

## HOLD THE PHONE! AT & T'S CONSTITUTIONAL CHALLENGE TO MISSISSIPPI'S DIVIDEND EXCLUSION STATUTE IS STILL ALIVE

A Mississippi trial court has again found unconstitutional the state's dividend exclusion statute, which disadvantages certain multistate taxpayers as compared to solely Mississippi taxpayers. This result comes from AT&T's 16-year effort to attack two statutes that denied it benefits available to taxpayers doing all of their business in Mississippi. A number of cases in the administrative appellate pipeline present the same issue(s) as AT&T, stemming from audit positions firmly maintained by the Mississippi Department of Revenue ("MDOR"), and have been held in abeyance pending a decision from the state's highest court. The recent trial court decision discussed here appears to present the vehicle for resolution of these constitutional questions.

**Background.** MDOR audited AT&T's Mississippi income tax returns for the tax years 1993 through 1996, and as a result, on January 5, 1999, assessed \$5,105,038 in additional tax. The primary adjustment made by MDOR was to change the AT&T affiliated group's method of computing tax for 1994-96 from a consolidated method to a combined method because the Mississippi multistate taxation laws only allowed consolidation for affiliated groups doing all of their business in Mississippi. If any member of the affiliated group was doing business outside Mississippi, as was the case with AT&T, the group was required by statute and regulations to use the combined method of reporting. The combined method does not allow intercompany transactions to be eliminated, resulting in the inclusion of, among other things, any intercompany gains or dividends in the recipient companies' gross incomes. AT&T's inability to exclude such intercompany dividends and/or to eliminate intercompany transactions resulted in the issuance of the audit assessment.

*First Litigation.* After going through the full administrative appeals process that was then in place, the assessment was reduced and upheld in the amount of \$5,088,516 ("Assessment I"). On January 7, 2000, AT&T filed a petition in chancery court requesting relief ("AT&T I"). AT&T's petition cited constitutional infirmities of two statutes. First, AT&T challenged the constitutionality of then-existing Code § 27-7-37(2)(a)(i) (the "Consolidated Return Statute"), which for the audit period prohibited AT&T from filing consolidated Mississippi income tax returns with its subsidiaries. AT&T contended that this law established a discriminatory method of taxation which violated the Commerce Clause, United States Constitution Art. 1, § 8; the Due Process Clauses contained in the United States Constitution, Amendments V and XIV; and the Equal Protection Clauses contained in United States Constitution, Amendments V and XIV.

Specifically, AT&T argued that the discrimination inherent within the Consolidated Return Statute arose because Mississippi permitted an affiliated group of corporations operating wholly within the state to file a consolidated income tax return and to enjoy the numerous tax benefits associated with such a return (e.g., enabling a parent company to eliminate all intercompany dividends paid and received by and between entities included in such a consolidated return), but did not permit the use of the same method for affiliated groups

that include corporations doing business outside of Mississippi.<sup>1/</sup> This prohibition thereby arguably denied multistate affiliated groups the option of availing themselves of the same tax benefits as “Mississippi only” affiliated groups. AT&T said that the Consolidated Return Statute and related regulations (on their face and as applied) under which MDOR issued Assessment I thus unconstitutionally burdened commerce, as well as violated AT&T’s rights to due process and equal protection.

The second constitutional challenge to Assessment I raised by AT&T concerned Miss. Code § 27-7-15(4)(i) (the “Dividend Exclusion Statute”). AT&T alleged that this statute establishes a discriminatory method of taxation, resulting in the same constitutional violations cited in the Consolidated Return Statute context. AT&T argued that the discrimination inherent within the Dividend Exclusion Statute arises because the Mississippi taxing scheme illegally favors taxpayers owning subsidiaries doing business in Mississippi by excluding from the taxpayer’s gross income dividends received from such subsidiaries, while denying such an exclusion for dividends received from subsidiaries that do not conduct business in Mississippi or file returns in Mississippi. MDOR’s position on the record (based on testimony in AT&T I) is that the unfavorable treatment in the latter case is based solely on the fact that such distributing subsidiaries fail to do business in the State. Accordingly, AT&T said that the Dividend Exclusion Statute and related regulations under which MDOR issued Assessment I unconstitutionally discriminated against interstate commerce and violated AT&T’s rights to due process and equal protection, on their face and as applied. AT&T claimed that it was entitled to a refund (totally separate from the Assessment I relief) on these grounds of \$3,365,934.

When AT&T filed its chancery court petition, in lieu of posting the bond specified by the statute as then in effect, AT&T elected to pay the full Assessment I amount under protest and seek a refund of such amount, plus interest and other consistent relief. The parties and the court agreed to bifurcate the AT&T I trial into a liability or substantive phase, and a remedy phase. The liability phase trial was held on March 30, 2004, before Judge William H. Singletary. Judge Singletary took the case under advisement and issued his ruling on June 12, 2006, holding that both the Consolidated Return Statute and the Dividend Exemption Statute were unconstitutional, essentially agreeing with legal arguments summarized above.

