ReedSmith

The business of relationships.

<u>PROPOSED REPEAL OF CALIFORNIA ENTERPRISE ZONE BENEFITS WOULD VIOLATE THE CONTRACTS AND DUE PROCESS CLAUSES OF THE CALIFORNIA AND UNITED STATES CONSTITUTIONS</u>

by
Marty Dakessian, Don Griswold, Brian Toman[1]
REED SMITH LLP

14 February 2011

Communities to Save Enterprise Zones has asked Reed Smith to articulate the legal case against Governor Brown's proposal to repeal the benefits associated with California's Enterprise Zone Program, including elimination of Enterprise Zone Benefits already earned and vested. In the pages that follow, we explain why the proposed repeal is more than just poor public policy. (That much is intuitive: Government should not target a specific group by deliberately inducing them to engage in specific, substantial action and then – after convincing them to perform those actions – take away the vested rights members of that group earned in exchange.) The purpose of this memorandum is to explain the reasons why this particular poor public policy is also illegal state action, and thus just as impermissible as it is imprudent.

<u>BACKGROUND</u>

In 1984, the California Legislature determined that certain areas of California were economically depressed. In response, the Legislature enacted the Enterprise Zone Program to "stimulate business and industrial growth in the depressed areas of the state by relaxing regulatory controls that impede private investment."[2] In enacting this program, the Legislature stated, "[i]t is in the economic interest of the state to have one strong, combined, and business-friendly incentive program to help attract business and industry to the state, to help retain and expand existing state business and industry, and to create increased job opportunities for all Californians."[3]

Currently, under the Enterprise Zone Program, the state has designated 42 separate areas ("Enterprise Zones"), in which private corporations and persons who invest resources – such as hiring new employees or purchasing machinery or equipment – can obtain certain tax benefits.

[1] Marty Dakessian, Don Griswold, and Brian Toman are partners in Reed Smith LLP's nationwide State Tax Group. Marty, who is resident in the firm's Los Angeles office, can be reached at mdakessian@reedsmith.com; Don, in the Washington DC office, at dgriswold@reedsmith.com; and Brian, in San Francisco, at btoman@reedsmith.com. The authors wish to thank Reed Smith State Tax associates Mike Shaikh (Los Angeles) and Rob Weyman (Philadelphia) for their invaluable assistance and insights.

[2] Cal. Gov't Code § 7071(a).

[3] Cal. Gov't Code § 7071(b).

Each of these Enterprise Zones is managed by the "Zone Administrator" of the city or county ("Locality") where the Enterprise Zone is located. Zone Administrators are in charge of administering all aspects of the Enterprise Zone Program within their Enterprise Zones. They administer the program pursuant to state statutes and regulations of the Department of Housing and Community Development (the "HCD").

The Enterprise Zone Program consists of the following benefits ("Enterprise Zone Benefits"): (1) a hiring tax credit for hiring certain qualified employees who face substantial barriers to employment (the "Hiring Credit"), (2) a sales or use tax credit for sales or use taxes paid on qualified machinery and machinery parts or purchases (the "SUT Credit"), (3) an increased expense deduction for certain depreciable property, (4) up to 100% net operating loss deduction and a 15-year carryforward, (5) a net interest deduction for lenders on loans made to firms within Enterprise Zones, and (6) preference points for contracts with the state.

Taxpayers' use of the Hiring Credit and the SUT Credit for investments made in any Enterprise Zone is limited based on the amount of their income that is derived from within the Enterprise Zone, as determined by an apportionment formula. The amount of the credit that cannot be used is then carried forward to subsequent years until it is exhausted.

Governor Jerry Brown now proposes to eliminate Enterprise Zone Benefits in their entirety. His proposal would not only eliminate the opportunity for taxpayers to obtain current and future benefits for actions they have already taken, but would also eliminate any benefits that taxpayers have already earned but have not yet been permitted to use because of the limitations on credit utilization.

Governor Brown's proposal violates the Contracts Clauses and the Due Process Clauses of the United States and California Constitutions.[4]

EXECUTIVE SUMMARY

Based on our analysis below, we find that Governor Brown's proposal would have the following negative effects on the state of California:

- The state would be guilty of illegal "bait and switch taxation,"
- The state would violate well-established protections afforded by the United States Constitution and the California Constitution,

[4] Governor Brown's proposal is also vulnerable to challenge on various non-Constitutional grounds and would give rise to various causes of action including breach of contract, promissory estoppel, declaratory relief, intentional interference with contractual relations, and intentional interference with prospective economic advantage. Additionally, Governor Brown's proposal would also subject cities and counties throughout the state to challenges on these same grounds.

- These violations would subject the state to refund claims and legal action to reinstate the EZ benefits, thereby nullifying the purported budgetary savings set forth in the Governor’s proposal,
- The state would invite legal action by local governments to enjoin the repeal of the legislation,
- Cities and counties would be vulnerable to taxpayer lawsuits, and
- The state’s already vulnerable bond rating would face more downward pressure once Wall Street understands that $1 billion dollars of gap-closing measures are constitutionally invalid.

Governor Brown’s proposal to repeal Enterprise Zone Tax Benefits, including the theft of credits that taxpayers have already earned in prior years, is constitutionally invalid for two independent reasons: (I) it violates the Contracts Clause of the United States and California Constitutions because repeal constitutes a massive breach of the state’s obligations to Localities and taxpayers and (II) it denies taxpayers Due Process because repeal retroactively deprives them of their vested rights in a targeted scheme of “bait and switch taxation.”

Contracts Clause Violation

The United States Constitution and the California Constitution both bar the state from passing any law “impairing the obligation of contracts.” The purpose of the Contracts Clause is to encourage trade by promoting confidence in the stability of contractual obligations.

The Governor’s proposal violates the Contracts Clause if (1) a contract exists, (2) the law impairs an obligation under the contract, (3) the impairment is substantial, and (4) impairment is not reasonable and necessary to serve an important public purpose. Based on our analysis, both taxpayers and Localities have strong cases that repeal of the Enterprise Zone Benefits soundly satisfies all four of these requirements, making repeal invalid.

Formation of Contracts**:** The relationships both between the state and taxpayers and between the state and Localities have all the elements of a contract. As between the state and taxpayers, the state offered Enterprise Zone Benefits if taxpayers invested and hired in an Enterprise Zone. Taxpayers accepted the state’s offers by taking those actions; and those very actions were the “consideration” that made the contracts binding.

Further, the circumstances of the transaction unmistakably imply that the Legislature intended itself to be contractually bound, for it knew its goals of incenting action could never be achieved if taxpayers could not rely on the state to follow through on its promises. To place the issue beyond doubt and to assure taxpayers that the state’s promise was real, the Legislature wrote into the Government Code statutes that Enterprise Zone designations would be binding.

As between the state and Localities, both parties entered into memoranda of understanding, whereby the state agreed to continue to induce taxpayers to invest and hire in Localities in consideration of the Localities investing their own resources into administering and marketing the Enterprise Zone Program.

Impairment: Repeal would deny taxpayers both valuable credits they have already earned (they have vested rights in their Enterprise Zone credit carry-forwards) and those they expect to earn for the remainder of an Enterprise Zone's 15-year designation. Repeal would also deny Localities the inducement of taxpayer investment that the state agreed to provide for the duration of an Enterprise Zone's 15-year designation.

Substantiality**:** Even by California's budget standards, the impairment is substantial. It is as if the State issued a $1 billion bond (instead of cash) in payment for services rendered, then later passed a law to make the bond worthless.

Lack of Reasonable Necessity**:** The United States Supreme Court finds budgetary need an illegitimate justification for a State's impairment of its contractual obligations. The Governor's appeal to "realignment of government functions" (push-down of obligations to Localities) may be a smoke-screen for the sole purpose of closing the budget gap, but in any event the proposed massive breach of contract – not to mention the breach of public trust and the devastating impact on distressed Localities, disadvantaged workers, and good corporate citizens who stood up to help them – is not essential to either of these goals. Gap closing and realignment can both be achieved through alternative, constitutionally permissible alternatives.

