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U.S. Supreme Court Update

U.S. SUPREME COURT UPDATE

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Two New Petitions Ask the Court to Grant Cert in SALT Matters

***36** On January 29, 2020, a new petition for writ of certiorari was filed with the U.S. Supreme Court in *Wis. Dep't of Revenue v. Union Pac. R.R. Co.*, (Docket No. 19-949), ruling below at 940 F.3d 336 (7th Cir.2019). The Court has been asked to review a decision of the U.S. Court of Appeals for the Seventh Circuit, which held that Wisconsin's intangible personal property tax singled out railroads as part of a targeted and isolated group in violation of the RailroadRevitalization and Regulatory Reform Act of 1976 (49 U.S.C. §11501(b)(4) (the ‘4-R Act‘)) since only railroad and utilities companies are required to pay anadditional tax on their intangible property. Also, in *Paz v. Director, Div. of Taxation*, (Docket No. 19-921) ruling below at 31 N.J. Tax 76 (N.J. Super. Ct. App. Div.), order denying certification, 239 N.J. 382 (2019), the Court is being asked to review the New Jersey Supreme Court's finding that 100% of the gain from a deemed sale of assets can be taxed in thedomiciliary state of a corporation for both corporation business tax purposes and non-resident shareholder gross income tax purposes.

As previously reported, we are awaiting a decision in *Espinoza v. Montana Dep't of Rev.* (Docket No. 18-1195), the case that addresses the constitutionality of Montana's Tax Credit Scholarship Program. The Court heard oral arguments on January22, 2020, and a decision is expected by this summer. In addition, we continue to follow *Elster v. City of Seattle*, Docket No. 19-608, which involves a challenge to Seattle's ‘Democracy Voucher Program.‘ Seattle filed a brief in oppositionto the petition and the Petitioner filed a reply brief, both of which are covered in this article.

Finally, the Court has denied action in three previously reported matters: (1) *Arizona v. California,* Docket No. 22O150, motion for leave to file bill of complaint denied Feb. 24, 2020; (2) *Steiner v. Utah State Tax Comm'n,* DocketNo. 19-755, petition for certiorari denied Feb. 24, 2020; and (3) *Barth v. Township of Bernards, New Jersey*, Docket No. 19-806, petition for writ of certiorari denied March 2, 2020.

Railroad's 4-R Act Challenge to Wisconsin's Property Tax Scheme

The U. S. Supreme Court received a new petition for writ of certiorari in *Wis. Dep't of Revenue v. Union Pac. R.R. Co.*, (Docket No. 19-949), ruling below at 940 F.3d 336 (7th Cir. 2019), seeking review of the U.S. Courtof Appeals for the Seventh Circuit's holding that ‘Wisconsin's intangible property tax singles out railroads as part of a targeted and isolated group in violation of subsection (b)(4)‘ of the 4-R Act.

The 4-R Act.

****2** The Railroad Revitalization & Regulatory Reform Act ('4-R Act') is a federal statute that provides that states *may not:*

> (1) [a]ssess rail transportation property at a value that has a higher ratio to the true marketvalue of the rail transportation property than the ratio that the assessed value of other commercial and industrial property in the same assessment jurisdiction has to the true market value of the other commercial and industrial property[;]
>
> (2)[l]evy or collect a tax on an assessment that may not be made under paragraph (1) of this subsection[;]
>
> (3) [l]evy or collect an ad valorem property tax on rail transportation property at a tax rate that exceedsthe tax rate applicable to commercial and industrial property in the same assessment jurisdiction[; or]
>
> (4) [i]mpose another tax that discriminates against a railcarrier providing transportation subject to the jurisdiction of the Board under this part. [49 U.S.C. §11501(b)].

Thus, under the 4-R Act, states are prevented from imposing on railroads greater taxes or assessment ratios than those imposed on other commercial and industrial property, as well as imposing any other discriminating taxes against railroads.

Wisconsin's property tax regime.

Chapter 70 of the Wisconsin Tax Code (the 'Code') governs the property taxation applicable to manufacturing and commercial companies. Chapter 76 of the Code governs the property taxation applicable to railroad and utilities companies. As explainedby the U.S. Court of Appeals, '[t]axpayers under chapters 70 and 76 must pay taxes on their real and personal property unless that property is exempt.' And, while the 'Code contains several exemptions from the general property tax forvarious classes of property including an exemption for 'all intangible personal property,' which covers custom computer software . . . [m]anufacturing and commercial taxpayers generally qualify for the intangible personal property exemption,but railroad and utilities companies do not.' Thus, the court notes that 'the parties do ***37** not dispute that railroad and utilities companies are the only taxpayers that Wisconsin requires to pay taxes on their intangibleproperty, including custom software.'

