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The new normal in state taxation

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In this edition of Inside Deloitte, the authors use the National Multistate Tax Symposium as a platform to discuss transformational state tax topics and state tax cases of the U.S. Supreme Court from the 2014 term, as well as to speculate on some state tax cases that the Supreme Court may choose to hear in the future and provide relevant taxpayer and practitioner considerations

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As more states continue to pursue revenue-raising measures through aggressive legislative initiatives and enhanced audit enforcement, state and local tax practitioners should ask themselves at what moment does a trend become the norm? At the National Multistate Tax Symposium on February 3-5 in Orlando, Florida — titled "The Shifting Landscape — Transformational Changes in State Taxation" — state and local tax practitioners from industry, law firms, and Deloitte Tax LLP gathered to provide a national perspective and leading practices on numerous transformational topics that could be considered the "new normal." Topics considered by panelists included:

- whether factor-based and economic presence nexus standards are consistent with a reasonable interpretation of the commerce clause and due process requirements;
- whether due process arguments continue to be viable with the increased state adoption of click-through and affiliate nexus standards;
- in market-based sourcing states, how to comply with the affirmative duty to know the market in which the availability of required data may be limited;
- whether there are lessons to be learned from the Multistate Tax Compact three-factor election litigation;
- whether Michigan's 2014 legislation retroactively repealing that state's compact membership is a disturbing trend that may encourage other states to enact retroactive state tax legislation to neutralize the revenue impact of taxpayer-favorable court decisions; and
- where states may be headed with regard to the sales and use taxation of electronically delivered services and digital goods.

In this article, the authors use the National Multistate Tax Symposium as a platform to provide a snapshot of various practical considerations, discuss the state tax cases of the U.S. Supreme Court from the 2014 term, and speculate on state tax cases that the U.S. Supreme Court may choose to hear in the future.

I. A Snapshot for Practitioners — Highlights From the National Multistate Tax Symposium

In discussing the movement of several states to market-based sourcing, Kristen Cove of Deloitte said that while states are trending toward market-based sourcing, there are varying approaches on how each state defines the market and how states may enforce their respective standards on audit.[1] Cove added that the varying approaches may provide proactive taxpayers with a potential opportunity to enhance their market-based sourcing positions on audit. Taxpayers should review their market-based sourcing facts as soon as is practical and compare their facts with each state's market-based sourcing rules for application of the applicable sourcing method.

In a session titled "State Transfer Pricing — Preparing for Increased Scrutiny of Intercompany Transactions," Mike Bryan of Deloitte emphasized to attendees that transfer pricing continues to be a priority for states and the MTC's inability to launch the Arm's-Length Adjustment Service program should not be interpreted as a lack of state interest. Bryan also encouraged middle-market companies to revisit their current transfer pricing studies, because states appear to target taxpayers that they perceive as potentially resource-constrained. Taxpayers should continue to consider developing state-relevant, exam-ready transfer pricing documentation to the extent such a study has not been previously

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[1]All statements referenced in this article were delivered at the 2016 National Multistate Tax Symposium.

prepared and review any existing transfer pricing studies to determine whether an update is advisable, given changes to the taxpayer's business activities or to take into account state laws.

Regarding transfer pricing, panelists discussed the state significance of the OECD base erosion and profit-shifting project, which was undertaken to address governments' concerns that principles of national and international taxation were not keeping pace with the global nature of modern trading and business models. Although there may not be any direct state tax implications, Karl Frieden of the Council On State Taxation explained that the BEPS project is the basis for tax haven legislation,[2] the state's enhanced focus on transfer pricing, and additional information reporting requirements. The District of Columbia and the following six states have enacted some form of tax haven legislation: Alaska, Connecticut, Montana, Oregon, Rhode Island, and West Virginia.

II. Ramifications of U.S. Supreme Court State Tax Decisions From the 2014 Term

A. *Direct Marketing Association v. Brohl* — Does Substantial Nexus Still Require Physical Presence?

In *Direct Marketing Association v. Brohl*,[3] the U.S. Supreme Court considered whether the Tax Injunction Act[4] (TIA) deprived the federal district court of jurisdiction to enjoin Colorado from enforcing its remote seller sales and use tax notice and reporting requirements. The litigation stemmed from a suit brought against the Colorado Department of Revenue by DMA[5] whereby DMA contested the constitutionality of Colorado's sales and use tax notice and reporting requirements. Under those requirements, a noncollecting retailer with $100,000 or more of sales to customers in Colorado is required to perform all of the following tasks or be subject to penalties[6]:

- notify its Colorado customers that sales or use tax is due on some taxable purchases and that the customer is required to self-report and pay use tax to the DOR;[7]
- provide to its Colorado customers with more than $500 in annual purchases an annual report detailing the purchases for the previous calendar year; the report should also notify each customer that sales or use tax is due on certain taxable purchases and that the customer is required to self-report and pay use tax to the DOR;[8]
- provide to the DOR an annual report listing each of the retailer's Colorado customers; the report should include each customer's name, billing address, shipping address, and total purchases.[9]

