Journal of Multistate Taxation and Incentives
Volume 24, Number 4, July 2014
Department: *U.S. SUPREME COURT UPDATE*

By DEBRA S. HERMAN, a partner in the New York City office of the law firm of Hodgson Russ, LLP. *She thanks K. Craig Reilly for his contributions to this column.* This article appears in and is reproduced with the permission of the Journal of Multistate Taxation and Incentives, Vol. 24, No. 4, July 2014. Published by Warren, Gorham & Lamont, an imprint of Thomson Reuters. Copyright (c) 2014 Thomson Reuters/WG&L. All rights reserved.

Court Will Hear Resident Income Tax Credit Commerce Clause Challenge

The U.S. Supreme Court has agreed to review a Maryland high court decision, *Comptroller of the Treasury of Maryland v. Wynne,* which held that a credit against the state's individual income tax for income taxes Maryland residents paid to other states was unconstitutional because the credit was not available to offset county-level income taxes. The Court's opinion could impact not only Maryland, which stands to forgo millions of dollars annually in lost revenue and face disastrous county-level tax refund claims for prior years if the decision is upheld, but also other states with similar tax regimes. An overview of the case is set forth below.

Also, as noted in our last column, the Court issued its decision in *U.S. v. Quality Stores, Inc.,* holding that severance payments made to employees who were terminated against their will in connection with a company's Chapter 11 Bankruptcy Plan, where such payments were not linked to the receipt of state unemployment benefits, were taxable wages under the Federal Insurance Contributions Act (FICA). As a result of this decision, the federal government will not have to pay the over $1 billion of refund claims filed by employers based on the lower courts' rulings in this case. Employers that implemented a supplemental unemployment compensation benefits plan that links severance pay to the receipt of state unemployment insurance benefits will also be relieved to learn that the Court expressly declined to consider whether the IRS's current position that allows such payments to be exempt from FICA is consistent with the broad definition of FICA wages found in this case. The Court's opinion is reviewed in more detail below.

In addition, the Court has received four new petitions for certiorari, two of which directly involve state and local taxes, while the other two concern federal taxation but with state and local implications.

As we go to press, we still await the Court's decision on whether to grant three previously filed requests for certiorari. And finally, the Court declined to review three other state and local tax cases.

Court Grants State's Petition in *Wynne*; Solicitor General Urges Reversal

The U.S. Supreme Court has agreed to hear *Comptroller of the Treasury of Maryland v. Wynne,* Docket No. 13-485, *cert. granted* 5/27/14, ruling below at 431 Md. 147, 64 A3d 453 (2013). Previously, in response to the Court's invitation to express the views of the federal government, on 4/4/14 the U.S. Solicitor General filed an amicus brief with the Court (2014 WL 1348934). According to the Solicitor General, "[t]he decision below is incorrect," and thus the Court should grant the petition for writ of certiorari, reverse the Maryland Court of Appeals (the state's highest court), and rule that Maryland's county income tax is constitutional.

In the brief, the Solicitor General argued that the Supreme Court "has long recognized that States have plenary authority to tax the entire income, wherever earned, of their own residents, who directly benefit from the services funded by income taxes, and who collectively have the political power to achieve the repeal of any undesirable tax laws. Although States often choose to grant tax credits to their residents for income taxes paid in other States, nothing in the Commerce Clause compels a State to offer such credits or otherwise defer to other States in the taxation of its own residents' income." The Solicitor General noted that the decision below will have significant financial consequences for Maryland, may lead to challenges in other jurisdictions, and is contrary to decisions made by the highest courts in other states.

The Solicitor General also presented three arguments as to why the Maryland county-level income tax was constitutional. He argued, first, that Maryland's county-level income tax is constitutional inasmuch as jurisdictions have the right to tax all the income of their

residents. He further explained that "[a] State does not lose authority to tax its own residents' income simply because the State in which the income was earned also taxes that income." Quoting *Oklahoma Tax Commission v. Chickasaw Nation,* 515 US 450, 132 L Ed 2d 400 (1995), the Solicitor General also argued that "[a]lthough sovereigns ... sometimes elect not to exercise their authority to tax all income of their residents, and thus commonly credit income taxes paid to other sovereigns, that is an independent policy decision and not one compelled by jurisdictional considerations" (internal quotation marks omitted). Next, he argued that "[i]f the Commerce Clause limited a State's authority to tax the income of its own residents, as the Maryland Court of Appeals believed, then a longstanding and significant principle of this Court's state-taxation jurisprudence would be a virtual dead letter," because such ruling would nullify the Court's Due Process Clause holdings that authorize states to tax their residents on all income earned. Third, the Solicitor General argued that "[i]t is far from clear that the *Complete Auto* test should apply to a State's taxation of its own residents' income."

In the case below, the Maryland court had analyzed the taxpayers' challenge to the statute under the dormant Commerce Clause test announced in *Complete Auto Transit, Inc. v. Brady,* 430 US 274, 51 L Ed 2d 326 (1977), whereby a state tax will pass constitutional muster if the tax: (1) applies to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate or foreign commerce; and (4) is fairly related to the services provided by the state. Focusing on the requirements of fair apportionment and no discrimination against interstate commerce, the Maryland court found that the lack of a credit against the county tax resulted in the tax's failing under both prongs.

