Overview of Spring Term 2019 Supreme Court Tax Decisions

In its 2019 Spring Term, the Supreme Court published five decisions regarding tax matters, three of which limit states' taxing authority. In a February decision, *Dawson v. Steager*, the Court held that a state cannot tax a federal retiree's pension benefits while declining to tax a similarly situated state retiree. The March decision in *BNSF Railway Co. v. Loos* held that lost wages paid to a worker who was injured on the job constitute taxable compensation under the Railroad Retirement Tax Act. Later in March, the Court held in *Washington State Department of Licensing v. Cougar Den* that a state tax imposed on a member of the Yakama Nation on importation of fuel via public highway is pre-empted by the 1855 Treaty Between the United States and the Yakama Nation of Indians. Then, in May, in *Franchise Tax Board of California v. Hyatt*, the Court held that a state may not be sued in another state's court in a private suit, unless it waives immunity. Finally, the Court issued its decision in *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust*, covered in a separate Disputing Tax post available here.

***Dawson v. Steager*, 586 U. S. ____ (2019)**

In *Dawson v. Steager*, the Supreme Court unanimously held that a state may not impose tax on pension payments to retired federal law enforcement officers while affording tax exemptions to retired state law enforcement officers. The petitioner, James Dawson, is a retiree from the U.S. Marshals Service, who received retirement income from the Federal Employee Retirement System. Under a state law, W. Va. Code Ann. §11-21-12(c)(6), West Virginia exempted state retirement income its residents received from West Virginia police; West Virginia Firemen's Retirement System; the West Virginia State Police Death, Disability and Retirement Fund; the West Virginia State Police Retirement System; or the West Virginia Deputy Sheriff Retirement System. Dawson amended his tax returns for 2010 and 2011 to claim the exemption under the state law, but the state denied the exemption. Dawson appealed, alleging that the state violated the inter-governmental tax immunity doctrine of 4 U.S.C. §111, which prohibits discriminatory state tax based on the source of federal employees' pay or compensation. Specifically, under 4 U.S.C. §111, the U.S. consents to state taxation of the "pay or compensation" of "officer[s] or employee[s] of the U.S." only if the "taxation does not discriminate against the officer or employee because of the source of the pay or compensation." Therefore, a state violates this law when it treats retired state employees more favorably than retired federal employees while no "significant differences between the two classes" exist to justify the differential treatment.[1] On this ground, the Court had previously invalidated Kansas tax that discriminated against federal retirees.[2]

In *Dawson*, the state argued that the exemption for state and local law enforcement pensions was not discriminatory because it impacted a *de minimis* number of retirees, did not meaningfully interfere with federal government operations, and was not intended to harm federal retirees. The Court rejected these arguments and held that if the state exempts only a narrow subset of retired state employees, the state can still be compliant with 4 U.S.C. §111 by exempting the comparable class of retired federal employees. Further, the Court held that in evaluating whether a state law is discriminatory, the state interest in adopting such law is "simply

[1] *Dawson v. Steager*, 586 U.S. ___, at *3, *quoting Davis v. Mich. Dept. of Treasury*, 489 U.S. 803, 816 (1989) (invalidating a tax on former federal employees' retirement benefits).
[2] *See Barker v. Kansas*, 503 U.S. 594, 599 (1992) (invalidating a tax on federal military retirement benefits).

irrelevant."[3] The Court also stated that the focus of the inquiry is whether federal retirees are similarly situated to state retirees who *do* receive tax breaks, not those who do not. The Court interpreted "similarly situated" as performing comparable duties.[4] In response to the state's assertion that the distinction may be based on the relative generosity of pension benefits, the Court held that the West Virginia statute, as it is enacted, does not draw distinction on such basis and thus discriminates based on the source of payment. The Court further articulated that where there is an explicit unlawful classification in the text of the statute, a lawful, but implicit, classification does not render the statute lawful. However, the Court did not adopt a bright line rule on whether the federal retirees were "similarly situated" and performed comparable duties, and remanded the case.

The decision's immediate impact is that if a federal employee's job responsibilities were similar to a comparable state employee's, the state may not tax the federal pay or compensation without doing the same to state pay or compensation. However, the question remains as to how courts will determine whether federal employees or retirees are similarly situated to state employees. It is also unclear whether the decision will actually benefit federal retirees, or whether states with similar statutes will choose to instead tax state retirees.

For its part, West Virginia must take action. First, it may have to issue refunds to some federal retirees who submit valid refund claims if their job responsibilities were similar to the petitioner's and they had already paid the taxes on their pension income. Prospectively, West Virginia may repeal the exemption for retired state employees or exempt the retirement benefits of similarly situated federal employees.