At the federal district court, DMA raised two claims under the dormant commerce clause: (1) the notice and reporting requirements *discriminate* against out-of-state retailers that do not collect Colorado sales tax; and (2) the notice and reporting requirements *unduly burden* interstate commerce. On March 30, 2012, the federal district court granted partial summary judgment in favor of DMA and permanently enjoined enforcement of the notice and reporting requirements, holding that the requirements violated the commerce clause.[10] On appeal, the Tenth Circuit held that the federal district court lacked jurisdiction to hear DMA's challenge under the TIA.[11] The Tenth Circuit found that DMA's challenge sought to restrain the collection of sales and use taxes in Colorado, and that DMA had a plain, speedy, and efficient remedy in Colorado for its claim since the state's administrative remedies provide for hearings and appeals to state court, as well as ultimate review in the U.S. Supreme Court.[12]

In a unanimous decision, the U.S. Supreme Court held that Colorado's enforcement of its notice and reporting requirements does not encompass the "assessment, levy or collection" of sales and use taxes in Colorado.[13] The Court reasoned that although enforcement of the notice and reporting requirements may improve Colorado's ability to assess and collect sales and use taxes, the TIA "is not keyed to all activities that may improve a State's ability to assess and collect taxes. . . . [It] is keyed to the acts of assessment, levy and collection themselves, and enforcement of the notice

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[2]Under typical tax haven legislation, an otherwise water's-edge filing group is required to include the income of any company incorporated or doing business in a tax haven.

[3]135 S. Ct. 1124, 1134 (2015), *rev'g* 735 F.3d 904 (10th Cir. 2013).

[4]28 U.S.C. section 1341.

[5]DMA is a trade association of businesses and organizations that market products directly to customers via catalogs, print advertisements, broadcast media, and the Internet.

[6]Retailers failing to provide transactional notices to Colorado customers are subject to a penalty equal to $5 for each transaction for which they fail to send the requisite notice. Colo. Rev. Stat. section 39-21-112(3.5)(c)(II). Retailers failing to provide annual reports to their Colorado customers are subject to a penalty equal to $10 for each report they fail to send. Colo. Rev. Stat. section 39-21-112(3.5)(d)(III)(A). Retailers failing to provide an annual report to the department are subject to a $10 penalty for each purchaser that should have been in the report. Colo. Rev. Stat. section 39-21-112(3.5)(d)(III)(B).

[7]Colo. Rev. Stat. section 39-21-112(3.5)(c)(I).

[8]Colo. Rev. Stat. section 39-21-112(3.5)(d)(I)(A); Colo. Reg. 39-21-112.3.5(2)(c)(I).

[9]Colo. Rev. Stat. section 39-21-112(3.5)(d)(II)(A),(B); Colo. Reg. 39-21-112.3.5(1)(a)(III) and (4)(a).

[10]*Direct Mktg. Ass'n v. Huber*, No. 10-cv-01546-REB-CBS (D. Colo. Mar. 30, 2012).

[11]*Direct Mktg. Ass'n v. Brohl*, 735 F.3d 904 (10th Cir. 2013). The TIA provides that federal district courts do not have jurisdiction to rule on an action to "enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such state." 28 U.S.C. section 1341.

[12]*Direct Mktg. Ass'n v. Brohl*, 735 F.3d 904.

[13]*Direct Mktg. Ass'n v. Brohl*, 135 S. Ct. 1124, 1131 (2015).

and reporting requirements is none of these."[14] Allowing the TIA to apply to all activities that may improve a state's ability to assess and collect taxes "would be inconsistent not only with the text of the [TIA] statute, but also with our rule favoring clear boundaries in the interpretation of jurisdictional statutes."[15] Therefore, the Court concluded that the TIA does not bar DMA's suit in federal court and remanded the case to the Tenth Circuit to decide the merits of DMA's commerce clause claims.[16]

***1. Kennedy suggests a reconsideration of* Quill**

In a concurring opinion, Justice Anthony M. Kennedy strongly suggested that it was time for "a reconsideration of the [U.S. Supreme] Court's holding in *Quill*."[17] In *Quill*, the Court held that a mail-order business could not be required to collect and remit state use tax without having a physical presence in the state.[18] In reaching this decision, the Court affirmed the *Bellas Hess* bright-line physical presence standard for substantial nexus under the commerce clause, stating that "the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law."[19] In closing his concurrence, Kennedy called on the legal system to "find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*."[20]

2. DMA Update

On February 22, 2016, the Tenth Circuit reversed[21] the federal district court's determination that the notice and reporting requirements violated the dormant commerce clause.[22] In reversing the federal district court's decision, the Tenth Circuit began by analyzing the scope of the Supreme Court's holding in *Quill* since it has ramifications for both DMA's claim for discrimination and for undue burden. The Tenth Circuit explained that while *Quill*'s bright-line physical presence test has not been overruled by the Supreme Court, the Court has also "not extended the physical presence rule beyond the realm of sales and use tax collection."[23] The Tenth Circuit further noted that its own precedent supports such a limited application of *Quill*, quoting its decision in *American Target Inc. v. Giani*:

