Exit taxes in California? Not so fast.

Overview

In the past two years members of California's Assembly twice tried to advance tax bills (AB 2088 and AB 310) that were designed to capture revenue from wealthy residents who fled the state to avoid the other income tax increases in those bills.[1] Both would have imposed a tax (levied annually for 10 years) on a California resident who leaves the state. This article argues that such an exit tax has grave legal defects that should prevent a state from imposing a wealth-based exit tax on its former residents.

Analysis

The two bills employed distinct approaches to capturing revenue from wealthy taxpayers who flee a state to escape its income taxes. AB 2088 would have imposed a new 0.4% tax on net worth in excess of $30 million, and purported to tax anyone in that bracket who fled the state for ten years after they moved away.[2] AB 310 would have imposed an annual tax of 1% on assets over $50 million and another 0.5% on assets over $1 billion.[3] It also would purport to tax California residents who move out of the state, for three years.[4]

Both bills have stalled in the state legislature. In case this issue recurs, this article assesses their legal merits and concludes that courts likely will invalidate similar exit tax schemes for departing Californians.

1. The exit tax does not violate California's takings clause

An exit tax might pass muster under the California constitution because it does not rise to the level of a taking by the state government. California's takings clause provides: "Private property may be taken or damaged for a public use and only when just compensation, ascertained by a jury unless waived, has first been paid to, or into court for, the owner."[5] The California Supreme Court has held that the Takings Clause in the California Constitution should be construed "congruently" with the

federal Takings Clause.[6] The high court has also held that the primary purpose of the Takings Clause "is to ensure that individual property owners are not compelled to bear burdens or incur costs that, in fairness and justice, should be borne by the public at large."[7] A tax of 100% on Mark Zuckerberg's income would clearly violate this purpose, but there is no clear threshold over which a tax becomes a taking. The California Supreme Court has held that various factors are taken into consideration when evaluating a taking, but "the determining factor, as we have seen, is fairness."[8] As in the U.S. Supreme Court, the California Supreme Court has only struck down cases with an obvious discriminatory impact: "an arbitrarily conceived exaction will be nullified as a disguised attempt to take private property for public use without resort to eminent domain or as a mask for discriminatory taxation."[9] Therefore, the California Supreme Court will likely evaluate an exit tax through the lens of "fairness."

An exit tax does not cause a disproportionate impact, as defined by the U.S. and California high courts. The revenue from an exit tax benefits the public, including those paying the tax. It targets a class of households (those worth over a certain amount), not an individual household. California's progressive tax system has passed muster in the courts even though it takes more from higher income-earners.[10] Although the narrow classification of the exit tax may only affect a few individuals, the exit tax also achieves fairness by assuring that the households included in the broader wealth tax do not avoid payment. And rates of 0.4% on $30 million plus, or 1% on $50 million plus, are below the range of ordinary marginal tax rates in other contexts.[11] Due to the low rates and overall benefits, the determining factor of "fairness" would uphold the exit tax in the California Supreme Court.

2. The exit tax violates the right to travel

The proposed exit taxes violate the right to travel because they burden citizens attempting to leave the state and continue to punish them long after moving. Travel restrictions are typically evaluated with an equal protection analysis.[12] The constitutional right to travel, including intrastate travel, has been recognized by

California courts.[13] An exit tax like these two proposals probably fails a California equal protection analysis. California only recognizes two levels of equal protection scrutiny (strict scrutiny and rational basis) and an exit tax is likely to receive strict scrutiny.[14]

A California court is likely to apply strict scrutiny because the exit tax infringes upon a fundamental right. That analysis requires the challenged law to be both justified by a "*compelling* interest" and "*necessary* to further its purpose."[15] The exit tax targets households above a certain income level, so it discriminates against citizens on the basis of wealth, which can be a suspect classification when a fundamental right is implicated.[16] Interstate travel is one such fundamental right.[17] The legislation "direct[ly] impair[s] . . . the right to move between the states, that is, the right to go from one place to another, including the right to cross state borders while en route" and so must be evaluated under strict scrutiny.[18] Because the exit tax only applies to persons above a certain income threshold when attempting to exercise their right to travel, it implicates a fundamental right and discriminates based on a suspect class.

The only way to justify such discrimination is with a "compelling interest" for enacting a "narrowly tailored" law.[19] California may argue that the tax addresses economic inequality and that the government has a compelling interest collecting revenue on a wealth-adjusted basis. It can argue that fairness requires linking tax rates to ability so that those who can pay more should do so. Given that the U.S. Supreme and California Supreme Court have allowed a progressive tax system, it is likely that the courts will find the exit tax serves a compelling government interest.