The Solicitor General argued in the alternative that even if the test applies, all four prongs are satisfied and therefore the tax does not violate the Commerce Clause of the U.S. Constitution. With respect to discrimination, the Solicitor General argued that the Supreme Court "has consistently distinguished laws that regulate evenhandedly with only incidental effects on interstate commerce from those that discriminate against interstate commerce" (quoting *Hughes v. Oklahoma,* 441 US 322, 60 L Ed 2d 250 (1979), internal quotation marks omitted), and concluded that the law at issue permissibly incidentally discriminates. The Solicitor General further argued that the fair apportionment prong was satisfied because

a state has the power to tax all income of its residents, not simply a "slice of the taxable pie." According to the Solicitor General, the "[r]espondents do not contend that, whenever a Maryland resident earns income in other States, Maryland may tax only a fixed portion of that income. Such a rule would saddle Maryland (and the other States) with the infeasible task of making an apples-to-oranges comparison—between the strength of Maryland's interest in taxing such income based on the recipient's residence and the strength of another State's interest in taxing the income based on the place where it was earned—in order to decide how much of the 'taxable pie' is fairly allocable to Maryland. Such a rule would also mean that some percentage of a Maryland resident's out-of-state income is beyond Maryland's power to tax *even if* the State in which the income is earned does not impose any tax upon it." (Emphasis in original.) The Solicitor General found that such a "rationale, which makes the taxing authority of Maryland and its counties contingent on taxing decisions of other States, cannot be reconciled with this Court's dormant Commerce Clause jurisprudence."

As noted above, the Supreme Court has granted Maryland's petition for writ of certiorari. Thus, the Court will consider whether the state's providing a credit against Maryland state income tax, but not against county-level income taxes, for incomes taxes paid to other states violates the Commerce Clause of the U.S. Constitution.

(For more on this case, including a discussion of Maryland's income tax scheme and a dissenting opinion in *Wynne,* see U.S. Supreme Court Update, 23 J. Multistate Tax'n 40 (February 2014).)

Court Decides Severance Pay FICA Case

On 3/25/14, the Supreme Court issued its decision in *U.S. v. Quality Stores, Inc.,* 134 S.Ct. 1395, 113 AFTR 2d 2014-1326, 188 L Ed 2d 413, 2014-1 USTC ¶50228 , *rev'g and rem'g In re Quality Stores, Inc.,* 110 AFTR 2d 2012-5827, 693 F3d 605, 2012-2 USTC ¶50551 (CA-6, 2012), *reh'g and reh'g en banc den.* 1/4/13. At issue was whether certain severance payments based on job seniority and length of service and paid to involuntarily terminated employees constituted taxable "wages" subject to the Federal Insurance Contributions Act (FICA, codified at IRC Section 3101 *et seq.*). The Court reversed the federal Court of Appeals for the Sixth Circuit, which had held that the payments were not taxable wages

under FICA. Justice Kennedy wrote the opinion for a unanimous Court. Justice Kagan took no part in the decision.

FICA's broad definition of "wages." The threshold question for the Court was whether FICA's definition of the term "wages" encompasses severance payments. The Court looked to the statutory language and noted that FICA taxes "wages" paid by an employer or received by an employee "with respect to employment" (IRC Sections 3101(a) and (b), and 3111(a) and (b)). The Court observed that FICA defines the term "wages" as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash" (IRC Section 3121(a)), and defines the term "employment" as "any service, of whatever nature, performed ... by an employee for the person employing him" (Section 3121(b)). Under the Court's reading of these definitions, "and as a matter of plain meaning," it determined that severance payments qualify as "remuneration" and that employees receive the severance payments "for employment." Thus, the Court found that severance payments are remuneration for employment per FICA's definitions. The Court also noted that FICA's list of specific exemptions reinforces the breadth of the general definition. And the Court observed that FICA's specific exemption for "termination-related payments"—Section 3121(a)(13)(A), which exempts severance payments made "because of ... retirement for disability,"—would be "unnecessary were severance payments in general not within FICA's definition of ‘wages.’"

Sixth Circuit incorrectly relied on IRC Section 3402(o). Next, the Court addressed the issue of whether IRC Section 3402(o), "relating to income-tax withholding, is a limitation on the meaning of ‘wages’ for FICA purposes." Section 3402(o)(1)(A) provides that "any supplemental unemployment compensation benefit paid to an individual ... shall be treated as if it were a payment of wages by an employer to an employee for a payroll period." As the Court explained, Quality Stores argued that "§3402(o)'s instruction that SUBs [supplemental unemployment compensation benefits, a term that all parties agreed includes the payments at issue before the Court] be treated ‘as if’ they were wages for purpose of income-tax withholding is an indirect means of stating that the definition of wages for income-tax withholding does not cover severance payments." Quality Stores Further contended that "if the definition of wages for purposes of income-tax withholding does not encompass severance payments, then severance

payments are not covered by FICA's similar definition of wages." The Court, however, disagreed with Quality Stores' reading of Section 3402(o). It also noted that the Sixth Circuit's holding that the payments are not wages taxed by FICA "relied not on FICA's definition of wages but on §3402(o) of the Internal Revenue Code, a provision governing income-tax withholding," and the Court found that conclusion to be "incorrect."