The second phase remedy trial was completed on August 12, 2009. After numerous court filings and months of protracted procedural wrangling, the final order in AT&T I was issued by Judge Singletary on November 16, 2010. The court first held that it had full and complete jurisdiction of the case (in response to an objection on these grounds that MDOR had continued to raise at every turn). Then the court awarded a Final Judgment in favor of AT&T in the amount of \$12,727,174, comprised of a refund of the Assessment I amount of \$5,088,516 paid under protest, the overpayment of \$3,365,934 attributable to the Dividend Exemption Statute’s unconstitutionality, and interest of \$4,272,724. Of course, MDOR appealed this decision (the final order in the case) to the Mississippi Supreme Court.

AT&T I was heard by the Mississippi Supreme Court on June 5, 2012. The Court rendered its decision on September 6, 2012, holding in favor of MDOR on procedural grounds—

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<sup>1/</sup> Instead, such multistate affiliated groups were permitted to file a single *combined* income tax return under Code § 27-7-37(2)(a)(ii) as it existed for the audit period.

i.e., ruling that the chancery court did not have jurisdiction to hear the case because AT&T had failed to comply with then-existing Miss. Code § 27-7-73 by not posting a bond equal to twice the amount in controversy.<sup>2</sup> The court never reached the merits of the constitutional issues raised in the case. AT&T's motion for a rehearing was denied by the Mississippi Supreme Court on December 6, 2012.

*Second Litigation.* MDOR audited the three subsequent years of AT&T's returns, 1997-99, and on June 11, 2003, issued an income tax assessment of \$11,755,044, on primarily the same grounds as Assessment I. After again going through the full administrative appeals process that was then in place, the assessment was reduced and upheld in the amount of \$10,703,608, plus up to date interest of \$1,160,690 ("Assessment II"). On August 6, 2004, AT&T appealed Assessment II to chancery court ("AT&T II") with the case being again assigned to Judge Singletary for reasons of judicial economy. However, in this instance, AT&T filed an appeal bond as specified by Miss. Code § 27-7-73 in the amount of \$23,728,596.

AT&T II finally came before the court in the form of competing motions for summary judgment filed by the parties in conjunction with related hearing and oral arguments. The court issued its Final Order Granting Summary Judgment on March 19, 2015. With certain settlement discussions between AT&T and MDOR apparently having occurred, the court noted in its order that "an amicable resolution was reached by the parties concerning the issue of consolidated/combined return filing methods" and therefore the constitutionality of the Consolidated Return Statute was not before the court.<sup>3</sup> The parties had stipulated as to all genuine issues of material fact and therefore, the only issue for consideration in the case related to the taxation of intercompany dividends, including interest and penalties attributable thereto—i.e., the constitutionality of the Dividend Exemption Statute.

The court followed almost verbatim the legal analysis that it applied in AT&T I, with the same result. The court concluded that (1) the Dividend Exemption is an unconstitutional violation of the Commerce Clause, and (2) since the Assessment II order from MDOR was based on this unlawful statute, it is, by its very nature, arbitrary and capricious and subject to reversal by the court (a point that addresses the standard of review of final orders of state administrative agencies, such as MDOR). With respect to relief, the court found that "the only appropriate

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<sup>2</sup> In 2005, Miss. Code § 27-77-7(3) became law, allowing taxpayers to *either* pay the amount of assessment under protest and seek a refund of such taxes, plus interest *or* post a bond for double the amount in controversy. In 2010, the Legislature further revised this section to allow taxpayers to either pay the amount under protest or post a bond for only half the amount in controversy. Finally, the 2014 Mississippi Taxpayer Fairness Act, generally effective Jan. 1, 2015, again amended § 27-77-7(3), this time to eliminate the mandatory posting of a surety bond in the amount of one-half of the amount in controversy in order to perfect a judicial appeal (the so-called "pay to play" provision). Thus, after this change taxpayers are able to go to court without having to first post any kind of bond or security, except in limited circumstances.

<sup>3</sup> This agreement may have to do with the fact that by the time the AT&T II petition was filed in court, the Mississippi legislature had amended Miss. Code § 27-7-37 to eliminate the consolidated method altogether, thereby placing both in-state and multistate taxpayers on the same footing and treating them equally on a prospective basis (the amendment affects tax years beginning on or after January 1, 2004. *See* H.B. 1333, 2004 Leg., Reg Sess (2004).

remedy which would place AT&T on even footing with those taxpayers who enjoyed the subject tax benefits is to strike the offensive limitations and grant those applicable tax benefits to AT&T for the years at issue.” The court further noted that “[b]ased upon the previous agreement between the parties, the application of the dividend exclusion will result in no additional income tax liability for AT&T for the relevant tax years.”

**Going Forward.** Given MDOR’s long held position that it has the obligation to assume and defend the constitutionality of the tax laws until the Mississippi Supreme Court says otherwise or the legislature changes the law, it will surely appeal this decision. And since AT&T II does not appear to have any procedural or jurisdictional issues that will foreclose a review and decision of this case on the merits, at long last we can probably expect the matter of the constitutionality of the Dividend Exemption Statute to finally be settled within the next year or so.

**Tax Tip.** Given the state of the case law in this area, which was well summarized by Judge Singletary in both AT&T I and AT&T II, most tax practitioners expect the trial court’s ruling in AT&T to be upheld by the Mississippi Supreme Court. With this in mind, multistate taxpayers that have open tax years and who have not been able to take advantage of the Dividend Exclusion Statute (because all of the dividends received by a reporting company did not come from subsidiaries doing business within Mississippi or because they did not file returns in Mississippi) should consider filing protective refund claims pending the final outcome of AT&T II.