sale.

2. *Florida Information Bulletin PTA-06-17 – Florida Department of Revenue (Oct. 20, 2006)*. This Bulletin clarifies that if a mortgage company or escrow agent pays property taxes as an agent, but is no longer involved with the property, and if no change of ownership has occurred since the taxes were paid, the tax should be refunded to the owner provided that the owner properly follows the refund procedure.

3. *31/32 Lexington Associates DTA No. 813845, 814194 – New York Division of Tax Appeals, Tax Appeals Tribunal (Aug. 21, 1997).* 31/32 Lexington Associates filed for a refund of New York Real Property Transfer Gains Tax. The Tribunal dismissed the claim on jurisdictional grounds, stating that there was no evidence that 31/32 Lexington was a party to the relevant transaction, had an ownership interest, transferred the property, or in fact paid the Gains Tax. Without such evidence, the Tribunal could not conclude that 31/32 Lexington was a proper petitioner.

D. Can refund claim be filed as a class action?

1. *Hearing No. 102,510 – Texas Comptroller of Public Accounts (Mar. 1, 2010).* The claimant filed a single sales tax refund on behalf of a provisionally certified class. The class had received a cash rebate for a purchase but did not receive a sales tax refund on the rebate amount. The Comptroller found that Texas does not have statutory authority for a refund to be granted to a class, and therefore the claimant did not have standing, nor did the Comptroller have authority to grant, a refund.

III. Rejection of Refund Claims On Statutory or Administrative Grounds

States have become very aggressive in denying refund claims on a variety of statutory or administrative grounds. Some of these cases demonstrate that the taxpayer may have not carefully thought through the pre-requisites to filing a refund claim. Again, the controlling state law-- which is different from state to state--- determines the outcome of these disputes.

A. Failure of the taxpayer to pay the tax

1. Generally, a person claiming a refund of taxes paid must have actually paid the taxes. When the facts show that the taxpayer was the not the party paying the taxes, or that the taxes were never paid, the refund claim is usually rejected.

2. *Singh v. City of Oakland*, 2006 WL 3335248 (Cal. Ct. App. 2006) – payment of the tax is a condition precedent to challenging tax assessments on both the state and local levels. A taxpayer intended to dispute city special assessment taxes on his real estate before he could seek a refund of the taxes. The taxpayer's sole remedy was an action for a refund after paying the taxes at issue, but the taxpayer argued that he did not need to

pay the tax to seek redress. The City argued that the taxpayer had not pleaded the requirements for a refund action. The rule that payment of a tax is a condition precedent to challenging the tax assessment was not confined to state-imposed taxes, so the taxpayer had to pay the disputed tax before he could seek a refund of the taxes.

B. Failure of the claimant to exhaust administrative remedies

1. Generally, a person claiming a refund of taxes paid must have sought redress through the administrative process in order to claim a refund. When the taxpayer attempts to seek a refund without properly protesting the tax or filing a claim for refund, the claim is usually rejected.

2. Some states use this argument to effectively prohibit class action suits in tax refund cases. For example, Indiana Code § 6-8.1-9-7 requires that every member of a class in a class action must file a timely claim for refund with the Indiana Department of Revenue and have that claim denied before the class may be certified.

3. *Stutrud v. City of Rohnert Park*, No. A118408, (Cal. Ct. App. 2008) – a class action proceeding was barred because all members of the class had not exhausted their administrative remedies. A group of taxpayers sought a refund of sewer fees assessed by a municipality. The taxpayers contended that Proposition 218 impliedly repealed the statutory procedures for seeking a refund or challenging the assessment of a fee or charge imposed as an incident of real property ownership. However, there was no change to the existing limitations on suing a government entity without first filing an administrative claim for compensation. Therefore, because all members of the class had not already exhausted their administrative remedies, the taxpayers were not authorized to maintain a class action proceeding.

4. *Cameron Appraisal District v. Rourk*, 194 S.W.3d 501 (Tex. Sup. Ct. 2006). A class could not be certified because the members did not exhaust their administrative remedies. A Texas law provides detailed administrative procedures for taxpayers who want to contest their property taxes. Some of the taxpayers pursued administrative remedies and filed timely appeals while others did not. The taxpayers sought to certify a class seeking to have their tax assessments set aside. Exhaustion of administrative remedies is mandatory, and a taxpayer's failure to pursue an appraisal review board proceeding deprives the courts of jurisdiction to decide most matters relating to property taxes. The class was therefore not certified.

