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28-AUG J. MULTISTATE TAX'N 43

Journal of Multistate Taxation and Incentives
****1**
August, 2018

U.S. Supreme Court Update

U.S. SUPREME COURT UPDATE

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Court Receives One New SALT Petition; Solicitor General Files Briefs in Two Other SALT Matters

***43** The U.S. Supreme Court has received one new petition for certiorari in a case involving state and local taxes. In *Nextel Communications of the Mid-Atlantic, Inc. v. Pennsylvania Dep't of Revenue* (Docket No. 17-1506), the Court has been asked to review a Pennsylvania Supreme Court decision, which held that although a state cap on net loss carryovers for tax year 2007 violated the Uniformity Clause of the Pennsylvania Constitution, the taxpayer, Nextel Communications, was not entitled to a refund of taxes paid, as the court ruled that the proper remedy was to sever the unconstitutional flat dollar cap provision from the law, as opposed to striking down the statute entirely. (Under the law in effect for tax year 2007, a corporate taxpayer's net loss carryover deduction was limited to the greater of 12.5% of the corporation's taxable income or $3 million.)

In addition to the one new petition for certiorari, a decision in *South Dakota v. Wayfair, Inc., et. al.* (Docket No. 17-494), along with three previously reported petitions, remained pending at the time of this writing. A review of the *Wayfair* oral arguments is provided, together with the U.S. Solicitor General's arguments in *Washington State Dep't of Licensing v. Cougar Den, Inc.* and *Dawson v. Steager.*

Also, the Court remains set to review a dispute between Delaware and several other states concerning which states have priority rights to claim abandoned, uncashed MoneyGram ‘official checks.‘ The MoneyGram cases set for review are *Delaware v. Pennsylvania et. al.*, Case No. 220145, and *Arkansas et. al. v. Delaware*, Case No. 220146. The Court has assigned the Honorable Pierre N. Leval, of the U.S. Court of Appeals for the Second Circuit, as Special Master in these cases, tasked with coordinating the taking of evidence and making reports. (The Court typically assigns original jurisdiction disputes—cases such as disputes between states that are first heard at the Supreme Court level—to a Special Master to conduct what amounts to a trial court proceeding.) We will continue to update readers as more details become available.

Nextel Challenges Decision to Deny Refund of Taxes Paid in Violation of State Uniformity Clause

****2** On 5/3/18, the U.S. Supreme Court received a new petition for certiorari in *Nextel Communications of the Mid-Atlantic, Inc. v. Pennsylvania Dep't of Revenue*, Docket No. 17-1506, ruling below at 171 A.3d 682 (Pa. 2017). In the decision below, the Pennsylvania Supreme Court upheld the lower Commonwealth Court's decision that a flat-dollar cap on net loss carryovers

for tax year 2007 violated the Uniformity Clause of the Pennsylvania Constitution. Despite this ruling, however, the state high court reversed the Commonwealth Court's remedy of allowing an unlimited net loss carryover deduction and, instead, severed the $3 million flat dollar cap from the law, leaving in place an income percentage-based cap, which resulted in the court denying Nextel's refund claim for net income taxes paid to Pennsylvania.

Pennsylvania's Uniformity Clause.

The Uniformity Clause of Pennsylvania's Constitution, which is found in Article 8, Section 1, provides, ‘All taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under general laws.‘ For tax year 2007, Pennsylvania also applied a net loss carryover (‘NLC‘) limitation under its corporate income tax laws, which restricted the amount of loss a corporation could carry over from prior years as a deduction to the greater of either (i) 12.5% of the corporation's 2007 taxable income, or (ii) a flat-dollar amount of $3 million. Nextel Communications (‘Nextel‘), which had its 2007 deduction capped at 12.5% of its 2007 taxable income, argued that Pennsylvania's NLC provision violated the state's Uniformity Clause and, therefore, it requested a refund of $3,938,220 in state income taxes paid toPennsylvania.

Penn. Supreme Court rules a flat-dollar cap on net loss carryovers violates the state Uniformity Clause.