> Both *Bellas Hess* and *Quill* concern the levy of *taxes* upon out-of-state entities. The Supreme Court in *Quill* repeatedly stressed that it was preserving *Bellas Hess*' bright-line rule "in the area of sales and use taxes." The Utah Act imposes licensing and registration requirements, not tax burdens. The *Bellas Hess/Quill* bright-line rule is therefore inapposite.[24]

Therefore, the Tenth Circuit concluded that *Quill* applies narrowly to and has not been extended beyond sales and use and the tax collection thereof.[25]

The Tenth Circuit then turned to DMA's discrimination claim. The Tenth Circuit first concluded that the notice and reporting requirements do not facially discriminate against interstate commerce. In analyzing the statutory language, the Tenth Circuit concluded that the law provides differential treatment "between those retailers that collect Colorado sales and use tax and those that do not," as opposed to explicit geographical (in-state or out-of-state) distinctions.[26] The Tenth Circuit next concluded that the notice and reporting requirements do not discriminate in its direct effects because (1) the Colorado reporting obligation does not give in-state retailers a competitive advantage;[27] (2) the non-collecting, out-of-state, retailers are not similarly situated to the in-state retailers who must comply with tax collection and reporting requirements;[28] and (3) the notice and reporting requirements are designed to increase compliance with preexisting tax obligations and apply only to retailers that are not otherwise required to comply with the greater burden of tax collection and reporting.[29] After engaging in a comparability analysis, weighting the in-state retailer and anticipated out-of-state retailer compliance and other regulatory obligations, the Tenth Circuit held that DMA failed to provide evidence to establish that "the notice and reporting requirements for non-collecting out-of-state retailers are more burdensome than the regulatory requirements in-state retailers already face."[30]

The Tenth Circuit further held that the notice and reporting requirements do not impose an undue burden on interstate commerce. Unlike the federal district court, the Tenth Circuit did not consider the U.S. Supreme Court's conclusions in *Quill* controlling. The Tenth Circuit reiterated that *Quill* is limited to the narrow context of sales and use tax collection and relied on the Supreme Court's prior analysis of the notice and reporting requirements in *Direct Marketing Association v. Brohl*, in which it was held that the notice and reporting requirements do not constitute a form of tax collection.[31] Therefore, the Tenth Circuit concluded

[14] *Id.*
[15] *Id.*
[16] *Id.* at 1133.
[17] *Id.* at 1135 (Kennedy, J., concurring).
[18] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[19] *Quill*, 504 U.S. at 317.
[20] *Direct Mktg. Ass'n*, 135 S. Ct. at 1135 (Kennedy, J., concurring).
[21] *Direct Mktg. Ass'n v. Brohl*, No. 12-1175 (10th Cir. 2016).
[22] At the conclusion of the National Multistate Symposium, an opinion had not been issued by the Tenth Circuit.
[23] *Id.* at 16.
[24] *Id.* quoting *American Target Inc. v. Giani*, 199 F.3d 1241, 1255 (10th Cir. 2000).
[25] *Id.* at 18.
[26] *Id.* at 23.
[27] *Id.* at 26.
[28] *Id.* at 27.
[29] *Id.* at 28.
[30] *Id.* at 31.
[31] *Direct Mktg. Ass'n v. Brohl*, 135 S. Ct. 1124.

that the U.S. Supreme Court's conclusion in *Direct Marketing Association* controlled, not *Quill*.[32]

a. Practical Considerations

Although the constitutional issues in *Quill* may be distinguished from those presented in *Direct Marketing Association*, the Tenth Circuit's decision may have significant implications for the practical application of the *Bellas Hess* and *Quill* bright-line physical presence standard. If the U.S. Supreme Court agrees to hear an appeal of the Tenth Circuit's decision, a ruling could have widespread implications, such as limiting the application of *Quill* or potentially defining the meaning of substantial nexus for state income, franchise, and gross receipts taxes. If the Supreme Court denies cert or upholds the Tenth Circuit's analysis that *Quill* is limited to sales and use tax collection, it could lead to widespread adoption of notice and reporting requirements similar to those enacted in Colorado by other states. The adoption of such requirements would certainly prompt remote sellers to examine whether it would be more efficient to collect and remit sales and use taxes than to comply with the notice and reporting requirements, rendering the practical application of *Quill*'s bright-line physical presence standard much less meaningful. The combination of widespread adoption and the Supreme Court's denying cert or upholding the Tenth Circuit's narrow application of *Quill* may cause *Bellas Hess* and *Quill* to "wash away with the tides of the time."[33]

