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Interpreting State Tax Exemptions, Deductions, and Credits

by Steve R. Johnson



Modern tax statutes serve many purposes beyond simply raising revenue, and the contours of those statutes are shaped by many (and sometimes conflicting) economic, social, and political objectives. Legislatures choose a variety of structural mechanisms — including exemptions, deductions, and credits — to advance those policy goals. Some-

times those features are drafted with less than meticulous precision. Other times, business practices have evolved since enactment of the provisions. In either event, revenue agencies and courts are frequently required to interpret those provisions.

This installment of “Interpretation Matters” concerns one such principle of interpretation: The canon that exemptions, deductions, and credits are construed strictly against the taxpayer. Part I describes the canon. Part II suggests ways by which taxpayers attempt to counter it.

I. The Canon

This canon is familiar in federal tax jurisprudence,¹ and it appears as well in tax cases in many states. In state tax cases, the precept is most frequently seen in controversies involving exemptions and exclusions. For example, one court put the matter as follows:

We are mindful that taxation is the rule and tax exemption is the exception. Here, taxpayer is claiming an exemption from tax on income that would otherwise be assessed but for the [exclusion at issue]. Thus, taxpayer has the burden of proving clearly that it comes within

the statutory exemption. Such exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation.²

The rule also is applied, although with somewhat less frequency, in cases involving state tax deductions³ and credits.⁴ The strict construction approach cuts across tax types. It has been considered in cases involving state income taxes,⁵ property taxes,⁶ and sales and use taxes.⁷

The courts typically do not explain the reason behind the canon. Probably, however, it trenches mainly on the principle of horizontal equity. Fairness is an important value in taxation — although it usually is sketchily defined and often is less than

²*Zebra Technologies Corp. v. Topinka*, 799 N.E.2d 725, 733 (Ill. App. 2003) (citing *Chicago Bar Ass’n v. Department of Revenue*, 644 N.E.2d 1166 (Ill. 1994), and *United Air Lines, Inc. v. Johnson*, 419 N.E.2d 899 (Ill. 1989)). To similar effect, see *Shetakis Dist. v. Department of Taxation*, 839 P.2d 1315, 1319 (Nev. 1992).

³See, e.g., *Potlatch Corp. v. State Tax Comm’n*, 913 P.2d 1157, 1159 (Id. 1996).

⁴See, e.g., *DaimlerChrysler Servs. v. Commissioner*, 875 A.2d 28, 32 (Conn. 2005), *Mississippi State Tax Comm’n v. Defenbaugh & Co. of Cleveland, Inc.*, 197 So. 2d 788, 789 (Miss. 1967).

⁵See, e.g., *Futura Corp. v. State Tax Comm’n*, 442 P.2d 174, 177 (Id. 1968).

⁶See, e.g., *Redford Opportunity House v. Township of Redford*, 2004 WL 1103769, at *2 (Mich. App. 2004) (unpublished opinion).

⁷See, e.g., *Epsilon Trading Co., Inc. v. Revenue Cabinet*, 775 S.W.2d 937, 941 (Ky. App. 1989), *Department of Tax’n v. DaimlerChrysler Servs. North American, LLC*, 119 P.3d 135, 137 (Nev. 2005).

In one case, the court stated: “Because [the statute at issue] represents an exclusion from taxation, it must be construed most favorably to the taxpayer.” On the government’s motion for reconsideration or clarification, the court revised the sentence to read: “Because [the statute at issue] represents an exclusion from taxation, it must be construed strictly against the taxpayer.” *H.R. Options, Inc. v. Zaino*, 800 N.E.2d 740, 744 (Ohio 2004), further op. sub nom. *H.R. Options, Inc. v. Wilkins*, 807 N.E.2d 363, 363 (Ohio 2004) (emphasis in original).

¹See, e.g., *Commissioner v. Schleier*, 515 U.S. 323, 328 (1995) (exclusions); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (deductions).

fully realized in practice. A significant facet of fairness in tax is horizontal equity, the idea that similarly situated taxpayers should be taxed similarly.⁸ Many court decisions have endorsed the horizontal equity principle,⁹ and its strength helps explain why nearly all state constitutions contain a provision requiring, to greater or lesser degree, that taxes be uniform or equal.¹⁰

Exemptions and exclusions are frequently construed strictly against the taxpayer.