Wisconsin DOR's audit of Union Pacific.

Since at least the 2006 tax year, Union Pacific R.R. Co. ('Union Pacific ') reported its custom computer software as exempt property in its property tax filings with the Wisconsin Department of Revenue ('DOR'). In 2016 and 2017, the DOR conductedan audit of Union Pacific's property tax assessment for tax years 2014 and 2015. As a result of that audit, the DOR issued an 'Omitted Property Assessment Notice' asserting that Union Pacific owed an additional $2,631,104.77 in taxes and interest forthe combined years 2014 and 2015, 'based on an adjustment required to 'add back property incorrectly claimed as exempt.'' Union Pacific decided not to pay the tax and filed a lawsuit in Dane County Circuit Court challenging the Omitted PropertyAssessment on state law grounds. Union Pacific then filed a lawsuit in the U.S. District Court for the Western District of Wisconsin. The District Court found that Union Pacific established a violation of the4-R Act. Both parties appealed to the U.S. Court of Appeals on cross motions for summary judgment.

4-R Act discrimination.

****3** The U.S. Court of Appeals summarized the mechanics of Wisconsin's intangible personal property tax:

> [It] singles out railroads as part of a targeted and isolated group in violation of subsection (b)(4). What Wisconsin refers to as its 'generallyapplicable property tax' is, functionally, generally applicable only to real and *tangible* personal property.

> Manufacturing and commercial companies generally must pay property taxes on the value of their real and tangible personal property.Only railroad and utilities companies, however, are required to pay an additional tax on their *intangible* property. Hence, Wisconsin does not simply exempt intangible property from taxation; rather, it imposes an intangible property tax only onrailroad and utilities companies. The intangible property tax 'exemption'—for which railroad and utilities companies categorically do not qualify—reflects and operates as 'anothertax that discriminates against a rail carrier' within the meaning of subsection (b)(4) and thereby offends the 4-R Act.

The court then analyzed whether the U.S. Supreme Court's decision in *Dep't of Revenue of Or. v. ACF Indus. Inc.,* 510 U.S. 332 (1994) foreclosed Union Pacific's discrimination claim. As explained by the U.S. Court of Appeals, in *ACF*, 'the Supreme Court held that a tax upon railroad property is not subject to challenge under subsection(b)(4) on the ground that certain other classes of commercial or industrial property are exempt.' However, 'the Court went on to explain that the case was not one in which the railroads—either alone or as part of some isolated and targeted group[were] the only commercial entities subject to an ad valorem property tax . . . . If such a case were to arise, it might be incorrect to say that the state 'exempted' the nontaxed property. Rather, one could say that the State had singled outrailroad property for discriminatory treatment.'

In light of the above, the U.S. Court of Appeals explained that 'the *ACF* holding does not apply where the 'exemption' is just a pretext for targeting railroads, either alone or as part of an isolated group.' The court further notedthat 'practically speaking, if a state exempts sufficient property from a particular property tax, that tax no longer can be said to be one of general application.' In this regard, the court observed that 'Wisconsin systematically exemptsfrom its intangible property tax all manufacturing and commercial taxpayers except for railroad and utilities companies' and that 'the effect of the intangible property tax challenged here is functionally similar to that of the iron ore concentratesdocks tax the Supreme Court cited in *ACF* as an example of a tax that runs afoul of subsection (b) . . . . and the taxes courts have regularly struck down under subsection (b)(4).'

Since Wisconsin did not provide a non-discriminatory justification for imposing a targeted tax on the intangible property of railroad and utilities companies, nor did it contest the district court's conclusion that the railroad and utilities companies area targeted and isolated group, the U.S. Court of Appeals affirmed the judgement of the district court.

Question presented.