Also, as noted by the Tenth Circuit and the Supreme Court in *Quill*, "Congress holds the 'ultimate power' and is 'better qualified to resolve' the issue of 'whether, when, and to what extent the States may burden interstate [retailers] with a duty to collect [sales and] use taxes.'"[34] Doug Lindholm of the Council On State Taxation emphasized the Court's reluctance, explaining, "The message by the U.S. Supreme Court is very clear. We don't want to touch [this]. This is for Congress." Several bills and discussion drafts, such as Marketplace Fairness Act of 2015 (S. 698), Online Sales Simplification Act of 2015, and Remote Transaction Parity Act (H.R. 2775), that seek to require out-of-state retailers to collect sales and use tax have been recently introduced or otherwise contemplated in Congress.[35] However, it is unclear whether Congress will pass any legislative proposals, including the Marketplace Fairness Act of 2015. The lack of congressional interest combined with Kennedy's concurrence in *DMA* has adjusted some states' approach to addressing *Quill*. Frieden explained that while states will continue to push for congressional intervention, they appear to be gearing up for litigation. States such as Alabama[36] and South Dakota[37] have adopted or proposed more broad sales and use tax nexus statutes, regulations, or administrative policies in an attempt to "find an appropriate case for th[e] Court to reexamine *Quill* and *Bellas Hess*," as Kennedy suggested. Steve P. Kranz of McDermott Will & Emery said that both proposed or enacted legislation and/or regulation in Alabama, Colorado, and South Dakota are part of the nexus war. "As states pass legislation, they are developing a litigation strategy," he added.

Finally, if the Colorado DOR prevails in litigation and the injunction is lifted at the Colorado district court level, it is expected that the DOR will issue guidance regarding the timing of its enforcement of the notice and reporting requirements. Remote retailers that may be subject to the requirements should continue to consider whether they are prepared to comply with the standards on enforcement by the DOR. Because of the potential compliance burden of the notice and reporting obligation or the complex sales and use tax system augmentations that may be placed on retailers, companies will need to consider whether voluntary sales tax collection and remittance is a more compelling alternative than compliance with the notice and reporting obligations.

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[32]*Direct Mktg. Ass'n*, No. 12-1175 at 34.

[33]*Id.* at 9 (Gorsuch, concurring).

[34]*Id.* at 35 (quoting *Quill*, 504 U.S. at 318).

[35]*See* Marketplace Fairness Act of 2015 (S. 698); Online Sales Simplification Act of 2015 (has not been introduced as of the date of this alert); Remote Transaction Parity Act (H.R. 2775).

[36]Ala. Admin. Code r. 810-6-2-.90.03 (effective for all transactions occurring on or after January 1, 2016). The regulation specifically applies to "out-of-state sellers who lack an Alabama physical presence but who are making retail sales of tangible personal property into the state." The regulation determines that these sellers "have a substantial economic presence in Alabama for sales and use tax purposes and are required to register for a license with the department and to collect and remit" if they meet certain other enumerated minimum activities.

[37]SB 106, 91st Legis. Assemb. (S.D. 2016). The proposed statute specifically applies to "any seller selling tangible personal property, products transferred electronically, or services for delivery into South Dakota, who does not have a physical presence in the state," and it requires them to "remit the sales tax and shall follow all applicable procedures and requirements of law as if the seller had a physical presence in the state" provided they meet certain other enumerated minimum sales thresholds. Section 7 of the proposed statute further provides proposed legislative findings for the act's need, which include "the seriously eroding [of] the sales tax base" of the state caused by "[t]he inability to effectively collect the sales or use tax from remote sellers who deliver tangible personal property, products transferred electronically, or services directly into South Dakota." The drafters of section 7 further clarify that their intention is to instigate litigation that will cause a reexamination of *Quill*. The section references Kennedy's concurrence in *DMA* and calls for the U.S. Supreme Court to reconsider the doctrine of *Quill.* Further, the section provides:

> At the same time, the Legislature recognizes that the enactment of this law places remote sellers in a complicated position, precisely because existing constitutional doctrine calls this law into question. Accordingly, the Legislature intends to clarify that the obligations created by this law would be appropriately stayed by the courts until the constitutionality of this law has been clearly established by a binding judgment, including, for example, a decision from the Supreme Court of the United States abrogating its existing doctrine, or a final judgment applicable to a particular taxpayer.

B. *Comptroller of the Treasury of Maryland v. Wynne* — Internal Consistency Is Key

In *Comptroller of the Treasury of Maryland v. Wynne*, the taxpayers challenged the constitutionality of the credit for taxes paid to other states as applied under Maryland's individual income tax regime, which comprises two components: a state income tax and a county income tax.[38] The Wynnes, a married couple, were Maryland residents who earned income through a Maryland-based S corporation. A substantial portion of that income was earned from and taxed in jurisdictions outside Maryland. Under Maryland's individual income tax regime, residents who earn income in other states were eligible to take a credit — based on income taxes paid to other states — against the state component of the Maryland tax, but not against the county component.[39] However, the Wynnes claimed credits against both their Maryland state and county tax for the tax amounts paid to other states on their 2006 Maryland individual income tax return. On audit, the comptroller determined that the taxpayers had underpaid their 2006 state individual income taxes by improperly claiming a credit against their county tax and issued a deficiency assessment.

In a 5-4 decision, the Supreme Court held that Maryland's individual income tax regime is unconstitutionally discriminatory and "operates as a tariff," thereby violating the dormant commerce clause.[40] The Court reasoned that by allowing only "partial" credit (that is, credit against the state portion of the tax) for income taxes paid by residents to other states on income earned from those other states, Maryland's individual income tax scheme discriminated in favor of intrastate over interstate economic activity.

