Railroad Taxes, Discrimination, and the 4-R Act: A Misstep by the Eighth Circuit

by Alan D. Viard

On October 14, 2011, the U.S. Court of Appeals for the Eighth Circuit decided Midwest Railcar Repair v. South Dakota Department of Revenue and Regulation, with a divided three-judge panel rejecting a claim that South Dakota’s imposition of sales and use tax on railroad car repairs violated the Railroad Revitalization and Regulatory Reform Act (the 4-R Act).1 In this article, I will show that the court’s rationale for its decision contradicts basic principles of public finance economics.

The court held that the sales tax could not discriminate against railroads because it was legally imposed on the company providing repair services to railroads rather than on the railroad receiving the services. As discussed below, this distinction has no economic content. I am not in a position to opine on the ultimate validity of the challenged South Dakota tax. I say only that the Eighth Circuit should have squarely addressed the validity of the tax and disregarded the irrelevant factor of its statutory incidence.

I begin by providing background on the 4-R Act and then discuss Midwest and the Eighth Circuit’s decision.

The 4-R Act

President Gerald R. Ford signed the 4-R Act into law on February 5, 1976. Section 306 of the act imposed three restrictions on state and local taxation of railroads, effective February 5, 1979, which were codified as section 28 of the Interstate Commerce Act (49 U.S.C. section 26c).2

The first two prohibitions concerned only property taxes. First, the statute prohibited property taxes based on assessments that featured a ratio of assessed value to true market value for “transportation property” that exceeded the corresponding ratio for “all other commercial and industrial property” in the same assessment jurisdiction. Second, it prohibited the imposition of ad valorem property taxes on transportation property at a higher rate than the tax rate “generally applicable” to commercial and industrial property in the same assessment jurisdiction.

The third prohibition, which was the forerunner of the provision at stake in Midwest, swept much more broadly. It forbade the “imposition of any other tax which results in discriminatory treatment of a common carrier by railroad.” I refer to this provision as the “catchall provision.”

To enforce its substantive restrictions on state and local taxation, the 4-R Act provided aggrieved taxpayers with a procedural advantage by creating an express exception to the Tax Injunction Act, which generally states that U.S. district courts “shall not 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.”3 Relief in federal

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328 U.S.C. section 1341. Although the current statutory text does not make this clear, the case law establishes that the Tax Injunction Act is not a mere restriction on the federal courts’ remedial powers, but is instead a limitation on their subject-matter jurisdiction. The U.S. Supreme Court recently said, “This Court and others have continued to regard the [Tax Injunction] Act as jurisdictional” despite a 1948 amendment that removed an explicit reference to jurisdiction, Levin v. Commerce Energy, Inc., 130 S. Ct. 2323, 2335 n. 10 (2010). Like other jurisdictional limitations, the restrictions imposed by the Tax Injunction Act cannot be waived by the parties and a court must raise the issue on its own motion if the parties fail to do so.
trial courts is generally unavailable to state and local taxpayers who challenge taxes under other federal statutes or under the U.S. Constitution; those taxpayers must generally litigate in state court, with the ability to petition the U.S. Supreme Court for discretionary review after the case has been heard by the highest state court in which a decision may be had.4 Overriding that provision, the 4-R Act authorized the U.S. district courts to "grant such mandatory or prohibitive injunctive relief, interim equitable relief, and declaratory judgments as may be necessary to prevent, restrain, or terminate any acts in violation" of the statutory prohibitions.

Although the text of the 4-R Act is unclear on this point, the Second, Third, Ninth, and Tenth circuits have also held that it abrogates states' 11th Amendment immunity, which generally protects them from being sued without their consent.5 This abrogation of 11th Amendment immunity potentially enables taxpayers to obtain refunds of past tax payments from the state treasury and not merely injunctive relief against future tax payments.6 These courts have held that this abrogation lies within the constitutional powers of Congress, based on their finding that Congress adopted the 4-R Act, in part, to enforce the equal protection clause of the 14th Amendment to the U.S. Constitution.7