The Court agreed, instead, with the government's position that "§3402(o)'s command that all severance payments be treated 'as if' they were wages for income-tax withholding is in all respects consistent with the proposition that at least some severance payments are wages." The Court adopted the Federal Circuit's reasoning when interpreting Section 3402(o) in *CSX Corp. v. U.S.,* 101 AFTR 2d 2008-1120, 518 F3d 1328, 2008-1 USTC ¶50218 (CA-F.C., 2008), quoting that court's view that the statement that "all men shall be treated as if they were six feet tall does not imply that no men are six feet tall."

The Court also found that Quality Stores could not rely on the boldface heading of IRC Section 3402(o) that states "Extension of withholding to certain payments other than wages," to support its argument that the statute excludes all severance payments from the definition of wages. According to the Court, "[t]he heading states that withholding is extended to 'certain payments.' This falls short of a declaration that all the payments listed in §3402(o) are not wages." The Court also looked to the regulatory background against which Section 3402(o) was enacted and concluded that it "illustrates the limited nature of the problem the provision was enacted to address." As the Court explained, supplemental unemployment compensation was established as a means to offer second-level protection against layoff by supplementing the unemployment benefits offered by the states. An issue arose, however, because in order for plans offering these benefits to work, it was necessary to avoid having the compensation be considered "wages" under federal law. Some states provided unemployment benefits only if terminated employees were not receiving "wages" as defined by federal law. Thus, employers lobbied the federal government to not treat the benefits paid out by these plans as wages. To address the issue, the IRS promulgated revenue rulings in the 1950s and 1960s that ruled that these payments were not wages under FICA or for purposes of income-tax withholding. Notwithstanding that the IRS exempted these payments from FICA and income tax withholding, the IRS considered them taxable income. To avoid timing issues, whereby terminated employees would have a huge

tax bill at the end of the year because no withholding occurred throughout the year, Congress enacted IRC Section 3402(o) so that the supplemental unemployment payments would be "treated as if" they were wages for purposes of income-tax withholding. As the Court underscored, "[n]ot all severance payment plans were tied to state unemployment benefits; and before §3402(o)'s 1969 enactment, the IRS ruled that severance payments not linked to state unemployment benefits were wages for purposes of income-tax withholding. See Rev. Rul. 65-251, 1965-2 Cum. Bull. 395; see also TAM 9416003." Thus, "[o]nce this background is understood, the Court of Appeals' interpretation of §3402(o) as standing for some broad definitional principle is shown to be incorrect."

For ease of administration, definition of wages should not vary. Lastly, the Court noted that its reasoning was consistent with the major principle recognized in *Rowan Companies, Inc. v. U.S.,* 48 AFTR 2d 81-5115, 452 US 247, 68 L Ed 2d 814, 81-1 USTC ¶9479, 1981-2 CB 191 (1981), i.e., "that simplicity of administration and consistency of statutory interpretation instruct that the meaning of ‘wages’ should be in general the same for income-tax withholding and for FICA calculations." The Court also addressed the current administrative position that the IRS provides for severance payments tied to the receipt of state unemployment benefits (i.e., they "are exempt not only from income-tax withholding but also from FICA taxation. See, e.g., Rev. Rul. 90-72, 1990-2 Cum. Bull. 211.)." According to the Court, "[t]hose Revenue Rulings are not at issue here. Because the severance payments here were not linked to state unemployment benefits, the Court does not reach the question whether the IRS' current exemption is consistent with the broad definition of wages under FICA."

New Petitions

As noted above, four new requests for certiorari have been filed with the Court.

Commerce Clause Challenge to Ad Valorem Tax on Natural Gas

In *Missouri Gas Energy v. State of Kansas Division of Property Valuation,* Docket No. 13-1216, petition for cert. filed 4/7/14, ruling below as *Appeals of Various Applicants From a Decision of Division of Property Valuation of State of Kansas for Tax Year 2009 Pursuant to*

K.S.A. 74-2438, 313 P3d 789 (Kan., 2013), the Kansas Supreme Court affirmed in part and reversed and vacated in part a decision of the Kansas Court of Tax Appeals regarding ad valorem taxes imposed on natural gas stored in facilities located in Kansas and under contract with interstate pipeline companies. The Kansas high court held that at least some of the taxpayers qualified as public utilities (i.e., out-of-state local distribution companies certified as public utilities in their states) and thus their gas was not exempt from tax under the Kansas Constitution, Article 11, §1, which exempts merchants' inventory from ad valorem taxation but does not exempt tangible personal property owned by a public utility. The court remanded the case for further proceedings to decide which of the taxpayers qualify as public utilities. The court also held that the ad valorem gas tax does not violate the Commerce Clause or Due Process Clause of the U.S. Constitution. Several of the taxpayers now petition the U.S. Supreme Court to review that holding, claiming that Kansas's tax unduly burdens interstate commerce.