As opposed to establishing a rule of priority — whereby a state would have to yield to another if one taxed on the basis of residence and the other on source — the Supreme Court's holding in *Wynne* was primarily based on the application of the internal consistency test. The internal consistency test "looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate."[41] The Court explained:

> By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other States, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as a result of the interaction of two different but nondiscriminatory and internally consistent schemes.[42]

Applying the internal consistency test, the Supreme Court concluded that if every state adopted Maryland's scheme, income earned by individuals from outside their state of residence would be taxed at a higher rate than income earned from intrastate sources.[43] The Court continued, stating, "Critically . . . the Maryland scheme's discriminatory treatment of interstate commerce is not simply the result of its interaction with the taxing schemes of other States. Instead, the internal consistency test reveals . . . Maryland's tax scheme is inherently discriminatory and operates as a tariff."[44] The Court deemed this conclusion "fatal because tariffs are '[t]he paradigmatic example of a law discriminating against interstate commerce.'"[45]

Practical Considerations

In various sessions at the National Multistate Tax Symposium, panelists highlighted that *Wynne* should serve as a reminder to taxpayers that internal consistency continues to be relevant. However, professor Richard Pomp of the University of Connecticut added that *Wynne* adds little to the "substance of internal consistency."

C. *Alabama Department of Revenue v. CSX Transportation Inc.* — Comparability of a State's Tax Regime

In *Alabama Department of Revenue v. CSX Transportation Inc.*, the taxpayer challenged 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.[46] CSX, a national railroad transportation services provider, is federally protected against certain state "acts [that] unreasonably burden and discriminate against interstate commerce" under the Railroad Revitalization and Regulatory Reform Act (4-R Act).[47] In accordance with 49 U.S.C. section 11501(b)(4) (subsection (b)(4) of the 4-R Act), a state is prohibited from "impos[ing] another tax that discriminates against a rail carrier providing transportation."[48] Under Alabama's sales tax regime, the purchase of diesel fuel is generally subject to the 4 percent sales tax. Alabama provides a sales tax exemption for diesel fuel purchased by a water carrier "engaged in foreign or international commerce

[38] *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015).

[39] Md. Code Ann., Tax-Gen section 10-703(a).

[40] *Wynne*, 135 S. Ct. at 1791.

[41] *Id.* at 1803 (*citing Oklahoma Tax Comm'n v. Jefferson Lines Inc.*, 514 U.S. 175, 185 (1995)).

[42] *Id.* at 1803.

[43] *Id.*

[44] *Id.* at 1804.

[45] *Id.* (*citing West Lynn Creamery Inc. v. Healy*, 512 U.S. 186, 193 (1994)).

[46] *Ala. Dep't of Revenue v. CSX Transportation Inc.*, 135 S. Ct. 1136 (2015).

[47] 49 U.S.C. section 11501.

[48] Note that the subsection (b)(4) reference to "another tax" distinguishes that provision from subsections (b)(1)-(3), which "contain three specific prohibitions directed towards property taxes."

or interstate commerce."[49] Alabama also provides a sales tax exemption for diesel fuel purchased by motor carriers; however, motor carriers are instead subject to a 19-cent-per-gallon fuel excise tax.[50] Alabama does not exempt from sales tax diesel fuel purchased by rail carriers. As a result, CSX brought a subsection 4(b) claim against the state of Alabama.

In a 7-2 decision, the Supreme Court held the appropriate comparison class of "similarly situated" taxpayers for purposes of determining discrimination was CSX's competitors (that is, motor and water carriers) and remanded the case to the Eleventh Circuit to further consider whether Alabama can demonstrate the requisite "sufficient justification" for its disparate treatment of the taxpayer and its common carrier competitors. The Supreme Court summarized discrimination under 4-R Act subsection (b)(4) as follows: "A tax discriminates under subsection (b)(4) when it treats 'groups [that] are similarly situated' differently without sufficient 'justification for the difference in treatment.'"[51]

In determining the proper class of similarly situated taxpayers, the U.S. Supreme Court concluded that the comparison class under 4-R Act subsection (b)(4) should not be limited to other commercial and industrial taxpayers as provided in 49 U.S.C. section 11501(b)(1)-(3).[52] The Court further explained that the comparison class will depend on the theory of the discrimination alleged.[53] If the railroad asserts that the tax burdens railroads more significantly than local businesses, all other commercial and industrial taxpayers are the comparison class.[54] If the railroad alleges that a tax disadvantages it as compared with its competitors in the transportation industry, the railroad's competitors in that jurisdiction are the comparison class.[55] Applying this reasoning, the Court held that the appropriate comparison class of similarly situated taxpayers was CSX's competitors in the transportation industry consisting of motor carriers and water carriers.[56]

The Supreme Court next turned to whether Alabama can sufficiently justify differences in the treatment between CSX and its competitors in the transportation industry. First, the Court examined Alabama's exemption for motor carriers, whose fuel purchases are exempt from the sales tax but are instead subject to a fuel-excise tax that was cited as "Alabama's tax-based justification."[57] Noting that there "is simply no discrimination when there are roughly comparable taxes," the U.S. Supreme Court stated that it could not approve of the Eleventh Circuit's "refusal to consider Alabama's tax-based justification" for the disparity between railroads and motor carriers.[58] The Court next recognized that Alabama cannot offer a similar tax-based justification in the context of water carriers, because water carriers pay neither the sales tax nor the fuel excise tax on their fuel purchases, but alternative justifications were offered and not considered by the Eleventh Circuit.[59] Thus, the Court remanded the case to the Eleventh Circuit to further consider whether Alabama can demonstrate the requisite "sufficient justification."