According to the Pennsylvania Supreme Court, the Uniformity Clause to Pennsylvania's Constitution was ‘intended to and does sweep away forever the power of the ***44** legislature to impose unequal burdens upon the people under the form of taxation.‘ Although the Pennsylvania Department of Revenue (the ‘Department‘) argued that this limitation requires only that a uniform tax rate be applied to the same tax base, the Pennsylvania Supreme Court held the limitation extends to deductions that, in effect, create unequal tax burdens.

In showing the effect of Pennsylvania's unconstitutional application of its NLC limitation, the court focused on the example of two taxpayers, each with net loss carryovers in excess of their 2007 income. According to the court, one such taxpayer, with taxable income of $3 million or less, would be able to deduct its losses without limitation, whereas a second taxpayer, with taxable income in excess of $3 million, would have its deduction capped, obligating the corporation to pay some income tax. This, according to the Pennsylvania Supreme Court, creates a ‘*de facto* total exemption from paying the corporate net income tax‘ for lower income taxpayers.

****3** ‘Consequently,‘ the court ruled, ‘although the NLC is not worded in the same fashion as the taxing provisions [that] explicitly exempt income below a certain threshold from taxation . . . , nonetheless it operates in a manner that creates the very same type of exemption from taxation solely on the basis of income, a scheme we determined in [our prior] decisions to be violative of the Uniformity Clause.‘ The court therefore affirmed the lower Commonwealth Court's decision that the NLC was unconstitutional as applied to Nextel.

Penn. Supreme Court severs unconstitutional provision and denies Nextel's refund claim.

In the lower Commonwealth Court's decision, the majority ruled that the ‘only practical solution‘ to Pennsylvania's unconstitutional tax was to ‘allow Nextel to use its prior operating losses to reduce its corporate taxable income to zero in the 2007 tax year.‘ Thus, it awarded Nextel a refund of the approximately $4 million in taxes it paid on its 2007 income. The Pennsylvania Supreme Court, however, reversed this ruling, finding instead that the portion of the NLC which created the constitutional violation—i.e., the $3 million flat deduction—could be severed from the remainder of the statute, while still enabling the statute to operate as the Legislature intended.

According to the Pennsylvania Supreme Court, ‘[a]s a general matter, ‘[t]he public policy of this Commonwealth favors severability’‘ where, ‘after severing the unconstitutional provisions of a statute, ‘the legislature [would] have preferred what

is left of its statute to no statute at all.'‘ To answer this question, the court considered the ‘twin policy objections‘ of the NLC provision, which it noted were to (1) ‘encourag[e] investment (by allowing corporations to deduct some of the losses they sustain when making [initial] investments against their future revenues)‘ and (2) ‘ensur[e] that the Commonwealth's financial health is maintained (through the capping of the amount of this deduction).‘

Having determined that the NLC was unconstitutional as written because of its inclusion of the $3 million flat deduction, the court then perceived three available options for curing the constitutional deficiency: ‘(1) sever the flat $3 million deduction from the remainder of the NLC; (2) sever both the $3 million and 12.5% deduction caps and allow corporations to claim an unlimited net loss . . . ; or (3) strike down the entire NLC and, thus, disallow any net loss carryover.‘

While Nextel argued (and continues to argue in its petition for certiorari) for the second option, and the Department argued for the third option, the court determined that ‘the legislature's intent to have the NLC jointly further both [the policy goals of private investment and public financial stability] can best be effectuated by severing from the NLC the $3 million flat deduction. ‘ ‘By striking this provision,‘ the court continued, ‘all corporations for the tax year 2007 would be limited to taking a net loss carryover deduction of 12.5% of their taxable income for that year. Thus, each corporation will be entitled to avail itself of a net loss carryover deduction, as the legislature intended, but such deduction will be equally available to all corporations during that year, no matter their taxable income. This fulfills the central tenet of the Uniformity Clause that the ***45** tax burden be borne equally by the class of taxpayers subject to paying it, inasmuch as it assures that all corporations will equally share in the obligation to pay corporate net income tax for tax year 2007.‘

****4** Accordingly, the Pennsylvania Supreme Court severed only the $3 million flat deduction from the NLC and, as a result, held that ‘Nextel is not entitled to have its 2007 tax assessment forgiven as, even with the offending provision of the NLC stricken, it is subject to the same tax liability for tax year 2007 as previously assessed by the Department.‘

Question presented.