Since its initial enactment, the 4-R Act has undergone only modest changes. Legislation adopted in 1978 moved the tax provisions from 49 U.S.C. section 26c to 49 U.S.C. section 11503 and made some wording changes, but left the substance of the prohibitions unaltered.8 The catch-all provision was reworded to provide that a state may not "impose another tax that discriminates against a rail carrier providing transportation subject to the jurisdiction of the [Interstate Commerce] Commission." Legislation adopted in 1995 moved the provisions once more, to 49 U.S.C. section 11501, and made trivial wording and punctuation changes.9

**For good or ill, Congress gave the courts the sweeping role of protecting railroads from even unintentional overvaluations.**

The U.S. Supreme Court has decided four cases interpreting the 4-R Act. In a unanimous 1987 decision, the Court held that railroads may challenge states' valuation of railroad property for property tax purposes.10 The Court rejected Oklahoma's argument that state valuations must be accepted, a position that would have left courts the mechanical role of comparing a state's assessed values to its determinations of market values. The Court also rejected the more moderate position that state valuations must be accepted unless the railroad demonstrated intentional discrimination. Although the latter position strikes this writer as an attractive way to balance protection for railroads with state tax autonomy, the Court was undoubtedly correct to conclude that it cannot be squared with the text of the 4-R Act. For good or ill, Congress gave the courts

abrogate this immunity when it is validly acting to enforce the rights guaranteed by the 14th Amendment, *Fitzpatrick v. Bitzer*, 427 U.S. 445 (1976), but generally may not do so when it is merely exercising the various powers granted by Article I of the Constitution, *Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996). It is undisputed that Congress adopted the 4-R Act, in part, under its power to regulate interstate commerce, granted by Article I, section 8, clause 3 of the Constitution; the act states that the taxes it prohibits "unreasonably burden and discriminate against interstate commerce." Of course, Congress may enact a statute under more than one of its powers; the Second, Third, Ninth, and Tenth circuits concluded that Congress adopted the 4-R Act under its 14th Amendment enforcement power as well as its commerce power.

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4See 28 U.S.C. 1257 (authorizing the Supreme Court to review judgments of state supreme courts that depend on federal law). Most of the U.S. Supreme Court's decisions examining the validity of state and local taxes under the dormant commerce clause of the U.S. Constitution, for example, have been handed down in cases originating in state court systems, because the Tax Injunction Act required taxpayers to bring their challenges there.

5CSX Transport v. New York State Office of Real Prop., 306 F.3d 87 (2nd Cir. 2002); Wheeling & Lake Erie Ry. Co. v. Pub. Util. Comm'n of Pa., 141 F.3d 88 (3rd Cir. 1998); Ore. Short Line R.R. Co. v. Dept of Revenue Ore., 139 F.3d 1259 (9th Cir. 1998); Union Pacific R.R. Co. v. Utah, 198 F.3d 1201 (10th Cir. 1999). The Tenth Circuit subsequently reaffirmed its position, Burlington N. and Santa Fe Ry. Co. v. Burton, 270 F.3d 942 (10th Cir. 2002). Although state governments enjoy 11th Amendment immunity, local governments do not, Lincoln County v. Luning, 133 U.S. 529 (1900). Because 11th Amendment immunity is not jurisdictional, it can be waived by states. A court need not raise an 11th Amendment issue on its own motion, although it may do so when appropriate.

6In addition to preventing unconsented suits brought explicitly against states, 11th Amendment immunity generally also prevents unconsented suits against state officers to obtain relief from the state treasury for past violations of federal law, Edelman v. Jordan, 415 U.S. 651 (1974). Eleventh Amendment immunity does not, however, prevent suits for injunctive relief against state officers in their official capacities to prevent future violations of federal law, Ex Parte Young, 209 U.S. 123 (1908).

7Unlike the purely statutory protections afforded by the Tax Injunction Act, 11th Amendment immunity is conferred by the Constitution and cannot be freely abrogated by Congress. The Supreme Court has held that Congress may (Footnote continued in next column.)
the sweeping role of protecting railroads from even unintentional overvaluations.