Practical Considerations

In evaluating *CSX*, Pomp expounded that the Supreme Court is inviting a complementary tax doctrine analysis that is embedded in dormant commerce clause case law. Turning back to the "sufficient justification" analysis in *CSX*, the Supreme Court explained, "Our negative Commerce Clause cases endorse the proposition that an additional tax on third parties may justify an otherwise discriminatory tax,"[60] citing *Gregg Dyeing Co. v. Query*.[61] In *Greg Dyeing*, the Court upheld a South Carolina tax on the grounds that the discriminatory nature of the challenged tax was neutralized by a complementary tax.[62] In ruling in favor of South Carolina, the Court stated:

> The question of constitutional validity is not to be determined by artificial standards. What is required is that state action, whether through one agency or another, or through one enactment or more than one, shall be consistent with the restrictions of the Federal Constitution. There is no demand in that Constitution that the State shall put its requirements in any one statute. It may distribute them as it sees fit, if the result, taken in its totality, is within the State's constitutional power.[63]

Pomp also suggested that this was not necessarily the end of the *CSX* story, speculating that this issue may return to the U.S. Supreme Court.

When considering what other lessons can be learned from *CSX*, practitioners and taxpayers should not discount

[49] Ala. Code section 40-23-4(a)(10).

[50] Ala. Code section 40-17-325(b).

[51] *Id*. at 1141, *citing CSX Transp. Inc. v. Ala. Dep't of Revenue*, 562 U.S. 277, 287 (2011).

[52] The dissent, in contrast, explained that the statutory structure "supports the conclusion that a tax 'discriminates against a rail carrier' within the meaning of subsection (b)(4) if it singles out the railroads for unfavorable treatment as compared to the general class of commercial and industrial taxpayers." *Id*. at 1145 (Thomas, J., dissenting). Under 49 U.S.C. section 11501(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.

[53] *Id*. at 1141.

[54] *Id*.

[55] *Id*.

[56] *Id*. at 1143.

[57] *Id*. at 1143.

[58] *Id*. at 1143-1144.

[59] *Id*. at 1144.

[60] *Id*. at 1143.

[61] *Gregg Dyeing Co. v. Query*, 286 U.S. 472 (1932).

[62] *Id*.

[63] *Id*. at 480.

the Supreme Court's opinion as only applicable to discrimination claims brought by a railroad under the 4-R Act. As discussed above, in addressing discrimination, the Court in *CSX* was at times guided by dormant commerce clause jurisprudence. After the Court's decision in *CSX*, at least one court has taken a broader view of the holding in that case. In weighing the burdens of Colorado collecting and non-collecting taxpayers, the Tenth Circuit in its recent *DMA* decision was guided by the *CSX* analysis,[64] quoting the opinion as follows:

> It does not accord with ordinary English usage to say that a tax discriminates against a rail carrier if a rival who is exempt from that tax must pay *another* comparable tax from which the rail carrier is exempt. If that were true, *both* competitors could claim to be disfavored — discriminated against — relative to each other. Our negative Commerce Clause cases endorse the proposition that an additional tax on third parties may justify an otherwise discriminatory tax. We think that an alternative, roughly equivalent tax is one possible justification that renders a tax disparity nondiscriminatory.[65]

As *CSX* continues to navigate through the federal court system, taxpayers should consider whether there may be broader implications in the context of a dormant commerce clause challenge to a state tax and how the ultimate outcome of *CSX* may impact a discriminatory tax analysis.

III. Looking Beyond the Supreme Court's 2014 Term

A. Compact Litigation — A Meaningless Taxpayer Election?

1. The Gillette Co. v. Franchise Tax Board

In *The Gillette Co. v. Franchise Tax Board*,[66] the California Supreme Court considered whether taxpayers could elect to use the Multistate Tax Compact's equally weighted three-factor appointment formula (compact election) in lieu of California's standard statutory apportionment method of double-weighted sales. To better understand the basis for this dispute, it is helpful to briefly review the history of California's apportionment formula. In 1974 California enacted and codified the entire text of the compact in California Revenue and Taxation Code section 38006. However, in 1993 the California Legislature amended Revenue and Taxation Code section 25128 and adopted a double-weighted sales factor.[67] In *Gillette*, the taxpayers sought corporate franchise tax refunds for tax years between 1993 and 2005 based on claims that they had the right to make a compact election to apportion their income, resulting in the application of the compact's equally weighted three-factor formula.

