# SALT Block

## U.S. Supreme Court SALT Decisions on the Horizon

*By Blaise Sonnier*

Issues of state taxation are rarely heard by the U.S. Supreme Court. However, during this past summer the Court granted writs in three state tax cases generating lots of excitement and chatter among SALT practitioners. Two cases present squarely the issue of state sovereignty in state tax administration and policy. The third requires the Court to determine whether a sales and use tax on diesel fuel sold to rail carriers is discriminatory under the federal Railroad Revitalization and Regulatory Reform Act of 1976. The Supreme Court's decision in each case will have serious implications for the states.

## *Treasury vs. Wynne*: Resident Income Tax Credit

In *Treasury vs. Wynne,*[1] the Supreme Court will decide whether the dormant Commerce Clause of the U.S. Constitution requires a state to grant an income tax credit to its residents for income taxes paid on out-of-state income to the state where the income was earned. The taxpayers in *Wynne,* residents of the state of Maryland, are shareholders in an S corporation that files state income tax returns in 39 states. Maryland law imposes both a state and county income tax and provides a credit against the state income tax for similar taxes paid to other states on out-of-state income. However, no credit is given against the Maryland county tax for similar local income taxes paid to other tax jurisdictions. The taxpayers in *Wynne* argue that failure to credit the Maryland county tax for similar taxes paid to states where the income is generated discriminates against interstate commerce in violation of the Commerce Clause of the United States Constitution.

The Maryland Court of Appeals, the state of Maryland's highest court, sided with the taxpayers in *Wynne* on the basis that the failure to grant a credit against the Maryland county tax for payment of similar out-of-state income taxes can result in significantly different treatment for a Maryland resident taxpayer that earns a substantial portion of its income from out-of-state activities as compared to one who earns its income entirely within the state of Maryland. The Court concluded that this creates a disincentive for Maryland taxpayers to engage in income-generating activities in other states thereby affecting the interstate market for capital and business investment. By the state of Maryland failing to grant a credit for income taxes paid to other states against their county income taxes, the Court concluded that the Wynnes paid a higher overall state income tax on



**BLAISE SONNIER** is the Wilcox Professor of Accounting, an Associate Professor of Tax Accounting, and the Department Chair of Accounting and Finance at the University of Colorado Colorado Springs. He is also Of Counsel with the law firm of Allen & Gooch with offices in Lafayette and New Orleans, Louisiana.

  

their income than Maryland residents whose sole source of income was from within the state of Maryland. The Court reasoned that the failure to credit the Maryland county tax by the local tax paid to the jurisdiction where the income was earned was the equivalent of the imposition of an additional tax on the out-of-state income. Therefore, the Court held that the failure to grant the credit resulted in discrimination against residents with income from outside of the state of Maryland in violation of the dormant Commerce Clause.

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The Maryland Court of Appeals ruling in *Wynne* has severe implications for the states if not overturned by the U.S. Supreme Court. If affirmed by the Supreme Court, the ruling would require states as a matter of constitutional law to grant an income tax credit to their residents for state and local income taxes paid on out-of-state income to the taxing jurisdiction where the income was earned. The Maryland Court of Appeals' decision in *Wynne* creates two consequences that appear to be inconsistent with the intent of the framers of the U.S. Constitution. First, the ability of a state to impose an income tax on the out-of-state income of its residents would be dependent on the tax laws of the state where the income was earned. For example, a state with a five-percent income tax would collect no income tax on the income of a resident who earns all of her income from a state with a state income tax rate of five percent or higher. In essence, a state's sovereign authority to impose a state income tax on its residents that generate all or substantially all of their income in another state would be dependent on the state income tax law and tax rate of the state where the income was earned. A state's fiscal position could be adversely impacted by the state legislature in another state increasing its income tax rates. Second, a state's income tax under this regime would discriminate against residents whose sole source of income is from within their state of residency. Residents with in-state income only would bear a disproportionate share of the cost of providing local services as compared to a resident whose income is generated primarily outside of the state. In fact, the state may need to increase tax rates on these residents to make up for the loss of income required by tax credits for residents with out-of-state income.

Ample support exists for the reversal of *Wynne* by the U.S. Supreme Court. It is well settled law that a jurisdiction may tax all the income of its residents, even income earned in another taxing jurisdiction. The privilege of residence in a state comes with the obligation to pay state income taxes (if imposed by the state) on all of the income earned by the resident regardless of the source of the income. At the same time, residents have the power of the vote to guard against an abusive tax system. On the other hand, the dormant Commerce Clause is intended to protect nonresidents that conduct business in a state against protectionist local measures that discriminate against interstate commerce in favor of local businesses. In those situations, the dormant Commerce Clause is necessary because the nonresidents do not have the power of the vote to influence their legislators. It is also nearly irresistible for politicians to impose tax burdens on out-of-towners that are nonvoters when possible rather than their own constituents. As the late Senator Russell Long (D-La.) was fond of saying, "don't tax me, don't tax you, tax the man behind the tree." Given these considerations, and the Supreme Court's decision to grant writs in *Wynne* at the urging of the U.S. Solicitor General, the odds would appear to favor reversal of the Maryland Court of Appeals' decision.