In a sequel to the 1987 decision, the Court ruled, again unanimously, in 2007 that railroads may challenge a state’s selection of the method it uses to value property, not merely the manner in which the state applies its chosen method. In 1994 the Supreme Court ruled 8 to 1 that the 4-R Act does not restrict the provision of property tax exemptions to property other than railroads. On February 22, 2011, the Supreme Court ruled that exemptions for taxes other than property taxes may be challenged under the catchall provision.

The Supreme Court has said that Congress acted to protect railroads from discriminatory taxation because it believed that they were particularly vulnerable to discrimination. The Court has cited legislative history in which Congress explains that the difficulty railroads would face in leaving a jurisdiction makes them “easy prey” for state and local tax authorities.

**The Challenge to South Dakota’s Tax on Railroad Car Repairs**

South Dakota generally imposes sales tax on repair services and on the parts and other tangible personal property used in those repairs, including repairs provided to businesses. However, South Dakota provides a tax exemption for repair services performed on aircraft, without providing a similar exemption for repair services performed on railroads.

On October 9, 2008, Midwest Railcar Repair Inc. filed suit against the South Dakota Department of Revenue and Regulation in the U.S. District Court for the District of South Dakota, challenging the unequal treatment of railcar and aircraft repairs as a violation of the 4-R Act’s catchall provision, which is now codified at 49 U.S.C. section 11501(b)(4). On June 23, 2010, U.S. District Judge Lawrence L. Piersol granted summary judgment to the department, concluding that Midwest could not invoke the protection of the 4-R Act because it was a company that serviced railroad cars and was not itself a railroad carrier. Midwest appealed that ruling to the U.S. Court of Appeals for the Eighth Circuit. A three-judge Eighth Circuit panel heard oral arguments in Minneapolis on February 16, 2011.

On October 14 the panel affirmed the district court’s ruling on a 2-1 vote. The opinion by Judge Roger L. Wollman, joined by Chief Judge William Jay Riley, agreed with the district court’s conclusion that the 4-R Act did not protect Midwest. Judge Kermit E. Bye filed a short dissenting opinion. The decision has been published, making it a binding precedent for all U.S. district courts within the geographical domain of the Eighth Circuit.

**Misplaced Focus on Statutory Incidence**

Citing several prior rulings, Judge Wollman said that the Eighth Circuit understands the 4-R Act to permit challenges only by railroads and by those other entities whose “close relationship” with railroads causes tax discrimination against them to “result in” discrimination against railroads. Based on this criterion, Wollman recognized the need to examine whether “the tax — imposed directly on Midwest — nonetheless results in discriminatory taxation of railroads.”

So far, Wollman’s analysis is unexceptional. Because the 4-R Act prohibits tax discrimination only against railroads, relief is clearly unavailable unless the challenged tax results in that discrimination. And a tax imposed on parties other than railroads surely cannot result in discrimination against railroads unless there is some kind of relationship between those parties and railroads. Unfortunately, Wollman’s opinion proceeded to apply an economically invalid conception of the type of relationship that is required for discrimination to result.

Wollman noted that prior Eighth Circuit rulings had found that the requisite relationship existed when the other parties “were in effect adjuncts, if indeed not corporate subsidiaries, of the railroads to which they provided rail cars.” These prior rulings involved Trailer Train and Railbox, which were formed and owned by a group of operating railroads as a pooling arrangement, and with which almost all rail carriers contracted to obtain rail cars at the lowest possible cost. Based on those precedents,