Denial of Due Process

The Due Process Clause of the United States Constitutions bars California from depriving a person of "life, liberty, or property, without due process of law." The Governor's proposal violates the Due Process Clause if the state has either (1) an illegitimate purpose for passing the legislation; or (2) the legislation fails to achieve a legitimate purpose by rational means. Based on our analysis, taxpayers would have a strong case that repeal of the Enterprise Zone's benefits would violate both prongs of the Due Process Clause analysis, making repeal invalid.

Illegitimate Purpose**:** The United States Supreme Court has indicated that if a Legislature has an "improper motive" for passing legislation, then it fails the legitimate purpose prong of the due process analysis. The Court reasoned that a taxpayer can establish improper motive if it shows that the Legislature (1) deliberately induced taxpayers to engage in specific transactions in exchange for a benefit; and then (2) targeted those taxpayers by then revoking the benefit.

A repeal of the Enterprise Zone's benefits would have all the hallmarks of deliberate inducement necessary to establish improper motive. The Legislature deliberately created an Enterprise Zone Program with benefits designed to induce taxpayers to either move their business into an Enterprise Zone or to remain in an Enterprise Zone. After moving into a Zone, the taxpayer was then encouraged to take specific actions such as hiring classes of disadvantaged employees selected by the state in exchange for promised benefits. In addition, the state, as well as local jurisdictions acting on its behalf, engaged in a targeted marketing campaign to convince taxpayers to move into Enterprise Zones in exchange for promised benefits. Those marketing campaigns indicated that the Enterprise Zones and their benefits would last for 15 years. Finally, the credit carryforwards generated by some taxpayers constituted vested property rights. Taxpayers reasonably understood that the state would not revoke such rights.

Thus, the Governor's proposal would violate due process because it targets Enterprise Zone taxpayers by revoking benefits after the state deliberately induced those taxpayers to take substantial and specific action in exchange for those benefits.

Immodest Retroactivity: Even if a taxpayer could not establish that California had an improper motive for repealing the Enterprise Zone's benefits, the proposed repeal would still constitute retroactive tax legislation in violation of the due process clause. For legislation repealing tax incentives such as the Enterprise Zone's benefits, retroactivity is calculated from the date the taxpayer first relied on the promised incentive. So if a taxpayer moved into the Enterprise Zone in 2005 to receive promised benefits and the Enterprise Zone's benefit were revoked in 2011, the repeal legislation would have a six year period of retroactivity.

The Supreme Court has indicated that the period of retroactivity for legislation must be "modest" to satisfy due process, and has explained that retroactivity of more than a year or perhaps two would be considered immodest. Since the Enterprise Zones and their related benefits have been in existence for more than two decades, numerous taxpayers would be able to argue that Governor's proposed repeal of the Enterprise Zone's benefits is impermissibly retroactive and violates due process.

Consequently, it would be unconstitutional and illegal for the Legislature to enact Governor Brown's EZ repeal proposal.

DETAILED ANALYSIS

Governor Brown proposes to repeal the benefits of the Enterprise Zone("EZ") Program established in California Government Code § 7071. The Governor here proposes illegal action, so the Legislature should reject this proposal. The proposed repeal is illegal because its enactment would violate the Contracts Clauses of both the United States Constitution and the California Constitution. An independent reason for the proposed repeals' illegality and invalidity is that it would violate the due process rights of taxpayers. This memorandum discusses these two major constitutional infirmities of the Governor's EZ repeal proposal.

I. CONTRACTS CLAUSE VIOLATION

Public and private contracts are protected from impairment by states pursuant to the United States Constitution and from impairment by California pursuant to the California Constitution. The federal Contracts Clause states, "No state shall… pass any… law impairing the obligation of contracts…"[5] The California Contracts Clause states, "[a] … law impairing the obligation of

[5] U.S. Const. art. I, § 10.

contracts may not be passed."[6] The purpose of the Contracts Clause is to encourage trade and credit by promoting confidence in the stability of contractual obligations.[7]

A Contracts Clause violation occurs if (1) a contract exists as to the specific terms allegedly at issue, (2) the law in question impairs an obligation under the contract, and (3) the impairment is substantial.[8] If the party bringing the Contracts Clause claim proves these three factors, the impairment violates the Contracts Clause unless it is reasonable and necessary to serve an important public purpose. As we will discuss later, the test for whether the impairment is reasonable and necessary is more stringent when dealing with the impairment of a state's own contracts, as opposed to a contract between private parties.[9]

A. THE STATE FORMED CONTRACTS WITH TAXPAYERS AND LOCALITIES THAT ARE SUBJECT TO THE CONTRACTS CLAUSE

Numerous state actions resulted in the formation of contracts. These actions include (1) the state's passage of the Enterprise Zone Program, (2) the HCD entering into memoranda of understanding with Localities, and (3) Zone Administrators promoting the benefits of the Enterprise Zone Program, thus inducing taxpayers to hire employees and purchase machinery and equipment in Enterprise Zones. Each of these actions must be analyzed to determine whether a contract exists. Additionally, all of the state's actions may be combined to show that a contract exists between taxpayers and the state.

1. Law

In determining whether a contract exists between a private party and the government, the government is ordinarily treated as a private party.[10] For purposes of the Contracts Clause, the term "contract" is used in its usual or popular sense, as signifying an agreement of two or more minds, upon sufficient consideration, to do or not to do certain acts.[11]

Legislation alone may form a binding contract absent any inducement by the state if the statutory language evinces a clear and unmistakable indication that the Legislature intends to bind itself contractually. For example, in *Bowen*,[12] a federal statute permitted a state to terminate

[6] Cal. Const. art. 1, § 9.

[7] *See U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 15 (1977).

[8] *General Motors Corp. v. Romein*, 503 U.S. 181, 186 (1992).

[9] *See U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977).

[10] *United States v. Winstar Corp.*, 518 U.S. 839, 887 (1996).

[11] *Crane v. Hahlo*, 258 U.S. 142, 146 (1922).

[12] *Bowen v. Public Agencies Opposed to Social Security Entrapment*, 477 U.S. 41 (1986).

agreements with the Secretary of Health and Human Services for social security coverage for state employees if the state provided the Secretary with a two-year notice. After many states began withdrawing, Congress amended the statute to provide that no state may terminate its social security coverage, even if the state had provided the two-year notice. California had provided such notice, but was not permitted to terminate coverage because of the new statutory amendment. In the language of the Social Security Act, Congress expressly reserved a right to alter, amend, or repeal any provision thereof. Because the language of the statute expressly reserved the right to amend the statute, the United States Supreme Court held that, pursuant to the unmistakability doctrine, the Social Security Act did not create a contractual right subject to the Contracts Clause.

On the other hand, in *U.S. Trust*,[13] a covenant between New York and New Jersey created by statutes in both states resulted in a contract between the states and holders of bonds issued by the Port Authority of New York and New Jersey when the covenant expressly protected from depletion the general reserve fund that was a security against the bonds. The express protection from depletion was a contract term that, if impaired, would result in a Contracts Clause violation.

When discussing the Contracts Clause, the Supreme Court, in *Fertilizing Co.*, stated, "[n]othing is to be taken as conceded but what is given in unmistakable terms, *or by an implication equally clear*."[14] Thus, the unmistakability doctrine may be met even without express language in the statute declaring the enactment a contract or stating that it cannot be amended, as long as the context in which the statute is passed makes clear the Legislature's intent to bind the state.

In addition to forming a contract by enacting legislation alone, states may contract with private individuals using methods that apply generally to contracts between any two parties – whether the government or private entities. Such contracts formed by promises or actions of the state are not subject to the unmistakability doctrine.

