2023 National Conference of State Tax Judges

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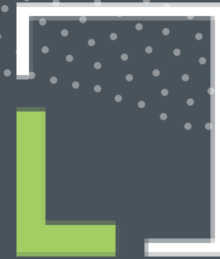

LINCOLN INSTITUTE OF LAND POLICY

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Modernizing the Tax Injunction Act

The Tax Injunction Act – a bar to fair litigation in state tax controversies

The Federal Tax Injunction Act (TIA), Section 1341 of Title 28, enacted nearly a century ago in 1937, prohibits most state tax cases from being heard in federal court. Taxpayers must file state tax claims in state courts "as long as a plain, speedy and efficient remedy may be had in state court." Unless the United States Supreme Court ("Supreme Court") agrees to hear a constitutional challenge to a state tax, which is relatively rare, taxpayers have no recourse from a state court decision in tax cases.

Quad Graphics
(and the Death of *Dilworth*?)

Quad Graphics, Inc. v. N.C. Dep't of Revenue (N.C. Dec. 16, 2022)

- The North Carolina Supreme Court reversed a decision by the state's Business Court that the state lacked nexus to impose a *sales tax* under the U.S. Supreme Court's decision in *McLeod v. Dilworth.*
  - In the 1944 *Dilworth* case, the Supreme Court determined that a sale occurred when title passed upon delivery to a common character, and the state that had nexus with the sale was the state in which title passed.
  - Applying *Dilworth*, the Business Court determined that, for the sale in issue, title passed out of state and North Carolina had no nexus over the sale.

- The North Carolina Supreme Court held that, while *Dilworth* had not been explicitly overturned, the U.S. Supreme Court's decisions in *Complete Auto* and *Wayfair* represented a rejection of its formalist approach.
  - Under the relaxed standard used in those later cases, the state was permitted to impose sales tax a transaction when title passed out of state.

U.S. Supreme Court denied certiorari

Taxpayer's Arguments in the Petition

- The taxpayer argued that, *Dilworth* had not been "implicitly overruled" by *Complete Auto* and *Wayfair*, because *Dilworth* can fit within the four-part test in *Complete Auto* to establish the transactional nexus and the overrule of "physical presence requirement" in *Wayfair* did not call *Dilworth* into questions.
- In addition, taxpayer pointed out there was a split among state high courts and lower courts about whether *Dilworth* remains good law and the questions presented in this case need the intervention of the U.S. Supreme Court.

Sales Tax Base

***Quad Graphics Inc. v. North Carolina Department of Revenue*, North Carolina Supreme Court No. 407A21-1, Tenth District (December 9, 2022) Petition for Cert. denied**

- The North Carolina Supreme Court upheld a sales tax assessment on a Wisconsin-based printing company's sales into the state, finding that U.S. Supreme Court precedent that would have required use tax to be levied instead was no longer valid.
- In a 6-1 decision, the state high court ruled that Quad Graphics Inc. had sufficient with the nexus with North Carolina to be subject to sales tax on sales of magazines, books and other printed materials from 2009 through 2011. The justices rejected a trial court's decision that negated the sales tax assessment under the U.S. Supreme Court's 1944 holding in *McLeod v. J.E. Dilworth Co.*, which set forth a formalistic distinction between sales and use taxes, saying the nation's highest court had subsequently disavowed Dilworth.
- The Dilworth decision had precluded sales tax liability in cases where out-of-state goods were delivered by a common carrier into a state and title and possession to the goods transferred to the purchasers outside the taxing state.

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Public Law 86-272
ACMA Litigation in California

P.L. 86-272

MTC Uniformity Committee Revised Statement on PL 86-272

- Purports to interpret the limits of PL 86-272 in the context of current technology
- Expands the list of unprotected activities to include:
  - A business has an employee that telecommutes on a regular basis unless the activities are limited to the solicitation of orders for tangible personal property.
  - The company provides post-sale assistance to customers via either electronic chat or email that is accessed through a link on the company's website.

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P.L. 86-272

- The company solicits and receives on-line applications for its branded credit cards via the company's website.
- The company contracts with a marketplace facilitator, whose marketplace offers for sale the company's products via a website. The marketplace maintains inventory, including the company's products, at fulfillment centers around the country.
- The company (a) inserts Internet "cookies" into the computers or other electronic devices of customers who access the company's website and (b) uses customer search information gathered by its cookies to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale.

