State Tax Developments, 2017-2018

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Agenda

- What is the current state of nexus?
- Additions, Addbacks and Other Cool Stuff
- Business Income and Other Sourcing Issues
- Federal Tax Reform?
- What is it worth? Transfer pricing woes continue in DC.
- Discrimination, is it ever okay?
- I am just not like anyone else – Alternative Apportionment
- Odds, Ends and Other Interesting Stuff

State of the State of the Never-ending Saga of Nexus

Is There Anything Left to Discuss About Economic Nexus?

- The Oregon Supreme Court concluded in *Capital One Auto Finance v. OR DOR* (2018) that two bank subsidiaries of Capital One Financial Corp. had substantial nexus with Oregon due to their extensive economic activities even though neither entity had property or payroll in the state.

- The Tax Court rejected the argument that the banks must have physical presence in Oregon to be subject to tax.

- In reaching its conclusion the Supreme Court pointed to the lending and depositing activities of the bank's clients in the state as support for the fact the banks were doing business in the state as that term is defined for financial institutions.

- The banks earned income in excess of $150 million in Oregon through interest and fee charges and under the terms of the statute this was income earned from sources within the state.

Solicitation: I Know It When I See It.

- The Maryland Tax Court held in *Blue Buffalo, Ltd. v. Comptroller of the Treasury* (MD Tax Crt. 2017) that Blue Buffalo, Ltd.'s activities in Maryland exceeded Public Law 86-272 protection when denying a refund claim.
- Blue Buffalo sells premium pet products in Maryland. The company employed a District Manager, an Account Manager, two regional Demo Managers and several dozen in-state representatives in Maryland.
- The Court found that the Account Manager's main job function was to maintain relationships between the company and the local store manager. The in-store representatives interacted with actual consumers of the product. These activities when taken together exceeded solicitation of orders.

Do You “Trust” Nexus?

- The North Carolina Supreme Court held in *Kimberley Rice Kaestner 1992 Family Trust v. NC Dep’t of Revenue* (NC 2018) that the presence in the state of an irrevocable inter vivos trust’s beneficiary is not sufficient to establish income tax nexus for the trust.
- Other than the trusts’ beneficiaries being residents of North Carolina, there were no other connections between the state and the trust.
- The trust did not have sufficient minimum connections with North Carolina to satisfy the due process requirements of the United States and North Carolina constitutions.

That Is Not Very Amusing.

- The Circuit Court of Cook County in *Labell v. City of Chicago (Cook County Cir. Ct.,* 2018) upheld the City of Chicago's amusement tax as imposed on streaming services.
- The court held that the amusement tax did not:

  1) violate the federal Internet Tax Freedom Act;
  2) violate the Commerce Clause of the United States Constitution;
  3) violate the Uniformity Clause of the Illinois Constitution; or
  4) exceed Chicago's home rule authority by taxing services occurring outside of Chicago.

South Dakota v. Wayfair, Inc.

- What is the right level of activity in a state? Is $100,000 in sales and 200 transactions a one size fits all?
- What about any element of retroactivity?
- Does the physical presence standard have any meaning?
- Why is Massachusetts pursuing “cookie nexus”?
- What is the impact on other taxes?
- Does Streamline matter?

Additions, Addbacks & Other Cool Stuff

You Can't Use All That.

- The Pennsylvania Supreme Court (agreeing with the Commonwealth Court) held in *Nextel Communications v. Commonwealth of Pennsylvania* (PA Sup. Crt, 2017) that the $3 million net loss deduction limitation in effect for the 2007 tax year at issue violated the Uniformity Clause of the Pennsylvania Constitution. The Pennsylvania Supreme Court, however, departed from the lower court on the question of an appropriate remedy.
- The Commonwealth court had allowed the taxpayer to take an uncapped loss deduction for the 2007 closed tax year at issue. The high court severed the flat-dollar limitation, but kept intact the percentage limitation (12.5 percent of taxable income for the tax year at issue). As such, the taxpayer was not entitled to a refund. On November 1, 2017, the taxpayer requested re-argument before the Pennsylvania Supreme Court on the remedy issue.
- Although the request for re-argument is still pending, the Department recently issued guidance (Corporation Tax Bulletin 2017-01) on the *Nextel* decision. Specifically, the Department will revise its forms and procedures to implement the decision of the Court on a prospective basis.
- Cert. petitioned filed by Nextel in May, 2018

Yes, You Can Deduct That Now.

