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Mississippi: State high court holds dividend exclusion rule is unconstitutional

The Mississippi Supreme Court affirmed a chancery court decision holding that a state statute allowing an exclusion only for dividends subject to Mississippi income tax was unconstitutional. The high court adopted the taxpayer's proposed remedy—to provide a dividends-received exclusion for all dividends subject to tax in Mississippi or in another state.

The case is: *Mississippi Dep't of Revenue v. AT&T Corp.*

State law

Under Mississippi Code section 27-7-15(4)(i), the words "gross income" do not include "…[i]ncome from dividends that has already borne a tax as dividend income under the provisions of this article, when such dividends may be specifically identified in the possession of the recipient."

The statute thus exempts from Mississippi corporate income tax any dividends received from domestic affiliates that do business and file Mississippi income tax returns. Conversely, dividends received from affiliates that do not do business in Mississippi are included in the Mississippi corporate tax base.

Background

A taxpayer protested the statutory treatment, arguing that the statute was unconstitutional. After an administrative review board upheld the assessment, the taxpayer appealed to the Hinds County Chancery Court.

The chancery court held that the statute clearly favored domestic corporations over foreign corporations and was, therefore, "discriminatory in nature and on its face." Furthermore, the Department of Revenue had presented no evidence that the statute was a “compensatory tax” designed to make interstate commerce bear a burden already borne by intrastate commerce. Finally, the chancery court addressed the proper remedy, noting that the Department had suggested that the statute be rescinded altogether and the tax benefits disallowed to all taxpayers. This suggestion, the chancery court concluded, was not permissible or practicable, as the statute of limitations for the tax years at issue (1997-1999) had expired for most taxpayers and retroactive assessments, if possible, would also raise constitutional issues. As such, the chancery court concluded that the appropriate remedy was to put the taxpayer on even footing with those taxpayers that enjoyed the benefits by striking the offensive limitations. The Department of Revenue appealed to the state’s Supreme Court.

Mississippi Supreme Court decision

The Mississippi high court affirmed the chancery court’s conclusion that the dividend exclusion statute was unconstitutional. However, the high court’s reasoning differed from that of the chancery court, as the high court applied the internal consistency test as articulated in a recent U.S. Supreme Court decision, *Comptroller v. Wynne,* and concluded that the Mississippi statute failed the test. Although Mississippi offered an exclusion for dividends received from the taxpayer’s nexus subsidiaries, dividends from non-nexus subsidiaries did not receive such an exemption because the dividend income had not already borne a tax under section 27-7-15(4)(i) of Mississippi law. The total tax burden on the taxpayer was, therefore, disparate because, with regard to its non-nexus subsidiaries, the taxpayer bore an additional burden from which its nexus subsidiaries were exempt. Having concluded that the application of the Mississippi statute violated the dormant Commerce Clause, the court declined to address the taxpayer’s Due Process and Equal Protection Clause arguments.

Remedy portion of decision

An interesting aspect of the decision is the remedy adopted by the Mississippi high court. The Department urged the court to sever Mississippi Code section 27-7-15(4)(i) in its entirety. Under this approach, the dividend exclusion would no longer be available to any taxpayer (i.e., all dividends would be taxable).

The taxpayer, in contrast, argued that the offensive portion of the statute was the language limiting the exemption to dividends having “already borne a tax as dividend income under the provisions of this article” (i.e., in Mississippi). In the taxpayer’s view, this language gave rise to the constitutional problem because it created a geographic distinction between those subsidiaries that paid tax in Mississippi and those that had not, thus discriminating against the out-of-state subsidiaries. The high court agreed, concluding that striking only the “under the provisions of this article” language preserved the intent of the legislature to tax dividend income, while at the same time allowing an exclusion for dividend income that had already borne a tax in Mississippi or another state. As such, the phrase “under the provisions of this article” was struck from Code section 27-7-15(4)(i), and the high court held that such severance was to be applied to the taxpayer for the tax years in issue.

KPMG observation

Tax professionals note that presumably, the severance likewise would apply to other taxpayers that were discriminated against due to Mississippi's unconstitutional dividend exclusion statute. These taxpayers need to consider filing refund claims for open tax years, if they have not already done so. Lastly, it remains to be seen as to whether the legislature will step in or the Department of Revenue will seek U.S. Supreme Court review.

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