



Arizona State Senate **Background Brief**

November 5, 2007

Note to Reader:

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LADEWIG v. STATE

INTRODUCTION

For more than 20 years, Arizona tax statutes provided a deduction from individual income for dividends received from corporations that do more than half their business in Arizona. Helen Ladewig, an Arizona taxpayer, challenged the constitutionality of this deduction. She instituted an administrative refund claim with the Department of Revenue (DOR) and also filed a class action lawsuit in tax court.

The tax court allowed the matter to proceed as a class action. The tax court held that the deduction at issue violated the Commerce Clause of the U.S. Constitution and was therefore unconstitutional. DOR did not challenge that portion of the court's ruling. Ladewig was the only taxpayer in the class who had filed an administrative claim for a refund with DOR. The Arizona Court of Appeals, while ruling that class actions could be pursued in tax court in Arizona, held that the class must be limited to taxpayers who had actually filed administrative claims with DOR. Ladewig appealed this portion of the ruling to the Arizona Supreme Court. On August 29, 2001, the Arizona Supreme Court in *Arizona Department of Revenue v. Dougherty*, 29 P.3d 862 (2001), held that class actions can be maintained in tax refund cases in Arizona, and, in order to effectively exhaust the class' administrative remedies, it was sufficient for Ladewig alone, rather than each individual taxpayer, to file an administrative refund claim.

On September 20, 2002, a proposed \$350 million class-action settlement was filed in Maricopa County Superior Court that would give a refund for dividends that an estimated 675,000 taxpayers reported for federal income tax purposes in 1986 through 1989. DOR was responsible for calculating refunds by using a prescribed formula for each taxpayer to provide certainty as to the state's liability and to reduce administrative costs. Refunds to taxpayers began in FY 2004-2005.

LEGISLATIVE ACTION

2002 – Laws 2002, Chapter 50, a Proposition 108 measure, retroactive to January 1, 2002, eliminated the corporate income tax subtraction for dividends received from Arizona corporations.

Laws 2002, Chapter 321, provided \$75 million for the FY 2002-2003 payments and costs associated with the case. Laws 2003, First Special Session, Chapter 2, reduced the allocation for FY 2002-2003 to \$15 million. These remaining monies were to pay administrative costs associated with the settlement.

2003 – Laws 2003, Chapter 263, allocated \$75 million in FY 2003-2004 for the second year of payments and costs relating to *Ladewig v. State of Arizona*. Of this amount, up to \$7.3 million was for administrative costs, and the remainder was set aside for future taxpayer refunds. The Governor line-item vetoed the FY 2003-2004 set-aside in order to provide an additional \$75 million in the state General Fund balance.

2004 – The Ladewig Settlement Budget Reconciliation Bill (Laws 2004, Chapter 285) allocated \$120 million in FY 2004-2005 for payments and costs associated with *Ladewig v. State of Arizona*. Unused amounts were reserved for future payments and of the amount up to \$3,753,300 could be used by DOR for administrative costs.

2005 – The Ladewig Settlement Payments Budget Reconciliation Bill (Laws 2005, Chapter 333) allocated \$58.3 million in FY 2005-2006 to DOR for payments and costs associated with the case of *Ladewig v. State of Arizona*, with any unused amount to be held in reserve for future payments.

2006 – The Case Settlements Budget Reconciliation Bill (Laws 2006, Chapter 347) allocated \$94,800,000 in FY 2006-2007 to DOR for payments and costs associated with the case of *Ladewig v. State of Arizona*. The \$94,800,000 includes up to \$1,000,000 to be used for administrative costs and review of payments. DOR is required to present an expenditure plan for review by the Joint Legislative Budget Committee that includes an estimate and scope of the entire administrative requirement associated with disbursing payments and costs for this case, before expending any of the \$1,000,000. Any unused monies revert to the state General Fund.

Final refund payments were made to taxpayers in FY 2006-2007. According to DOR, the total cost of the *Ladewig v. State of Arizona* settlement is \$304 million.

ADDITIONAL RESOURCES

- Department of Revenue
<http://www.revenue.state.az.us>
- Annual Appropriations Report, Joint Legislative Budget Committee
www.azleg.gov/jlbc.htm