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EXTERNAL ALERT

U.S. Supreme Court Hears Oral Arguments on Alabama Sales Tax "4-R Act" Case

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Overview

The U.S. Supreme Court recently heard oral arguments in *Alabama Department of Revenue v. CSX Transportation, Inc.*,[1] a case concerning whether Alabama's sales tax regime is discriminatory under the Railroad Revitalization and Regulatory Reform Act ("4-R Act"). The 4-R Act prohibits a state from "impos[ing] [a] tax that discriminates against rail carriers providing transportation . . . ."[2] The issue before the Court is whether Alabama's sales tax regime, which imposes a sales tax on a railroad's purchases of diesel fuel but exempts similar purchases by certain competitors (motor and water carriers), violates the anti-discrimination provisions of the 4-R Act.

In this Tax Alert we summarize the procedural history of *CSX* and the parties' arguments before the U.S. Supreme Court. We also provide some taxpayer considerations.

Background

The taxpayer in *CSX* provides railroad transportation services in multiple states, including Alabama. As stipulated by the parties, the taxpayer's competitors for the shipment of freight in interstate commerce are motor and water carriers. Rail, motor and water carriers purchase diesel fuel in order to provide transportation services. Under Alabama's sales tax regime, the purchase of diesel fuel is generally subject to the 4% sales tax. Alabama provides an exemption for diesel fuel purchased by a water carrier "engaged in foreign or international commerce or interstate commerce"[3] and for diesel fuel purchased by motor carriers who are instead subject to a 19 cent per gallon excise tax.[4] However, the state does not exempt from sales tax diesel fuel purchased by a rail carrier.

In 2008, the taxpayer filed suit in the United States District Court for the Northern District of Alabama ("District Court"), asserting that Alabama's sales tax violated the 4-R Act because the tax is imposed only on rail carriers and not on motor and water carriers. The suit was initially dismissed by the District Court as not cognizable under the 4-R Act,[5] and that decision was affirmed by the U.S. Court of Appeals, Eleventh Circuit ("Eleventh Circuit").[6] However, the U.S. Supreme Court reversed and held that the taxpayer may challenge Alabama's sales tax as a tax that discriminates against rail carriers under the 4-R Act.[7] The U.S. Supreme Court did not address whether Alabama's sales tax in fact discriminates against rail carriers by exempting interstate motor and water carriers and remanded the case for further proceedings on that issue.[8] The District Court then addressed the discrimination issue, finding no 4-R Act violation.[9] The taxpayer appealed the matter to the Eleventh Circuit.

Proceedings before the Eleventh Circuit / Oral Arguments before the U.S. Supreme Court

The Eleventh Circuit held that the Alabama sales tax was discriminatory under the 4-R Act.[10] In reaching their conclusion, the Eleventh Circuit addressed the following: (1) the proper class of taxpayers to which the court should compare a rail carrier when gauging discrimination ("comparison class");[11] and (2) the extent that the court should

[1] *CSX Transp., Inc. v. Ala. Dep't of Revenue*, No. 13-553 (U.S. argued Dec. 9, 2014).
[2] 49 U.S.C. § 11501(b)(4).
[3] Ala. Code § 40-23-4(a)(10).
[4] Ala. Code § 40-17-325(b).
[5] *CSX Transp., Inc. v. Ala. Dep't of Revenue*, No. 2:08-CV-0655-UWC, 2008 U.S. Dist. LEXIS 124754 (N.D. Ala. 2008).
[6] *CSX Transp., Inc. v. Ala. Dep't of Revenue*, 350 F.App'x 318 (11th Cir. 2009).
[7] *CSX Transp., Inc. v. Ala. Dep't of Revenue*, 131 S. Ct. 1101, 1114 (2011).
[8] *Id*.
[9] *CSX Transp., Inc. v. Ala. Dep't of Revenue*, 892 F.Supp.2d 1300 (N.D. Ala. 2012).
[10] *CSX Transp., Inc. v. Ala. Dep't of Revenue*, 720 F.3d 863 (11th Cir. 2013).
[11] Unlike 49 U.S.C. § 11501(b)(1)-(3) of the 4-R Act, the general statutory language of 49 U.S.C. § 11501(b)(4) does not define the comparison class. Under (b)(1)-(3), which addresses prohibited practices in the property tax context, the statutory language provides a comparison class of "other commercial and industrial" taxpayers.

consider other aspects of a State's tax scheme ("extent of the comparability analysis"). Both issues are now before the U.S. Supreme Court.

In the discussion that follows we summarize the Eleventh Circuit's holding on these issues and discuss related statements delivered by each party during the December 9, 2014, oral arguments before the U.S. Supreme Court.

