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Supreme Court Agrees to Hear Interstate Row About Agency Liability for Aggressive Tax Collection Practices

The U.S. Supreme Court granted certiorari of a Nevada Supreme Court decision that imposed tort liability against the California Franchise Tax Board for the agency's action in conducting a tax audit. The eventual decision by the U.S. Supreme Court will give guidance on the scope of sovereign immunity individual states and their agencies enjoy in out-of-state litigation.

Background

At issue in the dispute is action the California Franchise Tax Board's (FTB) auditors took several decades ago during an audit of inventor Gilbert Hyatt. Hyatt is a prolific technology creator who over the years has patented numerous computer technologies and profited from licensing fees. In 1991, just days before he received several hundred million dollars under a microprocessor licensing agreement, Hyatt purportedly moved his residence from California to Nevada. On his 1991 California tax return, Hyatt claimed non-residency status and thus did not report the licensing income as taxable in California.

The FTB initiated an audit of Hyatt and later determined that he had not established a new domicile in Nevada until 1992, making him a California resident still subject to tax liability on his entire gross income for the 1991 tax year. In the course of the audit, the FTB allegedly sent hundreds of inquiry letters to Hyatt's business contacts (including banks, utilities, and media outlets) as well as patent licensees. The FTB also allegedly disclosed his social security number and personal address to third parties in violation of applicable privacy laws. In addition, Hyatt claimed that the FTB conducted interviews with his ex-wife and other family members who had hostile attitudes toward him, while the agency refused to take testimony from family members on good terms with him.

The FTB eventually issued a deficiency notice for $1.8 million, based on the unreported income, plus asserted an additional $2.6 million in penalties and interest.

Hyatt contested the deficiency notice and maintained he was not a resident of California following his move to Nevada in 1991. As a Nevada resident, he also sued the FTB in 1998 in Nevada courts, contending that the FTB had violated his rights during the course of its audit. Hyatt claimed the FTB's unwarranted scorched-earth tactics caused embarrassment, social exclusion, and missed business opportunities as the result of the negative inferences created by the audit. He sought damages for the agency's bad-faith conduct and intentional infliction of emotional distress.

In initial procedural litigation, the FTB claimed that as a state agency it was exempt from such lawsuits in out-of-state courts. But the U.S. Supreme Court determined that the Nevada Supreme Court had authority to consider the case.

Ultimately, the Nevada Supreme Court held in September 2014 that the FTB could be held liable for fraud and emotional distress. While a jury had awarded nearly $500 million to Hyatt, including $250 million in punitive damages, the Nevada Supreme Court reversed the punitive damage award under comity principles as Nevada state law barred such damages against state agencies. Instead, it only allowed $1 million in fraud damages and remanded the case back to the trial court for further consideration of the emotional distress claims.

Legal Issues At Stake

The precise legal issues to be considered by the U.S. Supreme Court in *California Franchise Tax Board v. Hyatt*, Docket No. 14-1175, are whether Nevada must extend to California the same legal immunities that Nevada itself enjoys in its court system, and whether states can be sued in other jurisdictions without consent. The U.S. Supreme Court declined to consider the FTB's challenge to whether the discretionary-function immunity rule applies to intentional torts and bad-faith conduct.

Although the Supreme Court has previously held that states can be sued in other state courts without their consent (*Nevada v. Hall*, 440 U.S. 410 (1979)), the FTB is arguing that rule should be overturned. The FTB is arguing that the ability of out-of-state residents to sue California without California receiving the same legal treatment that Nevada would encounter in its courts severely damages the concept of sovereign immunity and would force states to weaken enforcement of their laws.

Related Issues

Although not a direct issue in the Supreme Court case, this acrimonious litigation highlights the difficulty taxpayers may face in proving a change of residence. Many states, including California, have earned a reputation for aggressive enforcement programs aimed at pursuing individuals the state deems to be residents for income tax purposes. These states often will challenge a taxpayer's assertion of moving to a different state when the taxpayer retains any indicia of continued presence within the original residence state.

For example, many wealthy California residents often relocate to Nevada, Florida, Texas, and other jurisdictions both because of California's high income tax rates and because of the more favorable tax regimes elsewhere. But the FTB often asserts such individuals have not truly changed their residency and remain subject to California taxes, and often argues that continued ownership of real property, vehicles, intangible property, or time spent within the state creates lingering income tax nexus. Greenberg Traurig professionals have been successful in numerous instances in helping taxpayers carefully plan changes in residency that have withstood audit scrutiny.

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