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The Latest & Greatest State Tax Litigation

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COST

Agenda

- U.S. Supreme Court Developments
- Income Tax Developments
  - Nexus
  - Unitary Reporting
  - Add-back Provisions
  - Treatment of Dividends
  - Apportionment
  - Tax Credits
  - Remedy
  - Penalties

U.S. Supreme Court

Dep't of Revenue v. Davis, 128 S.Ct. 1801 (May 19, 2008)

- Supreme Court held that Kentucky's differential tax scheme with respect to its public obligations (e.g., municipal bonds) did not violate the dormant Commerce Clause
- Applying *United Haulers*, the Court found that the issuance of debt securities to raise revenues to pay for public projects is quintessentially a public function, and that the differential tax scheme was designed to benefit the state as a bond issuer rather than private commercial interests - where state and local governments provide public goods and services that serve the vital functions of protecting the health, safety, and welfare of its citizens, laws favoring a state business over private business further the legitimate goals of the state, and are not subject to the dormant commerce clause's discrimination prong
- Prior to *Davis*, many Court observers predicted that *United Haulers* would have limited application to tax cases based on the fact that differential tax treatment is permissible only if the state is the provider of goods and services and the direct or indirect beneficiary of the beneficial tax treatment
- Market Participant Issues - some states have enacted "tax parity" provisions dealing with state tax advantages available to state residents who open a 529 college savings account under the resident's own 529 plan; Davis appears to have reduced potential challenges to 529 plans

U.S. Supreme Court

MeadWestvaco v. Illinois DOR, 128 S. Ct. 1498 (April 15, 2008)

- Taxpayer challenged Illinois' taxation of its gain on the sale of a business unit, Lexis, on the grounds that the business unit was unrelated to the taxpayer's business and did not serve an operational function
- Trial court held that Lexis was not unitary with the taxpayer but did serve an operational function - the Appellate court upheld the trial court's holding regarding the operational/investment function test and did not decide whether Lexis was unitary with the taxpayer
- The Supreme Court held the operational function test set forth in *Allied Signal* was not intended to modify the unitary business principle by adding a new apportionment ground. The operational function concept simply recognizes that an asset can be a part of a taxpayer's unitary business even without a "unitary relationship" between the "payor and payee.
- The Court held that when there is a sale of an asset or business the proper test is: 1) whether the seller and the business have a unitary relationship; and 2) whether the asset being sold is a unitary or a non-unitary asset - the Court remanded the case back to the Illinois Appellate Court to determine if unitary
- Appellate Court has remanded the case to circuit court for the limited purpose of conducting a hearing on the apportionment of intangibles based on Illinois' contacts with the capital asset rather than the taxpayer

U.S. Supreme Court

Valdez v. Polar Tankers, Inc., 182 P.3d 614 (Alaska 2008), *cert. granted* , No. 08-310 (U.S. 2009)

- City of Valdez imposes an ad valorem property tax on oil tankers that dock in their port. The tax is apportioned based upon a days-in-port formula. The numerator in the formula is the number of days in Valdez. The denominator is the number of days the tanker spent with a tax situs in other ports. Thus, the formula "throws out" from the denominator days spent in locations in which it did not obtain a tax situs.
- Taxpayer challenged the tax under the Tonnage Clause , the Due Process Clause and the Commerce Clause.
- Tonnage Clause
  - No state shall lay any duty of tonnage.
- Commerce Clause
  - Whether the tax is fairly apportioned.
  - Whether the tax is fairly related to the services provided by the state.

