Supreme Court Considers Whether Sales Tax Exemptions Can Be Discriminatory Taxes

By Joseph Henchman

Summary

If a state exempts particular businesses from paying sales tax but not their competitors, does that mean the tax system is discriminatory? On November 10, 2010, the U.S. Supreme Court will consider this question in the context of railroad taxation when it hears arguments in *CSX Transportation, Inc. v. Alabama Department of Revenue*, No. 09-520. The Tax Foundation’s Center for Legal Reform has filed a friend-of-the-court brief in the case, which this report summarizes.

The case involves the federal Railroad Revitalization and Regulatory Reform Act, colloquially known as the “4-R Act.” Enacted in 1976, the 4-R Act prohibits discriminatory state tax policies against railroads, but in an 8-1 ruling in a 1994 case, *Dep’t of Revenue of Oregon v. ACF Industries, Inc.*, the Supreme Court ruled that some pre-existing property tax exemptions are immune from challenge under the act.

Incorrectly extending the reasoning in *ACF* to sales and use tax exemptions, the lower court in this case concluded that sales and use tax exemptions for CSX’s competitors are not discriminatory against CSX, or at least that they can not be challenged under the 4-R Act. A Supreme Court decision to uphold the lower court’s reasoning would result in economic distortion and effectively give state governments all the discriminatory authority that they had exercised so enthusiastically before the 4-R Act was made law to rein them in.

To maintain the careful balance of states’ taxing power against businesses’ right to compete in the national market, the Supreme Court should reverse the decision of the lower court and specify that sales and use tax exemptions are discriminatory taxes and not immune to challenge under the 4-R Act.

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*Joseph Henchman is Tax Counsel and Director of State Projects*
Congress Has Banned State Taxes that Discriminate Against Railroads

In 1976, Congress enacted the Railroad Revitalization and Regulatory Reform Act, colloquially known as the “4-R Act.” This law bars forms of state taxation which, according to the Act, “unreasonably burden and discriminate against interstate commerce.” The law passed due to recognition that state and local governments had imposed disproportionately heavier tax burdens on interstate railroads than on others.

Chief among these were discriminatory property taxes. Since moving property to other jurisdictions is nearly impossible for interstate railroads, their property became subject to higher property tax rates and assessments than other comparable commercial property within a jurisdiction. For example, a 1961 congressional report indicated that Alabama assessed railroad property for tax purposes at twice other property (40% vs. 19.1%); California, two and a half times other property (50% vs. 20.3%); New Jersey, four times other property (100% vs. 27.7%); and Idaho, nine times other property (100% vs. 11.4%). Looking at results from 31 states where data was available, the report indicated that had railroads been assessed at the same value as other property, they would have paid $141 million less in property taxes, a 54% reduction.

The 4-R Act specifically outlawed this practice, requiring that property tax assessments and rates be no higher than other commercial and industrial property, as determined by a ratio set out in what is now 49 U.S.C. § 11501(b)(1)-(3). After specifically barring discriminatory property tax rates and assessments, Congress added a further provision. 49 U.S.C. § 11501(b)(4) indicates that states may not “[i]mpose another tax that discriminates against a rail carrier providing transportation subject to the jurisdiction of the Board under this part.” While the first three subsections are quite specific in discussing rates and assessments, this subsection is much broader. Litigation has arisen over its scope.

Are Property Taxes with Exemptions “Another Tax That Discriminates Against a Rail Carrier”?

Subsection (b)(4) specifically prohibits “another tax that discriminates against a rail carrier,” with no stated limitation on the kind of tax to be prohibited nor any requirement that the effect of the tax on a rail carrier be compared against its effect on “other commercial and industrial property.” Thus, while Subsections (b)(1)-(3) are limited to taxes on “rail transportation property,” (b)(4) contains no such limitation and indeed omits the term “other commercial and industrial taxpayers.”

So to what does (b)(4) apply? The Supreme Court faced this question in Department of Revenue of Oregon v. ACF Industries, Inc. There, railroad car leasing companies challenged Oregon’s property tax law for taxing railroad cars in full, while exempting about a third of comparable non-railroad commercial and industrial property. ACF challenged the competitors’ exemptions under subsection (b)(4).