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- The company remotely fixes products via the Internet and WIFI.
- The business sells extended warranty plans via a website to customers who purchase the company's products.
- The company streams videos and music to electronic devices for a charge.

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P.L. 86-272

- On August 24, 2022, the ACMA (American Catalog Mailers Association) filed a complaint in the Superior Court in San Francisco challenging the California Franchise Tax Board's adoption of comprising TAM 2022-01 and FTB Publication 1050.

- The Complaint states that the California memo would effectively remove PL 86-272 long-time protection from liability for the California income tax for many remote sellers. The case is *American Catalog Mailers Assn. v. Franchise Tax Board*.

- New York drafted a regulation very similar to the MTC's statement, while Oregon has taken a pass….for now.

- Minnesota just adopted the MTC statement verbatim.

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Remote Workers: Zelinsky (and misc.)

Zelinsky v. New York (2003)

- FACTS:
  - Ed Zelinsky is a tax law professor employed by Cardozo School of Law in New York City. He is a resident of Connecticut. When class was not in session, he stayed in Connecticut. Cardozo pays 100% of Zelinsky's salary.
  - During the 1994-95 academic year, Zelinsky physically commuted into New York 3 days a week to teach at Cardozo. On the other 2 days, he worked from home in Connecticut.
  - During the fall semester of 1995, Zelinsky was on sabbatical and worked from home the entire time.
- NEW YORK takes the position that Zelinsky is subject to NY tax on 100% of his Cardozo income.
  - As a nonresident, Zelinsky's income is subject to allocation and apportionment per 20 NYCRR 132.18[a]:
  - *"If a nonresident employee … performs services for his employer both within and without New York State, his **income derived from New York State sources** includes that proportion of his total compensation for services rendered as an employee which the **total number of working days employed within New York State [numerator]** bears to the **total number of working days employed both within and without New York State [denominator]**."*
  - *"any allowance claimed for **days worked outside New York** State **must be based upon the performance of services which of necessity**, as distinguished from convenience, **obligate the employee to out-of-state duties in the service of his employer**."*
  - Because Zelinsky's work in Connecticut was for his convenience and not required ("of necessity") by Cardozo, those days are counted as New York days rather than Connecticut days.

Fast Forward Two Decades…

- In 2021, Professor Zelinskys and his wife (Zelinskys), again, filed two petitions with the state of New York Division of Tax Appeals (Tax Appeals) for redetermination of deficiencies or for refund of personal income tax under New York Tax Law article 22 for the years 2019 and 2020.
- On November 17, 2022, the Tax Appeals granted Zelinskys' motion to consolidate the two petitions because common questions of law and fact are present in the two petitions.
  - In both petitions, Zelinskys challenged New York's "convenience of the employer" rule.
- **A hearing regarding the petition was conducted remotely on April 25th, 2023**.
- After the hearing, Zelinskys submitted a brief in support of their arguments in the petition on June 14, 2023.
- The final order is still pending.

Zelinsky’s Arguments

- In the brief, Zelinsky argued that no New York tax is due on the income earned at home for the COVID-19 period of 2019 and 2020.
  - During the relevant period, Professor Zelinsky’s salary from teaching for Cardozo Law School via Zoom without New York was not derived from New York source under 20 N.Y.C.R.R. § 132.4(b).
  - In addition, since Professor Zelinsky did not have a New York office or classroom and conducted remote teaching for “necessity” and not anybody’s “convenience”, so the “convenience of employer” did not apply.
  - New York's taxation through the “convenience of employer” rule violates overlapping principles under the dormant Commerce Clause and the Due Process Clause.
    - These principles include (i) income must be fairly apportioned to the states; (ii) states can only tax a nonresident's income from sources within the taxing state; (iii) states cannot tax extraterritorially beyond the state’s boundaries; (iv) states must use reasonable apportionment formulas; (v) The dormant Commerce Clause apply to the travel of individuals between states.
  - The Zelinsky 2003 decision, which upheld the “convenience of employer” rule, cannot apply in the current case because of the different facts (growth of remote working) and the adverse U.S. Supreme Court’s cases afterwards.