5. *TIN, Inc. v. Washington Parish Sheriff's Office et al. – Louisiana Court of Appeals (July 2, 2012).* Taxpayer, a local paper mill, pursued a raw

materials exemption by requesting sales/use tax refunds for purchases from 2001 through 2007. The trial court dismissed the taxpayer's claims and the appellate court affirmed, finding that taxpayer's refund claims were pre-empted under the administrative code effective for 2001 through June 30, 2003, and under the Uniform Local Sales Tax Code ("ULSTC") effective as of July 1, 2003. The appellate court explained that, under the administrative code, the taxpayer had two remedies for seeking refund – appeal to the board of tax appeals or payment under protest with suit to recover. The taxpayer had not appealed to the board, so its exclusive remedy was payment under protest with suit to recover (*i.e.*, simultaneously providing a notice of intent to file suit for recovery which prompts the State to place the payment in escrow for 30 days). The taxpayer did not provide a protest when remitting the tax and therefore was barred from recovery. Under the later ULSTC, when a taxpayer believes the collector has misinterpreted the law or rules and regulations, the taxpayer's sole remedy is payment under protest with a suit to recover. Because taxpayer believed the collector misinterpreted the raw materials exemption but taxpayer still failed to pay under protest, it was also barred from recovery under the ULSTC. Lastly, in addition to its failure to protest, the taxpayer did not file a timely suit under relevant Louisiana statutes.

6. *"Paying under Protest" as a Prerequisite*. Several states still retain the requirement of "payment under protest" in order to preserve a taxpayer's right to bring a refund action in court. For example, Washington requires a taxpayer to submit a written protest to the county treasurer at the time of paying property tax. This protest must set forth the grounds upon which the taxpayer believes the tax is unlawful or excessive. Wash. Admin. Code § 458-18-215(1)-(2). Montana also has a similar provision for its property taxes. If a Montana taxpayer fails to pay a tax or fee under protest, an appeal may continue, but a refund may not result from the appeal. Mont. Admin. R. 15-1-402(2).

C. *Failure of the claimant to timely file the claim.* Every state imposes a statute of limitations on the filing of a refund claim. As discussed in the cases below, the triggering event can vary based on the state and the type of tax.

1. *American Airlines, Inc., v. Department of Revenue*, 931 N.E.2d 666 (Ill. App. Ct. 2009), held that the statute of limitations on a refund claim was not tolled by the relation-back doctrine because the Illinois Use Tax Act contains no reference to the doctrine. The taxpayer filed a refund claim, which was timely filed, then filed a second claim beyond the statute of limitations for refunds. The taxpayer argued it was an amendment to the first claim, not a separate claim. The statute of limitations for the second claim was not tolled by the relation-back doctrine under the Code of Civil Procedure because the procedures and time requirements for use tax refunds were fully regulated by the Illinois Use Tax Act, which contained

no reference to the relation-back doctrine. The second refund claim was accordingly denied.

2. *MBNA America Bank, N.A. v. Commissioner of Revenue*, No. 7589-R (Minn. Tax Ct. 2004), rejected the refund claim because the claim was not filed one year from the date of the order assessing the tax. After an order assessing corporate franchise tax, the taxpayer paid, then sought a refund. The taxpayer argued that the payment of the assessment triggered the limitations period for filing the refund claim, but the Court held that the statutory refund provisions required the claim to be filed within one year from the order assessing the tax, not the payment of the tax.

3. *Ruling P.D. 96-137 of the Virginia Commissioner of Revenue* (1996) denied the refund because the amended return was filed more than 90 days after the change in federal tax liability. A corporation was assessed an additional federal tax liability, and more than three years after the due date of the original Virginia return, the corporation filed an amended return resulting in a refund. The refund was denied because taxpayer have 90 days after the final determination of the change in the corporation's federal tax liability in which to seek a refund, and the taxpayer had failed to amend its return in that window.

4. *Helton v. Reed*, 638 S.E.2d 160 (W.Va. Sup. Ct. 2006), denied the refund claim because the taxpayer failed to timely file with the correct administrative body. A separate case involving the Tax Commissioner refunding certain taxes was ongoing. The taxpayer incorrectly filed a petition for a severance tax refund with the Tax Commissioner when it should have filed the petition with the Office of Tax Appeals, thereby failing to timely file. The taxpayer was not entitled to be included in the separate case, and the refund claim was denied.

D. *Failure of the claimant to raise an issue.* Generally, a person claiming a refund of taxes paid must raise the issue appropriately. The states vary on their requirements for how a taxpayer can raise the issue of refund, as discussed below.

1. *Appeal of Beneficial California, Inc.*, No. 96-SBE-001, Cal. State Bd. of Equalization (1996), held that claims not addressed in an initial refund claim cannot be raised at a later date. A corporate taxpayer sought a refund of franchise taxes paid. Under California law, a claim for refund must set forth in detail the grounds upon which a refund is claimed and facts sufficient to apprise the Franchise Tax Board of the exact basis of the claim, and failure to raise an issue in the refund claim itself bars the taxpayer from raising it at a later date. The taxpayer sought several claims for refund that were not addressed in the taxpayer's initial claim, so the taxpayer was precluded from raising the issues on appeal.

2. *Appeal of Arizona Colorado Enterprises, LLC*, No. 534951, Cal. State Bd. of Equalization (2011), held that because the taxpayer failed to specify all the tax years at issue in its refund claim, the claim was denied. The taxpayer paid LLC fees for the 2001 through 2006 tax years under statutes which were struck down as unconstitutional in 2006. The taxpayer filed a refund claim for the 2001 tax year in 2006 and for the 2002 through 2006 tax years in 2009. The Franchise Tax Board allowed the refund claims for 2001, 2005, and 2006, but disallowed the claims for 2002 through 2004 on the basis that the claims were barred by the four-year statute of limitations. The statute governing the refund claim procedures requires that the taxpayer specifically list all the tax years at issue, so the taxpayer's claim for refund was denied.