Background. The taxpayers at issue in the case fall into one of three general categories: (1) out-of-state natural gas marketing companies; (2) out-of-state local distribution companies certified as public utilities in their home states; and (3) out-of-state municipalities. Each of the taxpayers purchased natural gas from producers or other marketers and then delivered the gas to an interstate pipeline company that allowed the taxpayer to withdraw equivalent amounts of gas at a later time from out-of-state distribution points. The natural gas at issue was thus stored for the taxpayer somewhere in the interstate pipeline's storage or transportation systems, which may or may not have been located in Kansas. The interstate pipeline also commingled the gas deposited by each taxpayer with the gas deposited by others. As such, each taxpayer obtained solely a contractual right to withdraw an amount of natural gas equivalent to the amount it deposited into the system.

The Kansas Division of Property Valuation determined that all of the taxpayers were "public utilities" for property tax purposes, and thus imposed ad valorem taxes based on an allocation formula, adopted from a Federal Energy Regulatory Commission-approved tariff. The taxpayers did not challenge the allocation methodology but appealed the appraisals and filed requests for ad valorem tax exemptions. The Kansas Court of Tax Appeals denied the taxpayers' exemption requests. It held that all the taxpayers were public utilities and

therefore their gas did not qualify for Kansas's constitutional or statutory exemptions. The Court of Tax Appeals, however, refrained from addressing whether the tax assessments violated the U.S. Constitution.

Kansas Supreme Court's constitutional analysis. The Kansas Supreme Court rejected the taxpayers arguments that the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota,* 504 US 298, 119 L Ed 2d 91 (1992), prohibits the state from assessing taxes if the taxpayer's only connection with the state is through a common carrier. As described by the court, "[t]he gravamen of their claim is that interstate pipelines are common carriers, the pipelines establish the taxpayers' only connection with Kansas, and that connection is insufficient for the purpose of assessing taxes." Citing the split of authority among its sister states as to whether *Quill*'s holding is limited to sales and use taxes, the Kansas Supreme Court ultimately determined that it "is best restricted to sales and use taxes," and thus does not act as an impediment to the taxation at issue.

The Kansas Supreme Court also rejected the taxpayers' additional Commerce Clause argument that the tax violated the test set forth in *Complete Auto Transit, Inc. v. Brady.* As noted above (in the discussion of *Wynne*), *Complete Auto* requires that to withstand a Commerce Clause challenge, a state tax must: (1) apply to an activity with a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate or foreign commerce; and (4) be fairly related to the services provided by the state. In this Kansas case, the taxpayers argued that the state's tax violates the first and fourth prongs of the *Complete Auto* test. But the Kansas Supreme Court disagreed.

Noting that the Oklahoma Supreme Court (*In re Assessment of Personal Property Taxes Against Missouri Gas Energy,* 234 P3d 938 (Okla., 2008); tax upheld under Commerce Clause) and Texas Court of Appeals (*Peoples Gas, Light and Coke Co. v. Harrison Central Appraisal District,* 270 SW3d 208 (Tex. App., 2008); tax violated Commerce Clause) have split on whether similar ad valorem taxes on natural gas stored in an interstate pipeline violated the Commerce Clause, the Kansas Supreme Court sided with the Oklahoma court and held that these taxes do not violate the Constitution. The court "agree[d] with the Oklahoma Supreme Court that the most important factor in determining whether a substantial nexus exists to tax the taxpayers' gas is that this is a personal property tax on

stored natural gas that was located in Kansas on the assessment date." Thus, the Kansas Supreme Court held that the ad valorem tax does not violate the Commerce Clause.

The court also determined that the tax did not violate the Due Process Clause of the U.S. Constitution. Quoting *Quill,* the court noted that the U.S. Supreme Court has held that due process "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." According to the court, "the taxpayers own tangible personal property stored in Kansas. And the property is stored in this state under the taxpayers' contracts with pipeline companies that own storage facilities in Kansas." Thus, "there is a sufficient nexus between the taxpayers' gas and the State of Kansas to establish the minimum contacts necessary to satisfy due process."

Question presented. In the petition for certiorari (2014 WL 1381353), the taxpayers ask the Court to consider: "Whether a state may, consistent with the dormant Commerce Clause, impose an *ad valorem* tax on natural gas that is being transported through interstate commerce but temporarily stored in the state by a common carrier, even though the taxpayer has no control over where the gas is stored and no other connection with the state."