Nextel argues in its petition for certiorari that a statutory severability analysis may not excuse a violation of the state constitution and that statutory severability under state law may not eliminate a federal constitutional right to relief under the U.S. Constitution's Due Process Clause. Specifically, in its petition for certiorari, Nextel asks the U.S. Supreme Court to answer the question: ‘Does the Due Process Clause require a state to make a remedy available to a taxpayer if the collection of a tax violates settled state law?‘

***Wayfair* and Pending Petitions**

A decision in *Wayfair* and action on three petitions for certiorari remained pending before the Court at the time of this writing.

Justices question need for overturning current sales tax nexus precedents.

As reported in our last column, on 4/17/18, the U.S. Supreme Court heard oral arguments in *South Dakota v. Wayfair, Inc., et. al.* (Docket No. 17-494). In South Dakota's closely watched petition for certiorari, the state asked the Court to review and overturn the physical presence nexus standard announced in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). According to South Dakota, *Quill*'s physical presence standard—which requires out-of-state businesses to maintain some type of physical connection (e.g., employees, inventory, or other property) within a state before the state may subject the business to its sales and use tax collection and remittance requirements—is harmful to local governments, brick-and-mortar businesses, and to interstate commerce itself. The state also argues that *Quill* is the kind of judicial mistake that need not be reinforced under stare decisis. Instead, South Dakota argues that courts should apply the four-prong test from *Complete Auto Transit Inc. v. Brady* when determining the constitutionality of a state's sales and use tax laws under the Commerce Clause.

At oral arguments, several Justices seemed to question the prudence of overturning the Court's prior precedents. With her second question to Marty J. Jackley, South Dakota's Attorney General, Justice Sotomayor noted she was ‘concerned about the many unanswered questions that overturning precedents will create a massive amount of lawsuits about.‘ Justice Sotomayor's concerns included possible retroactive application of new sales and use tax laws and the proper standard for determining sales tax nexus in the absence of *Quill*'s physical presence rule.

Similarly, Justice Alito asked, ‘if *Quill* is overruled, what incentives do the states have to ask for any kind of congressional legislation?‘ Justice Alito later noted that ‘South Dakota['s] law is obviously a test case . . . it was devised to present the most reasonable incarnation of this scheme,‘ and questioning Malcolm L. Stewart, who argued on behalf of the United States as amicus curiae, Justice Alito asked, ‘[D]o you have any doubt that states that are tottering on the edge of insolvency and municipalities which may be in even worse position have a strong incentive to grab everything they possibly can?‘

****5** Other Justices, however, appeared to acknowledge the need for a new sales and use tax nexus landscape. Justice Ginsburg, for example, questioned Wayfair's claim, argued by George S. Isaacson, that asking out-of-state sellers to collect tax on goods shipped in-state discriminates against interstate commerce. According to Justice Ginsburg, ‘as I see it, why isn't it, far from discriminating, equalizing sellers; that is, anyone who wants to sell in-state, whether an in-state shop, an out-of-state shop, everybody is treated to the same tax collection obligation. All who exploit an in-state market are subject to the in-state tax. Why isn't that equalizing rather than discriminating? ‘ Appearing to agree with Justice Ginsburg, Justice Gorsuch asked, ‘Why should we favor, this Court favor, a particular business model that relies not on brick and mortar but on mail order?‘

Solicitor General supports Wash.'s request for review of Yakama Nation ‘right to travel‘ without taxation victory.

On 6/14/17, the Court received a petition for certiorari in *Washington State Dep't of Licensing v. Cougar Den, Inc.*, Docket No 16-1498, ruling below at 188 Wash. 2d 55 (Wash. 2017), in which the Supreme Court of Washington held that the Yakama Nation ‘tribe[] w[as] entitled under [the Yakama Nation] [T]reaty to import fuel without holding [an] importer's license and without paying state fuel taxes.‘

As explained by the court below, Article II of the Yakama Nation Treaty of 1855 states in relevant part: ‘[I]f necessary for the public convenience, roads may be run through the said reservation; and on the other hand, the right of way, with free access from the same to the nearest public highway, is secured them; as also the right, in common with citizens of the United States, to travel upon all public highways.‘ ***46** (Treaty with the Yakamas, 12 Stat. 951, 952-953 (1855)).