****4** The DOR has presented the following question to the Court for review:

> The Railroad Revitalization and Regulatory Reform Act of 1976 ('4-R Act '), codified at 49 U.S.C. §11501,limits state taxation of railroads in several ways. Subsections (b)(1) – (3) provide specific rules for state property taxes, requiring States to apply the same assessment ratio and tax rate to railroads that they apply to commercial and industrial propertyowners. 49 U.S.C. §11501(b)(1) – (3). Subsection (b)(4) then prohibits States from '[i]mpos[ing] another tax that discriminates against[railroads].' 49 U.S.C. §11501(b)(4).
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> In *Department of Revenueof Oregon v. ACF Industries, Inc.*, 510 U.S. 332, 347–48 (1994), the Court held that the 4-R Act 'does not limit the States' discretion to exempt nonrailroad property, but not railroad property, from ad valorem property taxes of general application.'The Court left open the question of whether a State would violate subsection (b)(4) if 'railroads —either alone or as part of some isolated and targeted group—are the only commercial entities subject to an ad valorem property tax.' *Id.* at346. The question presented is:
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> Does a State violate subsection (b)(4) by exempting intangible personal property of non-railroads from its personal property tax, but not exempting such property for a limited group of taxpayers that includesrailroads?

Challenge to N.J.'s Taxation of 100% of Gain on Deemed Sale of Assets

***38** In *Paz v. Director, Div. of Taxation*, (Docket No. 19-921) ruling below at 31 N.J. Tax 76 (N.J. Super. Ct. App. Div.), order denying certification, 239 N.J. 382 (2019), the U.S. Supreme Court is being asked to review the New Jersey Supreme Court's finding that 100% of the gain from a deemed sale of assets can betaxed in the domiciliary state of a corporation for both corporation business tax purposes and non-resident shareholder gross income tax purposes.

Transaction background.

Xylem Dewatering Solutions, Inc. (formerly known as Godwin Pumps of America, Inc.) (the 'Corporation'), is a New Jersey corporation that, in 1997, elected to be taxed as an S corporation for both federal and New Jersey tax purposes. Until February 2010,John Paz, a non-resident of New Jersey, was its sole shareholder ('Paz'). On February 1, 2010, Paz transferred 49 of the 350 issued and outstanding shares of the Corporation to three grantor retained annuity trusts (the 'GRATs') established by him as grantor.Paz and the GRATs will be collectively referred to herein as the 'Shareholders.'

On August 3, 2010, the Shareholders sold all of the shares of the Corporation. The parties elected to apply IRC Section 338(h)(10) to the transaction. Because of the election, forfederal income tax purposes the sale of stock by the Shareholders of the Corporation was disregarded and the transaction was treated as a sale of all the assets of the Corporation, followed immediately by the liquidation of the Corporation. The Corporationfiled a short-year U.S. income tax return for an S corporation, Form 1120S, for the period ending August 3, 2010, reporting income from operations for that period, as well as the gain from the deemed sale of its assets. The gain from the sale totaled $357,290,215.00.Of this amount, $48,842,984.00 was attributed to the sale of tangible assets and $308,447,231.00 was attributed to the sale of goodwill.

****5** The Corporation also filed a New Jersey S Corporation Business Tax ('CBT ') return for the period ending August 3, 2010. On that return, the Corporation reported $113,385,758.00 to its shareholders as 'S corporation income/loss allocated to New Jersey' onthe Schedule K-1s to the return, while reporting total income of $370,356,782.00. Paz's New Jersey non-resident gross income tax ('GIT') return for calendar year 2010 reflected S corporation income in the amount of $113,417,512 from New Jersey sources.(Paz's individual share was $99,549,991.00 and the GRATs' share was $13,835,767.00).

The New Jersey Division of Taxation ('Division') audited the Corporation's CBT returns for the years 2009 through 2011 and issued proposed adjustment workpapers to the Corporation and Paz. With respect to the Corporation, the workpapers proposed as follows:(1) that net long term gain in the amount of $308,447,231.00 was assignable to New Jersey, thus increasing the amount of income from the Corporation sourced to New Jersey; and (2) an assessment against the Corporation of $3,580,461.00 in GIT on the incomeallocable to the GRATs as non-consenting S corporation shareholders.

The proposed Corporation adjustments resulted in an increase in New Jersey sourced income on Paz's non-resident GIT return. The Division issued workpapers to Paz asserting additional GIT of $19,162,818.00, plus interest and penalties of more than $5,800,000.00.

After the issuance of the proposed adjustments, the Corporation attempted to file a retroactive S Election Application, on which the GRATs evidenced their consent to New Jersey's jurisdiction to tax, but the election was rejected by the Division. The Corporationalso filed an amended return sourcing the gain on the deemed sale of fixed assets based on the location of the assets and the gain on the deemed sale of goodwill using the three-year average of its allocations factors for 2007, 2008, and 2009 (the 'AmendedCBT Return'). The Amended CBT Return included a statement that 'the gain from the Corporation's deemed asset sale is sourced to New Jersey under the *gross income tax* ***39** *rules* applicable to 'net gains or income from the disposition ofproperty.'' The Corporation issued amended Schedule K-1s to the Shareholders that resulted in Paz filing an amended GIT requesting a refund in the amount of $1,741,684.00.