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2 Id.
In an opinion by Justice Anthony M. Kennedy, the Supreme Court rejected the argument and concluded that property tax exemptions cannot be challenged under subsection (b)(4). First, the Court noted that subsections (b)(1)-(3) dealt with property taxes, so it is not plausible to say that property taxes could be “another tax” in subsection (b)(4). Second, Congress specifically excluded exempt property from being used as a basis of comparison for property tax discrimination in subsections (b)(1)-(3). According to the Court, “It would be illogical to conclude that Congress, having allowed the States to grant property tax exemptions in subsection (b)(1)-(3), would turn around and nullify its own choice in subsection (b)(4).” Finally, the Court expressed its unwillingness to permit challenges to long-standing property tax exemptions without stronger evidence that Congress intended that to occur.

Justice John Paul Stevens dissented in the 8-1 case. He wrote that any tax scheme that can’t be challenged under subsections (b)(1)-(3) is “another tax” challengeable under subsection (b)(4). He emphasizes that while Congress was focused on property tax rates and assessments, their inclusion of the “catch-all” provision shows that they did not mean the 4-R Act to be limited to rates and assessments.

Sales Taxes with Exemptions Can Be “Another Tax That Discriminates Against a Rail Carrier”

The circuit courts have reached conflicting conclusions as to whether the ACF holding is limited to property taxes or whether it also precludes challenges to any tax, such as a sales tax, that is discriminatory because of the presence of certain exemptions. The Eighth Circuit Court of Appeals has held that they may be challenged. The Ninth and Eleventh Circuits have held that they may not be challenged.

In its decision, the Eleventh Circuit held that the 4-R Act does not encompass a tax’s exemptions because subsection (b)(4) speaks only of discriminatory taxes, “not discriminatory tax exemption[s].” That court thus suggested that a “tax” that penalizes rail carriers falls within the scope of subsection (b)(4), while tax exemptions, deductions, and credits that provide benefits to their competitors, do not. This view conflicts with economic evidence and Supreme Court precedent finding that a tax exemption is a part and parcel of a “tax.” By effectively providing railroad competitors with a zero percent sales tax rate while railroads pay more, Alabama achieves the same discriminatory effect as a special tax on railroads.

Because manipulation of the components of a sales and use tax—its rates, method of assessment, and exemptions—is a method by which states can produce substantially discriminatory effects of the type prohibited by the Commerce Clause, the discriminatory nature of a tax on railroads and similarly situated carriers should be evaluated by looking at its effects, not its labels. Since the 4-R Act encompasses discriminatory tax impacts on interstate rail carriers, sales and use tax exemptions should be subject to challenge under the “catch-all” subsection (b)(4) of the Act.

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4 See Union Pac. R.R. Co. v. Minn. Dep’t of Revenue, 507 F.3d 693, 695 (8th Cir. 2007).
5 See Norfolk Southern Ry. v. Ala. Dep’t of Revenue, 550 F.3d 1306, 1314 (11th Cir. 2008); Atchison, Topeka, and Santa Fe Ry. v. Arizona, 78 F.3d 438, 443 (9th Cir. 1996).
6 Norfolk Southern, 550 F.3d at 1315.
The Supreme Court has consistently recognized that state tax policies, including exemptions, can result in impermissible discrimination against interstate commerce by suppressing a competitive playing field for similarly situated taxpayers. In *Camps Newfound/Owatonna v. Town of Harrison*, the Court found that a discriminatory real estate tax exemption violated the Commerce Clause. In *West Lynn Creamery v. Healy*, 512 U.S. 186, 193 (1994), the Court held that a discriminatory tax system involving subsidies violated “principle[s] of the unitary national market by handicapping out-of-state competitors, thus artificially encouraging in-state production” and “neutraliz[ing] advantages belonging to the place of origin.” In *Bacchus Imports Ltd. v. Dias*, the Court invalidated a discriminatory excise tax system using tax exemptions.