Comparison Class

Eleventh Circuit Decision

In addressing the comparison class issue, namely, identifying the class of taxpayers to which the court should compare a rail carrier when gauging discrimination, the Eleventh Circuit looked to the other U.S. Courts of Appeals decisions for guidance and concluded that there are generally two approaches: the functional approach (including all other commercial and industrial taxpayers in the comparison class) or the competitive approach (limiting the comparison class to interstate motor and water carriers).[12] The Eleventh Circuit reasoned that the appropriate approach was the competitive approach.[13]

Arguments before the U.S. Supreme Court

Counsel for the Alabama Department of Revenue ("DOR") pressed the U.S. Supreme Court to adopt the functional approach, asserting that the "courts should compare the taxation of railroads to the taxation of the mass of other businesses in the State with the focus on whether the State is targeting or singling out railroads for a tax that the general mass of other businesses do not have to pay."[14] Explaining further, counsel for the DOR argued the comparison class "should at least include the many businesses that also pay [the Alabama sales] tax [for] the items that they buy for their business[,]"[15] and there would be no "violation on the comparison class issue as long as the general mass of business are still paying the same tax rate."[16]

In contrast, counsel for the taxpayer argued that the Eleventh Circuit's adoption of the competitive approach was an accurate application of the law. Counsel for the taxpayer stressed that "it only makes sense to think about [discrimination] in the context of your competitors, because Congress's other purpose in this was to ensure that there would be financial stability, [that is] that the railroads would . . . be able to operate on their own."[17] The Assistant to the Solicitor General of the United States supported taxpayer's interpretation of the 4-R Act, providing that if railroads do not compete with a certain class of taxpayers, "it doesn't harm railroad's financial stability to have [that class of taxpayers] exempted."[18]

Extent of the Comparability Analysis

Eleventh Circuit Decision

The Eleventh Circuit declined to evaluate the overall fairness of Alabama's tax structure in relation to purchases of diesel fuel, stating "we look only at the sales and use tax with respect to the fuel to see if discrimination has occurred."[19] Thus, it was not relevant that Alabama's tax structure required motor carriers to pay an excise tax on their diesel fuel purchases, which may result in an equivalent amount of tax to be paid as the sales tax.[20]

Arguments before the U.S. Supreme Court

Counsel for the DOR urged the U.S. Supreme Court to evaluate the overall fairness of Alabama's tax structuring, weighing "a State's reasons for the exemptions in its tax code . . . with a focus on whether the railroads are suffering any practical disadvantage."[21] In supporting the DOR's position and in response to the Eleventh Circuit's holding, the Assistant to the Solicitor General of the United States asserted "[t]his Court, in its dormant commerce

[12] *CSX Transp., Inc.*, 720 F.3d at 867-868.
[13] *Id*. at 869.
[14] Transcript of Oral Argument at 3, *CSX Transp., Inc. v. Ala. Dep't of Revenue,* U.S. (No. 13-553), available at **http://www.supremecourt.gov/oral_arguments/argument_transcripts/13-553_6537.pdf**.
[15] *Id*. at 7.
[16] *Id*. at 8.
[17] *Id*. at 36.
[18] *Id*. at 27.
[19] *CSX Transp., Inc.*, 720 F.3d at 869, citing *Union Pac. R.R. Co. v. Minn. Dep't of Revenue*, 507 F.3d 693, 695 (11th Cir. 2007).
[20] This would appear to conflict directly with the approach employed by the District Court in its analysis of a rail carriers' competitors in "all relevant respects," including an evaluation of the state's overall tax scheme. *See*, *CSX Transp., Inc*, 892 F.Supp.2d at 1312 (N.D. Ala. 2012).
[21] Transcript of Oral Argument at 59, *CSX Transp., Inc. v. Ala. Dep't of Revenue,* U.S. (No. 13-553).

[clause] cases, in its cases about discrimination against the Federal government and those with whom it deals, does just that."[22]

Counsel for the taxpayer criticized the DOR's position stating "Alabama wants to do it in a very simpleminded way, how much are you paying today and how much are they paying today, and if it's close enough, that's good enough for government work."[23] Taxpayer's counsel further explained that an appropriate comparability analysis requires the courts to identify "the nature of the tax, the purposes of the tax, [and] the incidence of the tax, . . . [which] are all complicated issues . . . and if the State is only going to come in here and try to defend itself on the basis that at one point in time the money is pretty close, that's not going to get it done."[24] Counsel suggested further that courts are capable of engaging in some form of limited comparability analysis but only when addressing a single form of tax type, such as circumstances when all competitors are subject to a sales tax.[25] Taxpayer's counsel also frequently reminded the Justices that this case does not require the U.S. Supreme Court to address the comparability issue, asserting that Alabama's treatment of interstate water carriers is "facial discrimination."

Considerations

Railroad taxpayers should continue to monitor the status of *CSX* as the U.S. Supreme Court's decision may identify the appropriate comparison class for discrimination under the 4-R Act, which may potentially impact taxpayers operating in other states that employ tax regimes similar to that of Alabama. Additionally, the *CSX* opinion may also provide guidance on how the Supreme Court may view future state tax discrimination claims raised by federally regulated industries.

Contacts

If you have questions regarding this pending U.S. Supreme Court case, the 4-R Act, or other Alabama tax matters, please contact any of the following Deloitte Tax LLP professionals.

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[22] *Id*. at 29-30.
[23] *Id*. at 40.
[24] *Id*. at 54.
[25] *Id*. at 47-48.