As discussed above, to form a contract, there must be an agreement of two or more minds, upon sufficient consideration, to do or not to do certain acts.[15] The Restatement Second of Contracts states that an agreement is a manifestation of mutual assent on the part of two or more persons.[16] This manifestation of assent may be made by words or acts.[17] To be effective as a manifestation of assent, a party must intend to engage in the conduct and know or have reason to know that the

[13] *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977).

[14] *Fertilizing Co. v. Hyde Park*, 97 U.S. 659, 666 (1878) (emphasis added).

[15] *Crane v. Hahlo*, 258 U.S. 142, 146 (1922).

[16] Rest. 2d Contr. §3.

[17] Rest. 2d Contr. § 19.

other party may infer from his conduct that he assents.[18] Mutual assent must be manifest through objective means, not just subjective intent to enter into a contract.

Additionally, contracts require consideration, which is a performance or return promise that is bargained for. A performance or return promise is bargained for if it is sought by the promisor in exchange for a promise and is given by the promisee in exchange for that promise.[19]

Contracts may be unilateral or bilateral. A unilateral contract is one in which one party makes a promise and the consideration for the promise is an act, which may have already been executed. A bilateral contract is one in which the consideration is a promise – thus each party is both a promisor and a promisee.[20]

2. <u>Analysis</u>

As discussed above, numerous state actions created contracts with taxpayers that qualified for Enterprise Zone Benefits. In addition to each of these actions individually forming contracts, all of the state's actions collectively formed contracts.

a. The state's passage of the Enterprise Zone Program created a contract

The first state action that created a contract was the passage of the Enterprise Zone Program. By enacting such legislation, it precluded future Legislatures from eliminating the program – or at least eliminating the benefits of the program in a manner that affects taxpayers that had taken actions consistent with the program. Such legislation can form a contract if it explicitly or implicitly evinces an unmistakable indication that the Legislature intends to bind itself contractually.[21]

Section 7073(d)(1) of the Government Code states that, with certain exceptions, "a designation made by the [HCD] shall be binding for a period of 15 years from the date of the original designation." This language makes it clear that the state intended an Enterprise Zone designation to last 15 years, regardless of the actions of subsequent Legislatures. Thus, the state unmistakably intended to bind itself to Enterprise Zone designations. Any subsequent legislation that impairs these contracts would violate the Contracts Clause.

[18] Rest. 2d Contr. § 19.

[19] Rest. 2d Contr. § 71.

[20] *See* Rest. Contr. § 12; *see also* Williston on Contracts § 1:17 (4th ed.).

[21] *See Bowen v. Public Agencies Opposed to Social Security Entrapment*, 477 U.S. 41 (1986).

Any attempt to continue Enterprise Zone designations, but eliminate Enterprise Zone Benefits also results in a Contracts Clause violation. The Legislature intended not only to bind itself to 15-year designations, but to continue the Enterprise Zone Program and continue offering Enterprise Zone Benefits during that period.[22] At the time the Legislature passed the Enterprise Zone Program, it knew that no taxpayer would be induced into the behavior it sought unless the program provided benefits to taxpayers. If taxpayers believed that the benefits could be swept away in an instant by legislative action, they would not be incented to conduct business in Enterprise Zones. Thus, the Enterprise Zone Benefits were an integral part of the Enterprise Zone Program and the individual Enterprise Zone designations would be meaningless without the benefits. Therefore, the promise to continue Enterprise Zone designations for 15 years also included a promise to continue to provide the Enterprise Zone Benefits for at least that period of time.

b. HCD memoranda of understanding with Localities formed contracts that are subject to the Contracts Clause

The HCD enters into memoranda of understanding with Localities. When the HCD and each Zone Administrator signs a memorandum of understanding, each party makes a promise to fulfill its obligation to the other and, in return, is promised that the other party will fulfill its own obligation. Additionally, these memoranda of understanding set forth 15-year contract terms as required by Government Code section 7073(d)(1). Accordingly, memoranda of understanding create contractual rights between the HCD and Localities. The elimination of Enterprise Zone Benefits would impair the state's agreement to provide incentives to induce taxpayers to hire new employees, purchase machinery and equipment, and boost local economies in other ways.

The state unmistakably entered into agreements to provide benefits to Localities and taxpayers to encourage investment in economically depressed areas. The state agreed to continue the program and continue to provide these benefits for 15 years. Thus, when the Zone Administrators signed the memoranda of understanding, they did so with the understanding that the Enterprise Zone Program and its benefits would continue for the full 15 years.

The 15-year designation is provided not only by contract but also by state statute. This 15-year designation period implies not only designation as an Enterprise Zone, but also the Enterprise Zone Benefits. The 15-year designation period also implies that the state will continue to give Localities the support they need to continue to run the program and incent taxpayers to conduct business in the zones. Thus, the state entered into contracts with Localities, such that a repeal of the Enterprise Zone Benefits or the benefits given directly to Localities to further the goals of the program would impair contractual obligations.

[22] Cal. Gov't Cd. §§ 7070, *et seq*. and Cal. Rev. & Tax. Cd. §§ 23612.2, *et seq*.

c. By promoting the benefits of the Enterprise Zone Program, the state induced taxpayers to invest in Enterprise Zones, forming contracts between the state and taxpayers

The Enterprise Zone Act requires the HCD to "[e]nsure that each [Zone Administrator] has developed a method to make residents, businesses, and neighborhood organizations aware of the opportunities to participate in the [Enterprise Zone Program]."[23] Further, the HCD must "[h]elp the locality develop a marketing program for the enterprise zone."[24] Finally, the HCD must "[h]elp businesses to participate in the program."[25]

As a result of the above requirements, the HCD has dedicated substantial resources to ensure that taxpayers are aware of the Enterprise Zone Program and the benefits of investing in the Enterprise Zones. Additionally, in its memoranda of understanding with Localities, the HCD agrees to inspect Enterprise Zone activity, review and approve vouchering, marketing, incentive, financing, management, and other plans, agreements, documents, and products required by the Enterprise Zone Act. Thus, the HCD and Localities work together to ensure that private entities take advantage of the Enterprise Zone Program by conducting business in Enterprise Zones.

At the direction and with the advice of the HCD, Localities and their Zone Administrators engage in marketing activities, such as creating all-in-one websites where taxpayers can determine if they qualify, determine how to qualify, determine the value of the incentives, and fill out and submit applications for Hiring Credit vouchers. Additionally, Localities issue press releases detailing the benefits of conducting business in Enterprise Zones, provide business testimonials, manage mailing lists, and provide workshops, among other marketing activities. Localities also are a part of the California Association of Enterprise Zones, which provides its own marketing materials intended to induce companies to conduct business in any of the Enterprise Zones.

Additionally, the HCD engages in its own marketing activities. The HCD maintains a website to provide businesses with information on the Enterprise Zone Program. The HCD publishes monthly reports, sends email blasts, and prepares marketing materials intended to induce companies to invest in Enterprise Zones.

As discussed above, an enforceable contract subject to the Contracts Clause exists if there is an agreement of two or more minds, upon sufficient consideration, to do or not to do certain acts. Such an agreement is reached if there is an objective manifestation of mutual assent on the part of two or more persons (or entities) and each party intends to engage in conduct and knows or has reason to know that the other party may infer from his conduct that the other party assents.

---

[23] Cal. Gov't Cd. § 7076(a)(1)(B).

[24] Cal. Gov't Cd. § 7076(a)(1)(C).

[25] Cal. Gov't Cd. § 7076(a)(1)(F).

Here, the minds of taxpayers and the state met. Taxpayers assented to performing actions consistent with the Enterprise Zone Act in return for Enterprise Zone Benefits. The state assented to provide ongoing Enterprise Zone Benefits to taxpayers that conduct their affairs consistent with the Enterprise Zone Act. This assent was manifest, not only by legislation, but also by numerous actions intended to induce taxpayers to hire workers, invest in machinery and equipment, and conduct other activities in Enterprise Zones.