***BNSF Railway Company v. Loos*, 586 U.S. ____ (2019)**

In *BNSF Railway Co. v. Loos*, the Supreme Court held that lost wages paid to a worker who was injured on the job constitute "compensation" under the Railroad Retirement Tax Act (RRTA), because the definitions of "compensation" in the RRTA and "wages" in the Federal Insurance Contribution Act (FICA) and the Social Security Act (SSA) are similar. Loos, who was injured on the job, sued BNSF Railway Company under the Federal Employers' Liability Act for withholding $3,765 of taxes from the $30,000 of lost wages awarded to him. Lower courts held that awards to injured railroad workers for lost wages are not taxable under the RRTA. Thus, the issue before the Court was whether payment of lost wages due to a railroad worker's on-the-job injury is taxable "compensation" under RRTA.

Even though compensatory damages for physical injuries are excluded from gross income under §104 of the Internal Revenue Code, the RRTA imposes a separate tax on "compensation." The RRTA and Railroad Retirement Act (RRA) define "compensation" as "any form of money remuneration paid to an individual for services rendered as an employee."[5] This is similar to how FICA and the SSA define "wages," as "all remuneration" for "any service, of whatever nature, performed…by an employee."[6] Under both systems, the taxes and benefits are measured by an employee's "wage" or "compensation." The Court concluded that the definitions of "wages" and "compensation" are materially indistinguishable, relying on earlier cases

[3] *Dawson*, 586 U.S. ____, at *5, *citing Davis*, 489 U.S. at 816.
[4] 586 U.S. at *6.
[5] IRC §3231(e)(1); 45 USC §231(h)(1).
[6] IRC §3121(a)-(b); 42 USC §§409(A), 210(a).

interpreting "wages." In the past, the Court has held that other types of employment-related payments constituted "wages."[7] In line with this precedent, the Court held that "compensation" under RRTA and RRA includes payment for periods of absence from service, regardless of whether the employer chooses to make it or is legally required to do so.

The narrow impact of the decision is that settlement awards of lost wages for railroad employees will be taxable, and railroad employers must withhold on them. More broadly, the opinion signals that settlement payments for work-related injuries that are allocated to lost wages will be taxable, though the Internal Revenue Code explicitly exempts workers' compensation payments from the FICA tax.[8]

***Washington State Department of Licensing v. Cougar Den*, 586 U. S. ____ (2019)**

In *Washington State Department of Licensing v. Cougar Den*, the Supreme Court held that a state tax imposed on a member of the Yakama Nation on importation of fuel via public highways is pre-empted by the 1855 Treaty Between the United States and the Yakama Nation of Indians. Cougar Den, Inc., a Washington state fuel wholesaler owned by a Yakama Nation member, challenged a $3.6 million state assessment for taxes, penalties and licensing fees in 2013. The state imposes taxes on "motor vehicle fuel importer[s]" who bring large quantities of fuel into the state by "ground transportation."[9] The company challenged, arguing that the tax violated Article III of an 1855 treaty with the federal government that gives the Yakama Nation and its members the "right, in common with citizens of the United States, to travel upon all public highways," 12 Stat. 953, and therefore the right to import fuel from Oregon to gas stations owned by other members of the nation via Washington's public highways. The Washington Supreme Court agreed with the company, and the state appealed. The Supreme Court affirmed.

In its analysis of whether the treaty preempted the state tax, the Court first looked to a well-established principle of treaty interpretation. The Court explained that when it considers the language of a tribal treaty, the treaty should be interpreted as the Yakama understood it.[10] Accordingly, the *Cougar Den* Court stressed that the language of the treaty should be construed to have the meaning that the Yakamas understood it to have in 1855.[11]

In making this determination, the Court first considered how the Yakamas understood the right to travel "in common with the U.S. citizens."[12] It noted that in *Yakama Indian Nation v. Flores*, the court found that the Yamakas understood the term "in common with" to mean that the treaty provided them "with the right to travel on all public highways without being subject to any licensing and permitting fees related to the exercise of that

[7] *Social Security Bd. v. Nierotko*, 327 U.S. 358 (1946) ("wages" include payment for active service as well as periods of absence from service, including back pay for lost wages due to the employer's wrongful conduct); *United States v. Quality Stores, Inc.*, 572 U.S. 141 (2014) (under FICA, "wages" include severance payments).
[8] IRC § 3121(a)(2)(A); Treas. Reg. § 31.3121(a)(2)-1(a).
[9] Wash. Rev. Code. §§82.36.010(4), (12), (16).
[10] *See Minnesota v. Mille Lacs Band of Chippewa Indians*, 526 U.S. 172 (1999).
[11] *See United States v. Winans*, 198 U. S. 371, 380-381(1905); *Seufert Brothers Co. v. United States*, 249 U. S. 194, 196-198 (1919); *Tulee v. Washington*, 315 U. S. 681, 683-685 (1942); *Washington v. Washington State Commercial Passenger Fishing Vessel Assn.*, 443 U. S. 658, 677-678 (1979).
[12] 586 U. S. ___at *10-11.