New Jersey convenience of the employer rule

Assembly Bill 4694 created a "convenience of the employer" doctrine for employees of New Jersey based companies that reside in other states

- Applies to New Jersey non-resident employees who reside in a state that also has a convenience doctrine (Connecticut, Delaware, Nebraska, and New York)
- Under the rule, any employee with a New Jersey based office would be taxed in New Jersey for days they work remotely from another state with a convenience of the employer rules
- This new law will be retroactive to January 1, 2023; Companies that are compliant as of 9/15/2023 should not face tax, penalties or interest

Residency of an Athlete

***Buck v. Utah State Tax Comm'n*, Utah, No. 20200531**

- The Utah Supreme Court ruled that retired professional baseball player John Buck and his spouse do not owe Utah $400,000 in back taxes because the state erred in determining their domicile was Utah.
- The Bucks own a house in Utah but moved to Florida when John Buck joined the Miami Marlins. The state tax commission found that the Bucks were still domiciled in Utah for the tax year 2012 and put them on the hook for almost $400,000.
- In 2012, the Bucks only spent a few weeks in their Utah home and otherwise lived full time in Miami, Florida.
- The Supreme Court of Utah found that the Commission wrongly interpreted the Utah Individual Income Tax Act to effectively preclude the Bucks from being able to overcome the rebuttable presumption of domicile.
- The court ruled that the Bucks in fact lived in Florida during 2012 and held that taxpayers are allowed to present broad evidence to establish that they are not domiciled in Utah for individual income tax purposes.

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Cleveland Cannot Tax Out-of-State Remote Worker

***Dr. Manal Morsy v. Sharon Dumas*, CV-21-946057**

- An Ohio judge ruled that Cleveland cannot impose its income tax on a Pennsylvania resident who worked remotely in 2020 due to the coronavirus pandemic, stating that the resident's out-of-state status was a major factor in the decision.
- Manal Morsey, a Pennsylvania resident and an employee of a Cleveland based company, claimed that she should was entitled to a refund for municipal income taxes paid to Cleveland for days that she worked from home in Philadelphia.
- The law was passed in 2020 and temporarily allowed Ohio cities to tax remote workers in other municipalities during the pandemic, which required workers to pay municipal income taxes in cities that they did not live or work in during that time.
- Judge Gary L. Yost of the Cuyahoga County Court agreed that the Ohio legislature cannot give cities the power to engage in extraterritorial taxation.
- Judge Yost granted Morsey a refund for the municipal income tax she paid to Cleveland for the days she worked remotely in PA and enjoined the city from collecting any further taxes on the income Morsey earned outside the city. .

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St. Louis Ordered to Give Refunds to Teleworkers

Mark Boles et al. v. City of St. Louis et al**., case number 2122-CC00713**

- A Missouri Circuit Court ordered St. Louis to issue an earnings-tax refund to teleworkers for days worked outside of the city.
- A St. Louis ordinance imposes a 1% tax on earnings.
- People were previously refunded for taxes collected while they worked outside of the city.
- However, the city abruptly switched how they interpreted the earnings tax ordinance so that remote workers were not entitled to refunds for time they worked outside of St. Louis.
- Ruling for the Taxpayer, the judge explained that the ordinance is limited to taxing services performed or rendered by worker physically in the city.
- The court relied on the plain language of the ordinance and expressed dislike of city's capricious 180-degree interpretation of the ordinance which taxpayers had come to rely on.
- Of note – the city unpersuasively claimed that "[a] loss of revenue of this magnitude would be a devastating blow to the city's credit and fiscal condition, and would seriously impair the city's ability to provide basic city services."; also, a factually similar dispute is being considered by the Ohio Supreme Court

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Remote Worker Owes Alabama $33.78 in Taxes

Bollinger v. Alabama Department of Revenue (No. Inc. 22-390-LP)(Ala.)

- An Alabama court ruled that an out-of-state remote worker's income earned working for an Alabama corp. was taxable as Alabama-sourced income.
- Bollinger moved from Alabama to Idaho in September 2020 because his employer (BBVA) approved him to be permanent remote. Bollinger continued working for BBVA, kept using his Idaho drivers license, but terminated his Alabama lease and voted in Idaho in 2020.
- First, the court ruled that Bollinger had unequivocally relocated to Idaho intending it to be his permanent resident.
- Second, the court ruled that even though Bollinger was a non-resident for several months in 2020, the income Bollinger received while working remotely was properly taxable as Alabama-sourced income.
- The court relied on Alabama Supreme Court precedent which found that Bollinger continued to transact business in Alabama because of his "regular and legal employment with BBVA, which was in Alabama. . . [and because he] report[ed] to the same Alabama supervisors to whom he had reported while working physically in Alabama."