In 2013, Cougar Den, a Confederated Tribes and Bands of the Yakama Nation corporation, began transporting fuel from Oregon to the Yakama Indian Reservation. The company sold the fuel to businesses located on Tribal land and owned by Tribal members. The Washington Department of Licensing, however, issued tax assessments on the imported fuel ($3.6 million of taxes, penalties, and fees for hauling the fuel across state lines). Cougar Den refused to pay the assessment, arguing that the imposition of the tax violated its right to travel under the Yakama Nation Treaty of 1855.

In reviewing the assessment, and upholding the lower courts' ruling in Cougar Den's favor, the Washington Supreme Court noted that ‘[t]here is no dispute that the taxes and licensing requirements would apply if the treaty provision does not apply here.‘ The court further explained, however, that the U.S. Supreme Court's rule of treaty interpretation requires that ‘Indian treaties must be interpreted as the Indians would have understood them.‘ And, the court concluded that ‘[t]he Department's interpretation of the treaty provision ignores the historical significance of travel to the Yakama Indians and the rule of treaty interpretation established by the United States Supreme Court. ‘ The court specifically noted that ‘[i]n ruling in Cougar Den's favor, both the ALJ and the Yakima County Superior Court based their decisions on the history of the right to travel provision of the treaty, relying on the findings of fact andconclusions of law from *Yakama Indian Nation v. Flores*, 955 F. Supp. 1229 (E.D. Wash. 1997),‘ in particular the depiction in the record of a ‘tribal culture whose manner of existence was dependent on the Yakamas' ability to travel.‘

****6** The Washington State Department of Licensing presents the U.S. Supreme Court with the following question for review in its petition for certiorari: 'Whether the Yakama Treaty of 1855 creates a right for tribal members to avoid state taxes on off-reservation commercial activities that make use of public highways.'

In response to the Court's order inviting the U.S. Solicitor General to express the views of the U.S. Government, on 5/15/2018, the Solicitor General filed an amicus curiae brief with the Court recommending that Washington State's petition for certiorari should be granted. The Solicitor General argues that '[t]he Washington Supreme Court erred in concluding that Article III of the 1855 Treaty exempted respondent from paying Washington's motor fuel tax' and that '[t]he right, in common with citizens of the United States, to travel upon all public highways protected by the 1855 Treaty . . . is not violated by the tax at issue here, which taxes the introduction of a good into the stream of commerce, no matter where the good originates or how it enters the State.'

Solicitor General agrees that W. Va.'s differential treatment of retirement benefits violates intergovernmental immunity.

On 9/19/17, the Court received a petition for certiorari in *Dawson v. Steager,* Docket No. 17-419, ruling below at *Steager v. Dawson*, 2017 WL 2172006 (W. Va. 2017), in which the Supreme Court of Appeals of West Virginia held that Mr. Dawson, a retired U.S. Marshal, was not entitled to exempt his Federal Employee Retirement System ('FERS') income from state income tax.

According to the state high court, James Dawson ('Dawson') worked as a deputy U.S. Marshal in West Virginia. Dawson was enrolled in FERS, a federal retirement plan, and sought a West Virginia exemption for all of his FERS income. The court, however, noted that, under West Virginia law, unlike certain state law enforcement retirees who may exempt all of their state retirement benefits from taxable income, Dawson was entitled to exempt only a portion of his FERS income. The Supreme Court of Appeals of West Virginia held that this distinction did not violate the doctrine of 'intergovernmental tax immunity.'

According to the court, 'the total structure of West Virginia's system for taxing personal income does not discriminate against retired members of the United States Marshals Service in violation of 4 U.S.C. §111.' Instead, the court held the exemption at issue merely gives a benefit to 'a very narrow class of former state and local employees, and that benefit was not intended to discriminate against former federal marshals.'

Dawson asks the U.S. Supreme Court to consider the following question for ***48** review: 'Whether this Court's precedent and the doctrine of intergovernmental tax immunity bar states from exempting groups of state retirees from state income tax while discriminating against similarly situated federal retirees based on the source of their retirement income.'