In a unanimous decision, the California Supreme Court reversed the California Court of Appeal's decision, denying the taxpayers the benefit of the compact election. The supreme court held that the compact was not a binding reciprocal agreement among the member states, therefore the California Legislature may properly eliminate the compact's election provision. In considering whether the compact is a binding reciprocal agreement, at the urging of the Multistate Tax Commission, the California Supreme Court applied the test derived from the U.S. Supreme Court's decision in *Northeast Bancorp Inc. v. Board of Governors*.[68] The California Supreme Court first determined that the compact's provision of a taxpayer election to use either the Uniform Division for Income Tax Purposes Act formula or any other state apportionment formula did "not create an obligation of member states to each other" and that it was "more akin to the adoption of a model law rather than the creation of any mutual obligations among Compact members."[69] Second, the California Supreme Court concluded that the compact's effectiveness did not depend on the conduct of other members because the compact was effective "once it had been 'enacted into law by any seven States,'" an event occurring before California joined in 1974.[70] Also, that the states can adopt different apportionment formulas and unilaterally join and withdraw from the compact weighed against a finding that the compact was a binding interstate agreement.[71] Finally, the California Supreme Court concluded that the Multistate Tax Commission was not a joint regulatory organization or body because it only served an advisory and informational role and lacked any binding authority over the member states.[72]

Having determined that the California Legislature had the unilateral authority to eliminate the compact's election provision, the court concluded that the Legislature intended to do so regarding the apportionment formula.[73] The California Supreme Court determined that "[California Revenue and Taxation Code] section 25128(a) explicitly provides that '*all business income shall be apportioned* to this state by' using the formula it sets out, '[n]*otwithstanding Section 38006*. There is no ambiguity in this language.'" The California Supreme Court was also persuaded that the legislative

[64]*Direct Mktg. Ass'n*, No. 12-1175 at 30.

[65]*Id.* at 30 (quoting *CSX*, 135 S. Ct. at 1143).

[66]62 Cal. 4th 468 (Cal. 2015).

[67]Amended CRTC section 25128(a) provides that "notwithstanding Section 38006, all business income shall be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four, except as provided in subdivision (b) or (c)."

[68]*Northeast Bancorp Inc. v. Bd. of Governors of Fed. Reserve Sys.*, 472 U.S. 159 (1985).

[69]*The Gillette Co.*, 62 Cal. 4th at 479.

[70]*Id.* at 480.

[71]*Id.* (noting that only seven of the compact's 16 members employ the equally weighted UDITPA formula).

[72]*Id.* at 481-483.

[73]*Id.* at 484.

history supported the intent to amend the apportionment formula. As such, the California Supreme Court concluded that "there is no credible argument that the Legislature intended to retain the Compact's election provision."[74]

Practical Considerations

The California Supreme Court's decision in *Gillette* is just one of many chapters in this debate. Compact election issues similar to those at stake in *Gillette* — including whether the compact creates binding obligations among member states and the constitutionality of state provisions that alter, amend, supersede, or repeal the compact — have been moving through the courts in various other states, with most holdings to date in favor of the states. However, it is conceivable that courts in other states ultimately could conclude differently on similar issues that, along with the constitutional issues involved, may possibly provide grounds for U.S. Supreme Court review.

In discussing the likelihood of the U.S. Supreme Court to grant certiorari in *Gillette*, Valerie Dickerson of Deloitte concurred with other panelists that it may come down to how the case is presented, suggesting a movement away from whether the compact is a binding compact. If the issue is instead presented from the perspective of what does it mean to be a lower-level compact, the U.S. Supreme Court may be inclined to grant cert since there are potentially numerous lower-level compacts in existence.

B. Retroactive Tax Legislation — A Cause for Taxpayer Awareness in Michigan and Other States

1. Gillette Commercial Operations North America & Subsidiaries v. Department of Treasury

In *Gillette Commercial Operations North America & Subsidiaries v. Department of Treasury*, the Michigan Court of Appeals considered whether the enactment of 2014 Mich. P.A. 282 retroactively rescinded Michigan's membership in the compact effective January 1, 2008.[75] The retroactive repeal legislation was enacted by the Michigan Legislature in September 2014 to reverse the impact of the Michigan Supreme Court's July 2014 decision in *IBM v. Department of Treasury*,[76] which had validated the availability of the compact election during the initial year of the Michigan business tax (that is, 2008). By way of history, in 1969 Michigan enacted and codified the entire text of the compact in MCL section 205.581. In 2007 the Michigan Legislature adopted the Michigan business tax (MBT) effective January 1, 2008. The MBT provided a single-sales-factor formula for apportioning both the modified gross receipt tax (MGRT) and the business income tax (BIT) components of the MBT,[77] though no explicit limitation existed on a taxpayer's ability to otherwise make the compact election for MBT purposes until Michigan amended its version of the compact in 2011.[78] In *IBM* the Michigan Supreme Court held that nothing in the MBT Act could be interpreted as "impliedly repealing" the compact election; thus, taxpayers could elect to compute both the MGRT and BIT components of their 2008 MBT liability using the compact election in lieu of the single-sales-factor apportionment formula.[79] The Michigan Legislature later enacted 2014 Mich. P.A. 282, repealing the compact provisions of Michigan law "retroactively and effectively beginning January 1, 2008."