Challenge to Alleged Racially Discriminatory Property Tax

In *India Lynch v. Alabama,* Docket No. 13-1232, petition for cert. filed 4/10/14, ruling below as *I.L. v. Alabama,* 739 F3d 1273 (CA-11, 2014), the federal Court of Appeals for the Eleventh Circuit considered a series of allegedly discriminatory property tax restrictions contained in the Alabama Constitution. The petitioners, black and white Alabama public school students, challenged state constitutional provisions dealing with both millage caps and property classifications, and argued that the provisions cripple the ability of certain rural, nearly all-black public schools in Alabama to raise necessary revenues. With regard to the students' challenges to the millage caps, the circuit court remanded the case to the district court with instructions to dismiss the challenges without prejudice for lack of standing. As for the challenges to the property classification provisions, the court affirmed the district court's 804-page order concluding that the students had failed to show that the allegedly discriminatory provisions were unconstitutional. The petitioners now ask the U.S.

Supreme Court to review both the circuit court's ruling as to standing and to decide the correct constitutional standard for reviewing the allegedly discriminatory provisions of Alabama's Constitution.

Standing and the Tax Injunction Act. Although the district court found that the millage cap provisions in the Alabama Constitution were enacted with a racially discriminatory intent, the circuit court began its analysis by considering whether the plaintiffs had standing for the various claims they assert. As stated by the circuit court, in order to have standing a plaintiff must demonstrate injury in fact, causation, and redressability. Alabama, the defendant in the case below, claimed that the plaintiffs both lacked a cognizable injury and could not show that any alleged injury would be redressed by the relief requested. The court disagreed with the state's first contention finding that "impediments to public education funding arising from racially discriminatory state laws can constitute particularized and concrete injury for purposes of standing," but concurred that, with regard to the challenges to the millage cap provisions, the plaintiffs lacked a substantial likelihood for redress and therefore lacked standing to challenge those provisions.

With regard to redressability, the court separated its analysis into two parts: (1) the plaintiffs' challenges to the millage cap provisions, and (2) the plaintiffs' challenges to the property classification provisions. First, noting that the U.S. Supreme Court has described redressability as "a substantial likelihood that the relief requested will redress the injury claimed" (internal citation and quotation marks omitted), the circuit court concluded that removal of the millage caps (i.e., the remedy the plaintiffs sought) would not redress the plaintiffs' asserted injury, which was the inability of the plaintiffs and their elected officials to raise state and local revenue for public education. According to the court, regardless of the constitutional caps in place, further legislation was necessary to achieve higher millage rates, and "the contingency of [legislative] action makes the redress of plaintiffs' injury ... speculative" (internal citation and quotation marks omitted). Moreover, the record below indicated that Alabama voters in the counties in which the plaintiffs reside, where property taxes were below the maximum permissible rate, have, in fact, rejected various proposals to increase property taxes. The uncertainty as to whether revenue would increase in the absence of constitutional millage caps led the court to conclude that granting the plaintiffs

the relief they requested "would result in nothing more than a mere ‘moral’ victory, something the federal courts may not properly provide."

Conversely, the court found that by removing the property classification provisions that limit assessment ratios in Alabama, the state would necessarily receive more tax revenue, at least some of which could be used to fund public education. Thus, if successful, the plaintiffs' challenges to the property tax classification provisions would likely redress the plaintiffs' injury, which, according to the court, was enough for standing purposes. Thus, the court allowed the challenges to the property classification provisions to move forward.

Although Alabama also urged the court to rule that the Tax Injunction Act (codified at 28 USC §1341), a jurisdictional rule that limits a district court's review of state and local taxes, deprived the district court of jurisdiction over the case, the circuit court relied on *Hibbs v. Winn,* 542 US 88, 159 L Ed 2d 172 (2004), and dismissed the state's argument. As the circuit court explained, in *Hibbs* "the Supreme Court distinguished between ‘taxpayer claims that would reduce state revenues and third-party claims that would enlarge state receipts.’" The Eleventh Circuit found the challenge at hand to be in the latter category and stated that "*Hibbs* at the very least stands for the proposition that third-party challenges to the validity of state taxing schemes fall outside the ambit of the Tax Injunction Act if the challenges, were they to prove successful, would result in the increase of the tax liabilities of others (and therefore an increase in tax revenues to the state)."

(For a discussion of *Hibbs,* see U.S. Supreme Court Update, "Tax Injunction Act No Bar to Third-Party Challenge to State Tax Credit in Federal Court," 14 J. Multistate Tax’n 45 (September 2004).)

Because the court concluded that the plaintiffs lacked standing to challenge the millage cap provisions, the Eleventh Circuit solely addressed the merits of the plaintiffs' challenge to the property tax classification provisions.

Discriminatory intent. In considering the plaintiffs' ability to prevail on their constitutional challenges to Alabama's property tax classifications, the court relied on U.S. Supreme Court precedent and ruled that "the plaintiffs were required to prove not only discriminatory impact, but also racially discriminatory intent or purpose." (Here, the court

cited *Hunter v. Underwood,* 471 US 222, 85 L Ed 2d 222 (1985).) Moreover, the circuit court noted that a district court's finding as to discriminatory intent is a factual one that cannot be set aside unless it "is clearly erroneous." And unlike its view of the discriminatory intent behind the millage cap provisions, the district court found that the property classification provisions were primarily motivated by permissible financial considerations.