U.S. Supreme Court – *Cert.* Granted

Hemi Group, LLC, and Kai Gachupin v. City of New York, Appeal from 2nd Circuit U.S. Court of App. (06-1665-cv), cert. granted May 4, 2009 (Case No. No. 08-969)

- Does a city have the right to sue using the federal Racketeer Influenced and Corrupt Organizations Act (RICO) for unpaid cigarette taxes
- 2003 City of New York sued online cigarette retailer for intentionally not complying with the Jenkins Act (file reports of cigarettes shipped into state) which deprived the states of the ability to collect cigarette excise taxes – advertised cigarettes were "tax free"
- Complaint was originally dismissed by district court, standing for city to sue upheld by Second Circuit U.S. Court of Appeals in September, 2008

U.S. Supreme Court – *Cert.* Pending

Capital One Bank v. Comm'r of Rev., 899 N.E.2d 76 (Mass. 2009), petition for cert. filed (Mar. 19, 2009)

- Massachusetts Supreme Judicial Court concluded the taxpayer banks' deliberate and targeted exploitation of the Massachusetts economic marketplace constituted substantial nexus
  - Taxpayers targeted Massachusetts credit card customers through advertising campaigns.
  - Taxpayers used their intangible property (Capital One logo) in state.
  - Taxpayers received hundreds of millions of dollars from Massachusetts customers.
  - Taxpayers used Massachusetts governmental infrastructure to collect delinquent accounts.
- Petition for Writ of Certiorari filed with United States Supreme Court
  - Virginia and South Dakota filed an *amicus* asking the Court to take the case

U.S. Supreme Court – *Cert.* Pending

Geoffrey v. Comm'r of Rev., 899 N.E.2d 87 (Mass. 2009), petition for cert. filed (March 3, 2009)

- Out-of-state corporation licensing intangibles to Massachusetts customers subject to corporation excise tax
- Based on its holding in *Capital One*, the Court concluded the physical presence requirement in *Quill* applied only for sales/use tax purposes
- Court concluded Geoffrey had substantial nexus with Massachusetts
  - Geoffrey purposefully derived substantial economic gain from the Massachusetts market
  - Earned $33 million from licensing intangibles in Massachusetts
- Petition for Writ of Certiorari filed with United States Supreme Court

Income Tax - Nexus

MBNA America Bank v. Dep't. of Revenue, 895 N.E.2d 140 (Ind. Tax Ct. Oct. 20, 2008)

- Indiana Revenue Department assessed financial institutions tax from 1992-1998 which MBNA paid and subsequently claimed a refund
- The Department denied the refund in 2005 and taxpayer appealed to the Indiana Tax Court
- Indiana Tax Court noted that two state courts have addressed companies that issue credit cards differently
  - Tennessee – *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831 (1999), held that *Bellas Hess* and *Quill* physical presence controlled
  - West Virginia – *Tax Comm'r of W.V. v. MBNA*, 640 S.E.2d 226 (2006), held *Bellas Hess* and *Quill* limited to sales/use taxes
- Indiana Tax Court found reasoning of WV Supreme Court in *MBNA* more persuasive and held economic presence is sufficient to satisfy substantial nexus requirement

Income Tax - Nexus

Praxair Technology, Inc. v. Division of Taxation, 961 A.2d 738 (N.J. Superior Ct., App. Div. 2008)

- Case involved Praxair's IP Holding Company for tax years 1994-1999.
- Tax Court held that the addition of the trademark licensing example to the Regulations in 1996 merely clarified prior law, so that NJ could apply it to prior years. (In *Lanco*, NJ Tax Court had questioned retroactivity of the regulation.)
- Sustained constitutionality of 5% amnesty related penalty, which taxpayer had challenged as violating due process.
- Tax Court also held that there was no reasonable cause for late filing despite the Tax Court's earlier decision (not overturned until 2005) in *Lanco*. Judge noted that the *Lanco* litigation had not commenced when the taxpayer made the decision not to file tax returns.
- Superior Court reversed, finding that "there can be no clearer indication of the pre-1996 understanding that prevailed in the subject mater area than the perceived need to add the clarifying example . . . "

Income Tax - Nexus

Iowa Economic Nexus

KFC Corporation v. Dept. of Revenue, Dkt. No. 07DORFC016 (Iowa Admin. Hearing Div. Aug. 8, 2008)

- KFC had franchise agreements and derived royalty and license income from such agreements.
- The Iowa Administrative Board ("Board") held that KFC was deriving income from sources within Iowa as a result of the royalty payments received from its franchisees and was subject to corporate income tax.
- The Board found that KFC's franchise agreements had become an integral part of its business activity occurring regularly in Iowa and that Iowa's taxation of income does not violate the Commerce Clause because physical presence is not a requirement for nexus in imposing income tax when KFC has intangible property from which it derives income within Iowa.