- The Indiana Tax Court held in *E.I. DuPont de Nemours and Company v. Indiana Department of State Revenue* (IN Tax Crt. 2017) that a company properly deducted its intercompany interest expenses. The company received loans from its affiliate. Interest accrued while the loans were outstanding, but the company was not required to pay any interest until the loans came due.
- The company deducted the interest expense that accrued while the loans were outstanding in computing its Indiana tax liability.
- The court held that the state could not disallow the deduction based on its finding that the loans giving rise to the interest had a business purpose and economic substance.

Close But No Cigar…Well Maybe a Tiparillo.

- On rehearing, the Supreme Court of Virginia held in *Kohl's Department Stores, Inc. v. Virginia Department of Taxation* (VA 2018) that the Virginia addback statute's subject-to-tax exception applied only to the extent that royalties paid to a related member were actually taxed by another state, but that the exception does not require the related member to be the entity that actually pays the tax on the royalty income.
- Because of the statute's ambiguity, the court looked to the legislative intent of the subject-to-tax exception and determined that extending the exception to royalty payments that were not taxed by another state would effectively negate the addback statute's intended operation and "resurrect the loophole" that the statute was designed to close.
- Remember that in a 4-3 decision, the Virginia Supreme Court had affirmed the Circuit Court's holding that only the portion of the royalties that are actually taxed by another state falls within the subject to tax exception.
- The Court acknowledged that the plain language of the statute is ambiguous and that both Kohl's and the Department's respective positions could be supported by the statute. The Court deferred to the Department's interpretation. Because of such ambiguity, the Court looked to the legislative intent of the subject to tax exception. The Court stated that it would effectively negate the addback statute's intended operation and "resurrect the loophole" that the statute was designed to close. Thus, to prevent a conflict with the statute's purpose and intent, the Court held that the exception applies only to the extent the royalty payments are "actually" taxed by another state.

Close But No Cigar…Well Maybe a Tiparillo. (cont.)

- Note: Three justices dissented to this opinion finding that the statute is not ambiguous and favored the taxpayer's application of the statute.
- The Court, however, upheld Kohl's alternative argument and held that the Department incorrectly calculated the amount of royalties that qualified for the subject to tax exception. The Department disallowed an exception for royalties apportioned to, and taxed in, states where Kohl's filed combined income tax returns. The Department argued that the addback statute applies only to intangible expenses for a "related member" and reasoned that the Court can look only to Kohl's Illinois's, and not Kohl's, tax returns. The Court disagreed with the Department, stating that the statute contains no such requirement and thus, to the extent the royalties were actually taxed by separate return states or combined return states, they should qualify for the subject to tax exception. The Court reversed the Circuit Court's decision in that respect, and remanded for the Circuit Court to recalculate the portion of the royalty payments actually taxed by another state.

Close But No Cigar…Well Maybe a Tiparillo. (cont.)

- In a dissenting opinion, three justices resolved any ambiguity in the addback statute in favor of the taxpayer as they determined that the statute constituted an imposition statute. And, the dissenting justices found that a subsequent law change enacted by the Virginia legislature was evidence that the addback statute should be applied in a manner consistent with the taxpayer's proposed application.

Riddle Me This Taxman – What Is the Difference Between a Treaty and a Law?