In *Gillette*, the taxpayers challenged the retroactive effects of 2014 Mich. P.A. 282 and whether it violated their due process rights under the U.S. and Michigan constitutions, among other claims. The Michigan Court of Appeals affirmed the lower court decision that 2014 Mich. P.A. 282 retroactively rescinded Michigan's membership in the compact effective January 1, 2008. In addressing the due process issues, the Michigan Court of Appeals applied the U.S. Supreme Court's due process standard in *United States v. Carlton*,[80] in which "retroactive application of a statute is supported by a legitimate purpose furthered by rational means." The court of appeals held that a legitimate purpose was satisfied based on the stated legislative goal of preventing significant revenue loss associated with compact-based claims, as well as the legislative motivation to correct a perceived misinterpretation of the application of the compact provisions of Michigan law.[81]

The court of appeals also concluded that 2014 Mich. P.A. 282 was a rational means to further the identified legitimate purpose. The court determined that 2014 Mich. P.A. 282 clarifies the method of apportioning the tax base for a previously enacted tax as opposed to "reaching back in time to assess a 'wholly new tax.'"[82] Next, the court ruled that taxpayers were unable to rely on the availability of the three-factor apportionment method, because "[t]ax legislation is not a promise, and a taxpayer has no vested right in a tax statute."[83] The court also reasoned that the Michigan Legislature acted promptly to correct the apportionment defect by introducing and enacting the retroactive legislation within two months of the Michigan Supreme Court's

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[74] *Id*. at 485.

[75] *Gillette Commercial Operations N.A. & Subsidiaries v. Dep't of Treasury*, No. 325258, slip op. (Mich. Ct. App. Sept. 29, 2015). All page reference citations are from the version of *Gillette* found on the Michigan Court of Appeals' website.

[76] *IBM v. Dep't of Treasury*, 852 N.W.2d 865 (2014).

[77] Mich. Comp. Laws section 208.1301(2).

[78] *Id*. In May 2011 Michigan amended Article III(1) of the compact to provide that "beginning January 1, 2011 . . . a taxpayer subject to the Michigan Business Tax Act . . . shall not apportion or allocate" in accordance with the compact. Public Act 40 of 2011.

[79] *IBM*, 852 N.W.2d at 865.

[80] 512 U.S. 26, 30-31 (1994).

[81] *Gillette*, slip op. at 26.

[82] *Id*. at 26 (quoting *United States v. General Motors Corp.*, 121 F.2d 376 (7th Cir. 1941)).

[83] *Id*. at 26, (quoting *Carlton*, 512 U.S. at 33).

decision in *IBM*.[84] Finally, the court of appeals ruled that the 6 1/2 year retroactive period was "sufficiently modest."[85]

2. Practical Considerations

Tom Cornett and Samantha Hesley at Deloitte recently described the increasing trend of state legislatures enacting retroactive state tax legislation to neutralize the revenue impact of a taxpayer-favorable court decision as one of "the most significant issues in state and local taxation."[86] The enactment of retroactive legislation is a questionable tax policy that could lead to unintended taxpayer consequences, including the potential for financial statement impact. Unfortunately, state court decisions over the last 10 years in Michigan and elsewhere have consistently ruled against taxpayers seeking to bring due process challenges to retroactive tax legislation, holding that anticipated revenue loss is a legitimate legislative purpose and that the retroactive period is sufficiently "modest" so long as it directly relates to the potential refund periods. This trend of retroactive state legislation, particularly as a response to successful taxpayer litigation regarding unclear or poorly drafted tax legislation, can be expected to continue absent U.S. Supreme Court intervention.

Recently, in *AK Steel Holding Corp. v. Department of Treasury*, the Michigan Court of Appeals considered whether 2014 Mich. P.A. 282 also clarified the legislative intent regarding the availability of the compact election for the single business tax (SBT), effective from January 1, 1976, until December 31, 2007.[87] In confirming the availability of the election for SBT purposes, the court of appeals noted:

> [T]he Legislature included nothing in 2014 PA 282 regarding the validity of the Compact election provision for multistate taxpayers subject to the SBTA before the effective date of the MBT[]. In so doing, the Legislature left open the application of the Compact apportionment formula during tax years subject to the SBTA. If it so chose, the Legislature easily could have closed this door. Instead, it chose not to, and it is not our role to second guess its reasoning for not doing so.[88]

This analysis raises the question whether the Michigan Legislature will once again take further legislative action to retroactively remove Michigan from the compact for years before 2008.

IV. Conclusion

Although each of the above "new normal" topics may affect taxpayers differently, one constant remains. Prudent taxpayers should continue to thoroughly develop and document their potentially contentious state tax positions in expectation of aggressive audit and enforcement mechanisms from state revenue agencies. ✰

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[84]*Id.* at 26.

[85]*Id.*

[86]Tom Cornett and Samantha Hesley, "Taxpayer Challenges to Retroactive State Tax Legislation," *State Tax Notes*, Feb. 29, 2016, p. 647.

[87]*AK Steel Holding Corp. et al. v. Dep't of Treasury*, No. 327175, slip op. (Mich. Ct. App. 2016). All page reference citations are from the version of AK Steel found on the Michigan Court of Appeals' website. At the conclusion of the National Multistate Symposium, an opinion had not been issued by the Michigan Court of Appeals.

[88]*Id.* at 16.