Income Tax - Nexus

Arizona Economic Nexus

In the Matter of [Redacted], Case No. 200700083-C (Ariz. Admin. Hearing, March 27, 2008).

- Taxpayer had franchise agreements that granted the right to use intangible property (service mark) in exchange for royalties based on a percentage of franchisee's sales in Arizona. Taxpayer also provided the franchisees with training and operational materials, software and other franchise support (marketing, employee recruiting), including at least one on-site visit each year.
- Taxpayer argued that a franchisor/franchisee relationship is different from parent/subsidiary relationship (that existed in other IHC cases in other states) because a franchisor does not control its franchisee. The hearing officer noted that no other cases have attached any significant relevance to the issue of control.

Income Tax - Nexus

Maryland Cases - Intangible Holding Companies

The Classic Chicago, Inc. v. Comptroller and ***The Talbots, Inc. v. Comptroller***, Md. Tax Ct., Nos. 06-IN-OO-0226, 06-IN-OO-0227 (April 11, 2008)

- Wholly-owned subsidiary licensed trademarks to parent in exchange for a royalty. The Maryland Tax Court affirmed assessments issued by the Comptroller against the parent and its subsidiary finding that the subsidiary lacked economic substance.
- The court noted that the subsidiary had minimal operating expenses and little or no expenses for compensation for officers, salary, wages and cost of labor and minimum expenditures for travel, maintenance, professional services, service charges, directors' fees and rent.
- The subsidiary generated no other income and the royalty payments to the subsidiary were returned to the parent in the form of a dividend.
- Court held that the subsidiary lacked economic substance as a separate business entity and had nexus with Maryland through the activities of its operating parent.

Nordstrom, Inc. v. Comptroller, Md. Tax Ct., No. 07-IN-00-0317 (Oct. 24, 2008)

- Tax Court looked at whether subsidiaries were sufficiently independent from parent. Finding they were not sufficiently independent, the Tax Court held the subsidiaries had nexus with Maryland.

Income Tax - Unitary Reporting

North Carolina – Forced Combination

Delhaize America, Inc. v. Hinton, No. 07 CVS 020801 (Wake County N.C. Superior Ct.)

- NC DOR combined taxpayer's NC and FL entities with intercompany payments in order to "reflect true net earnings."
- DOR assessed tax and imposed penalties.
- Taxpayer paid assessment and filed a refund claim. The allegations include:
  - DOR misinterpreted the combination law.
  - DOR violated Commerce Clause and Due Process.
  - DOR violated the NC uniformity rule and Equal Protection.

Income Tax – Unitary Reporting

North Carolina – Forced Combination (continued)

- ***Delhaize America, Inc. v. Hinton***, 07 CVS 020801 (Wake County N.C. Superior Ct.)
  - After conducting discovery, Taxpayer uncovered documents indicating a concerted effort to conceal the standard for combination from taxpayers
    - Former Commissioner told COST members attending a regional meeting that he would not issue guidelines because taxpayers would just "argue that their activities do not meet those criteria."
    - DOR emails express concern that guidelines would fall into the hands of the "dreaded" taxpayers.
  - Taxpayer amended complaint alleging additional violations of
    - Administrative Procedures Act
    - Deprivation of constitutional rights under 42 U.S.C. § 1983.

Income Tax – Unitary Reporting

Wal-Mart Stores East, Inc., v. Reginal S. Hinton, Secretary of Revenue of the State of North Carolina, No. COA08-450 (North Carolina Court of Appeals)

- Court unanimously upheld Secretary of Revenue's decision to require a Wal-Mart operating subsidiary to file a combined report with other select subsidiaries.