The Division issued Notices of Assessment against the Corporation and Paz. The Division alleged additional CBT of $3,580,810.00 against the Corporation, plus interest and penalties, for the income allocable to the GRATs as non-consenting S corporation shareholders.Against Paz, the Division alleged additional GIT of $19,166,036.18, plus interest and penalties, for a total amount due of $26,792,003.92, based primarily on the characterization of 100% of the gain ($308,447,231.00) on the deemed sale as 'non-operationalincome' allocable to New Jersey under the CBT Act, and included in the Shareholders nonresident GIT calculations as New Jersey source income.

New Jersey Tax Court's opinion.

****6** The New Jersey Tax Court ruled against the Shareholders primarily based on its prior decision that a corporation's gain from an asset sale under Section 338(h)(10) is 'nonoperationalincome,' which was upheld by the New Jersey Appellate Division in *McKesson Water Prods. Co. v. Dir., Div. of Tax'n*, 23 N.J. Tax 449, *aff'd*, 408 N.J. Super. 213 (N.J. Super. Ct. App. Div. 2007), order denying certification, 200 N.J. 506 (2009). The court further ruled that 'there is no constitutional requirement that such income be apportionedand it is appropriately allocated to the domiciliary state, New Jersey.' (Or, stated differently, the court determined that only the business income of a unitary business must be apportioned among all the jurisdictions in which it conducts business. Andwhere, as here, the gain on the deemed sale of assets is nonbusiness (or non-operational) income, apportionment is not required because 'it was not 'earned' as business income beyond the borders of New Jersey.')

New Jersey Appellate Division's opinion.

The per curiam order of the Appellate Division affirmed the Tax Court's judgment. The concurring opinion by Judge Sabatino acknowledged that the appellants had raised substantial issues, but ultimately concluded, as did the majority of the Appellate Court,that 'it is best here to defer to the expertise of the Division and the Tax Court on these close and rather arcane issues. ' Also, the judge concluded his opinion by stating that 'counsel have advised us the pertinent statutes have been amendedsince the tax years in question in this case, and those laws now make clear the proper method of allocation or assignment.' The New Jersey Supreme Court issued an order denying the Shareholders' petition for certification.

Questions presented.

The petition for writ of certiorari presents the following questions:

> In *Mobil Oil Corp v. Comm'r of Taxation of Vermont*, 445 U.S. 425, 444 (1980), this Court stated that, for State income tax purposes, taxation by allocation and taxation by apportionment are 'theoretically incommensurate.'
>
> The questions presented are:
>
> 1.Whether it is constitutionally permissible for the domiciliary State of a corporation engaged in a multistate unitary business to allocate to itself for taxation purposes the entire gain realized by the corporation on the sale of all the assets of the unitarybusiness, given the fact that the corporation apportioned the gain among over 20 States where the business was conducted, in accordance with this Court's decisions in *Mobil Oil Corp.*, supra; *Container Corp. of America v. Franchise TaxBoard*, 463 U.S. 159, 169 (1983); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), and *MeadWestvaco Corp. v. Illinois Department of Revenue,* 553 U.S. 16 (2008).
>
> 2. Whether a nonresident individual taxpayer, as the sole shareholder of an S corporation conducting a multistate unitary business, may be personally taxed by the corporation's domiciliary Stateon 100% of the gain realized on the sale of all the assets of the business, even though the same gain was taxed on an apportioned basis by the other States where the business was conducted and only 25% of the gain was apportioned to the domiciliary State.

****7** [Ed. note: As this issue of the JOURNAL went to press, the Court denied the petition for certiorari.]

Briefs Filed in *Elster v. City of Seattle*

We continue to follow *Elster v. City of Seattle, Wash.* (Docket No. 19-608) concerning whether Seattle's ‘Democracy Voucher Program‘ is subject to a constitutional challenge. This program, funded by property taxes, provides vouchers toregistered municipal voters and qualifying residents, who can, in turn, give the vouchers to a qualified municipal candidate who can then redeem them for campaign purposes. On February 10, 2020, the City of Seattle filed a brief in opposition to the petition ***40** for certiorari, and on February 21, 2020, the Petitioners filed a reply brief.