California will struggle to show that its wealth exit tax is narrowly tailored to achieving its purpose to close the wealth gap fairly. Narrowly tailored is defined as "the least restrictive means" to accomplish the government's goal.[20] California can implement other measures to address the wealth gap without violating the right to travel, such as a state earned-income tax credit or higher personal income taxes for families at the top of the tax bracket; neither infringe on the right to travel.

An exit tax likely will fail strict scrutiny because it burdens the right to travel. The tax is not justified by a narrowly tailored government purpose. Thus, an exit tax should be invalidated under California's equal protection analysis.

3. The exit tax violates the federal Commerce and Due Process clauses

a. The federal Commerce Clause problem

The exit tax probably violates the federal constitution's Commerce Clause, which grants Congress power "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."[21] In *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, the Supreme Court ruled that a tax on interstate commerce will be sustained "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[22] The fact that an exit tax requires valuing net worth weighs in the first element, which requires a substantial nexus as the minimum presence a taxpayer or company must have with a state to be subject to their tax system. To be taxed, an activity must have a substantial nexus with the taxing state, and the taxpayer must "'avail[] itself of the substantial privilege of carrying on business' in that jurisdiction."[23] This is a flexible inquiry that focuses on the taxpayer's activity in the state.[24]

Many wealthy individuals have substantial equity holdings held by proxy, so to capture a true net worth valuation an exit tax must cover "property held indirectly, as through a corporation, partnership, limited liability company" or trust.[25] Intangible property like stocks and bonds are financial assets with no real physical presence — unlike a house, they lack a situs. This means that when an ex-Californian sells an asset outside of California to a non-Californian, California is attempting to tax a transaction between a seller from a one state and a buyer from another state, neither of which has a nexus to California, and where the thing purchased and the purchase funds also have no contact with California. This violates the nexus requirement because California is unconnected with the seller, the buyer, and the transaction.

The exit tax fails the rule of multiple taxation, which provides that "a state may not exact from interstate commerce more than the state's fair share."[26] The test is that "a tax must be structured so that if every state were to impose an identical tax, no multiple taxation would result."[27] A California exit tax that runs for years after the resident moves away includes enough time for the resident to move again. A person could potentially pay an exit tax on their wealth in multiple states each year. Such a trailing exit tax would cause people to pay triple taxes if they sold and realized their gains: paying California's trailing exit tax, a capital gains tax in their new home state, and a federal tax. Thus, imposing a trailing exit tax would violate the fair apportionment requirement.

The exit tax fails the third element because it discriminates against interstate commerce. Discriminatory is defined as a tax that imposes "greater burdens on out-of-state goods or activities than on competing in-state goods or activities."[28] A state "may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."[29] A tax is not discriminatory if it is exacted before interstate movement begins or after it has ended.[30] Here, the tax occurs on the interstate movement itself. A California exit tax is discriminatory because it is only triggered on residents as they attempt to leave the state, whereas in-state residents may never trigger the tax.

Even if a tax is held as non-discriminatory, courts will employ a balancing test to determine whether the benefits of the tax outweigh the harm caused by the tax.[31] This balancing test relies heavily on the next factor: the benefit relationship requirement. There is no formula for a benefit relationship and courts have held a tax meets the element because the person being taxed has a "sufficient nexus" with the state and so has "enjoyed the opportunities and protections that the state has afforded it."[32]

Because an exit tax violates two key principles of tax policy, it likely fails the benefit relationship test.[33] Those two principles are equity and fairness, and effective tax administration. Fairness and equity are achieved when similarly situated taxpayers

are taxed so that everyone pays their fair share of taxes.[34] According to the U.S. Government Accountability Office: "when making judgments about the overall equity of government policy, it is important to consider both how individuals are taxed and how the benefits of government spending are distributed."[35] California could argue that the exit provision is a necessary component designed to ensure vertical equity, which means that wealthier taxpayers should pay at least the same proportion of income in taxes as those who are less wealthy.[36] While California has a tiered income tax rate, the linear rates do not satisfy vertical equity. If the base rate is 10% and the max rate is 25%, then a person earning $50,000 at 10% only nets $40,000, while a $100 million earner nets $75 million. It's way easier to live on $75 million than $40,000. Due to this, the current income tax system does not satisfy vertical equity so the proposed tax may be a necessary addition. This addition would better satisfy the principals of fairness and fairness.

But an exit tax will violate the other key component: "how the benefits of government spending are distributed."[37] Wealthy residents who leave the state will not partake at all in the benefits of government spending. The tax cannot be construed as the ultra-wealthy's fair share when the taxpayer no longer shares in the enjoyment of the state or the benefits of the government.