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Individual Tax Credits

***Diane Zilka v. City of Philadelphia*, 20 EAP 2022 pending before the Pennsylvania Supreme Court**

- A Philadelphia resident claims that the city unconstitutionally subjected her to double taxation by refusing to credit her Delaware state income taxes paid against her city wage tax liabilities
- The Pennsylvania Commonwealth Court found that Philadelphia wasn't required to refund wage taxes to offset the remainder of her Delaware state income tax liability after Pennsylvania credited her for taxes paid to Delaware
- Zilka had alleged that the Commonwealth Court misapplied the U.S. Supreme Court's 2015 *Comptroller v. Wynne* ruling, which held that Maryland violated the Constitution's commerce clause by not providing a credit for other state taxes paid against a county tax
- *Wynne*, she said, required that state and local taxes "must be considered as one" rather than analyzed individually.

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Verizon (New York): Internet Tax Freedom Act

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

VERIZON NEW YORK INC. :

for Redetermination of a Deficiency or for Refund of Corporation Tax under Article 9 of the Tax Law for the Years 2008 through 2011. :

DETERMINATION
DTA NO. 829240

Petitioner, Verizon New York Inc., filed a petition for redetermination of a deficiency or for refund of corporation tax under article 9 of the Tax Law for the years 2008 through 2011.

A hearing was held before Donna M. Gardiner, Administrative Law Judge, in New York, New York, on June 28, 2022, with all briefs to be submitted by November 4, 2022, which date began the six-month period for the issuance of this determination. Petitioner appeared by Eversheds Sutherland (US) LLP (Eric S. Tresh, Esq. and Chelsea E. Marmor, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (David Markey, Esq., of counsel).

ISSUES

I. Whether Tax Law § 184 imposes tax on the gross receipts of Verizon New York Inc. for the tax years ended December 31, 2008 through December 31, 2011.

II. If so, whether such taxation violates the Internet Tax Freedom Act of 2007.

INTERNET TAX FREEDOM ACT

Maryland’s Digital Services Tax & *Comcast* Litigation

Comptroller of Maryland v. Comcast of California
484 Md. 222, 297 A.3d 1211 (2023)

- In **Comptroller of Maryland v. Comcast**, the Maryland Supreme Court (Court) granted the Comptroller's petition for certiorari and held that the Companies were *required to exhaust administrative remedies* in the Tax-General Article, and their failure to do so deprived the Circuit Court for Anne Arundel County (Circuit Court) of jurisdiction to entertain this declaratory judgment action.

- The Companies argued that Section 13-505 of the Tax-General Article (Statute) did not prohibit all judicial intervention, such as declaratory judgment, in tax cases until a final administrative determination is issued.
  - Meanwhile, the Companies invoked the constitutional exception to the administrative exhaustion requirement.

- The Comptroller interpreted the Statute broadly to present a legislative intent to preclude all judicial intervention in tax cases before a final administrative determination.

- The Court agreed with the Comptroller on the statutory interpretation, and held the constitutional exception to "permits a judicial determination without administrative exhaustion when there is a direct attack upon the power or authority ... of the legislative body. . . " did not apply since the administrative remedies in this case are exclusive.
  - — The order of the Circuit Court was vacated and the case remanded.

Digital Advertising

Maryland Digital Advertising Gross Revenues Tax

- House Bill 732
  - Creates a new digital advertising gross revenues tax separate from, and in addition to, the existing Maryland sales tax.
  - The tax is imposed on a person's annual gross revenues derived from digital advertising services in Maryland.
- Senate Bill 787 delayed the start of the digital advertising tax by one year, to January 1, 2022.
- Senate Bill 787 also included a pass-through prohibition: "A person who derives gross revenues from digital advertising services in the State may not directly pass on the cost of the tax imposed under this section to a customer who purchases the digital advertising services by means of a separate fee, surcharge, or line-item."