Another way to look at the state's assent is to view the marketing materials as an offer to the general public. The state offered to provide Enterprise Zone Benefits to taxpayers that conduct business in Enterprise Zones. The offer was communicated to the public not only with legislation, but also with marketing materials promising Enterprise Zone Benefits. The offer was accepted by any taxpayer that hired qualifying employees in an Enterprise Zone, purchased machinery or equipment for use in an Enterprise Zone, made a loan to a business in an Enterprise Zone, or moved into an Enterprise Zone.

In addition to an agreement, a contract must have sufficient consideration – the other party must either do or not do something. Here, the consideration that the state received from taxpayers qualifying for Enterprise Zone Benefits was the investment of resources in Enterprise Zones by hiring new workers, investing in machinery and equipment, or even moving into an Enterprise Zone. As shown by its marketing campaigns, this was exactly the consideration that the state sought in return for its assent to provide Enterprise Zone Benefits. In fact, in a study conducted by the Public Policy Institute of California, the authors concluded that the effectiveness of an Enterprise Zone was greater when the Localities conducted greater marketing and outreach activity.[26] This shows that state's contracts with private entities had the exact effect that they sought. Thus, there was sufficient consideration here.

The contracts that the state had with private entities were unilateral contracts. They were contracts where one party (the state) made a promise (to provide Enterprise Zone Benefits) and the other party (the taxpayer) performed an act (hired workers, purchased machinery, etc. in Enterprise Zones). The moment a taxpayer qualified for an Enterprise Zone Benefit, a contract was formed – a contract under which the taxpayer already performed its part and pursuant to which the state must continue to perform. At that moment, there was no remaining contingency. Even if the benefits could not be used in the year they were generated due to limitations on their use, the benefits still remain vested and could be carried forward.

d. The state's actions as a whole combine to form a contract with taxpayers who qualify for Enterprise Zone Benefits

As discussed above, the state's legislation, the HCD's memoranda of understanding, and the action-inducing activities of the state and Localities were each sufficient to form contracts, the

[26] Jed Kolko and David Neumark, *Do California's Enterprise Zones Create Jobs?*, Public Policy Institute of California, 2006.

impairment of which would violate the Contracts Clause. Additionally, all the state's actions, when taken as a whole, objectively manifest intent to agree to provide taxpayers with Enterprise Zone Benefits if, in consideration thereof, the taxpayers invest in Enterprise Zones by hiring employees, purchasing machinery and equipment, or performing other acts.

Unlike in *Bowen*, the state here goes far beyond merely enacting a statute. Although the statute alone was sufficient to form a contract due to the context in which it was enacted, the state's subsequent actions reinforced the formation of a contract. The state took various active steps towards inducing taxpayers to conduct their activities in a manner that qualifies them for the Enterprise Zone Benefits. The state engaged in a marketing campaign meant to inform taxpayers of the substantial benefits of the program. The state then encouraged the hiring of employees in that area, not only with the Hiring Credit, but also with a vouchering program that gives taxpayers clarity on whether they qualify. The HCD promulgated regulations to ensure uniform administration of the vouchering program. The state entered into contracts with Localities to ensure uniform application of the Enterprise Zone Program in general and to ensure that the Localities and their Zone Administrators conducted proper marketing to induce taxpayers to take advantage of its benefits.

In return for promising Enterprise Zone Benefits and taking actions consistent with that promise, the state received the exact consideration it sought – taxpayers invested resources in Enterprise Zones to help lift the economies in these areas. In fact, the Public Policy Institute of California study, discussed above, showed that the more marketing efforts that the state put into the program, the better the results. This shows a direct link between the state's active efforts to create, regulate, and administer the program and the successes of the program – a direct link between the state's promise to provide Enterprise Zone Benefits and the consideration it received in return. This direct link shows that the state and taxpayers entered into contracts.

B. The State's Elimination of Enterprise Zone Benefits Would Impair its Obligations under the Contracts Clause

The obligations of a contract are impaired by a law that renders them invalid or releases or extinguishes them.[27] For example, a law that discharges a debtor from liability was held invalid as applied to contracts in existence when the law was passed.[28]

Here, the elimination of Enterprise Zone Benefits would discharge the state from its obligation to taxpayers who entered into contracts by investing in Enterprise Zones. Taxpayers would lose the entire benefit of their bargain with the state. Thus, the elimination of Enterprise Zone Benefits would impair contracts between taxpayers and the state.

Additionally, a repeal of Enterprise Zone Benefits would impair contracts between the state and Localities. Localities invested in the furtherance of the program and, in return, expected the state to continue inducing taxpayers to invest in their local economies. By removing the Enterprise Zone Benefits, taxpayers would no longer be induced into such actions and Localities would lose the benefit of their bargain with the state.

C. Impairment of State's Contract Obligations would Be Substantial

As discussed above, the impairment of a contract violates the contracts clause if the impairment is substantial. One court has held that impairment is substantial if it constitutes a severe disruption of contractual expectations.[29] Here, the impairment would be substantial because it would completely eliminate the benefits of contracts that taxpayers and Localities entered into with the state.

D. This Impairment Would Not Be Reasonable and Necessary to Serve an Important Public Purpose

1. <u>Law</u>

A state's action that substantially impairs a contract violates the Contracts Clause unless the action has a significant and legitimate public purpose.[30] Such a public purpose could include

---

[27] *Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 431 (1934).

[28] *Fourth La Costa Condominium Owners Ass'n v. Seith*, 159 Cal.App.4th 563, 584-585 (Cal. Ct. App. 2008) (*citing Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 431 (1934)).

[29] *Dairyland Greyhound Park, Inc. v. Doyle*, 295 Wis.2d 1, 55-56 (2006).

[30] *Energy Reserves Group v. Kansas Power and Light Co.*, 459 U.S. 400 (1982).

remedying a broad and general social or economic problem.[31] However, courts have held that general protection of the public treasury is unacceptable to support impairment of a contract.[32]

When the state is a party to the impaired contract, the state's impairment must be both reasonable and necessary to serve an important public purpose.[33]

In *U.S. Trust*, the United States Supreme Court stated that a state "cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors."[34] In that case, the state could not deplete the security interests of its bondholders to further the public goal of encouraging public transportation.

The Court stated that this justification was neither necessary to achieve the state's plan nor reasonable in light of the circumstances. The determination of necessity was considered on two levels: first, that the total repeal of a covenant was not essential in light of less drastic alternatives, and second, that the state could have adopted alternative means of achieving its goals without modifying the covenant at all. Further, the Court stated that the repeal of the covenant was not reasonable in light of the surrounding circumstances – specifically, that the need for mass transportation was not a new development and was a concern when the covenant was adopted.

2. <u>Analysis</u>

Governor Brown's budget proposal summary states, "Within the context of a budget that proposes deep spending reductions across state government, all spending must be scrutinized." The Governor's proposal goes on to state, "These changes are intended to move the responsibility and the authority for local development efforts to the local jurisdictions and their voters. Eliminating state tax benefits for EZs is a fundamental part of this change."

Based on the budget proposal summary, the purpose of eliminating Enterprise Zone Benefits is twofold: (1) to address the state's budget gap by reducing government spending and (2) to place the responsibility of local development in the hands of local governments. For the state's impairment of contractual relationships to stand, one of these two purposes must be both necessary and reasonable in light of the two-part test set forth in *U.S. Trust*.

---

[31] *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978).

[32] *See Campbell v. Boston Housing Authority*, 443 Mass. 574, 583 (2005) (*citing U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 26, 29 (1977)).

[33] *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977).

[34] *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 29 (1977).

Courts have held that the protection of the public treasury is an unacceptable purpose for impairing contracts.[35] Such a purpose is even more illegitimate when the state's own obligations are involved. If a state could impair its own contracts simply to protect its own treasury without furthering a nobler goal, its contracts would be meaningless, because it could simply pass a law that relieves it of its obligations. Accordingly, the state's first goal of reducing government spending is illegitimate.