The Supreme Court has also used a substance-over-form inquiry when examining tax credits, deductions, exemptions, and exclusions for possible discriminatory effects among interstate competitors, looking at the actual effect of tax policies and not merely their forms or stated intentions. In *Camps Newfound*, the Court stated that “[t]o allow a State to avoid the strictures of the dormant Commerce Clause by the simple device of labeling its discriminatory tax [as a local tax] would destroy the barrier against protectionism that the Constitution provides.” In *Bacchus*, the Court concluded that the excise tax scheme improperly had “both the purpose and effect of discriminating in favor of local products.” In *Westinghouse Elec. Co. v. Tully*, the Court disallowed a tax credit because it was “discriminatory [in] economic effect.” In *Hughes v. Oklahoma*, the Court wrote, “Under [the] general rule, we must inquire (1) whether the challenged statute regulates evenhandedly with only "incidental" effects on interstate commerce, or discriminates against interstate commerce either on its face or in practical effect.” In *Quill Corp. v. North Dakota*, the Court noted that the Commerce Clause is informed by “structural concerns about the effects of state regulation on the national economy” (emphasis added).

This Supreme Court has thus consistently recognized that formalistic distinctions between taxes and tax exemptions have no place in a legal analysis of discriminatory tax burdens. Granting a tax exemption, or a zero percent rate, to one company, can produce identical outcomes as a heavier tax on its competitors. Thus, sales and use taxes that are discriminatory because of exemptions should be challengeable under subsection (b)(4).

If the Lower Court’s Decision is Upheld, It Would Render Subsection (b)(4) Meaningless

If the lower court’s decision were upheld, states could easily make an end-run around both their own principles of uniform taxation and the Commerce Clause, enacting discriminatory taxes by another means. In particular, states could convert an impermissible discriminatory tax with higher rates on competitors into a permissible discriminatory tax with exemptions for competitors that achieve the same result, thus allowing the states to modify their tax codes to produce the same discriminatory results for rail carriers that existed prior to the enactment of the 4-R Act. Excluding tax exemptions from consideration under the 4-R Act would thus deprive the law of its operative effect.

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7 520 U.S. 564, 593 (1997).
10 520 U.S. at 575.
11 468 U.S. at 273.
13 441 U.S. 322, 335 (1979).
Moreover, the Supreme Court has never held that non-property tax exemptions are precluded from challenge under the 4-R Act. In *ACF*, this Court emphasized that it was dealing with only *property* tax exemptions: “The structure of [the 4-R Act] warrants the conclusion that subsection (b)(4) does not limit state discretion to levy a tax upon railroad *property* while exempting various classes of nonrailroad *property* (emphases added).”\(^{15}\) The Court also noted that non-property tax exemptions could lead to forbidden discriminatory effects: “It is true that tax exemptions as an abstract matter, could be a variant of tax discrimination.”\(^{16}\) Thus, the lower court was misplaced in interpreting the *ACF* decision as effectively immunizing sales and use tax exemptions from challenge.\(^{17}\)

Congress designed subsection (b)(4) as a prophylactic “catch-all” provision to prevent states from imposing “another tax that discriminates against a rail carrier.” There is no language in the 4-R Act that precludes (b)(4)’s application to non-property taxes that are discriminatory as a result of exemptions. Thus, while subsections (b)(1)-(3) address *ad valorem* property tax rates and assessments, subsection (b)(4) must address a non-property tax that is discriminatory on any basis.

**Immunizing Discriminatory State Sales Taxes Would Have Grave Consequences**

The *ACF* decision showed hesitation to permit challenges to states’ ability to grant broad-based homestead exemptions or tax real property at different rates based on varying types of improvements. Sales tax classifications, however, are routinely industry-based and have great potential to be used to achieve discriminatory results. Sales tax systems are more capable than property taxes of being used to export tax burdens to out-of-state or national enterprises. Thus, the principles of *ACF* may be limited specifically to property taxes, harmonizing with states’ own constitutional requirements for uniform classifications of real property.