13CSX Transportation, Inc. v. Alabama Department of Revenue, 131 S. Ct. 1101 (2011). For the decision, see Doc 2011-3737 or 2011 STT 36-1.
14ACF Industries, supra note 12, 510 U.S. at 336.
15By taxing repair services provided to businesses, South Dakota is violating the consensus view of economists that business purchases should not be subject to sales tax. See Alan D. Viard, “Sales Taxation of Business Purchases: A Tax Policy Distortion,” State Tax Notes, June 21, 2010, p. 967, Doc 2010-12212, or 2010 STT 118-4. Of course, this violation of sound economic principles does not raise any legal issues.
16For prior coverage of the district court’s decision, see “Sales and Use Tax on Rail Car Repairs Doesn’t Violate 4-R Act,” State Tax Notes, July 12, 2010, p. 85, Doc 2010-14728, or 2010 STT 128-5.
17Under 28 U.S.C. section 41, those courts are in Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota.
18The prior rulings were Trailer Train Co. v. State Board of Equalization, 710 F.2d 468 (8th Cir. 1983) (challenge to North Dakota tax), Trailer Train Co. v. Blair, 765 F.3d 744 (8th Cir. (Footnote continued on next page.)
Wollman rejected the idea that the 4-R Act could be invoked by “unaffiliated enterprises that merely provided railcar repair services.” Unfortunately, basic principles of public finance make clear that this focus on whether the taxed party is owned by or affiliated with railroads is completely misplaced.

For simplicity and in accord with the facts alleged in Midwest, I consider a tax that is alleged to discriminate against railroads relative to airlines. For purposes of discussion, I assume that railroads and airlines are similarly situated and that the state offers no valid justification for disparate treatment of their transactions. Then, according to public finance principles, if a tax system discriminates against a party because it transacts with railroads rather than airlines, the tax system discriminates against railroads. The mere fact that the party transacts with railroads is a sufficient relationship to result in discrimination against railroads, even if the party is a completely unaffiliated enterprise dealing with the railroads at arm’s length.

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This conclusion follows straightforwardly from the fact that a tax on one party to a transaction is economically equivalent to an otherwise identical tax on the other party to that transaction. As uniformly taught in undergraduate public finance textbooks, a tax legally imposed on buyers and an otherwise identical tax legally imposed on sellers have the same economic effects. In other words, the statutory incidence of the tax is economically irrelevant. The buyer tax and the seller tax depress output with the same effect on the quantity of transactions and also have the same economic incidence or distribution of the tax burden. In either case, the buyers and sellers share the economic burden based on their relative flexibility (the extent to which they would cut back on purchases or sales if they faced less favorable terms), with the less flexible party bearing the greater economic burden.

Because taxes on buyers and taxes on sellers are economically equivalent, the relevant comparison is between the total tax on a railroad’s transactions (including any tax legally imposed on the railroad and any tax legally imposed on the party transacting with the railroad) and the total tax on an airline’s comparable transaction (including any tax legally imposed on the airline and any tax legally imposed on the party transacting with the airline). If the former total tax is greater than the latter total tax and the disparity has no valid justification, the railroad faces discrimination. The division of the legal burden of the tax on the railroad’s transaction between the railroad and the party with which it transacts is irrelevant, as is the division of the legal burden of the tax on the airline’s transaction.

The irrelevance of statutory incidence is clear in other contexts. An employer payroll tax that applied only to wages paid to members of a racial minority would constitute racial discrimination in the same way and to the same extent as an otherwise identical employee payroll tax that applied only to wages received by members of that minority. That the employer payroll tax applied to employers of all races would not change its discriminatory nature. Of course, discrimination against railroads is morally benign, in comparison with the invidious evil of racial discrimination, but the logical analysis required to determine whether the discrimination exists is the same in each case.

If the tax on repair services had been imposed on the purchasers, there would be little doubt that applying the tax to railroads, but not airlines, would trigger scrutiny under the 4-R Act. The same scrutiny should apply when the tax is instead imposed on the sellers of the repair services.

Wollman said that Midwest offered only “bare assertions that South Dakota’s tax has the effect of discriminating against rail carriers.” He concluded that ruling in favor of Midwest “would have required the district court to rely on speculation with respect to whether South Dakota’s tax on railcar repair services performed by a privately owned, third-party service provider and any tangible personal property used therein impermissibly result in discriminatory treatment of a rail carrier” and that “such speculation would have been an improper basis” for decision. In reality, however, the disparate effect of the tax is apparent on the face of the statute and no speculation is required.

Judge Bye’s dissent uses the correct analysis, noting that a tax on services provided to railroads “can increase the cost of an activity to a rail carrier’s detriment” and that “the financial burden the state of South Dakota imposes upon Midwest is transferred to, and shared by, rail carriers.”