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Digital Advertising

***Comcast v. Comptroller of Maryland*; Case No. C-02-cv-21-000509 (Oct. 20, 2022)**

- An Anne Arundel County Circuit Court Judge granted the Plaintiff's motion for summary judgement on the basis that the Maryland Digital Advertising Tax:
  - Discriminates against interstate commerce
  - Violates the Internet Tax Freedom Act
  - Violates the First Amendment because it single out the internet over traditional media

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Misc. Corporate Income Tax Cases: Apportionment, Unitary Business, Royalty Deductions

Vectren Infrastructure Services Corp. v. Department of Treasury No. 163742, 2023 WL 4874684 (Mich. July 31, 2023)

- Taxpayer, a pipeline repair company, had low Michigan sales in most years
- Following a catastrophic oil spill, Taxpayer was hired to perform cleanup and repair work on a pipeline in Michigan, resulting in a significant (and presumably temporary) increase in its Michigan sales.
- During that same year, Taxpayer's shareholders sold all their shares, electing to treat the transaction as a sale of all Taxpayer's assets.
  - Taxpayer calculated its liability under the Michigan Business Tax by including gains from this transaction in both its business income tax base and in its sales factor denominator.
- On audit, the Department determined that the gains had been properly included in the tax base but were not includable in the sales factor denominator because they were not "sales" under Michigan's statutory definition.
  - This resulted in Taxpayer's Michigan apportionment increasing from about 15% to about 70%, which would be applied to gains from the sale of the company.
- Taxpayer filed suit, arguing that it was entitled to alternative apportionment because including the gains in the tax base but excluding them from the apportionment formula improperly attributed long-term gain to Michigan.
  - Taxpayer also argued that excluding gains from the apportionment formula violated the Commerce and Due Process clauses

Vectren Infrastructure Services Corp. v. Department of Treasury No. 163742, 2023 WL 4874684 (Mich. July 31, 2023)

- After a complicated journey through the Michigan court system, the case reached the state supreme court for the second time.
  - The Court of Appeals had twice ruled that application of the statutory formula violated the U.S. Constitution and that Taxpayer was entitled to use of an alternative formula.
- The Michigan Supreme Court held (1) that the disputed gain was properly included in the tax base; and (2) that Taxpayer was not entitled to alternative apportionment.
- Gains were properly included in the apportionable tax base because they were *not un*related to business activities in Michigan (the required constitutional threshold) and accumulated goodwill might be used in Michigan in the future.
  - A dissent argued that it was improper to include gains from assets held and goodwill accumulated in other states.

- Taxpayer was not entitled to alternative apportionment because the income attributed to Michigan was not out of proportion to business transacted in the state.
  - Taxpayer's argument focused unusual level of Michigan sales in the tax year at issue (compared with its historical figures.)
  - The court rejected this argument, holding that the Department had no obligation to consider historical tax information when determining liability for a specific tax year.
  - The court applied the standard constitutional test for alternative apportionment, determining that the statutory formula was both internally and externally consistent.
  - Taxpayer had not shown "by clear and cogent evidence" that it was entitled to alternative apportionment.

Tractor Supply Company v. South Carolina Department of Revenue No. 19-ALJ-17-0416-CC (S.C. Admin. Law Ct., Aug. 8, 2023).

- The South Carolina Administrative Law Court (ALC) upheld the DOR's application of combined reporting
  - On audit, the DOR asserted that the taxpayer's transfer pricing allowed it to minimize its South Carolina tax exposure by shifting income from its retail sales to Texas through the use of a 9.7 percent markup on inventory
- The ALC first determined that "combined reporting" is an alternative method of apportionment and the DOR was permitted to require combined reporting as an alternative method
- Next, the ALC addressed whether the DOR had proven that an alternative formula, combined reporting, was warranted and whether it was reasonable
- The ALC recognized that the reporting method was not the true problem in this case- it was the transfer pricing
- But neither party had produced a corrected transfer price, which in the court's view meant it could not fix the issue by adjusting the transfer pricing
- In the court's view, combined unitary reporting reasonably carved out and fairly represented the income associated with the taxpayer's business activity in South Carolina, which were its retail sales
- While no method of apportionment is perfect, unitary reporting had the benefit of removing the unreliable transfer price while recognizing the value flowing between the entities and carving out only the income from retail sales associated with South Carolina

Target Enterprise, Inc. v. Florida Dep't of Rev. (Fla. 2nd Jud. Cir. Nov. 28, 2022)