- The New Jersey Tax Court held in *Infosy's Limited v. Director, New Jersey Dept. of Taxation* that Infosys' net income for New Jersey purposes was equal to federal taxable income as shown on the federal return. The Director argued even if line 29 of the Federal Form 1120 established the tax base the Director has the authority to addback to taxable income any deduction or exemption allowed under foreign tax treaties. The basis for the argument was statutory language which allows the addback of "specific exemption or credit allowed in any law of the United States." It is the Director's position that a treaty is the law of the United States and therefore the addback provision applies.
- The Tax Court found that a treaty is not a law of the United States but rather by definition an agreement between foreign governments. Treaties are governed by international law. The Tax Court held neither a treaty protection nor the IRC limitation on the scope of the taxation of foreign entities qualifies as a specific exemption or credit that is required to be added back to taxable income under New Jersey law.

Okay, What About the Difference Between At Tax and a Fee?

- The California Court of Appeal held in *N. Cal. Water Ass'n v. State Water Res. Control Bd.* (Cal. Ct. App. 2018) that an annual fee imposed on water right permit and license holders was a fee and not an unlawful tax under California's Constitution.

- The court found that the fee was not a tax because the fee did not require the permit and license holders to pay for activities attributable to other right holders that were not subject to the fee.

Seattle, the Home of Coffee and a Personal Income Tax?

The King County Superior Court held on November 17, 2017, that Seattle's recently adopted city income tax is illegal under Washington law. The case was resolved on two alternative statutory grounds.

- First, the court concluded that Seattle's income tax was not an "excise tax" and, therefore, was not authorized by any state statute. Washington cities only have the taxing authority that is delegated to them by the state legislature. While state law authorizes cities to impose an excise tax on certain privileges, the superior court concluded that the right to live and earn a livelihood is not "privilege" for which the city may impose an excise. According to the court: "[T]he City's tax, which is labeled, "Income Tax," is exactly that. It cannot be restyled as an 'excise tax' on the alternate 'privileges' of receiving revenue in Seattle or choosing to live in Seattle."
- Second, the court held that Seattle's income tax was preempted by state law prohibiting city and county taxes on "net income." RCW 36.65.030. The court looked to various definitions of "net income" and concluded that, "[r]egardless of which of these definitions one uses, the conclusion is the same: the City's income tax is a tax on net income."

Be Careful of What You Wish For. Foreign Dividends Taxable In New Mexico.

- In *GE v. New Mexico Taxation and Revenue Department* (NM Hearings 2018)The New Mexico Administrative Hearings Office mostly denied General Electric's protest of corporate income tax and penalty assessment, finding that the Taxation and Revenue Department's treatment of the taxpayer's income received from foreign subsidiaries did not violate the U.S. Constitution's foreign commerce clause.
- The Hearing Office did abate the assessment of penalty on the taxpayer because it made a mistake of law in good faith.

Be Careful of What You Wish For. Foreign Dividends Taxable In New Mexico. (cont.)

- During the audit period, Taxpayer had 419 foreign subsidiaries from which it received dividends, most of which were more than 50% owned by Taxpayer or United States subsidiaries of Taxpayer’
- During the audit period, Taxpayer elected to be a consolidated group, not a separate or combined, corporate filer
- During the audit, the Department rejected Taxpayer's exclusion of dividends received for its foreign subsidiaries and federal Subpart F income from Taxpayer's New Mexico corporate income tax base. The Department recalculated Taxpayer's corporate income tax base, including those disputed dividends received from Taxpayer's foreign subsidiaries.

You Can’t Tax That. Colorado Follows Its Own Rules.

- The Court in *Oracle v. Dept. of Rev.* (Crt. Of App. 2017) affirmed the lower court pointing to the statute and the Department’s own regulation. Further, unlike the lower court the Appellate Court did not find the statute to the ambiguous.
- The conclusion was not inconsistent with the statute’s waters-edge provision. Finally, there is no alternative basis for the taxation OJH’s income. The Department does not have the authority to allocate the income among the members of the combined group. Thus, rejecting the Department’s economic substance argument.
- OJH was formed pursuant to the term of a note secured by Oracle from Nippon Steel and there is no evidence of abuse to support the transfer of income but rather the company was formed for a reasonable business purpose.