- Court addressed statutory and constitutional issues raised by that taxpayer, finding that the State's combined reporting statute should be construed broadly, and that the Secretary may mandate combined reporting if he finds that the corporation has not disclosed its true earnings.

- Court rejected the Taxpayer's constitutional arguments, finding that the combination did not violate the state's Uniformity Clause even though there was no combined reporting requirement for every corporate taxpayer affiliated with a business investment trust and sustained the 25% underreporting penalty.

  - Linda Millsaps (Chief Operating Officer of the DOR) noted that the DOR is still interpreting the decision and hopes to have guidance out to taxpayers soon after the decision is final.

Income Tax - Add Back

VFJ Ventures, Inc. v. Surtees, Case No. 1070718 (Ala. Sup. Ct. Sept. 19, 2008).

- Alabama trial court held for VFJ in a 2007 ruling that royalty payments made to a related intangible holding company satisfied the "unreasonable exception" to addback because the intangible holding company had substance and was not a sham.

- Alabama Court of Civil Appeals reversed the trial court and held that the unreasonable exception only applies when addback results in a distortion of the taxpayer's income or when it results in the payment of tax that is "out of proportion" to the taxpayer's Alabama activities.

- Alabama Supreme Court's decision affirmed and adopted in its entirety the opinion of the Court of Civil Appeals that Alabama's intangible and interest expense add-back statute did not violate the Commerce and Due Process Clauses of the U.S. Constitution.

- The U.S. Supreme Court denied VFJ's petition for a writ of *certiorari.*

Income Tax - Add Back

Beneficial New Jersey, Inc. v. Director, Div. of Taxation, N.J. Tax Ct., Docket No. 009886-2007 (pending)

- In 2004, New Jersey, a separate company state, enacted a wide range of taxpayer-unfriendly statutes. One of the most controversial is the disallowance of the deduction for intercompany interest expenses.
- The law goes beyond disallowing deductions related to intangible holding companies and affects taxpayers who engage in arm's-length intercompany transactions in the regular course of their trade or business operations.
- Beneficial New Jersey is a subsidiary of Household Finance Corporation ("HFC"). HFC borrows from non-affiliated lenders and loans funds to its subsidiaries. The subsidiaries then turn around and loan them to their customers.
- The deduction for intercompany interest expense paid by Beneficial New Jersey to HFC was disallowed by the Division of Taxation.
- Beneficial New Jersey filed a complaint in the New Jersey Tax Court challenging the disallowance of the deductions. The arguments raised include statutory interpretation, legislative intent and constitutional violations.

Income Tax – Treatment of Dividends

Apple Inc. v. FTB, San Francisco Sup. Ct. No. 471129

- Case involves issue whether dividends paid by foreign corporations in a water's edge setting should be eliminated under RTC § 25106 or deducted under RTC § 24402.
- FTB applied a LIFO proration approach and prorates the dividends between RTC § 25106 and RTC § 24402.
- Apple contends that a preferential ordering approach is mandated under RTC § 25106 and *Fujitsu Holdings, Inc. v. FTB*, 120 Cal. App. 4th 459 (2004), and that all dividends should be eliminated.
- Case also involves the issue whether interest expense deductions should be disallowed under RTC § 24425, i.e., was Apple's dominant purpose in borrowing funds to provide funds to the foreign dividend payors.
- Trial court issued a tentative decision on May 19, 2009, holding in favor of the taxpayer on the interest expense issue and in favor of the FTB on the dividend ordering issue.
- Proposed statement of decision is being prepared. Further briefing and another hearing is scheduled.