3. *American Airlines, Inc., v. Department of Revenue,* 931 N.E.2d 666 (Ill. App. Ct. 2009), held that although refund claims can be amended, the new issues must be related for it to qualify as an amendment rather than an additional claim. The taxpayer filed a refund claim, which was timely filed, then filed a second claim beyond the statute of limitations for refunds. The second refund claim was premised upon a different legal principle and involved different issues, so it was a separate claim and subject to the statute of limitations apart from the timely filed first claim. The second refund claim was therefore not an amendment to the taxpayer's first refund claim, and was denied.

E. *Refunds are not allowed for the claimant's stated reasons*. Refund claims are sometimes allowed only under certain circumstances. If those circumstances are not met, the refund claims will be denied.

1. *Nationwide General Insurance Company,* No. 00 MR 5, (Ill. Cir. Ct, Sangamon County 2001), held that an unconstitutional statute is not necessarily erroneous, and thus does not necessarily merit a refund. Taxpayer claimed a refund of Illinois privilege tax on foreign insurance companies, a tax which was found unconstitutional in 1997. The taxpayer did not pay under protest, but did pay. The statute authorizing the granting of refunds for taxes paid without protest stated that refunds can only be allowed when there was a mistake of fact, error in calculation, or erroneous interpretation of a statute. That the tax was declared unconstitutional did not render the enforcement of the tax erroneous, so the refund claim was denied.

2. *In re Sumitomo Mitsui Banking Corp.*, DTA No. 820097, N.Y. Div. of Tax Appeals (2006) – Refunds due to a change in an apportionment factor were not allowed in a New York bank franchise tax case. The refund claims, which were based on a recalculation of the taxpayer's New York payroll percentages, were filed just one day after the taxpayer reported changes to federal taxable income, which resulted in additional franchise tax liability for two of the years at issue. However, under New York law

with respect to overpayments of tax resulting from reported federal changes, the amount of any refund had to be computed without a change to the taxpayer's allocation of income. The refund claim was thus denied.

3. *In re Bartsch*, DTA No. 819558, N.Y. Div. of Tax Appeals (2004), held that because the claimant withdrew his protest, he was thus not entitled to a refund. The taxpayer filed his refund claim after paying revised amounts of tax pursuant to an agreement. By the express terms of the agreement, the taxpayer waived his right to claim a refund. Thus, when he petitioned regarding a refund, the claim was properly dismissed on the basis that it was precluded by his execution of a Withdrawal of Protest form.

4. *Hearing No. 44,849 – Texas Comptroller of Public Accounts (Sep. 16, 2011)*. This decision highlights an amendment to Texas' Tax Code. Since 2003, the Code has provided that "a person may not file a refund claim for the same transaction or item, tax type, period, and ground or reason that was previously denied" by the Comptroller. Tex. Tax Code Ann. § 111.107(b). If a taxpayer receives an adverse decision on its refund claim, the taxpayer cannot re-litigate by filing the same claim a second time.

5. *Hearing No. 103,306 – Texas Comptroller of Public Accounts (May 17, 2010)*. The taxpayer purchased a vehicle from a car dealer, paying 6.25% motor vehicle sales tax on the transaction. Due to financial issues, the taxpayer later returned the vehicle for less than the purchase price and then filed a refund claim for the sales tax paid on the vehicle. The Comptroller explained that sales tax legally applies to every sale, and the taxpayer was not entitled to a refund because this was not a true cancellation of that sale (refund was at less than full purchase price). Therefore, the tax would apply to both the taxpayer's purchase and the "resale" of the vehicle to another customer.

IV. What Can A Taxpayer Do?

A. Make sure the claim is made on the proper refund claim form and includes all required information.

B. Don't just fill out the claim forms. Carefully review the law (statutes and regulations) and recent rulings for the state.

C. If you need proof of agency status or a power of attorney under a state's law, make sure you include it and that it is properly completed by an authorized signatory.

D. When in doubt, file in the most conservative manner. If there is any question that you are filing in the right party's name, or any concern that another party may be the right entity to file the claim, file for that other entity, too (and note that you are doing this for protective purposes.) This is an area where a "belt and suspenders" approach is appropriate.

E. Include all supporting information with the filing. Do not give them an excuse to deny the claim for insufficient evidence.

F. When a hearing on the refund claim is allowed by statute or regulation, ask for a hearing in the refund claim itself.

G. When making a tax payment, include a statement that an amount is "paid under protest", if you intend to file a refund claim.

H. File protective refund claims as soon as possible, although as demonstrated by Johnson Controls, even the taxpayer which pursues litigation can be cut off.

I. Keep an eye on the state legislature after a taxpayer-friendly decision is rendered by the courts in that state and enlist taxpayer organizations to monitor and oppose efforts to restrict refunds, especially retroactive changes in law.

J. Make sure you have claimed the maximum amount at issue, including all possible tax, interest and penalties sought.

K. Make sure you have asserted all possible arguments (factual and legal) in support of the claim.