The state's second goal – pushing down local development responsibilities – appears to be a mere smokescreen for actually furthering the first goal of protecting the public treasury. However, taking this goal at its face, it still falls short of being necessary and reasonable to further a public purpose.

a. The impairment is not necessary in light of alternatives that would further the state's realignment goal without impairing its contractual obligations

The first requirement for a state's impairment to be constitutionally acceptable is that it is necessary. The United States Supreme Court split this requirement into two levels: that it is essential in light of a less drastic alternative and that the state could have adopted alternative means of achieving its goals without modifying the covenant at all.

At least one constitutionally permissible alternative to impairing contractual obligations exists. The state could allow Enterprise Zone designations to expire at the end of each Enterprise Zone's promised 15-year period and not designate any new Enterprise Zones.

Allowing Enterprise Zone designations to expire would shift the responsibility of local development to local governments. This method would allow local governments ample time to create local development policies that they could implement when their Enterprise Zone designations expire. Additionally, giving local governments time to implement their own development programs would allow local governments time to raise revenue to fund such programs, possibly by working together with other governments that are currently part of the Enterprise Zone Program. Thus, there exists an alternative to the Governor's proposal that furthers the state's goal without impairing its contractual obligations. Accordingly, eliminating Enterprise Zone Benefits would be an unconstitutional impairment of the state's contracts.

Additionally, because there exists a method that furthers the state's goal without impairing its contracts, any alternative proposals that impair its contracts would be unconstitutional. These unconstitutional alternatives include (1) suspending the use of Enterprise Zone Benefits for a limited period of time and (2) allowing previously-earned and unused credits but eliminating credits that have not yet been earned.

[35] *See, e.g., Campbell v. Boston Housing Authority*, 443 Mass. 574, 583 (2005) (*citing U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 26, 29 (1977)).

b. Elimination of Enterprise Zone Benefits is not reasonable

As discussed above, the state can achieve its goal of pushing down local development responsibilities to local governments without impairing its contracts. Even without this alternative method of reaching its goals, the elimination of Enterprise Zone Benefits would violate the Contracts Clause because doing so is not reasonable.

With respect to the reasonableness requirement, we must look to the surrounding circumstances of the contract and the elimination of Enterprise Zone Benefits. Prior to enacting the Enterprise Zone Program, the state was aware that local governments could implement incentive programs to bring new businesses to their boundaries and that taking such responsibility on themselves would result in fewer local governments enacting their own development programs. Knowing all this, the state still chose to enter into contracts with taxpayers to give them incentive to invest in these areas. Because the state was aware that local governments could enact their own programs, it is unreasonable for the state to renege on its promises just because it has been irresponsible in its fiscal planning and has decided to shift the burden back to local governments.

To more directly compare *U.S. Trust* to this case, the government impairments in both cases purported to have very similar purposes. In that case, the purpose of impairing contractual obligations was ostensibly to move resources from securing financiers of vehicular travel to funding public transportation. Thus, the alleged purpose was to encourage the use of public transportation. Here, the stated reason for impairing contractual relationships is to move the burden of encouraging local economic activity to local governments. Much like the purpose in *U.S. Trust*, the state would impair its contracts to achieve a goal that was foreseeable at the time the state entered into contracts.

Additionally, shifting the responsibility of local development to local governments is similar to New Jersey shifting money from vehicular transportation to public transportation. In both instances, the government impairs contracts simply to shift general treasury funds away from the subject of its contracts and towards other goals. If anything, the goal here is less reasonable than that in *U.S. Trust*. In *U.S. Trust*, the goal was to move funding to a cause stated to be more important by the state. Here, the stated goal is apparently to shift away from itself a burden the state is contractually obligated to carry. Eliminating the Enterprise Zone Benefits only accomplishes one thing – protection of the public treasury. As discussed above, this is a constitutionally impermissible reason for a state to impair contracts.

Thus, both of the state's purposes for eliminating Enterprise Zone Benefits are illegitimate. The goal of budgetary savings is invalid because protecting the treasury is not a permitted reason to impair state contracts. The goal of shifting burdens to local governments is neither necessary nor reasonable. Thus, elimination of Enterprise Zone Benefits would violate the Contracts Clause, so such elimination by the legislature would be unconstitutional, illegal and invalid.

II. DENIAL OF DUE PROCESS

The Due Process Clause of the Fourteenth Amendment to the United States Constitution is the primary constitutional protection against unjust state interference with an individual's rights. Specifically, the Due Process Clause prohibits any state from depriving a person of "life, liberty, or property, without due process of law."[36] The California Constitution also includes this due process protection.[37] In both contexts, a "person" has long been considered to include not only individuals, but also corporate entities.

In conducting its due process analysis, a court first looks to the nature of the right protected. This determines the scrutiny applied to (1) the state's reasoning for depriving a person of a right and (2) the means by which the right is deprived. Tax statutes are considered economic legislation because they impinge on "economic rights" and courts scrutinize economic legislation using what we will refer to as the "legitimate purpose" test.[38]

As a start, economic legislation – legislation that adjusts burdens and benefits of economic life – is presumed to be constitutional.[39] To overcome this presumption, the person affected must establish that the legislation is so "harsh and oppressive as to transgress the constitutional [due process] limitation."[40]

In determining whether legislation is "harsh and oppressive", a Court applies the legitimate purpose test to determine whether a legislature (1) has a legitimate purpose for enacting the legislation; and (2) whether that purpose is achieved by rational means.[41] For purposes of the rational means analysis, legislation that is retroactive is subject to greater protection than strictly prospective legislation.[42]

---

[36] U.S. Const. Amend XIV, §1.

[37] Cal. Const. art. 1, §7(a).

[38] *U.S. v. Carlton*, 512 U.S. 26 (1994).

[39] *Pension Benefit Guaranty Corp. v. U.S.*, 467 U.S. 717, 729 (1984) *citing Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976)

[40] *Welch v. Henry*, 305 U.S. 134, 139 (1938). In economic right due process cases outside of the tax context, the applicable standard is "arbitrary and irrational." *See Pension Benefit Guaranty Corp. v. U.S.*, 467 U.S. 717, 729 (1984) *citing Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976). However, the Supreme Court has confirmed that this standard is synonymous with the "harsh and oppressive" standard referred to in tax cases. *U.S. v. Carlton*, 512 U.S. 26, 28 (1994).

[41] *Pension Benefit Guaranty Corp. v. U.S.*, 467 U.S. 717, 733 (1984).

[42] *U.S. v. Carlton*, 512 U.S. 26 (1994).

We will consider whether a repeal of the Enterprise Zone Benefits would conflict with either requirement of the legitimate purpose test. In part one, we will consider whether the legislature would have a "legitimate purpose" for passing legislation eliminating the Enterprise Zone Benefits. In part two, we will consider whether the elimination of the Enterprise Zone Benefits achieves a legitimate purpose through "rational means", specifically considering whether the legislation would be deemed impermissibly retroactive.

A. CALIFORNIA'S PURPOSES FOR REPEALING ENTERPRISE ZONE BENEFITS INCLUDE AN ILLEGITIMATE MOTIVE

The primary purposes set forth for the various proposals in the *2011-12 Governor's Budget Summary* are to address the budget shortfall and to pursue "realignment" by pushing certain governmental functions down from the state level to the local level.

1. <u>Law</u>

In the tax context, courts have found that raising revenue is a sufficiently legitimate purpose to withstand a due process challenge.[43] Similarly, we would expect courts to find legitimate Governor Brown's purported realignment purpose, even if that turns out to be merely an alternative way of describing the revenue-raising purpose.

It is not enough to save a law from due process challenge, however, to find that the legislature had one or more legitimate purposes for the law. That is the beginning, not the end, of the analysis. The United States Supreme Court reasoned in *U.S. v. Carlton* that a legislature that acts with an "improper motive" violates due process, even if the legislature had alternative legitimate purposes – such as raising revenue – for enacting the statute.[44] In other words, legitimate purposes (like revenue raising or governmental realignment) will not save a statute from constitutional invalidation if the legislature also had an illegitimate or improper motive for passing the legislation.