## *Direct Marketing Association vs. Brohl:* Scope of Tax Injunction Act

In *Direct Marketing Association vs. Brohl*,[2] the Supreme Court will address whether the Tax Injunction Act[3] divests federal courts of jurisdiction in the Direct Marketing Association's (DMA) challenge to Colorado's sales and use tax reporting statute. In *Quill Corp. v. North Dakota*,[4] the Supreme Court held that the dormant Commerce Clause prohibits a state from requiring retailers without a physical presence there to collect the state's sale or use taxes. Therefore, when the resident of a state purchases an item from a remote retailer the state is dependent on the purchaser to self-report the purchase and pay the state use tax. A 2010 report by the state of Colorado estimated that Colorado's state and local governments would lose $172.7 million of sales tax in 2012 because of the failure of its residents to pay use tax on purchases from out-of-state-retailers.

To combat the loss of revenue caused by growing Internet sales and the *Quill* rule, the Colorado legislature enacted legislation in 2010 that imposed an obligation on out-of-state retailers with annual gross sales in Colorado in excess of $100,000 (1) to provide notices to Colorado purchasers at the time of the sale of their obligation to pay use tax on the purchase; (2) to send annual purchase summaries to Colorado residents of their purchases during the year; and (3) to report to the Colorado Department of Revenue sales to Colorado residents on an annual basis. The DMA filed suit in federal district court challenging Colorado's notice and reporting regime as unconstitutional under the dormant Commerce Clause arguing that it discriminates against and imposes an undue burden on interstate commerce.

On appeal from a federal district court ruling granting a permanent injunction against the state of Colorado prohibiting enforcement of its notice and reporting regime as being in violation of the dormant Commerce Clause, the 10th U.S. Circuit Court of Appeals dismissed the suit holding that the federal Tax Injunction Act (TIA) divested the federal district court of jurisdiction in the case. The TIA provides that "district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." The 10th Circuit ruled that the broad language of the TIA prohibits federal courts from interfering with state tax administration. In its petition for a writ of certiorari to the U.S. Supreme Court, the DMA argued (1) that the TIA does not apply to a suit challenging Colorado's notice and reporting regime since it does not impose a tax on remote retailers or require them to collect a tax, and (2) that the doctrine of comity does not apply to an action challenging Colorado's notice and reporting regime.

The original version of the TIA was enacted by Congress in 1867. As far back as 1871, the U.S. Supreme Court expressed reluctance to interfere with the administration of state tax systems. In *Dow v. City of Chicago*,[5] the Supreme Court observed:

> It is upon taxation that the several States chiefly rely to obtain the means to carry on their respective governments, and it is of the utmost importance to all of them that the *modes adopted to enforce the taxes levied* should be interfered with as little as possible. (Emphasis added.)

The first issue before the Supreme Court in *Direct Marketing Association vs. Brohl* is whether the TIA prohibits the exercise of jurisdiction by a federal district court in a challenge to Colorado's notice and reporting statute. A narrow construction of the TIA should result in a ruling in favor of the DMA upholding the exercise of jurisdiction because the Colorado statute does not technically involve "the assessment, levy or collection of any tax." It simply imposes reporting requirements on remote retailers; the payment of the tax remains the obligation of the residents of Colorado that purchase products from remote retailers. However, as a general rule, statutes granting jurisdiction to federal courts are narrowly construed. Because the TIA is a curtailment of jurisdiction instead of a grant of jurisdiction, it would seem logical that the Supreme Court may opt for a broad construction of the statute. The Supreme Court may uphold the ruling of the U.S. 10th Circuit Court of Appeals given that the Colorado statute is intended or designed to aid in the collection of the tax on remote sales to Colorado residents by promoting reporting and payment of the use tax on purchases. However, one can certainly make the argument that even a broad construction of the statute would require an acrobatic leap of statutory construction for Colorado's notice and reporting statute to be construed as involving "the assessment, levy or collection" of a tax.

The second issue in *Direct Marketing Association vs. Brohl* is whether principles of comity require the federal courts to refrain from exercising jurisdiction in the case. Comity refers to the doctrine where federal courts refrain from hearing cases involving state government administrative issues given the U.S. Constitution's federalism framework where the federal government and governments of the states co-exist with each having its respective spheres of authority. Out of respect for state sovereignty, federal courts generally refrain from hearing cases that involve the state's administration of its own affairs. Nothing is as central to a state's affairs as the power to tax and to enforce its tax laws.