Income Tax – Apportionment

California – Treasury Function Gross Receipts

General Mills, Inc. v. FTB, Cal. Ct. App., No. A120492 (Apr. 15, 2009)

- Trial court concluded that commodity hedging transactions did not generate "gross receipts" for sales factor purposes.
- Trial court did not reach the issue whether inclusion of such receipts would be distortive under RTC § 25137 (i.e., UDITPA § 18).
- Court of Appeal reversed the trial court's decision.
  - Full sales price of commodity futures contracts are "gross receipts" includible in the sales factor.
  - Court noted that hedging activity was an integral part of the taxpayer's business activity.
  - Case remanded to trial court to address the distortion issue.
- Petition for review filed with California Supreme Court.

Income Tax – Apportionment

Right to Apportion?

New Jersey Natural Gas Co. v. Director, 24 NJ Tax 59 (2008)

- NJ premises right to apportion income away from NJ upon the taxpayer having a "regular place of business" outside the state – office or other space with one or more employees. This rule is arguably unconstitutional per *Mobil* because taxpayer will be subject to apportioned tax in any state where it has nexus. Nexus standard is lower than "regular place of business" and NJ law creates Fair Apportionment/Internal Consistency problems. Court held that New Jersey's "right to apportion" rule is internally consistent because if every state granted full tax credits for taxes paid to other states, as NJ had done, then an interstate taxpayer would pay tax to only one state.

Lehman Bros. Bank v. State Bank Commissioner, 2007 Del. Lexis 496 (Del. Sup. Ct., Nov. 7, 2007), cert. denied U.S. Supreme Court, April 28, 2008

- Federally chartered savings bank ("Bank") challenged Delaware's assertion that all of its income should be subject to the Delaware Bank Franchise Tax. The court held that even though the Bank's officers, directors and mortgage-related decisions are made from its office in New York, the Bank's "principal office" is in Delaware as that is its "home office" listed on its federal stock charter. Because the Bank's "principal office" was in Delaware, its entire net income was taxed in Delaware because the bank lacked an out-of-state "branch" or "subsidiary".

Income Tax – Apportionment

New Jersey Throwout Rule

Pfizer, Inc. v. Division of Taxation, 23 N.J. Tax 515 (NJ Tax Ct. 2008), *remanded by* 960 A.2d 388 (N.J. 2008)

- Case represents consolidated challenge (Pfizer, GE, Federated Brands and Whirlpool) to constitutionality of New Jersey's Throwout Rule. Taxpayers' filed summary judgment motions requesting that the Throwout Rule be declared facially unconstitutional – must establish that no set of circumstances exists under which throwout would be valid.
- Court held that under the Due Process and Commerce Clauses, the Throwout Rule is constitutional on its face because, in at least some circumstances, it can operate in a constitutional manner. The Court also held that because the Throwout Rule is not a tax the use of a throwout procedure in multiple states would not produce multiple taxation and hence does not violate internal consistency.
- Finally, court held that Throwout Rule does not violate the Supremacy Clause because the rule does not impose a tax, which would be prohibited by P.L. 86-272, but merely is a part of the calculation to determine what portion of a corporation's total income will be taxed in New Jersey
- New Jersey Supreme Court remanded an interlocutory appeal back to the appellate court to address whether the throwout rule is facially unconstitutional.

Income Tax - Business/Nonbusiness

Maine Business/Nonbusiness Decision

Gannett Co. v. State Tax Assessor, 959 A.2d 741 (Maine 2008)

- The Maine Supreme Judicial Court held that a group of broadcasting and news media corporations and a cable company affiliate were engaged in a unitary business. Thus, it was permissible for Maine to tax an apportioned share of the gain resulting from the sale of the cable company.
- Taxpayer provided centralized tax, legal, audit, financial and risk management services to all of its affiliates, including the cable company, which created functional integration and economies of scale.
- Centralized health and benefit plans, shared directors, officers and management expertise, support unitary.
- Court also held that the amount of income attributed to Maine bore a rational relationship to the taxpayer's in state activities because the taxpayer had extensive business in Maine.