right while engaged in the transportation of tribal goods."[13] Next, the Court looked to historical records, such as the treaty negotiations and the United States' representatives' statements to the Yakamas, which indicate that the Yakamas understood the right to travel to implicitly include the right to travel with goods for purposes of trade. Finally, the Court concluded that the imposition of a tax on traveling with goods would burden the right to travel, and that the treaty intended to protect the Yakamas from such burden. Based on the foregoing analysis, Justice Breyer's plurality opinion found that the state statute is preempted by the treaty, because the statute burdens the Yakamas' right to travel on public highways with goods for sale, a right which is protected by the treaty.

This decision has a narrow, but direct, impact on interpretation of treaties with the only two other Native American tribes having provisions similar to the Yakama provisions in their treaties: the Nez Percés in Idaho and the Flatheads in Montana.[14]

***Franchise Tax Board of California v. Hyatt*, 587 U. S. ____ (2019)**

The Supreme Court ruling in *Franchise Tax Board of California v. Hyatt* provides broad protection for states from private lawsuits filed in other states. The Court had ruled on this very issue in *Nevada v. Hall*, 440 U.S. 410 (1979), where it held that states did *not* have sovereign immunity from private lawsuits filed against them in courts of other states. Overturning this long-standing precedent of *Hall*, the majority held in a 5-4 decision that it is unconstitutional for a private party to bring a lawsuit against a state in a different state's court without its consent.

The *Hyatt* case's history spans over a decade and involves litigation in several different forums, including three separate trips to the Supreme Court. The case stems from Gilbert P. Hyatt's suit in Nevada court against the Franchise Tax Board of California, alleging torts committed during tax audits. In *Hyatt I*, the Supreme Court found for Hyatt and held that the Full Faith and Credit Clause, U.S. Const., Art. IV, § 1, does not require Nevada to give full faith and credit to California's statute providing immunity to the Franchise Tax Board of California. Hyatt was awarded over $400 million in damages in Nevada.[15] The *Hyatt II* decision involved two questions: (1) whether to overturn *Hall* and hold that Nevada courts lacked jurisdiction over California's state agency and (2) whether Nevada courts are bound by the $50,000 statutory limit on damages in a similar lawsuit against one of its own agencies. The Court was evenly split on the first question, due to the passing of Justice Scalia. On the second, the Court held that the Full Faith and Credit Clause does not allow Nevada to award greater damages against California than it could award against its own agencies, and instructed on remand to reduce the damages in line with Nevada's statutory limit.[16]

In *Hyatt III*, the Court re-examined the question of whether a state can assert sovereign immunity against a lawsuit in another state's court. While the Court had previously held in *Hall* that states do not have sovereign immunity barring suit in another state's court, it reversed itself in *Hyatt III*. Justice Thomas, writing for the Court's majority, said that *Hall* was an "erroneous precedent" that "is contrary to our constitutional design and

[13] *Id*. at *3 (*quoting Yakama Indian Nation v. Flores*, 955 F. Supp. 1229, 1262 (E.D. Wash. 1997)).
[14] Brief of *Amici Curiae* Multistate Tax Commission and Federation of Tax Administrators in Support of Petitioner, 5 n.5, *Wash. State Dep't of Licensing v. Cougar Den*, 586 U. S. ___ (2019).
[15] *Franchise Tax Bd. of Cal, v. Hyatt*, 538 U.S. 488 (2003).
[16] *Franchise Tax Board of California v. Hyatt*, 578 U.S. ___, at *9 (2016).

the understanding of sovereign immunity shared by the States that ratified the Constitution."[17] Further, Justice Thomas wrote that, although the Constitution does not explicitly grant sovereign immunity to states, it is "a historically rooted principle embedded in the text and structure of the Constitution" similar to "judicial review, intergovernmental tax immunity, executive immunity and the President's removal power."[18] As a result of this decision, the Court's 2016 decision in *Hyatt II* was reversed and remanded to the Nevada Supreme Court.

The overturning of *Hall* in *Hyatt III* is significant because it prohibits private lawsuits brought against states in another state's courts, unless the defendant state consents. The decision will most likely enhance state tax agencies' power to collect tax from out-of-state taxpayers because taxpayers' ability to challenge the imposition and collection of state taxes will be limited to the administrative and judicial remedies available in the state imposing the taxes.

[17] *Franchise Tax Board of California v. Hyatt* 587 U.S. ____ at *4 (2019).
[18] *Id*. at *16.