In reviewing the lower court's finding, the circuit court acknowledged the district court's "exceptionally thorough discussion of Alabama's long history of racial discrimination." This, according to the circuit court, "belied" any "suggestion that the district court ignored or improperly discounted" the probative value of the historical context surrounding the enactment of the challenged Amendments, as argued by the plaintiffs. Instead, the circuit court concluded that it "cannot say that the district court clearly erred in finding that [the property classification] system was not the product of invidious discriminatory intent." And "[a]lthough the evidence presented could have supported a finding of discriminatory intent, ... [u]nder clear-error review, [the court was] not free to second-guess the district court's choice between two permissible views of the evidence." The circuit court therefore affirmed the district court's ruling as to the constitutionality of the property classification provisions.

Questions presented. In the petition for certiorari (2014 WL 1430814), the petitioners raise three questions before the Court. First, noting that "[t]he district court found that several provisions of the Alabama Constitution of 1901 were adopted for the purpose of limiting the imposition on whites of property taxes that would pay for the education of black public school students," the petitioners ask, "Do black public school children and their parents have standing to challenge the validity under the Equal Protection Clause of [sic] state constitutional provisions adopted for the purpose of limiting the imposition on whites of property taxes that would be used to educate black public school students?"

Next, the petitioners note that "[i]n 2004, the District Judge in *Knight v. Alabama* [458 F Supp 2d 1273 (DC Ala., 2004)] held that certain aspects of [the property classification Amendments] to the Alabama Constitution were adopted for racially discriminatory reasons. In 2011, the District Judge in the instant case, applying different legal standards, concluded

that the Amendments were enacted for a nondiscriminatory purpose." The second question presented is therefore "[w]hich district judge applied the correct constitutional standard?"

Finally, the petitioners state: "The district court in the instant case found that prior to 1971 real property in Alabama was assessed far below its fair market value, and that the 'primar[y]' reason for those low assessments was to protect white landowners from paying property taxes that would be used to educate black public school students. After 1971, Alabama adopted two constitutional amendments whose purpose, the court of appeals recognized, was to 'entrench' those race-based pre-1971 assessments." The petitioners therefore ask "[i]s the Equal Protection Clause violated by a state constitutional amendment adopted for the purpose of entrenching pre-existing race-based property tax assessments?"

Federal Tax Petitions With State and Local Tax Implications

We also note two petitions involving federal taxes that, if granted, may have state and local tax implications.

FICA and unemployment tax wage caps. In *Cencast Services, L.P. v. U.S.,* Docket No. 13-1098, petition for cert. filed 3/11/14, ruling below at 112 AFTR 2d 2013-6029, 729 F3d 1352, 2013-2 USTC ¶50511 (CA-F.C., 2013), the U.S. Court of Appeals for the Federal Circuit considered the annual wage-based caps under the Federal Unemployment Tax Act (FUTA) and the Federal Insurance Contributions Act (FICA). FUTA and FICA each limit an employer's tax liability with a per-year, per-employer cap on taxable wages; wages paid above the cap are not taxed.

In the case below, the Federal Circuit held that the petitioner, a payroll service company that serves various motion picture and television production companies, should have calculated the FUTA and FICA wage-based caps as though the employees who received payments from the petitioner were in an "employment" relationship with each of the several production companies that hired them, rather than with the payroll service company, the "statutory employer" that paid the wages. The circuit court noted that the production companies were the employees' common law employers, and nothing in FUTA or FICA suggested that Congress intended that common law employers be given the option of

choosing a different wage cap (effectively reducing the amount of their tax liability) based on whether they chose to administer payrolls themselves or to delegate that responsibility to a payroll service company.

In its petition for certiorari (2014 WL 975923), the payroll service company asks the Court to review the circuit court's ruling and to decide "whether the annual wage caps apply only once, to all wages the statutory employer pays a given employee, or multiple times, to the wages the employee earns in each of his several common-law employment relationships."

A second question concerns the common-law defense of recoupment which "allows a defendant to decrease a plaintiffs recovery based on any claims the defendant has arising out of the same transaction." Noting that "[t]he circuits are divided on how recoupment applies in tax cases," the petitioner asks "whether, absent a statutory limitation on recoupment, a taxpayer may assert overpaid payroll taxes in support of a recoupment defense to limit the government's recovery of payroll taxes owed for the same year."

Given that states, like the federal government, have similar annual caps for employment taxes, this case could have potential state and local tax implications.

Economic substance doctrine. Many state tax cases involve questions relating to the bona fides of a transaction, in particular whether the transaction had "economic substance" and/or a nontax business purpose. If the Supreme Court agrees to hear *WFC Holdings Corp. v. U.S.,* Docket No. 13-1037, petition for cert. filed 2/26/14, ruling below at 112 AFTR 2d 2013-5815, 728 F3d 736, 2013-2 USTC ¶50485 (CA-8, 2013), the holding could be instructive in state tax matters. In this case, which involves WFC Holdings Corp., a wholly owned subsidiary of Wells Fargo & Company, the federal Court of Appeals for the Eighth Circuit affirmed the district court's ruling denying the petitioner a tax refund for a capital loss it claimed as a result of a complex transaction involving the transfer of commercial leases from two banking subsidiaries to a non-banking subsidiary in exchange for the stock of the non-banking subsidiary. According to the circuit court, WFC failed to show that the transaction had objective economic substance or that the transaction had a subjective, nontax business purpose.