Bye noted that one federal appellate court has addressed this issue correctly. In a 1991 decision authored by Judge Richard A. Posner, the Seventh Circuit said:

1985) (challenge to Iowa tax), and Trailer Train Co. v. State Tax Comm’n, 929 F.3d 1300 (8th Cir. 1991) (challenge to Missouri tax).

Who conducts the activity that is taxed is irrelevant. The tax will increase the cost of the activity, to the railroad’s detriment. The statute applies to taxes on rail transportation property and to other taxes if they discriminate against rail carriers; it is thus not limited to cases in which the railroad is the taxpayer . . . . The state . . . cannot levy a tax on inputs into railroading alone.20

As Bye observed, Wollman’s opinion quoted this statement approvingly and yet failed to heed its admonition.

A similar error made a brief appearance in the U.S. Supreme Court’s jurisprudence of the dormant commerce clause of the U.S. Constitution. In a 1989 decision, the Court said that “it is not a purpose of the Commerce Clause to protect state residents from their own state taxes.”21 This dictum appeared in a portion of the Court opinion representing the views of six justices. In a concurring opinion, Justice John Paul Stevens said that this statement squarely contradicted many of the Court’s prior decisions and emphatically rejected the notion that a state “may discriminate among its own residents by placing a heavier tax on those who engage in interstate commerce than on those who merely engage in local commerce.”22 In a separate concurring opinion, Justice Sandra Day O’Connor expressed her agreement with Justice Stevens’s observation.23

Fortunately, the Court’s ill-reasoned dictum has not resurfaced in later dormant commerce clause cases. The analysis of discrimination set forth above is fully applicable in this context and makes clear that Stevens and O’Connor were correct. A tax on interstate transactions engaged in by a state’s residents that exceeds, without appropriate justification, taxes on within-state transactions engaged in by the residents, constitutes discrimination against interstate commerce (or a violation of trade neutrality), regardless of whether the tax is described as being imposed on the residents or on the out-of-state parties with whom they transact. Any other rule would make the finding of discrimination depend on the economically arbitrary feature of the identity of the party on whom the tax is legally imposed.24

**Conclusion**

The 4-R Act was adopted to protect railroads from discriminatory taxation. An accurate determination of whether a particular tax actually discriminates against railroads can be difficult. It is necessary to identify other parties that are similarly situated to railroads and compare the taxation of their transactions with the taxation of railroads’ transactions. It is also necessary to consider whether any valid justifications can be offered for differences in treatment. These analyses can be quite difficult.25 Having had no opportunity to perform that analysis for the South Dakota sales tax statute challenged in Midwest, I cannot offer an opinion regarding its ultimate validity.

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**Allowing taxes to escape scrutiny based on statutory incidence allows state and local governments an easy path to avoid the strictures of the 4-R Act.**

Economic theory makes clear, though, that the Eighth Circuit’s refusal to scrutinize the tax relied on an irrelevant factor. The Legislature’s decision to legally impose the tax on one, rather than the other, party to the transaction does not change its discriminatory nature or lack thereof. Allowing taxes to escape scrutiny based on statutory incidence allows state and local governments an easy path to avoid the strictures of the 4-R Act. Only a reality-based analysis that ignores irrelevant factors such as statutory incidence will allow the act’s purpose to be achieved.

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20Burlington N. R.R. Co. v. City of Superior, Wis., 932 F.2d 1185, 1186-1188 (7th Cir. 1991).
22Goldberg, 488 U.S. at 268 (Stevens, J., concurring opinion).
23Goldberg, 488 U.S. at 270 (O’Connor, J., concurring opinion).
25Justice Clarence Thomas recently discussed these general issues in an opinion joined by Justice Ruth Bader Ginsburg, CSX Transportation, supra note 13, 131 S. Ct. at 1115-1120 (Thomas, J., dissenting opinion). In a decision issued on July 27, 2011, the Seventh Circuit also discussed these issues and surveyed how they have been treated by various federal appellate courts, Kansas City Southern Ry. Co. v. Koeller, 653 F.3d 496, 507-510 (7th Cir. 2011).