The next principle of good tax policy is effective tax administration, which favors minimizing collection costs for both the government and taxpayers.[38] Under both AB 2088 and AB 310, the California Franchise Tax Board would adopt regulations to value publicly traded assets, interests in business entities, interests in trusts, and debts and liabilities.[39] Taxpayers entering the state would need to calculate their current net worth before they move so they could accurately calculate how much their net worth increases during the time they live in California. The new tax administration would be complex, costly — and potentially ineffective.[40]

The exit tax fails to meet the benefit relationship requirement, and so the tax should fail the balancing test. Because the exited taxpayer no longer lives in California nor does business there, they receive no benefits from residing in the state and will not partake in the public goods or services provided by the revenue of the taxes.

Because the tax fails the balancing test under *Complete* Auto *Transit*, a court likely would invalidate the tax under the Commerce Clause.

b. The due process problem

In the tax context the federal constitution's Due Process Clause is a jurisdictional limitation on a state's power to tax.[41] A California exit tax would violate this boundary for several reasons: the person no longer receives the benefits of the state when leaving its borders, nor conducts enough business or economic activity to tie them to the state. The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[42] Apportionment is a requirement of the Due Process Clause because a "state may not exact from interstate commerce more than the state's fair share."[43] This idea of fair share complements the Commerce Clause's benefit relationship discussed above.[44]

Most recently, the U.S. Supreme Court denied hearing a case between the states of California and Arizona.[45] The issue regards California's taxation of nonresident members of California LLCs and nonresident shareholders of California corporations. Arizona argued that the tax violates the Due Process Clause because the cross-border investment is passive, so there are insufficient minimum contacts between a nonresident and the in-state business to support California's jurisdiction to tax.[46] While the Court did not lay down a decision on the case, Arizona posed strong arguments on the merits of an exit tax violating the Due Process Clause. In that tax, the shareholders and the members are involved in a California company but live in Arizona. Here, the taxpayers' investments, even passive ones, may not have any connection to California. So, the exit tax has insufficient "minimum contacts" with California.

As in the Commerce Clause analysis, after moving a taxpayer likely would lack the requisite minimum contacts with the state to be taxed. The principle that movable property follows the person applies to the intangible personal property that an exit tax would target.[47] That principle would prevent California from arguing that the

taxpayer's assets derived economic benefit from the state. Thus, California's attempt to tax wealth after a taxpayer has moved likely will violate the federal Due Process Clause.

4. The better solution is to tax those who change their state residence

There is a better path to capturing additional tax revenue here. There are two times that a resident can be required to value their unrealized gains before the asset is actually sold: expatriation and death. The United States has an exit tax for taxpayers who renounce their citizenship; they are subject to an immediate tax on a deemed sale of all worldwide assets on the day immediately before the date of expatriation.[48] Net capital gains are included as income, so the expatriate is forced to recognize the gains from the asset and pay a tax on them.[49] The estate tax, which is levied on an estate when a person dies, is another triggering event that forces a non-sale asset valuation.[50] The same policy reasons and legal framework that underlie the expatriate and estate taxes can apply here.

California could craft an exit tax that similarly invokes a triggering event and captures a person's nexus with the state: it could enact a one-time "exit tax" on persons over a certain net worth who move out of the state. The key with both the expatriate and estate taxes is that the taxpayer had a substantial nexus with the taxing entity and availed itself of the substantial privilege of carrying on in the state immediately prior to the tax. A Fleeing Taxpayer Exit Tax (FTET) would address the problems discussed above by incorporating elements from the estate and expatriate tax framework.

The FTET will have a sufficient connection between the taxpayer and California because the person and their economic activity was all in California, and the tax is imposed in California while the taxpayer is still a California resident. Under the Fleeing Taxpayer Exit Tax, the tax occurs before the person transfers states just as the estate tax is on the transfer of wealth between generations. The nexus is no longer between California and a person living in another state but on a California resident taxpayer.

The FTET is fairly apportioned because it taxes the appreciation of the assets. This

could potentially be difficult if the asset was acquired before moving into the state. People moving into the state would need to have their assets valued upon entry, so the state could then calculate the net gains if they eventually leave. While this would be burdensome, the incoming resident would save money in the long-term by only paying taxes on the appreciation in California, rather than on the whole asset. Every state could implement it because the taxation is only on the gain of assets while the person was domiciled in the state, and a person can only have one true domicile.[51] Because a person only has one domicile and only pays the tax when changing domiciles, a person would not face double taxation because they cannot move from two different states at the same time and can only have one domicile at a time.