WFC describes the transaction and the lower court's ruling in its petition for writ of certiorari (2014 WL 825174) as follows: "In 1998, petitioner WFC Holdings Corporation and its subsidiaries entered into a lease restructuring transaction that generated tens of millions of dollars in economic benefits for the company and its shareholders. The government concedes that, under the plain language of the Internal Revenue Code ..., the transaction also entitled petitioner to a tax deduction that reduced its corporate income tax liability by approximately $148 million. The Eighth Circuit nevertheless denied petitioner's claim for the deduction under the judge-made ‛economic substance doctrine.’ It held that the transaction's structure was designed to achieve the tax deduction and was not necessary to obtain the non-tax economic benefits." WFC now asks the Court "[w]hether an objectively profitable transaction can be disregarded for tax purposes under the judge-made economic substance doctrine because it was structured to achieve income tax deductions authorized by the plain language of the Code."

Petitions Still Pending

As we go to press, as noted above, we still await the Court's decisions on whether to grant three previously filed requests for certiorari.

Due process challenge to Mississippi's tax appeal procedure.

In *Equifax, Inc. v. Mississippi Department of Revenue,* Docket No. 13-1006, petition for cert. filed 2/19/14, ruling below at 125 So 3d 36 (Miss., 2013), *reh'g den.* 11/21/13, *rev'g* Miss. Ct. App., No. 2010-CA-01857-COA, 5/1/12, 2012 WL 1506006 , *reh'g den.* 9/4/12, the Mississippi Supreme Court reversed the Mississippi Court of Appeals decision and reinstated the judgment of the chancery court, which had upheld the Mississippi Department of Revenue's (MDOR's) assessment of corporate income and franchise taxes against Equifax, Inc. and its subsidiary, Equifax Credit Information Services, Inc. (collectively "Equifax"). In what is viewed by many as a surprising decision, the state high court upheld the MDOR's use of an alternative apportionment method—market-based sourcing—in determining Equifax's Mississippi income and, in particular, upheld the chancery court's ruling *placing the burden of proof on the taxpayer* to show that the MDOR's use of an alternative apportionment method was "arbitrary and capricious."

The court found that the use of the market-based sourcing method was not a promulgation of a new rule in violation of the Mississippi Administrative Procedures Act and applied a more-limited trial court "arbitrary and capricious" standard of review, rather than a *de novo* standard of review of the substantive issues underlying the tax assessment. Applying this standard, the court also determined that the chancery court could not reverse the MDOR's decision to impose penalties against Equifax, notwithstanding that the chancellor would have ruled differently on the merits.

On 4/1/14, Mississippi legislators sent a bill, which emerged from a House-Senate conference committee, to Governor Phil Bryant (R), who then signed the bill into law (H.B. 799, 4/10/14; Laws 2014, effective 1/1/15). The new law requires that the MDOR use alternative apportionment only when it can show with a "preponderance of evidence" that the method best reflects a taxpayer's business activity in the state. As previously reported in this column, an earlier version of the bill set a higher standard of "clear and convincing evidence." Whether this legislative response will impact the U.S. Supreme Court's decision on whether to grant certiorari remains to be seen.

(For more on this case, including a more detailed discussion of the ruling below, see U.S. Supreme Court Update 24 J. Multistate Tax’n 40 (May 2014). *Equifax* was also discussed in Wilson, "Mississippi: State High Court Reverses Lower Court's Shift of Burden of Proof to Revenue Department," 23 J. Multistate Tax’n 28 (January 2014). The new legislation was reviewed in Shop Talk, "Mississippi Legislation Includes Response to *Equifax* Decision," in this issue of The Journal (24 J. Multistate Tax’n 36 (July 2014)).)

Tax Injunction Act challenge. In *Direct Marketing Ass'n v. Brohl,* Docket No. 13-1032, petition for cert. filed 2/25/14, ruling below at 735 F3d 904 (CA-10, 2013), *rem'g Direct Marketing Ass'n v. Huber,* DC Colo., No. 10-CV-01546-REB-CBS, 3/30/12, 2012 WL 1079175 , the federal Court of Appeals for the Tenth Circuit overturned a district court's ruling that a Colorado law imposing information notice and reporting requirements on remote retailers, violated the Commerce Clause. The circuit court remanded the case to the district court for dismissal on procedural grounds, finding that the Tax Injunction Act (TIA, codified at 28 USC §1341) precluded federal court jurisdiction over the claims. The plaintiff,

the Direct Marketing Association, asks the Supreme Court to clarify the scope of the TIA's jurisdiction.

(For more on this case, including a detailed discussion of the Colorado notice and reporting requirements, see U.S. Supreme Court Update 24 J. Multistate Tax’n 40 (May 2014). For more background, see also Hecht, "Information Reporting for Out-of-State Vendors Just as Unconstitutional as Tax Collection Responsibility," 22 J. Multistate Tax’n 6 (August 2012).)