80/20 Companies – Considered Domestic or Foreign In Alaska?

- At issue in *Costco v. Alaska* (Admin. Hearing 2017) is the deduction of dividends received from an affiliated corporation that is not included in Costco's Alaska water's-edge combined return because it has 80% or more of their property and payroll outside the U.S. The statute provides for 100% deduction of dividends received from members of the unity group. The statute does not address the treatment of dividends received from a domestic company that does not meet the 80% test.
- The ALJ concluded based on a review of legislative history that the 80% exclusion was to reflect the expense incurred by a domestic multinational parent to support the income producing activities of the foreign affiliate. In addition, there was no indication from the legislation that a domestic corporation that only had foreign income would be treated differently than a foreign corporation. Thus, there is equal treatment among domestic and foreign corporations not included in a combined return.

It Only Hurts For a Bit. Pre-consolidated Losses Allowed In Consolidated Years.

- The Alabama Appellate Court upheld the Circuit Court's decision in *State Department of Revenue v. Coca Cola* (AL App. Crt. 2017) allowing the use of net operating losses incurred in separate return years to affect the income of the consolidated group.
- Coca Cola did business in Alabama as did a number of subsidiaries. The other entities filed corporate income tax return on a separate company basis for the year 1992 through 2007. Effective 2007 the three companies elected to file a consolidated return.
- The Court rejected the Department's argument concluding that Coca Cola was a member of an Alabama Affiliated Group ("AAG") in the loss years. In analyzing the statute, it was concluded that all the corporations were members of an AAG for 1999 through 2007 and as such are entitled to use the losses. The fact that a consolidated return was not filed does not alter the fact they were members of the AAG. The limitation found in the statute applies to net operating losses that were incurred in years prior to becoming a member of the AAG.

Business Income and Other Sourcing Issues

Wait a Second, I Thought Maryland Was a Separate Company State?

- The Maryland Court of Special Appeals held in *Staples, Inc. v. Controller* (2018) for Tax Years 1999 to 2004 (how far back is that?) that Superstore (an intangible management company) and Staples, Inc. (an administrative services company) lacked economic substance despite the fact that the parties conceded to physical presence in Maryland.

- The taxpayers had admitted nexus to render the economic substance test was unnecessary.

- If economic substance was found, the standard three-factor apportionment applied.

- The Court found in an uncitable case that Superstore and Staples lacked economic substance as each was wholly dependent on each other.

Extra Interest Earned Is Allocable Income.

- In *ConAgra v. New Mexico* (NM AHC 2017) the New Mexico Office of Administrative Hearings granted ConAgra Foods' Motion for Summary Judgment concluding the interest earned on acquisition Notes was properly characterized as non-business income.
- In March 2008, ConAgra entered into an agreement to sell its Food Trading and Merchandise business and the purchaser issued PIK Notes to Conagra as part of the sale proceeds. The gain recognized on the disposition was reported to New Mexico as apportionable business income. At issue here was whether the interest income subsequently earned by ConAgra on the PIK Notes was allocable or apportionable income.
- Applying the unitary principles the Hearing Office concluded the interest income did not arise from transactional activity which occurred in ConAgra's regular business operations and were not the proceeds from the disposition of a line of business.

Education Is Earned Where the Teachers are Located.

- The Indiana Tax Court in *The University of Phoenix v. IN Dept. of Revenue* (IN Tax Crt. 2017) addressed the question as to whether the University's online campus revenue can be sourced to Indiana based on the student's Indiana address or the location of its teachers.. The Tax Court concluded the Department erroneously sourced the University's income based on the location of its market rather than using the cost of performance method set forth in the statute.
- In reaching its conclusion the Tax Court applied the statutory cost of performance method e.g. the receipts were to the sourced based on the location of the income producing activities. The court rejected the Department's argument that the only income producing activity was the opportunity to attend an online class which occurred in Indiana. Effectively, the court rejected the notion that income producing activity should be viewed from the student's prospective.

And Yet Legal Services are Sourced to the Clients Location.