The *Carlton* court upheld a federal statute that retroactively eliminated an estate tax deduction. Prior to the passage of that legislation, Carlton purchased over $11 million in stock and then sold the stock at a loss in order to take advantage of the deduction. Carlton had also filed the required tax returns prior to the passage of the retroactive legislation. Thus, Carlton suffered a substantial loss as the result of his sale of stock, but could not take advantage of the tax deduction he had relied on before making that sale.

The Court found that Congress had a legitimate purpose in passing a retroactive repeal of the deduction, even though Carlton had acted in reliance on the repealed deduction. Congress's

[43] *See e.g. U.S. v. Carlton.*, 512 U.S. 26, 33 (1994). As discussed above, raising revenue is *not* a legitimate purpose for a state to impair its contract obligations in the Contracts Clause context.

[44] *U.S. v. Carlton*, 512 U.S. 26 (1994).

legitimate purposes were to ensure the solvency of the public purse and to correct an unintended mistake in the passage of the prior statute. However, in making its legitimate purpose determination, the Court also focused on what it *did not find* in that case. Specifically, the Court stated that its determination was dependent on the complete lack of evidence that Congress had an *improper motive* for repealing the deduction. Specifically:

> Congress acted to correct what it reasonably viewed as a mistake [in the prior law] that would have created a significant and unanticipated revenue loss. There is no plausible contention that Congress acted with an improper motive, as by *targeting estate representatives* such as Carlton after *deliberately inducing them to engage in…transactions*.[45]

Thus, if Congress *had* targeted estate representatives after deliberately inducing them to engage in specific transactions, then Congress would have had an improper motive and the law would have been unconstitutional. Other conceivable legitimate purposes would not save the law from invalidation. The specific example in *Carlton* is legislation that targets a specific group after deliberately inducing that group to engage in certain transactions. The broader principle is that deliberate inducement of detrimental reliance can prevent a legislature from later revoking a statutory benefit from taxpayers who relied on that bargained-for benefit.

Of course, every tax statute affects some group of taxpayers and many tax provisions seek to influence taxpayer behavior. To violate due process, the legislation eliminating a benefit for a group of taxpayers – after inducing those taxpayers to rely on the benefit – must be "so harsh and oppressive as to transgress the constitutional limitation."[46]

2. **<u>Analysis</u>**

We have not found any examples of a state deliberately inducing taxpayers to take substantial and specific actions for over two decades in exchange for promised benefits, and then having the temerity to revoke those benefits after taxpayers acted in reliance on the state's promise, as Governor Brown proposes. Consequently, it is not surprising that the Supreme Court has never had occasion to uphold a due process challenge on improper motive grounds.[47] Simply put, no state has ever attempted to enact such a brazen example of "bait-and-switch" taxation.

The *Carlton* court, however, reasoned that the enactment of legislation with an improper motive would violate due process. Such improper motive exists when a legislature deliberately induces detrimental reliance from a specific group in exchange for a promised benefit, and then targets

---

[45] *U.S. v. Carlton*, 512 U.S. 26, 32 (1994)(emphasis added).

[46] *Welch v. Henry*, 305 U.S. 134, 147 (1938). This language is used in the context of assessing the constitutional limitation of retroactive legislation, but is equally applicable in this context.

[47] *Licari v. Comm'r of Internal Revenue*, 946 F.2d 690, 694 (9th Cir. 1991).

that group by revoking the benefit. We will discuss these two elements – (a) inducement of action in exchange for promised benefits and (b) targeted revocation of the bargained-for benefit – in turn.

a. California deliberately induced taxpayer action in exchange for EZ Credits

In challenging the repeal of the Enterprise Zone Benefits, a taxpayer would be able to point to numerous examples of actions taken by California that deliberately induced taxpayers to engage in a wide variety of activities in order to assist the state in achieving its goal of reviving depressed areas in the state. The substantial and specific nature of the induced reliance in the Enterprise Zone context makes it easily distinguishable from general tax incentives and tax attributes such as net operating loss carryforwards.

Specifically: (i) the Enterprise Zone Program deliberately induced specific, substantial detrimental reliance in exchange for promised benefits; (ii) California and Localities acting on its behalf actively promoted the program and produced public documents that strongly indicated that the Enterprise Zone Program (and thus its benefits) would last for a specific period of time; (iii) the Enterprise Zone Program created vested rights and entitlements; and (iv) there is no evidence that California mistakenly granted benefits to Enterprise Zone participants.

(i) The State induced taxpayers to take specific and substantial actions in exchange for EZ Credits

California designed the Enterprise Zone Program to induce businesses to make substantial investments by either relocating or expanding their businesses in specific areas designated by the state. Many taxpayers relocated or created an entirely new business center in an Enterprise Zone in reliance on the promised benefits provided by the Enterprise Zone.[48]

Once in an Enterprise Zone, taxpayers were then induced to take further specific actions in exchange for specified future benefits. A good example of induced action is the Hiring Credit. In order to receive a Hiring Credit, a taxpayer had to hire qualified employees that faced substantial barriers to employment. Merely hiring the employee was not sufficient. The taxpayer also had to submit documents and information to local Zone Administrators establishing that the hired employees were eligible for a credit. The business also paid a non-refundable fee to the Locality to process the application. Once the Locality's Zone Administrator received the application, information, documents, and the fee, it provided the taxpayer with a voucher stating that the employee qualified for the Hiring Credit. The voucher then served as evidence of a qualified hiring for the purposes of taking the Hiring Credit on the state tax return.

[48] *See e.g.* http://www.neontommy.com/news/2011/01/conflicting-data-muddles-true-impact-enterprise-zones; and http://www.sbsun.com/ci_17239083?IADID ("It is the combination of these incentives that influenced Kohl's to choose San Bernardino as the location for its 'west of the Rockies' e-commerce center.")

Thus, an Enterprise Zone participant detrimentally relied on the promise of a Hiring Credit when it hired and employed specific classes of employees that it would not otherwise have hired without inducement by the state. Further, it paid non-refundable fees in exchange for vouchers so that it could establish that it had hired employees that qualified for the credit.

The elimination of the Hiring Credit carryforward would mean that taxpayers who paid Localities for vouchers solely for the purpose of receiving a Hiring Credit would then be denied the use of the credit carryforward after they had already paid the Locality a fee for the voucher.

(ii) The government promoted a 15-year period for EZ benefits

As discussed above, any tax incentive can be considered an inducement. For example, in *Carlton*, Congress merely passed a statute permitting a tax deduction. It took no steps to market that deduction or to indicate that the deduction would last for a specific period. In fact, the permitted deduction was actually a mistake that Congress corrected within 14 months.

California, on the other hand, did not merely enact the Enterprise Zone Program. Instead, it took several additional affirmative steps to induce taxpayers to take part in the program on the basis that an Enterprise Zone designation would last 15 years and would grant specific benefits to EZ businesses going so far as to declare that "a [Enterprise Zone] designation made by the department shall be binding for a period of 15 years from the date of the original designation."[49]

As discussed above, the statutory scheme specifically anticipated that the HCD and local jurisdictions would target potential business by marketing the advantages of the Enterprise Zone Program in order to induce the taxpayers to enter the zone. In fact, targeted marketing was a statutory requirement, specifically mandating that the HCD "[h]elp the locality develop a marketing program for the enterprise zone."[50]

As part of this coordinated marketing effort, California and Localities entered into memoranda of understanding that required the Locality to develop and implement a marketing plan. These marketing plans included online websites advertising the Enterprise Zone and its benefits, as well as news releases and public statements. These marketing efforts constituted an active attempt to induce businesses to relocate to an Enterprise Zone.