****7** In response to the Court's order inviting the U.S. Solicitor General to express the views of the U.S. Government, on 5/15/2018, the Solicitor General filed an amicus curiae brief providing that Dawson's petition for certiorari should be granted. The Solicitor General argues that the West Virginia court 'misapplied the doctrine of intergovernmental tax immunity' and that, '[u]nder the test articulated in *Davis v. Michigan Department of the Treasury*, 489 U.S. 803 (1989), the court should have asked whether the State's inconsistent tax treatment of former federal and state law-enforcement officers 'is directly related to, and justified by, significant differences between the two classes.' ' The West Virginia high court's application of a 'totality of the circumstances' analysis, the Solicitor General argues, 'is inconsistent with *Davis* and with this Court's other intergovernmental tax immunity decisions.'

Court asked whether California FTB immune from taxpayer tort claims in Nevada.

On 3/12/2018, the U.S. Supreme Court received a new petition for certiorari in *Franchise Tax Bd. of Cal. v. Hyatt*, Docket No. 17-1299, ruling below at 407 P.3d 717 (Nev. 2017). In the decision below, the Nevada Supreme Court held that the California

Franchise Tax Board (the 'FTB') was not entitled to immunity from intentional and bad-faith tort claims brought by a former California resident, Gilbert Hyatt.

This petition for certiorari marks the latest in a long-running saga between Hyatt and the FTB, stemming from the FTB's attempt to collect approximately $10 million in taxes on patent licensing fees earned by Hyatt in the 1990s. Following its audit, in which the FTB determined Hyatt to be a California resident, Hyatt sued the FTB in Nevada state court, claiming that the FTB's abusive investigation techniques cost him business opportunities and inflicted emotional distress. The Nevada Supreme Court eventually largely reversed a state court jury award of tort and punitive damages awarded to Hyatt. Citing to *Nevada v. Hall*, 440 U.S. 410 (1979), however, which held that the U.S. Constitution does not grant states sovereign immunity from suit in the courts of other states, the Nevada Supreme Court eventually rejected the FTB's claim of complete immunity. Ultimately, the U.S. Supreme Court affirmed Nevada's decision in *Franchise Tax Bd. of Cal. v. Hyatt (Hyatt I)*, 538 U.S. 488 (2003).

After another round at the Nevada Supreme Court, which held that the FTB was liable for fraud and intentional infliction of emotional distress only, the FTB appealed once again to the U.S. Supreme Court. The Supreme Court granted certiorari for the second time, agreeing to consider two questions: (1) whether the Nevada Supreme Court erred by failing to apply to the FTB the statutory immunities available to Nevada agencies, and (2) whether the U.S. Supreme Court's prior decision in *Nevada v. Hall*, 440 U.S. 410 (1979), should be overruled. In its second decision, *Franchise Tax Bd. of Cal. v. Hyatt (Hyatt II)*, 136 S. Ct. 1277 (2016), the Court held that, with regard to California's first claim, the Full Faith and Credit Clause does not 'permit[] Nevada to award damages against California agencies under Nevada law that are greater than it could award against Nevada agencies in similar circumstances.' As to California's second question, however, the Court, in the wake of Justice Antonin Scalia's death, spilt 4-4 on whether *Hall* should be overruled.

****8** On remand from *Hyatt II*, the Nevada Supreme Court followed the high court's instructions and held that the FTB was entitled to the benefit of Nevada's statutory damages cap and instructed the trial court to enter a damages award for fraud within the cap of $50,000. The FTB has now again requested the U.S. Supreme Court grant certiorari, arguing that 'under our federal system, an agency of one State may not (absent its consent) be sued in the courts of another State.' Specifically, the FTB now asks the Court to answer the question it agreed to decide in *Hyatt II:* 'whether *Nevada v. Hall* should be overruled.'

Nextel argues that a statutory severability analysis may not excuse a violation of the state constitution and . . . eliminate a federal constitutional right to relief.

The FTB now asks the Court to answer the question it agreed to decide in *Hyatt II:* 'whether *Nevada v. Hall* should be overruled.'

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