Exemptions, deductions, and credits may occasion suspicion on horizontal equity grounds. That is especially so if relatively few taxpayers can qualify for the benefit. The narrower the tax preference, the more it may appear as a violation of equality and uniformity in taxation.¹¹ There are, in fact, some cases that justify the strict construction canon in terms of horizontal equity.¹²

II. Countering the Canon

The strict construction canon will typically be asserted by the revenue authority, of course. When it is asserted, how can the taxpayer and the taxpayer's representatives attempt to counter it? Depending on the circumstances, at least three strategies may be available:

- arguing that the provision at issue is not an exemption;
- setting out other, contrary canons; and
- urging the court to dispense with canons altogether or at least to deemphasize them.

A. Escaping Classification as an Exemption

An exemption removes from taxation an item that would be taxable absent a special rule. An item that never comes within the ambit of taxability in the first place needs no exemption. To illustrate, consider the income taxability of gifts and of loan

proceeds under federal definitions that have been adopted by many states. Section 61 of the Internal Revenue Code defines gross income, with an assist from the case law definition that gross income items are "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."¹³ Gifts have those three characteristics, so are within the general definition of gross income. They are shielded from taxability only because another statute, IRC section 102, overrides the section 61 result. In contrast, loan proceeds are not income under section 61. Because the receipt of the proceeds is matched by a corresponding obligation to repay, the receipt entails no accession to wealth. In short, nontaxability of gifts depends on an exemption or exclusion from the general rule, while nontaxability of loan proceeds flows from the general rule itself, not from an exemption or exclusion. The strict construction rule would attach to gifts but not to loan proceeds.

A Maryland case exemplifies the same distinction in the sales tax context. The state sought to tax a corporation's purchase of patterns subsequently used by it to manufacture steel castings. The corporation rejoined that the sales tax did not apply because the patterns were purchased for resale and were in fact resold to customers. The court agreed with the taxpayer, observing:

the exclusion of tangible personal property purchased for the purpose of resale in its original form, or for the purpose of incorporation into a finished product, is by force of the definition and not by inclusion in the exemptions set out in [a later section]. Sales in the categories mentioned are simply not within the scope of the taxing statute. Thus the rule of strict construction of an exemption does not apply.¹⁴

B. Countercanon

Fight fire with fire. If the government deploys the strict construction canon, the taxpayer may seek to counter it with a pro-taxpayer canon, if available. For example, it is often held that remedial statutes are construed liberally to effectuate their purposes.¹⁵ Thus, the taxpayer could develop the origin and purpose of the deduction, credit, or exemption at issue. It usually will be possible to make a plausible case that the feature is remedial of some inequity or

⁸See generally David Brunori, *State Tax Policy: A Political Perspective* 17-18 (2005).

⁹See, e.g., *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 544 (1979); *Commissioner v. Sunnen*, 333 U.S. 591, 599 (1948).

¹⁰For discussion of those provisions, see Jerome R. Hellerstein and Walter Hellerstein, *State and Local Taxation: Cases and Materials* ch. 3 (8th ed. 2005).

¹¹*Cf. Apache Bend Apartments, Ltd. v. United States*, 964 F.2d 1556, 1562 (5th Cir. 1992) (expressing concerns about preferential tax transitional rules but ultimately rejecting equal protection challenge), *rev'd en banc*, 987 F.2d 1174 (5th Cir. 1993) (holding that the plaintiffs lacked standing to assert the challenge).

¹²See, e.g., *Delta Air Lines, Inc. v. Commonwealth Revenue Cabinet*, 689 S.W.2d 14, 18 (Ky. 1985).

¹³*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

¹⁴*Baltimore Foundry & Machine Corp. v. Comptroller*, 127 A.2d 368, 369 (Md. App. 1956); see also *Foss Nivsystems, Inc. v. Comptroller*, 822 A.2d 1297 (Md. Spec'l App. 2003); *Xerox Corp. v. Comptroller*, 428 A.2d 1208 (Md. App. 1981) (both distinguishing *Baltimore Foundry*).

¹⁵See, e.g., *A.N.B. Corp. v. Comptroller*, 1990 WL 10957, at *7 (Md. Tax 1969).

other policy problem, perhaps balancing the pro-government strict construction precept with a pro-taxpayer remedial statute precept.