In its brief, Seattle sets forth three arguments for why the Court should deny the writ for certiorari: ‘(1) Petitioners present no issue warranting this Court's intervention; (2) this case is a poor vehicle for exploring the questions presented; and(3) the Washington Supreme Court correctly followed established public-campaign finance law.‘ Specifically, Seattle argues that this was ‘a new, one-of-a-kind program that rests on a minimal tax‘ and that ‘appellate courts besides the WashingtonSupreme Court have not grappled more generally with whether, as Petitioners claim, compelled-subsidy case law overrides longstanding public-campaign-finance principles.‘ With respect to Seattle's second argument, the brief asserts that this case is a poorvehicle for exploring the questions presented primarily because the program need not (and may not in the relatively near future) be funded through a property tax. Finally, Seattle also questions whether the Petitionershave standing for their lawsuit.

Petitioners' reply brief countered with three primary arguments: (1) Petitioners have standing as municipal taxpayers and because of the First Amendment injury arising from the compelled subsidy of speech; (2) the petition raises pressing and unaddressedquestions about the First Amendment's compelled-subsidy doctrine; and (3) the petition is a good vehicle for addressing the questions presented.

Matters Denied

The Court has declined to consider the following matters:

On February 24, 2020, the Court denied the motion for leave to file a bill of complaint in *Arizona v. California* (Docket No. 22O150). On February 28, 2019, the Court had received a bill of complaint filed by Arizona against California. Arizonachallenged California's taxation under its ‘doing business‘ standard, specifically against entities that invest in manager-managed limited liability companies. Arizona had requested the following relief from the Court: (1) declare California's assessmentsviolate the Due Process Clause and the Commerce Clause of the Constitution; (2) declare California's assessments violate the Due Process Clause and the Fourth Amendment of the Constitution; (3) preliminarily and permanently enjoin California's assessments;(4) enter an injunction requiring California to refund to all Arizona businesses all funds collected; and (5) award compensatory damages to Arizona in an amount to be approved before a Special Master. A dissentingopinion by Justice Thomas, joined by Justice Alito, questioned whether the Court has the discretion to decline review in cases of original jurisdiction arising between states: ‘Today the Court denies Arizona leave to file a complaint against California.Although we have discretion to decline review in other kinds of cases, see 28 U.S.C. §§1254(1), 1257(a),we likely do not have discretion to decline review in cases within our original jurisdiction that arise between two or more States.‘

****8** Also on February 24, 2020, the Court denied certiorari in *Steiner v. Utah State Tax Comm'n*, (Docket No. 19-755), ruling below at 449 P.3d 189 (Utah 2019). The Court was asked to review a decision by the Utah Supreme Court regarding the Utah tax code, which extends a credit for income taxes paid to other states but does not extend a similar credit for taxes paid to foreigncountries or make other adjustments for foreign income. Steiner, a resident of Utah, claimed a tax deduction (specifically, an ‘equitable adjustment‘ under Utah Code §59-10-115) on his 2011, 2012, and 2013 income tax returns (filed on a jointbasis with his wife), that excluded foreign (non-U.S.) business income earned from an S corporation. The question presented to the Court was as follows: ‘Utah's tax code extends a credit for income taxes paid to other States but does not extend a similarcredit for income taxes paid to foreign countries or make other adjustments for foreign income. The result is a double taxation of income that state residents earn from foreign commerce. The question presented iswhether this scheme discriminates against foreign commerce in violation of the dormant Commerce Clause.'

On March 2, 2020, the Court denied certiorari in *Barth v. Bernards Township, New Jersey*, (Docket No. 19-806), ruling below at 2019 WL 1111133. The taxpayer had challenged the denial of a farmland tax assessment and related imposition of rollbacktaxes as a result of a change in status of the property. The question presented to the Court was as follows: 'There are a number of questions and sub questions whether to revisit, or distinguish this case from, *National Private TruckCouncil, Inc. v. Oklahoma Tax Commission,* 515 U.S. 582 (1995); alternatively distinguish this case from the denial for petition for certiorari in *General Motors Corp. v. City of Linden,* 143 N.J. 336 (1996), *cert denied,* 519 U.S. 816 (1996); or uniquely and independently consider these facts and circumstances to grant *certiorari* on grounds because of the federal unconstitutional process of the courtbelow, in whatever terms it should be characterized.'

The Court has been asked to review a decision which held that Wisconsin's intangible personal property tax singled out railroads as part of a targeted and isolated group in violation of the 4-R Act.

The Court is asked to review the N.J. Supreme Court's finding that 100% of the gain from a deemed sale of assets can be taxed in the domiciliary state of a corporation for both corporation business tax purposes and non-resident shareholder gross incometax purposes.

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