Furthermore, the public marketing of the Enterprise Zone repeatedly emphasized that an Enterprise Zone designation (and thus the associated benefits) would last for a full 15 years. For example, the HCD issued press releases to announce the designation of new zones with language such as "Each zone designation is in effect for 15 years."[51] The HCD would also issue letters to

[49] Cal. Gov't Code §7073(d)(1).

[50] Cal. Gov't Code § 7076(a)(1)(C).

[51] *See e.g.* http://www.hcd.ca.gov/news/release/12152010EnterpriseZones.pdf.

Localities announcing the approval of an Enterprise Zone. These letters specifically stated that the zone would be effective for 15 years and were often included in the Locality's marketing campaign.[52]

In contrast, in *Carlton*, the federal government did not take any steps to encourage taxpayers to engage in activities that would allow them to take the statutory deduction. Congress merely passed a statute.

Thus, unlike the federal statute at issue in *Carlton*, California and Enterprise Zones acting on its behalf engaged in a coordinated and extensive campaign to draw businesses into Enterprise Zones, and those campaigns made it appear that the benefits zone would last for the full 15-year term. The active marketing campaign combined with numerous public documents indicating that the zones would last for a full 15 years establish the deliberate inducement necessary to show improper motive.

(iii) ***<u>The EZ Program granted vested property interests to taxpayers</u>***

Unlike traditional tax attributes such as net operating loss carryforwards, California granted certain Enterprise Zone participants a vested property interest in credit carryforwards, especially those generated after July 1, 2008. Specifically, taxpayers are permitted to sell their credits to certain statutorily defined affiliates.[53,54]

The ability to sell and assign credits significantly distinguishes Enterprise Zone credit carryforwards from other tax attributes such as net operating loss carryforwards. For example, states generally limit the NOL carryforward time period and do not permit the sale of NOLs. Thus, the state makes the taxpayer aware from the very beginning that it may never be able to use the NOL and that it may not sell it, which limits the potential for induced reliance. Furthermore, the NOL carryforward is not a benefit granted in return for specific taxpayer behavior. The only requirement is that a taxpayer lose money during a taxable year. Thus, the taxpayer is not required to take specific actions to earn the NOL. Again, this limits the potential for induced reliance.

Unlike an NOL, which taxpayers can obtain without any additional action beyond operating their business, California induces businesses to take specific actions in order to earn EZ credits; actions that they may not have taken absent the inducement. For example, the purpose of the

---

[52] *See e.g.* Letter from HCD to City of Oroville dated December 7, 2007. Available on City of Oroville Enterprise Zone website.

[53] Cal. Rev & Tax Code §23663.

[54] *See* FAQ E. http://www.ftb.ca.gov/law/intParty/Credit_Assignment_Revenue_and_Taxation_Code_section_23663_faqs.shtml#D.

Hiring Credit is to induce employers to hire qualified employees that otherwise have difficulty obtaining employment. The business, by hiring the employee, is providing a specific benefit to the state in reliance on the state's assurance that it will receive a later benefit. The business takes this action, in part, because the statute provides that the credit will never expire. Furthermore, the state offers a further incentive by permitting the business to sell the credits. Thus, an EZ credit is valuable as soon as it is earned, constituting a vested right (discussed in more detail in section 2). By stating that credits do not expire and creating vested rights in certain credits, California induced taxpayers to take actions to earn those credits on the basis that they would not expire before use. Thus, the state induced detrimental reliance, further establishing improper motive.

(iv) The grant of EZ Credits was not a legislative mistake

The *Carlton* court specifically stated that the induced reliance must be *deliberate* on the part of the legislature. In *Carlton*, there was significant evidence that the legislature granted a tax deduction that was far broader than it had intended. As a result, the Court found that the legislation to eliminate the deduction that Carlton relied upon was acceptable because the legislature did not deliberately induce Carlton's action. The legislation was merely a correction of a mistake.

The Enterprise Zone Program on the other hand was specifically designed to induce businesses to relocate into or remain in an Enterprise Zone and to take specific actions in order to receive promised benefits. The program has been in existence for over 25 years and California has amended the program several times over this period without significantly reducing the benefits or changing the binding nature of the zone designations. In fact, when the Legislature has altered the benefits, it has amended them to apply *more broadly*. For example, prior to 1995, the Hiring Credit was available for individuals who were enrolled as participants under the Job Training Partnership Act ("JTPA").[55] On January 1, 1995, the Legislature expanded Hiring Credit eligibility to include individuals who were eligible for enrollment in the JTPA, whether or not they were actually enrolled.[56] The express legislative purpose in making this change was "to broaden the pool of individuals whom an Enterprise Zone employer can hire and still qualify for the EZ hiring credit." Assembly Committee on Revenue and Taxation, Bill Analysis of Senate Bill 1770, prepared for August 15, 1994 hearing. The Bill Analysis states that the amendment: "[e]xpands the pool of eligible individuals to cover *anyone who meets the eligibility requirements* for the specified programs, *regardless of whether they have ever attempted to enroll for services.*" (Emphasis added.) These circumstances, where the benefits in question were expanded – not contracted – despite the Legislature repeatedly amending the Enterprise Zone statutes, demonstrate that the benefits were in fact intended, unlike the tax deduction in *Carlton* that was clearly enacted by mistake and quickly corrected.

---

[55] Cal. Rev & Tax Code §23622.7 (1994).

[56] Cal. Rev & Tax Code §23622.7 (1995).

3. California targeted EZ Credit recipients for revocation of their bargained-for benefits

The second of the two requirements under *Carlton* "improper motive" analysis is that the challenged legislation must be targeted at the group that was deliberately induced to engage in specific actions by the state. In this case, businesses that operated in an Enterprise Zone in exchange for the various benefits offered by the zone would constitute the requisite targeted group. Repeal of the EZ Program would constitute impermissible legislative targeting. The Legislature would target these businesses by eliminating the various existing and future Enterprise Zone Benefits that the state had used to induce taxpayers to relocate into or remain in the Enterprise Zone, and to take specific actions such as hiring specially designated employees.

Thus, the repeal of the Enterprise Zone Benefits is further distinguishable from existing case law because of the scale of the induced, detrimental reliance. California and Enterprise Zones acting on its behalf actively marketed the Enterprise Zone with the intent of inducing taxpayers to uproot entire businesses and to relocate those businesses in areas specified by the state. Once relocated, California induced these businesses to take further actions such as hiring employees specified by the state in exchange for the promise of vested property interests. There is no argument that California mistakenly offered these benefits. The combination of all these factors indicates that California would have an improper motive for repealing the Enterprise Zone Benefits, and thus the repeal would violate due process.

B. Repealing EZ Benefits would Violate Due Process Protections against Immodest Retroactive Taxation

1. Law

In *Carlton*, the United States Supreme Court held that retroactive tax legislation does not violate due process if the period of retroactivity is "modest."[57] The tax law at issue in *Carlton* had a 14-month period of retroactivity. Furthermore, within 3 months of the passage of the tax deduction law upon which the taxpayer had relied, the IRS had announced that it would not permit the deduction in certain circumstances, including taxpayers with Carlton's facts. Justice O'Connor, concurring in the judgment, explained that, in her view, "[a] period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise... serious constitutional questions."[58] Indeed, as she noted, "[i]n every case in which [this Court has] upheld a retroactive federal tax statute against due process challenge, . . . the law applied retroactively for only a relatively short period prior to enactment."[59]

---

[57] *U.S. v. Carlton*, 512 U.S. 26, 32 (1994)

[58] *U.S. v. Carlton*, 512 U.S. 26, 38 (1994)

[59] *Id.*

Our two primary questions for purposes of *Carlton* "immodest retroactivity" analysis are: (a) would repeal of the Enterprise Zone Benefits constitute retroactive legislation? and if so, (b) would the period of retroactivity satisfy the U.S. Supreme Court's modesty requirement?