Unlike property tax exemptions, no language in the 4-R Act suggests that Congress sought to shield states’ discretion to award sales and use tax exemptions. The “catch-all” language of subsection (b)(4) and the broad purpose of the 4-R Act suggest the opposite.

The problems created by discriminatory state property taxes are no different from those created by discriminatory non-property taxes—namely that rail carriers will be forced to pay more than their non-rail competitors, thus putting them at a comparative disadvantage. Moreover, states have incentives to discriminate against interstate rail carriers and favor intrastate competitors. If this Court declines to allow challenges under subsection (b)(4) of the 4-R Act to non-property taxes that have become discriminatory through exemptions, states will once again target rail carriers for the kinds of tax discrimination the 4-R Act was meant to prevent.

Prior to the 4-R Act’s passage, Congress noted how there was “widespread, long-standing and deliberate” tax discrimination against rail carriers by the states.\(^{18}\) States were even ignoring their own

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\(^{15}\) *510 U.S.* at 343.

\(^{16}\) *Id.*

\(^{17}\) *See Norfolk Southern*, 550 F.3d at 1312 (“Under the 4-R Act, as interpreted and applied by the Supreme Court, a state remains free to exempt certain transactions or entities from generally applicable taxes, such as the sales and use tax at issue here.”).

\(^{18}\) *Union Pac. R.R. v. Utah*, 198 F.3d 1201, 1206 (10th Cir. 1999).
constitutional uniformity requirements in doing this.\textsuperscript{19} The result was that interstate rail carriers were subject to over $900 million in discriminatory taxation over a period of nine years.\textsuperscript{20}

Congress also noted, “State procedures to challenge discriminatory State tax assessments are often difficult, time consuming, and not productive of material relief. For example, the Southern Pacific and its rail affiliates were required to bring 48 separate suits in 48 separate California superior courts to challenge the level of assessments of railroad property by 48 counties and cities in California.”\textsuperscript{21}

The incentives that lead states to favor local carriers over interstate carriers, namely the promotion of the local economy over the health of the nation’s economy, have not changed since the 4-R Act was passed. Nor has the difficulty for an interstate rail carrier to defend itself against a plethora of discriminatory taxes that not only vary from state to state, but by county, city, or township. The essence of the 4-R Act was to provide an efficient means for rail carriers to defend themselves against discriminatory state taxation, whether through property or non-property taxes. The Eleventh Circuit’s decision heralds a return to widespread tax discrimination against interstate rail carriers that the 4-R Act was crafted to prevent, and will force those companies back into a multitude of lawsuits at the state level to protect themselves. It could not have been Congress’s intention to allow that.

Conclusion

The lower court’s unwarranted expansion of this Court’s decision in \textit{ACF} creates artificial constraints on the scope of the 4-R Act’s enacting purpose of prohibiting taxes that discriminate against rail carriers. Even though the 4-R Act does not explicitly refer to sales and use tax exemptions as a type of discriminatory tax policy subject to challenge, those tax exemptions were not meant to be immunized, they are discriminatory, and they fall within the scope of the “catch-all” subsection (b)(4).

Courts have understood that the touchstone of discriminatory taxes is their economic effects. No economic distinction can be made between the burdens imposed by a higher rate on one party relative to his competitors, and the burdens imposed by a rate of zero on competitors while the party pays the tax. Taxpayers should have standing under subsection (b)(4) to challenge such exemptions for their possibly discriminatory impact on similarly situated competitors in the rail transportation industry.

To maintain the careful balance of states’ taxing power against businesses’ right to compete fairly in the national market, the Supreme Court should reverse the decision of the lower court and specify that sales and use taxes, including their exemptions, are not immunized from challenge under subsection (b)(4).

\bibliography{example}

\begin{thebibliography}{9}
\bibitem{19} See \textit{id}.
\bibitem{20} \textit{id.}, citing S. Rep. No. 91-630, at 3 (1969).
\bibitem{21} \textit{id.} at 1207, citing S. Rep. No. 91-630 at 6-7.
\end{thebibliography}
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