It usually would be worthwhile to assert the pro-taxpayer canon as a counter to the strict construction canon.

Another candidate might be the canon, operative in many states, that tax statutes are construed narrowly in favor of the taxpayer.¹⁶ In some states, the strict construction canon appears to outrank the pro-taxpayer canon.¹⁷ However, the hierarchy of those rules is not settled in most jurisdictions, so it usually would be worthwhile to assert the pro-taxpayer canon as a counter to the strict construction canon.

C. Dispense With, or Deemphasize, Canons

What if the taxpayer has no counter-canon to set against the strict construction rule? The taxpayer might then ask the court to stare straight at the statute, with vision undistorted by the prism of any canon.

There are occasional cases that seemingly would dispense with canons altogether. For example, in a prominent federal tax case, the U.S. Supreme Court dismissed the pro-taxpayer canon — and by extension, other similar rules of construction — despite that canon's appearance in many previous decisions. The Court remarked:

We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be. Here doubts which may arise on a cursory examination of [the statute at issue] disappear when they are read, as they must be, with every other material part of the statute . . . and in the light of their legislative history.¹⁸

¹⁶For discussion of this canon, see an earlier installment of this column "Pro-Taxpayer Interpretation of State-Local Tax Laws," *State Tax Notes*, Feb. 9, 2009, p. 441, *Doc 2009-1826*, or *2009 STT 25-2*.

¹⁷See, e.g., *Dick Simon Trucking, Inc. v. State Tax Comm'n*, 84 P.3d 1197, 1198-1199 (Utah 2004).

¹⁸*White v. United States*, 305 U.S. 281, 292 (1938); see also Steve R. Johnson, "The Canon that Tax Penalties Should Be Strictly Construed," 3 *Nev. L.J.* 495, 511-514 (2003).

In a similar vein, Justice Antonin Scalia remarked: "To the honest textualist, all of these preferential rules and presumptions are a lot of trouble."¹⁹ Instead, "a text should not be construed strictly, and it should not be construed leniently, it should be construed reasonably to contain all that it fairly means."²⁰

One might be cautious about putting too much weight on the above approach. After all, courts have invoked various canons in many thousands of tax and nontax cases, including many Supreme Court cases decided after the Court and after Justice Scalia wrote the words above. So, "dispense with canons altogether" may be a hard sell.

Fortunately, there is milder — and hence perhaps more readily salable — version of the argument. That version nominally accepts the relevance of the adverse canon but defangs it by assigning it little weight. For example, the Nevada Supreme Court held for the taxpayer in a recent, significant sales tax case. The court gave lip service to the strict construction precept but accorded it a limited role, commenting:

Because this case specifically involves the interpretation of a tax exemption, we will strictly construe its meaning. Still, as the Indiana Tax Court has noted, "when construing an exemption, the court must always . . . avoid reading the exemption so narrowly [that] its application is defeated in cases rightly falling within its ambit."²¹

In short, if you have a canon, argue it. If only the other side has a canon, downplay the significance and usefulness of canons. ☆

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¹⁹Antonin Scalia, *A Matter of Interpretation*, 28 (1997).

²⁰*Id.* at 23.

²¹*Sparks Nugget, Inc. v. State ex rel. Department of Taxation*, 179 P.3d 570, 574 (Nev. 2008) (*per curiam*) (quoting *Dawley, Inc. v. Department of State Revenue*, 605 N.E.2d 1222, 1225 (Ind. T.C. 1992)). For discussion of *Sparks Nugget*, see a prior installment of this column, "Use and Abuse of 'Plain Meaning,'" *State Tax Notes*, Sept. 22, 2008, p. 831, *Doc 2008-19121*, or *2008 STT 185-3*; see also Jennifer Carr and Cara Griffith, "Possible Outcomes of Nevada's Complimentary Meals Case," *State Tax Notes*, May 5, 2008, p. 407, *Doc 2008-9392*, or *2008 STT 88-18*; Andrew W. Swain and Jennifer E. Gauger, "Casino 'Comps' — Are Freebies Really Free?" *State Tax Notes*, July 14, 2008, p. 95, *Doc 2008-13854*, or *2008 STT 136-2*.