- The Michigan Appellate Court held in *Honigman Miller Schwartz & Cohn v. Detroit* (MI Crt. Of App. 2018) that for purposes of sourcing the income from legal services one must look to where the service is delivered not where the service is performed.
- In determining the firm’s income sourced to Detroit a three factor formula consisting of property, payroll and sales is used. The sales factor is gross revenue derived from sales made and services rendered in Detroit. The issue relates to whether “services rendered” is where the clients receive the service or where the work is performed.
- The court analyzed the statutory language and concluded the term “service rendered” to mean where the service was received. If the services were as received in Detroit the receipts were properly sourced to Detroit. In other words the sales factor adopts a destination approach for sourcing sales of services.

Who Is Your Customer? Sourcing In Wisconsin

- The Tax Commission, in *Microsoft Corp. v. WI Dept. of Revenue* (WI TAC 2017) rejected the Department’s argument that royalties received from an out-of-state original equipment manufacturer (OEM) for licensing the right to replicate and install software programs must be sourced to Wisconsin.
- The taxpayer is in the business of developing, licensing, manufacturing and distributing computer software. The Commission rejected the Department’s argument that the receipts should be sourced to Wisconsin as gross receipts from the use of computer software even though the OEM did not have an instate presence because a significant amount of the end-users to whom the OEM sold the software license, as part of the sale of computers, were located in Wisconsin.
- The Commissioner reasoned that the purchaser of the OEM’s computers were the customer of the OEM rather than the taxpayer. Thus, the Commission held with respect to the sales and licensing of the taxpayer’s software to the OEM outside of Wisconsin, the taxpayer did not have any income producing activities or direct costs of performance in Wisconsin.

State Response to Federal Tax Reform

The States Fight Back!

Elimination of the SALT Deduction.

- Let’s set up a charity – California, New Jersey

- Violation of States’ Rights – NY, CT and NJ

- Any chance of winning?

Why Can’t You Just Take Care of Your Own? Discrimination Anyone?

Different Does Not Mean Discrimination! Huh?

- In *Harley Davidson, Inc. v. FTB* (CA SC 2018) the discriminatory effect of California's mandatory requirement for out-of-state corporations to report combined tax liability on a single return doesn't outweigh the state's interest in preventing tax manipulation, a state appellate court said.
- In an unpublished opinion, the Fourth Appellate District court of Appeal agreed with a San Diego trial court judge's 2016 ruling in favor of the Franchise Tax Board. The trial court said that although California's taxation scheme treats intrastate and interstate corporations differently, a better alternative doesn't exist.
- Both the trial and appellate courts rejected Harley-Davidson's challenge of California rules that allow in-state unitary companies to choose between combined reporting or separate accounting–but require out-of-state companies to use combined reporting.

State Benefits Are So Not Taxable!

- In *James and Elaine Dawson v. Dale Steager*, as State Tax Commissioner of West Virginia, case number 17-419, the West Virginia's highest court upheld a state tax law that disadvantages federal law enforcement retirees by treating them differently from state law enforcement retirees.
- At issue is whether the Supreme Court's precedent and the doctrine of intergovernmental tax immunity bar states from exempting groups of state retirees from state income tax while discriminating against similarly situated federal retirees based on the source of their retirement income.
- In *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 815-16 (1989), the Supreme Court held that a state may not impose a heavier tax burden on federal employees than state employees, unless the discriminatory treatment is "justified by significant differences between the two classes." Such tax discrimination— even against a "subcategory" of federal employees— violates the doctrine of intergovernmental tax immunity and 4 U.S.C. § 111.

Won’t It Ever End????