As recently as 2010, the U.S. Supreme Court stated in *Levin vs. Commerce Energy, Inc.*[6] that the comity doctrine "is more embracive than the TIA" and "restrains federal courts from entertaining claims for relief that risk disrupting state tax administration." Based on principles of comity, a strong argument exists supporting the U.S. 10th Circuit's decision dismissing *Direct Marketing Association vs. Brohl.* Since writs were granted in the case, one must assume that the Supreme Court justices feel that it is important to delineate the scope of the TIA and the comity doctrine as it applies to the administration of a state's tax system when faced with a challenge arising under the U.S. Constitution.

As an aside, after DMA's federal lawsuit was dismissed it was refiled in Colorado state court. Proponents of the argument that our federalism framework works can undoubtedly point to the fact that DMA has exercised its right to challenge Colorado's notice and reporting regime as being in violation of the U.S. Constitution in Colorado state court. After working its way through the state court system, either the state of Colorado or the DMA can apply for writs to the U.S. Supreme Court if it disagrees with the state appellate court's ruling on the issue of U.S. constitutional law. Whether the case works its way through the federal or state court system, the ultimate plea for relief can be made for writs to the U.S. Supreme Court to resolve the question of U.S. constitutional law on the merits. What is likely driving DMA's desire to be in federal court is the small percentage of cases in which writs are granted by the Supreme Court. In the event that the Supreme Court ultimately declines writs on the merits of the case, the DMA appears to prefer that the last court to hear the case be the U.S. 10th Circuit Court of Appeals rather than the Colorado Supreme Court.

## *CSX Transportation vs. Dept. of Revenue:* A Question of Statutory Interpretation

*CSX Transportation vs. Dept. of Revenue*[7] involves the proper standards to apply under the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act) in determining whether a tax discriminates against a rail carrier. In general, the 4-R Act prohibits a state from imposing a tax that discriminates against a rail carrier. The state of Alabama imposes a four-percent sales tax on diesel fuel used off-road—for instance in farm equipment and trains. The purchasers of diesel fuel used on-road, such as in automobiles and tractor trailer rigs, bear a fuel excise tax of 19¢ per gallon. CSX Transportation, a rail carrier, pays the four-percent sales tax on diesel it purchases for use in its trains, but does not pay the 19¢ per gallon excise tax on such diesel fuel. Likewise, motor carriers or truckers pay the 19¢ per gallon excise tax but do not pay the four-percent sales tax on diesel.

CSX Transportation challenges the imposition of the four-percent sales tax as discriminating against rail carriers under the 4-R Act. CSX's position is based on the fact that motor carriers do not pay the four-percent sales tax. After a trial on the merits, the district court concluded that the four-percent sales tax did not discriminate against CSX since motor carriers (its competitors) pay essentially the same amount in fuel excise taxes. The U.S. Court of Appeals for the 11th Circuit reversed holding that the only question was whether the sales tax discriminated against railroads and that it was not appropriate for the district court to examine the sales tax for fairness against the entire tax structure of the state. In the 11th Circuit's opinion, the payment of a roughly equivalent amount of tax by motor carriers was not relevant to the determination of whether the four-percent sales tax was discriminatory against rail carriers.

The issues presented in *CSX Transportation vs. Dept. of Revenue* are relatively narrow in scope and apply to relatively few taxpayers. The first issue on appeal is whether the comparison for determining whether discrimination exists against rail carriers should be its competitors (*i.e.,* other transportation companies) or other "commercial and industrial taxpayers." This is based on language in the 4-R Act prohibiting discrimination in the valuation of railroad property in comparison to commercial and industrial property. The second issue is whether courts should consider the entire state's tax regime when determining whether there has been discrimination against rail carriers under the 4-R Act or just the particular tax being challenged.

## Conclusion

The SALT cases on the U.S. Supreme Court's docket next term have created much buzz among those with an interest in state and local tax issues. Of particular interest will be the decisions in *Wynne* and *Direct Marketing Association* which will necessarily involve issues of state sovereignty and the right of states to establish their own tax policy and administer their tax system without federal interference. Regardless of how the Court rules in the SALT cases on the docket in the upcoming term, the decisions will certainly have a long-lasting impact.

### ENDNOTES

1 *Maryland State Comptroller of the Treasury v. Wynne*, 431 Md. 147 (Md. 2013), *cert granted*, SCt, 134 SCt 2660 (2014).
2 *Direct Marketing Association vs. Brohl,* CA-10, 735 F3d 904 (2014), *cert granted,* SCt, 134 SCt 2901 (2014).
3 28 U.S.C. §1341.
4 *Quill Corp. v. North Dakota,* SCt, 504 US 298 (1992).
5 *Dow v. City of Chicago*, SCt, 78 US 108 (1871), 11 Wall. 108, 110 (1871).
6 *Levin vs. Commerce Energy, Inc.,* SCt, 560 US 413, 424 (2010).
7 *CSX Transportation vs. Dept. of Revenue*, CA-11, 720 F3d 863 (2013), *cert. granted*, SCt, 134 SCt 2900 (2014).