The FTET is not discriminatory because it treats California and out-of-state taxpayers the same. A person will not avoid the tax simply because they move out of the state. The wealth that was accumulated in the state will be taxed and attributed to the state despite what other state it was sold in. Even taxpayers who benefited economically from their time in California would be treated equally if they move to a lower-tax state.

Finally, FTET meets the benefit relationship requirement. A person's departure from California is a triggering event that occurs while the taxpayer's economic activity is still tied to California. Thus, the tax is only associated with the time the person actually spent in the state. During that time, the person received the benefits of government programs, public infrastructure, and other services from the state. This satisfies the benefit relationship.

The FTET will survive an equal protection challenge. The tax burdens persons leaving the state and entering the state because they now need to value their assets beforehand as their basis. While the valuation may be an administrative burden, it would be difficult to argue that it places a substantial burden on the fundamental right to travel given that assets commonly must be valued before being sold. Because it is only an incidental burden, the tax should be subject to rational basis review, rather than strict scrutiny. To pass the rational basis test, the statute or ordinance must have a legitimate state interest, and there must be a rational connection between the statute's/ordinance's means and goals. California has a legitimate interest in its residents' asset appreciation. The tax affects only economic

activity sustained in the state. And the FTET is rationally connected between the state and its goals because it targets the increase of the assets only while a resident lives in the state. The result is that the FTET avoids the flaws in the two previous exit tax proposals.

Conclusion

Two previous California attempts at an exit tax shared fatal constitutional defects. Because both affected former residents, they lacked a substantial nexus or minimum contacts between the taxpayer and the tax enacted. Both were vulnerable to an equal protection challenge, and both burdened a person's right to travel.

Yet California could pass a one-time exit tax similar to the U.S. expatriation tax or an estate tax. A person's decision to move would be a triggering act for the state to value their net worth before departure, which is a tax on economic activity in the state. That should survive judicial scrutiny, and it would capture the ultra-wealthy who soak up the California sun and run before paying their share.

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Chloe Amarilla is a research fellow at the California Constitution Center.

1. Assem. Bill No. 2088 (2019–2020 Reg. Sess.); Assem. Bill No. 310 (2021–2022 Reg. Sess.); *See also* Bishop-Henchman, *California Wealth and Exit Tax Would Be an Unconstitutional Disaster*, National Taxpayers Union Foundation (Aug. 27, 2020) (quoting Rob Bonta that "all California must step up and contribute their fair share"). ↑

2. Assem. Bill No. 2088 (2019–2020 Reg. Sess.). ↑

3. Assem. Bill No. 310 (2021–2022 Reg. Sess.). ↑

4. Galle, Gamage, Saez & Shanske, *The California Tax on Extreme Wealth (ACA 8 & AB 310): Revenue, Economic, and Constitutional Analysis*, (Mar. 23, 2021) Indiana Legal Studies Research Paper No. 461. ↑

5. Cal. Const., art. I, § 19. ↑

6. *Bottini v. City of San Diego* (2018) at 311; *see also San Remo Hotel, L.P. v. San Francisco* (2002) 41 P.3d 87, 100–01 (noting that the California Supreme Court has construed the Fifth Amendment and the California takings clause congruently). ↑

7. *Penn Cent. Transp. Co. v. City of New York* (1978) 438 U.S. 104, 127; *Williams v. Moulton Niguel Water Dist.* (2018) 22 Cal.App.5th 1198, 1210. ↑

8. *Liberty v. California Coastal Com.* (1980) at 503. ↑

9. *Ibid.* ↑

10. *Beamer v. Franchise Tax Board* (1977) 19 Cal.3d 467; *See Bolens v. Frear* (Wis. 1912) 134 N.W. 673, 689–90 (holding that a progressive income tax was not so confiscatory as to violate basic principles of justice and equality); *see generally* Kades, *Drawing the Line Between Taxes and Takings: The Continuous Burdens Principle, and its Broader Application* (2002) 97 Northwestern U. L.Rev. 189. ↑

11. York, Erica, *Income Taxes on the Top 0.1 Percent Weren't Much Higher in the 1950s* (Jan. 31, 2019) Tax Foundation; Galle, Gamage, Saez & Shanske, *The California Tax on Extreme Wealth (ACA 8 & AB 310): Revenue, Economic, and Constitutional Analysis*, (Mar. 23, 2021) Indiana Legal Studies Research Paper No. 461. ↑

12. *See* Duane W. Schroeder, *The Right to Travel: In Search of a Constitutional Source* (1976) 55 Neb. L.Rev. 117, 122. ↑