- Issue was whether the DOR could require the taxpayer to apportion its income using a formula based on the square footage of its parent's stores within the state
  - Under a regulation, receipts are sourced to Florida if the greater proportion of the income producing activity is performed in Florida, based on costs of performance (IPA/COP rule)
  - Because most of its payroll was out of state, the taxpayer generally had no service receipts attributed to Florida under the IPA/COP rule
  - The DOR asserted the taxpayer had not sufficiently supported its IPA/COP analysis so an alternative method was required
- The court determined that the taxpayer had complied with its duty to provide books and records to the DOR, and had provided sufficient documentation to support its IPA/COP analysis
- The court further determined that the DOR's proposed method was not compatible with the statute
  - The taxpayer provided services to its parent at its parent's Minnesota headquarters; none of these services were performed in Florida

Apportionment-Back Door Market Sourcing

***Target Enterprises, Inc. v. Florida Dept. of Rev.*, Case No. 2021-CA-002158 (Fl. Cir. Ct.), complaint filed Dec. 2021**

- Florida DOR is using a market-based sourcing approach despite the fact it adheres to cost of performance sourcing
  - TEI provides marketing, merchandising, strategy/consulting, and brand building services to the Target Group. TEI employees perform these services at corporate headquarters in MN and provide them to Target Group employees at corporate headquarters in MN.
  - The FL DOR contends that TEI is performing these services for Target Group retail stores and, due to the unusual and unique circumstances of the case, using a market-based sourcing approach based on the Target Group's retail square footage in FL is reasonable.
  - The Leon County Circuit Court agreed with Target and rejected the Department's arguments that the service could be sourced to Florida based on total square footage of Target stores in Florida to total footage of Target stores overall. The judge noted 94.9 percent of Target Enterprise's payroll was attributable to Minnesota, while less than 0.1 percent was Florida payroll. The judge wrote "It is clear from the facts presented that TEI is not directly providing services to individual Target retail locations,"

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STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition

of

LENDLEASE AMERICAS HOLDINGS, INC. & SUBSIDIARIES

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Tax Years ended June 30, 2007, June 30, 2008 and June 30, 2009.

DETERMINATION
DTA NO. 829540

Petitioner, Lendlease Americas Holdings, Inc. & Subsidiaries, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under article 9-A of the Tax Law for the tax years ended June 30, 2007, June 30, 2008 and June 30, 2009.

A hearing was held in Albany, New York, on August 9, 2022 and continued to completion on August 10, 2022, with all briefs to be submitted by January 27, 2023, which date began the six-month period for the issuance of this determination. Petitioner appeared by Lowenstein Sandler, LLP (Edmund Cohen, Esq., of counsel) and the Division of Taxation appeared by Amanda Hiller, Esq. (David Markey, Esq., of counsel). After reviewing the entire record in this matter, Winifred M. Maloney, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Division of Taxation properly determined that petitioner should have filed on a combined basis with Yarmouth Lend Lease KOP, Inc. for the tax years ended June 30, 2008, and June 30, 2009.

New York Once Again Denies Royalty Deduction

***International Business Machines Corp*. and *Combined Affiliates v. Tax Appeals Tribunal of the State of New York*, Dkt. No. 533572, (Supreme Court, Appellate Division, Third Judicial Department.)**

- A New York appellate court rejected IBM's appeal of the state tax department's denial of a $109 million tax refund in a dispute over the deduction of foreign royalty payments.
- The Appellate Division upheld a 2021 ruling by the State Tax Appeals Tribunal rejecting IBM's argument that the state's denial of its deduction claimed for foreign royalties received in the tax years 2007 through 2012 violated the dormant commerce clause of the U.S. Constitution. The court agreed with the Tribunal that IBM could not deduct the royalties received from foreign affiliates for the use of intangible assets because those affiliates were not New York taxpayers subject to the state's add-back laws, so the royalties were not taxed elsewhere.
- The court disagreed with IBM's assertion that the Tribunal's interpretation of the state's royalty income exclusion and royalty expense add-back rules in place at the time failed both the internal and external consistency tests of the dormant commerce clause. The court called IBM's arguments "nearly identical" to those raised by The Walt Disney Co. in an appeal that was rejected by the Court in October.