2. <u>Analysis</u>

a. Repeal of EZ Benefits would constitute retroactive legislation

The Supreme Court has reasoned that a statute is only retroactive if "the new provision attaches new legal consequences to events completed before its enactment."[60] Thus, a court looks to whether a law "takes away or impairs vested rights acquired under existing laws or creates a new obligation, imposes a new duty, or attaches a new disability, in respect to transactions or considerations already past."[61] Courts look to considerations of "fair notice"; "reasonable reliance"; and "settled expectations" in making this determination.[62] A parallel line of reasoning states that "one of the relevant circumstances [in determining whether a statute is unconstitutionally retroactive] is whether, without notice, a statute gives a different and more oppressive legal effect to conduct undertaken before the enactment of the statute."[63]

Justice Scalia's concurrence outlines a particularly strong argument for finding that a repeal of the Enterprise Zone Benefits, including the elimination of the benefits on a go-forward basis would constitute a retroactive act. As Scalia states, "in the case of a tax incentive provision, as opposed to a tax on continuous activity (like earning income), the critical event is the taxpayer's reliance on the incentive, and the key timing issue is whether the change occurs after the reliance."[64]

Under Scalia's reasoning, the date a taxpayer moves into an Enterprise Zone in order to receive a tax incentive is the start date for purposes of the retroactivity analysis. If a taxpayer moves into a zone in 2005 with the expectation of receiving the benefits of that zone until 2020 (and credit carryforwards until they are exhausted), the later elimination of the zone in 2010 would constitute five years of retroactivity.

Scalia draws a clear distinction between legislation repealing tax incentives, which induce reliance by the taxpayer, and new taxes on continuous activity (like the earning of income). Thus, we can clearly distinguish the repeal of the Enterprise Zone Benefits from the court cases

---

[60] *Martin v. Hadix*, 527 U.S. 343, 358 (1999).

[61] *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

[62] *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

[63] *U.S. v. Hemme*, 476 U.S. 558, 569 (1986).

[64] *U.S. v. Carlton*, 512 U.S. 26, 40 (1994)(Scalia concurring).

upholding the repeal of tax attributes like NOL carryforwards. Repeals of NOL carryforwards are not retroactive even though the carryforward was "accrued" in a prior tax year because an NOL carryforward is not a tax benefit.[65] A NOL carryforward is a policy mechanism for equalizing taxes on continuous activity (earning income). It cannot be considered a tax incentive (the idea of an incentive for losing money is obviously absurd). Instead, it is a way of moderating the arbitrary nature of the annual accounting method. Some businesses have smooth earning cycles and thus consistently earn income each year. Other taxpayers earn income in longer cycles, with large losses for several years while creating a product followed by significant income in later years when the product is brought to market. The NOL carryforward moderates this discrepancy in business cycles. Since NOL carryforwards are not tax incentives and instead are related to the "continuous activity" of earning income, the date for determining retroactivity is the year the taxable income to which the carryforward will be applied is earned. The Enterprise Zone Benefits, on the other hand, are "tax incentives" designed to induce a particular action on the part of the taxpayer. Thus, for purposes of retroactivity, the date that the taxpayer takes an action in reasonable reliance on that provision is the relevant date for retroactivity purposes.

It should also be noted that even if a Court were to find that the statute repealing the Enterprise Zone Benefits was not entirely retroactive, there are strong arguments that certain parts of the repeal would apply retroactively.

Specifically, qualified taxpayers with EZ credits accrued after July 1, 2008 have a vested right in those EZ credits because it is entitled to sell the credit at any time. Legislation that interferes with a vested right is considered to be retroactive.[66] A vested right is considered to be "something more than such a mere expectation as may be based upon an anticipated continuance of the present general laws; it must have become a title, legal or equitable, to the present or future enjoyment of property."[67] Since the taxpayer would be entitled to sell the credit at any time, its right is no longer an "expectation" because the taxpayer would have the present ability to sell the credit. Thus, the elimination of such saleable credits would likely be deemed retroactive.

Revocation of Hiring Credit or sales and use tax credit carryforwards would also present a strong argument for retroactivity. These credits are earned in the year in which they are generated. The fact that they are carried forward from one tax year to another has to do with use limitations, not with whether they have been earned. Retroactive confiscation of credit that has been earned but not yet utilized is no less immoral than repealing credit that has been utilized on a return.

[65] *Miller v. Commissioner*, 115 F.2d 479 (9th Cir. 1940), *Garofolo, Curtiss, Lambert & MacLean, Inc. v. Commonwealth*, 648 A.2d 1329 (Pa. Commw. 1994).

[66] *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

[67] *Cusick v. Feldpausch*, 243 N.W. 226 (1932).

Elimination of carryforward amounts to elimination of the credit retroactive to the year in which it was earned. In the case of the hiring credit, there is a strong argument that retroactivity goes back even further, to the date the employee was hired.

b. Proposed retroactive elimination of EZ Benefits would be immodest and thus impermissible

Assuming that a Court did find that a statute repealing the Enterprise Zone Benefits operated retroactively, the question is whether the retroactivity violates due process. As discussed above, the *Carlton* court stated that a "modest" period of retroactivity is reasonable, and Justice O'Connor strongly suggested that the period of retroactivity should be limited to one year.

In the case of the Enterprise Zone, the period of retroactivity would vary based on the taxpayer. For example, many taxpayers could potentially have unused EZ credit carryforwards from the beginning of the Enterprise Zone Program in the 1980s because credits never expire. Eliminating the carryforward for those taxpayers would result in over two decades of retroactivity. Other taxpayers may have shorter periods of retroactivity. Regardless, it is clear that many taxpayers would have a strong argument that the statute is impermissibly retroactive because the retroactivity would extend for several years. For example, in applying *Carlton*, California courts have found an eight (8) year retroactive statute to be in violation of the due process clause.[68] Other courts have found a two to three year retroactive statute to be unconstitutional.[69]

And while some courts have upheld a longer period of retroactivity, those cases are largely distinguishable from the case at hand. For example, the Third Circuit upheld a six-year retroactive government action, but distinguished itself from *Carlton* because it was upholding a regulation, not a statutory change.[70]

Thus, many taxpayers would have a strong argument that a repeal of the Enterprise Zone Benefits is (1) a retroactive statute and (2) many taxpayers would be in a position to challenge that statute as impermissibly retroactive under *Carlton* because the period of retroactivity was immodest.

III. CONCLUSION

Governor Brown's proposal to repeal Enterprise Zone Tax Benefits is constitutionally invalid for two independent reasons. First, the proposed repeal would violate the Contracts Clause of the United States and California Constitutions because repeal constitutes a massive breach of the

---

[68] *City of Modesto v. National Med. Inc.*, 27 Cal. Rptr. 3d 215 (Ct. App. 2005)

[69] *Rivers v. State*, 490 S.E.2d 261 (S.C. 1997).

[70] *Tate & Lyle v. C.I.R.*, 87 F.3d 99 (3rd Cir. 1996).

state's contractual obligations to Localities and taxpayers. Second, the proposed repeal would deny taxpayers due process because this repeal would retroactively deprive them of their vested rights in a targeted scheme of "bait and switch taxation."

Based upon these legal conclusions, we are concerned that this portion of Governor Brown's budget proposal is utterly unreliable, for the constitutional infirmity of the proposed EZ Program repeal would expose the State of California to refund claims and other lawsuits that would eliminate the revenue benefit that officials have been anticipating from the repeal.

Above and beyond this exposure to lawsuits and the resulting nullification of anticipated benefits for this particular budget, we are concerned about the serious harm that EZ repeal could do to the State of California's ability in the future to attract businesses into the state with tax incentives. If the legislature decides to renege on its obligations under the EZ Program, this breach of the public trust likely would do serious damage to the credibility and effectiveness of future state efforts to use its tax code to encourage business development.

In sum: The proposed repeal of Enterprise Zone Benefits would be both unconstitutional and poor public policy.