Income Tax – Tax Credits

Dicon Fiberoptics, Inc. v. FTB, Cal. Ct. App., No. B202997 (May 7, 2009)

- Taxpayer filed a suit for refund challenging the FTB's authority to look behind its Enterprise Zone hiring credit vouchers.
- The trial court sustained the FTB's demurrer and the taxpayer appealed.
- The Court of Appeal held that while the FTB has the authority to audit vouchers, the vouchers are prima facie proof a worker is a qualified employee.
- The Court also held that in auditing the vouchers, the FTB bears the burden of proving the worker did not meet the criteria to be a "qualified employee."
- In meeting its burden of proof, the FTB may not rely on the employer's failure to produce during the audit documents establishing a worker's eligibility.
- The FTB filed a petition for rehearing on May 22, 2009.

Income Tax - Remedy

Vulcan Lands v. Surtees, Alabama Supreme Court, No. 1070386, 1070399 (Sept. 26, 2008)

- Stems from USSC's decision in *South Central Bell,* 526 U.S. 160 (1999), that Alabama's franchise tax was unconstitutionally discriminatory against out-of-state corporations
- Vulcan sought refund of franchise taxes paid
- Court rejected Department of Revenue's arguments that 1) Vulcan had to show it had an in-state competitor and 2) state should not have to pay refunds based on reliance on overturned precedent (*Reynolds Metals*, 558 So. 2d 373)
- Case remanded to appeal court to determine damages – par value of stock versus market value

Income Tax - Remedy

Abbott Laboratories, Inc. v. FTB, *Cal. Court of Appeal, No. B204210* (March 20, 2009)

- RTC § 24402 provides a dividend received deduction for dividends paid from income subject to tax in California.
- Court in *Farmer Bros. Corp. v. FTB*, 108 Cal. App. 4th 976 (2003), held that "subject to tax in California" requirement was unconstitutional.
- For tax years after 1998, FTB's remedy was to deny all § 24402 DRDs.
- In an unpublished decision, the Court invalidated § 24402 in its entirety:
  - Court did not sever the invalid portion of § 24402 under statutory severance clause (§ 23057)
  - Court declined to reform § 24402 as inconsistent with legislative intent
- Case was resubmitted on April 20, 2009 upon FTB's request that opinion be published.

Income Tax - Remedy

Tax v. Fee – California LLC "Fee"

Northwest Energetic Services, LLC v. FTB, 159 Cal. App. 4th 841 (2008), review denied (June 11, 2008)

Ventas Finance I, LLC v. FTB, 165 Cal. App. 4th 1207 (2008), review denied (2008), cert. denied (April 6, 2009)

- Both decisions held that the fee was actually a tax.
- Tax held to violate Commerce Clause under *Complete Auto* (430 U.S. 273) because tax fails both the internal and external consistency tests.
- *Ventas* court held that that the LLC "fee" statute could not be judicially reformed because the Legislature rejected apportionment.
- Court also held that Ventas was not entitled to a full refund under *McKesson* (496 U.S. 18); refund limited to the amount of the tax (or fee) not based on fair apportionment.
- FTB issued Notice 2009-04 (May 22, 2009): LLC can use 1) default option using % of CA sales versus everywhere (schedule R) or 2) actual income (must provide info by August 20, 2009).

Penalties

California's 20% Understatement Penalty

- Cal. Rev. & Tax. Code § 19138 imposes 20% penalty on understatements of corporate franchise/income tax exceeding $1million for tax years after 2002
- Cal-Tax filed lawsuit arguing the penalty is invalid because:
  - Penalty is a tax that was not passed by 2/3 vote of Legislature (Prop 13)
  - Legislature violated procedural rules in enacting RTC 19138 at 11th hour
  - Penalty is retroactive in violation of substantive Due Process
  - RTC § 19138 violates procedural Due Process by failing to provide adequate remedy to challenge FTB's imposition of the penalty
  - Penalty violates Equal Protection, Commerce Clause and Excessive Fines Clause
- Superior court sustained validity of the penalty

Questions?

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