4R Act tax discrimination challenge. On 1/27/14, the Supreme Court invited the U.S. Solicitor General to file a brief expressing the views of the federal government in *Alabama Department of Revenue v. CSX Transportation, Inc.,* Docket No. 13-553, petition for cert. filed 10/30/13, ruling below as *CSX Transportation, Inc. v. Alabama Department of Revenue,* 720 F3d 863 (CA-11, 2013). As we go to press, we still await the government's brief.

In Alabama's petition for review, the state's attorney general asks the Court to review the decision by the federal Court of Appeals for the Eleventh Circuit holding that Alabama's failure to provide a tax exemption from the state's sales and use taxes for railroads' purchases of diesel fuel, while exempting both interstate motor carriers and water carriers, was discriminatory in violation of the federal Railroad Revitalization and Regulatory Reform Act of 1976 (the "4R Act," codified at 49 USC §11501).

(For more background on this request for certiorari, including a discussion of Alabama's tax scheme at issue, the procedural history, and a dissenting opinion in this latest case, see U.S. Supreme Court Update, 23 J. Multistate Tax’n 40 (February 2014).)

Certiorari Has Been Denied in:

Tesoro Corp. v. Alaska Department of Revenue, Docket No. 13-1023, *cert. den.* 6/2/14, ruling below at 312 P3d 830 (Alaska, 2013), in which the Alaska Supreme Court held that Tesoro Corporation, a petroleum company headquartered in Texas, and its subsidiaries constituted a unitary business subject to formula apportionment in Alaska. According to the court, the facts as found by the administrative law judge (ALJ) demonstrate functional integration, centralization of management, and economies of scale—

relationships that the state's highest court and the U.S. Supreme Court have held to be unitary. The court also found that Tesoro lacked standing to challenge the constitutionality (i.e., internal consistency) of Alaska's apportionment scheme because the company failed to demonstrate an actual injury that it suffered as a result of the alleged constitutional violation. Finally, the court also held that the Alaska Department of Revenue's use of an alternative apportionment formula was reasonable as applied to the taxpayer.

(For more on this case, including Tesoro's business operations and an analysis of the ruling below, see U.S. Supreme Court Update, 24 J. Multistate Tax'n 40 (May 2014).)

Commerce & Industry Insurance Co. v. Department of the Treasury, Docket No. 13-1164, *cert. den.* 5/27/14, ruling below at 836 NW2d 695 (Mich. Ct. App., 2013), *app. den.* Mich., No. 147440, 12/23/13, in which the Michigan Court of Appeals held that the state's retaliatory insurance tax regime does not overly burden insurance companies doing business in New York. The court refused to rule whether the retaliatory tax regime violates the Equal Protection Clause. The taxpayer and two other subsidiaries of American International Group Inc. had argued that such violation occurs when Michigan taxes New York insurers writing workers' compensation policies at rates six times higher than the rates it applies to tax Michigan insurers writing the same types of policies. The insurers were unable to challenge the law on a Commerce Clause basis because, according to the court, the McCarran-Ferguson Act (codified at 15 USC §1011 *et seq.*) "removed all Commerce Clause limitations on the authority of the States to regulate and tax the business of insurance" (quoting *Western and Southern Life Insurance Co. v. State Board of Equalization of California,* 451 US 648, 68 L Ed 2d 514 (1981)).

New York Life Insurance Company v. U.S., Docket No. 13-849, *cert. den.* 4/28/14, ruling below at 112 AFTR 2d 2013-5555, 724 F3d 256, 2013-2 USTC ¶50458 (CA-2, 2013), in which the Supreme Court was asked to consider the application of the "all events" test—a foundational test within the tax law that governs the timing of deductions for accrual-basis taxpayers. The effects of this test at the federal level, of course, pass through to the deductions claimed at the state level. In the case below, New York Life Insurance Company (N.Y. Life), an accrual-basis taxpayer, claimed deductions on its federal income tax returns related to certain accrued policyholder dividends. Concluding that the deductions did not

satisfy the "all-events" test, the IRS disallowed them and determined that N.Y. Life could not deduct the dividends until the year of payment. When N.Y. Life challenged the Service's actions in court, the IRS filed a motion to dismiss under Fed. Rul. Civ. Proc. 12(b)(6) for failure to state a claim. The district court granted the Service's motion to dismiss (107 AFTR 2d 2011-2107, 2011-1 USTC ¶50373, 780 F Supp 2d 324 (DC N.Y., 2011)). The federal Court of Appeals for the Second Circuit affirmed, finding that "New York Life's complaint fails to state a plausible claim that the deductions at issue satisfied the first prong of the all-events test." (For more background on this case, see U.S. Supreme Court Update, 24 J. Multistate Tax’n 39 (Mar/Apr 2014).) **[]**

END OF DOCUMENT - © 2014 Thomson Reuters/Tax & Accounting. All Rights Reserved.