- In *CSX v Dept. of Rev.* the Alabama Court of Appeals granted Alabama’s petition for a rehearing in regards to how much discretion the Department should have over remedying the discrimination it had found on applying the sales tax to dyed diesel fuel used by a rail carrior.
- The Court gave examples of remedies when it opined that the state could either repeal the water carrier exemption or retain the water carrier exemption and exempt all rail carriers buying or using diesel fuel for interstate hauls.
- The case has been before the USSC twice and focuses in on CSX’s challenge to the imposition of sales tax on dyed diesel fuel used by railroads.
- In 2015 the USSC held that a roughly equivalent alternative tax could be used to show there was no discrimination. The Court than remanded the case back to Alabama to determine if the tax on CSX had a roughly equivalent tax on other carriers.

Alternative Apportionment Issues

I Know It When I See It.

- The Minnesota Supreme Court held in *Associated Bank N.A. v Comm. of Revenue* (MN SC 2018) that the Commissioner of Revenue properly exercised the alternative-apportionment authority under Minn. Stat Section 290.20(1).

- The commissioner assessed additional corporate franchise tax, concluding that Taxpayer's method of calculating the tax owed based on the relevant statutes for apportioning income to Minnesota didn't fairly reflect its income from Minnesota sources.

I Know It When I See It (cont.)

- The tax court, replying on the supreme court's decision in *HMN Fin., Inc. v. Comm'r of Revenue*, 782 N.W.2d 58 (Minn. 2010), agreed that the commissioner improperly invoked her alternative-apportionment authority.

- The supreme court noted that, to exercise the alternative-apportionment authority, the commissioner must present substantial evidence to show that: (1) the apportionment method required by Minn. Stat. Section 290.191 didn't fairly reflect the taxpayer's taxable net income arising from Minnesota sources, and (2) an alternative apportionment method does so.

- The supreme court concluded that the Legislature plainly authorized the commissioner to use the alternative apportionment method in seeking to rebut the presumption that Taxpayer's method produced fair and correct results. Accordingly, the supreme court reversed the tax court's decision and remanded the case.

Odds, Ends and Other Interesting Stuff

The Odd – Sister States Suing Each Other?

- Forty-five states are asking the USSC to review *Franchise Tax Bd. Of California v. Hyatt* to revisit whether one state can be sued in another state's courts, saying that out-of-state taxpayers have recently brought at least five such tax suits.
- The *Hyatt* litigation, which has been ongoing for two decades, has already been before the USSC twice. The case involves damages sought by Gilbert P. Hyatt for several torts allegedly committed by the FTB in it audits of him. In April 2016 the USSC split 4 to 4 on whether it should overrule it 1979 decision in *Nevada v. Hall* allowing states to be sued in courts of over states.
- On remand, the Nevada Supreme Court reduced the damages awarded to Hyatt. The request hear is in the form of a rehearing as Supreme Court rules allow for this type of petition when there previously had been a split court.

The End – Audits Are Not the Be All and End All.

- An Illinois appeals court, in *The People of the State of Illinois ex rel. Richard and Ralph Lindblom v. Sears Brands LLC et al* has revived a False Claims Act suit against Best Buy finding that the state Department of Revenue's initiation of an audit of the store's sales tax calculation practices did not bar a qui tam complaint.
- The appeals court said a trial court erred in granting Best Buy's motion to dismiss the qui tam action because neither the department's audit of Best Buy nor the Informal Conference Board's review was a "government action bar" under 740 Ill. Comp. Stat. § 175/4(e)(3), which does not allow qui tam actions where the target of the action is the subject of an administrative civil money penalty proceeding with the state as a party.

Not That Is “Interest” ing!

- The Maryland Court of Special Appeals held in *Comp of the Treas. V. Jason Pharm., Inc.* (Md. Ct. Spec. App. 2018) that the Comptroller of the Treasury was not required to pay interest to a corporation on refunds of sales tax because the corporation’s error in paying the tax was not “attributable to the State.”
- Under Maryland law, interest is not owed by the state where the basis of the refund of tax paid is an error or mistake of the claimant not attributable to Maryland.
- After filing sales tax returns, a corporation determined that it qualified for a sales tax exemption.
- Because the corporation admitted that it had in effect originally misapplied the law through no fault of the state, the court found that the corporation was not entitled to collect interest on its sales tax refunds.