US Supreme Court state tax case update

By Mark A. Loyd, Esq., CPA

2015 has been a big year for United States Supreme Court state tax cases. It has not been since the early 1990s that the Supreme Court took up so many tax cases.

Supreme Court State tax cases of 1992

1992 was a high point for Supreme Court cases concerning state taxes. Four landmark cases were decided. In *Quill v. North Dakota*, the Supreme Court upheld *National Bellas Hess's* physical presence nexus requirement for sales tax under the Commerce Clause, but overturned it to the extent that it was based on the Due Process Clause which had previously prohibited Congress from overriding the physical nexus requirement via legislation. In *Allied Signal v. New Jersey*, the Court held that the Commerce Clause forbade New Jersey from taxing a non-unitary gain on a sale of stock by including it in a taxpayer's apportionable income tax base. In *Kraft v. Iowa*, the Court held that a statute that taxed dividends received from foreign subsidiaries but not dividends received from U.S. domestic subsidiaries discriminated against foreign commerce. And, in *Wrigley v. Wisconsin*, the Court interpreted PL 86-272 which prohibits states from imposing income tax on an out-of-state company which limits its activities in a taxing state to solicitation of orders to be fulfilled from outside of the state. Obviously, these are high-level summaries of the holdings. The devil is in the details of each.

Supreme Court State tax cases of 2015

In 2015, the Supreme Court issued opinions in three cases: *Alabama Dept. of Revenue v. CSX Transportation, Inc.* (property tax); *Direct Marketing Association v. Brohl* (sales tax); and, *Maryland v. Wynne* (income tax). Coincidentally, each of these cases has something in common with a 1992 decision, although the connections range from tenuous to direct.

Alabama v. CSX

The *CSX* case, like *Wrigley*, involved an interpretation of a federal statute that restricts a state's authority to impose certain taxes, *i.e.* 4-R Act which prohibits states from imposing taxes that discriminate against a rail carrier. The Court held that exempting CSX's main competitors from Alabama's sales tax is discriminatory as to rail carriers in violation of the 4-R Act in that Alabama had not offered a sufficient justification for this exemption.

While the *CSX* case is similar to *Wrigley* in that it pertains to a federal act restricting states' power to tax, it is quite different in the narrow scope of its direct impact. The 4-R Act is limited to railroads as compared to P.L. 86-272 which has widespread applicability.

Nonetheless, one take away from *CSX* is that it is very important to identify the comparison class. Oftentimes, but certainly not always, one could observe that the identity of the comparison class can be outcome determinative.

DMA v. Brohl

The *DMA* case pertains to the Tax Injunction Act which provides that federal 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."

Colorado had put in place a use tax information reporting scheme that required out-of-state retailers to: [i] notify Colorado purchasers that Colorado requires purchasers to pay use tax and file a tax return; [ii] provide a report to Colorado purchasers listing their purchases; and, [iii] provide a report listing Colorado purchasers, addresses and total amounts. This scheme also imposed penalties for failure to comply.

Unlike most state tax cases, this case was being considered by the federal courts. The question before the Supreme Court was whether the Tax Injunction Act barred the federal court's consideration of Colorado's use tax reporting scheme. The U.S. Supreme Court held that it was not because the

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statutes did not enjoin, suspend or restrain the assessment, levy or collection of any tax. The Court, however, did not address the Comity Doctrine which counsels federal courts to refrain from interfering with fiscal operations of state governments.

Again, similar to the *CSX* case, the *DMA* case would not, at first blush, appear to be of wide spread interest. However, Justice Kennedy, in his concurrence made the following statement:

"Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*, a case questionable even when decided. *Quill* now harms states to a degree far greater than could have been anticipated earlier."

Obviously, one Supreme Court Justice has some interest in the Court considering whether the *Quill* physical presence test should be changed. If *Quill* were to be overturned, then the states could be anticipated to impose a collection responsibility on out-of-state remote sellers with no physical presence in the testing state.

Interestingly, as noted above, *Quill* itself was a challenge to *National Bellas Hess*. One can anticipate that the states will attempt to provide the Court with an opportunity to review *Quill*.

It is one Justice's opinion. Whether or not the rest of the Justices would agree with Justice Kennedy's apparent disposition would obviously be a matter for the Court.

Maryland v. Wynne

The *Wynne* case involved a challenge under the Commerce Clause to Maryland's "county tax" to all of the income of an S corporation owned by a married couple residing in Maryland, without allowing a credit for tax paid to other states. The Court of Appeals of Maryland, the state's highest court, held that the county individual income tax was not fairly apportioned, in violation of both the internal consistency and the external consistency tests and also discriminated against commerce with interstate activities being taxed more than intrastate activities.

Notably, Maryland's county tax scheme differs from the local tax scheme which is prevalent in Kentucky. Localities in Kentucky subject individuals and businesses to tax on income from sources within the locality. This is different from the Kentucky state individual income tax scheme, which subjects all of a resident's income to tax and provides a credit for income taxes paid to other states. Maryland's county tax scheme is thus somewhat similar to Kentucky's state tax scheme, but different from the local tax scheme. The state model of taxing all of a resident's income and providing a credit for state taxes paid to other states is prevalent in states imposing an individual income tax.

The Court held that Maryland's county income tax scheme fails the internal consistency test, using hypotheticals to demonstrate via the internal consistency test that Maryland's tax scheme is inherently discriminatory and operates as a tariff. This was fatal to the Maryland county tax scheme because a tariff is a paradigmatic example of a law discriminating against interstate commerce. Accordingly, the Court held that the county tax system violated the Commerce Clause.

Walter Sobchak: Excuse me, dear? The Supreme Court has roundly rejected prior restraint!

The Dude: This isn't a First Amendment issue, man.

The Big Lebowski (1998)

After a relatively long drought of considering state tax cases, the United States Supreme Court has seemingly warmed up to providing guidance in this area which is important to taxpayers and state and local governments alike. Hopefully, the Court will continue to consider important state cases like these.

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