13. *In re Taylor* (2012) at 229 (citing *In re King* (1970) at 234–235; *In re White* (1979) at 148). ↑

14. *See Craig v. Boren* (1979) 429 U.S. 190, 197; *see also Hardy v. Strumpf* (1978) 21 Cal. 3d 1, 7. ↑

15. *See Westbrook v. Mihaly* (1970) at 785; *see generally* California Constitution Center, *The Proposed Palo Alto Wealth Tax Has Many Defects*, SCOCAblog (July 24, 2020) (analyzing a proposed 40% one-time tax on those leaving Palo

Alto). ↑

16. *See Serrano v Priest* (1976) at 766. ↑
17. *See generally Crandall v. State of Nevada* (1867) 73 U.S. 35. ↑
18. *Chavez v. Illinois State Police* (2001) at 649. ↑
19. *Westbrook v. Mihaly* (1970) 2 Cal. 3d 765, 785, vacated on other grounds by 403 U.S. 915 (1971); Carrillo & Chou, California Constitutional Law (2021) at 574. ↑
20. *People v. Martinez* (2020) 59 Cal.App.5th 280. ↑
21. U.S. Const., art. I, § 8, cl. 3. ↑
22. *Complete Auto Transit, Inc. v. Brady* (1977) at 279. ↑
23. *Polar Tankers, Inc. v. City of Valdez* (2009) at 2284. ↑
24. *See generally South Dakota v. Wayfair, Inc.* (2018) 138 U.S. 2080. ↑
25. Brotman, *An Update on California's Proposals to Tax the Rich*, Brotman Law (Jan. 8, 2021). ↑
26. *See* Allied-Signal, Inc. v. Dir., Div. of Taxation (1992) 504 U.S. 768. ↑
27. *See* Cong. Rsch. Serv., *State Taxation and the Dormant Commerce Clause*, Constitution Annotated (last visited Mar. 11, 2022). ↑
28. Cong. Rsch. Serv., *State Taxation and the Dormant Commerce Clause*, Constitution Annotated (last visited Mar. 11, 2022). ↑
29. *Armco Inc. v. Hardesty* (1984) at 642. ↑
30. Cong. Rsch. Serv., *State Taxation and the Dormant Commerce Clause*, Constitution Annotated (last visited Mar. 11, 2022). ↑
31. *United Haulers Assn., Inc. v Oneida-Herkimer Solid Waste Management*

*Authority (*2007) at 1797. ↑

32. Cong. Rsch. Serv., *State Taxation and the Dormant Commerce Clause*, Constitution Annotated (last visited Mar. 11, 2022). ↑

33. In 2017, the Tax Division of the American Institute of Certified Public Accountants (AICPA) updated their Tax Policy Concept Statements which lists 12 guiding principles of good tax policy, two of which are essentially ignored in California's tax proposition. *See generally* AICPA, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2017). ↑

34. *See* Fiore, *Guiding Principles of Good Tax Policy*, Journal of Accountancy (Jan. 31, 2002). ↑

35. AICPA, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2017) at 4. ↑

36. *Id.* at 7. ↑

37. *Id.* at 4. ↑

38. *Id.* at 8. ↑

39. Assem. Bill No. 2088 (2019–2020 Reg. Sess.); Assem. Bill No. 310 (2021–2022 Reg. Sess.). ↑

40. Edwards, *Taxing Wealth and Capital Income*, Cato Institute (Aug. 1, 2019). ↑

41. "No state shall . . . deprive any person of life, liberty, or property, without due process of law . . . ." U.S. Const., 14th Amend. *See* Cong. Rsch. Serv., *Due Process and Taxation: Doctrine and Practice*, Constitution Annotated (last visited Mar. 11, 2022). ↑

42. See *Miller Brothers Co. v. Maryland* (1954) at 344–45. ↑

43. Cong. Rsch. Serv., *State Taxation and the Dormant Commerce Clause*, Constitution Annotated (last visited Mar. 11, 2022). ↑

44. *See New York ex. rel. Cohn v. Graves* (1937) at 313. ↑

45. Bagchi*, Supreme Court Won't Hear Arizona Challenge to California Tax (1)*, Bloomberg Tax (Feb. 24, 2020). ↑

46. *Ibid.* ↑

47. *See* Cong. Rsch. Serv., *Due Process and Taxation: Doctrine and Practice*, Constitution Annotated (last visited Mar. 11, 2022). ↑

48. 26 U.S. Code § 877. ↑

49. *Id.* ↑

50. IRS, *Estate Tax* (last updated Nov. 15, 2021). ↑

51. *Noble v. Franchise Tax Bd.* (2004) at 570. ↑