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No Deduction for Royalty Payments (Wisconsin)

***Skechers USA Inc. v. Department of Revenue,* (Dkt. No. 10-I-071 an 10-I-072 (February, 2023)**

- The Wisconsin Tax Appeals Commission held that Skechers USA's wholly owned subsidiary was created for sham transactions that were part of a tax-avoidance scheme and had no valid business purpose. Therefore, Skechers could not claim royalty and interest deductions for transferring domestic intellectual property rights to a holding company and then licensing them back.
- In June 1999 Skechers formed Skechers USA Inc. II (SKII) as a Delaware corporation to transfer its IP to for purposes of licensing the IP back to Skechers. SKII was formed after Skechers was approached by its audit firm with a presentation on state tax minimization services.
- Noting that the assessment by the DOR has a presumption of correctness and that Skechers has the burden of proving that the transactions were not shams, the commission said that "every piece of documentary evidence that was contemporaneously produced to justify the creation of SKII and the subsequent transactions at issue stressed the reduction of state tax liability."

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Washington Excise Tax on Capital Gains

Income Tax or Excise Tax…You Decide

Quinn v. Washington **No. 100769-8, March 25, 2023**

- The Washington Supreme Court upheld the capital gains tax, ruling it is constitutional. The decision reverses the holding of the lower court issued in January, 2023 which held that the tax was unconstitutional because it did not apply equally to everyone.
- The Washington Supreme Court held that "Because the capital gains tax is an excise tax under Washington law, it is not subject to the uniformity and levy requirements of article VII. The Court further held the capital gains tax is consistent with the Washington state constitution privileges and immunities clause and the federal dormant commerce clause. The Court therefore rejected the Plaintiffs' facial challenge to the capital gains tax.

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Quinn v. Washington (Wash. Mar. 24, 2023)

- The Washington State Supreme Court upheld the constitutionality of the state's capital gains tax.
  - Enacted in 2021, the capital gains tax is imposed at a rate of 7 percent on an individual's Washington allocated capital gains (after a standard deduction of $250,000 for both individuals and joint filers).
- Plaintiffs argued that the tax was a property tax on income, which would be subject to uniformity and levy limitation requirements set forth in the state Constitution.
  - The plaintiffs also alleged that the tax violated the Washington State privileges and immunities clause and the federal dormant commerce clause.
- The state argued that the capital gains tax was an excise tax not subject to the uniformity and levy restrictions.
- The court ruled that the tax is properly characterized as an excise tax rather than a property tax.
- The court rejected the privileges and immunities clause challenge on the grounds that there was no fundamental right under the state constitution to be exempt from taxes from which other Washingtonians are exempt and that, the legislature's classification choice (e.g., the $250,000 exemption) was reasonable.
- The capital gains tax, in the Court's view, complied with the four-part test from *Complete Auto Transit v. Brady*, meaning there was no dormant commerce clause violation.
- A two-justice dissent argued that the tax is a prohibited graduated income tax because it is a tax on the recognition of income from a capital transaction (rather than on the transaction itself) and is imposed on net (rather than gross) income.

U.S. Supreme Court Petition

- The plaintiffs petitioners filed a petition for a writ of certiorari to the U.S. Supreme Court on August 21, 2023.
  - The defendants respondents waived its rights to respond on September 6, 2023.
- The plaintiffs petitioners argued that while it may solve the state law issue by holding the capital gains tax was an excise tax not subject to the uniformity and levy restrictions, the Washington Supreme Court created a federal-law problem.
  - The plaintiffs petitioner alleged that the new excise tax will reach beyond the state's borders to tax transactions that occur in other states involving property located out of state.
  - Therefore it defied the rule under the U.S. Constitution that no state may tax transactions that take place in other states.
- The plaintiffs petitioners further argued that the Washington Supreme Court's decision squarely conflicts with the law of the Ninth Circuit.
  - In *Sam Francis Foundation v. Christie's, Inc.*, 784 F.3d 1320 (9th Cir. 2015) (en banc), the Ninth Circuit invalidated a California law that required the seller of a work of fine art to pay the artist 5% of the sale price even if the sale took place entirely in another state if the seller was a California resident.
- Based on the above reasons, the plaintiffs petitioners concluded that the U.S. Supreme Court should grant certiorari and hold Washington's excise tax on out-of-state transactions unconstitutional.