Discussion of State Tax Cases, Issues and Policy Matters to Watch in 2014

California & Pacific Southwest Regional

State Tax Seminar

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Agenda

- Due Process and Commerce Clauses
- Federal Legislation
- MTC Compact Litigation
- Nexus
- Apportionment
- Business/Nonbusiness
- Interest/Royalty Addback

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Due Process and Commerce Clauses

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Do You think the Due Process Clause is useful in SALT cases?

1) Yes
2) No
3) What is the Due Process Clause?
4) Yes; when taxes are due or even when they are not due, the government just wants you to pay what is due and they will process it. There you have it – due process.

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Due Process: The Basics

The Standard: "purposeful availment" of "minimum contacts" in forum State such that the exercise of jurisdiction "does not offend traditional notions of fair play and substantial justice."

International Shoe v. WA, 326 U.S. 310 (1945)

General Jurisdiction: any and all claims – continuous and systematic contact

Special Jurisdiction: activity or occurrence – "purposeful availment" invoking the benefits and protections of its laws

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Due Process: The Questions

- *Asahi Metal Industry Co. v. Superior Court of Calif.*, 480 U.S. 102 (1987)
  - the "stream of commerce" and "foreseeability"
- *Quill v. North Dakota*, 504 U.S. 298 (1992)
  - the "split" and hints at the demise of the dormant commerce clause
- *United Haulers Association Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330 (2007)
  - Open contempt by Justices Scalia and Thomas

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Due Process: Recent Cases

Daimler AG v. Bauman, 134 S. Ct. 746 (2014)

- The U.S. Supreme Court rejected a broad agency theory basis for general jurisdiction under the Due Process Clause.
- On appeal from the Ninth Circuit, 644 F.3d 909 (9th Cir. 2011)

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Due Process: Recent Cases

Walden v. Fiore, 134 S. Ct. 1115 (2014)

- The U.S. Supreme Court held that for a state to exercise jurisdiction consistent with due process, the defendant's action must create a substantial connection with the forum state.
- On appeal from the Ninth Circuit, 688 F.3d 558 (9th Cir. 2011)

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Commerce Clause

Comptroller v. Wynne, No. 107 (Md. Jan. 28, 2013), *cert. granted*, No. 13-485 (May 27, 2014)

- The Maryland Court of Appeals held that Maryland's denial of a credit for taxes paid to the state where the income was sourced violated the Commerce Clause
- Discrimination because without the credit, it is more costly to do business in interstate commerce than intrastate commerce

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Federal Legislation

Pending Federal Legislation

- Mobile Workforce State Income Tax Simplification Act of 2013 (H.R. 1129)
  - On April 29, 2014, the House Judiciary Subcommittee held a hearing
  - The bill creates a bright-line 30-day threshold
  - Many industry members and organizations support the bill
  - Many states oppose the bill
- Marketplace Fairness Act of 2013 (S. 743)
  - Would require collection on all sales shipped to the states that are "full members" of the Streamlined Sales and Use Tax Agreement.
  - Passed by Senate on May 6, 2013 by a vote of 69-27
  - H.R. 684 is current House version
    - On Sept. 18, 2013, the House Judiciary Committee released its seven "Principles on Internet Sales Tax"
- Digital Goods and Services Tax Fairness Act of 2013 (S. 1364)

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Which will happen first?

1) Mobile Workforce State Income Tax Simplification Act of 2013 becomes law

2) Marketplace Fairness Act of 2013 becomes law

3) Digital Goods and Services Tax Fairness Act of 2013 becomes law

4) The Dodgers win the World Series

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Multistate Tax Compact Litigation

Compact = Multistate Tax Compact

MTC = Multistate Tax Commission

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Framing the Issue

- Compact
  - Uses standard, three-factor apportionment formula with equal weight to each factor
  - Some states that have adopted the Compact and are members of the MTC have amended their laws to provide for a weighted or single sales factor
  - Can a taxpayer "elect" to use the standard, equally-weighted three-factor formula instead of a weighted or single sales factor?
- Other Questions
  - When and how should a taxpayer make the "election"?
  - Can taxpayer make the election on an amended return?
  - Can a state retroactively repeal its adoption of the Compact and/or membership in the MTC?

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Compact Developments

- California
  - *Gillette Co. v. FTB*, No. A130803 (Cal. Ct. App. 10/2/12)
    - Court held that the Multistate Tax Compact is enforceable and its three-factor election is binding on member states until those states withdraw from the Compact
    - On appeal to CA Supreme Court
    - S.B. 1015 (6/27/12) – repeals MTC provisions and withdraws CA from the Compact; but questions surround legislation
    - FTB Notice 2012-1 (10/5/12) provides procedural guidance on filing claims for refund

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Compact Developments

- Michigan
  - *IBM Corp. v. Michigan Dept. of Treas.*, No. 306618 (Mich. Ct. App. 11/20/12)
    - Court held that the Compact election was impliedly repealed with the enactment of the more specific Michigan Business Tax Act
    - On July 14, 2014, Michigan Supreme Court reversed on statutory grounds
  - *Anheuser-Busch, Inc. v. Michigan Dept. of Treas.,* No. 11-85-MT (Order and Opinion, Mich. Ct. of Claims 06/06/13)
    - Michigan Court of Claims held that the Compact is a binding, multistate compact that cannot be repealed by a separate, subsequent statute
    - Taxpayer was entitled to apportion its income under the former Michigan Business Income Tax (BIT) component of the Michigan Business Tax (MBT) using the Compact's equally-weighted, three factor formula rather than the statutory single sales factor formula

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Compact Developments

- Oregon
  - *Health Net, Inc. v. Dept. of Rev.*, TC 5127 (Or. Tax Ct.)
    - Oregon law provides that the state's UDITPA provisions control over the state's Compact provisions when there is a conflict
    - On Feb. 11, 2014, Health Net filed with the Oregon Tax Court a Motion for Summary Judgment.
    - The Oregon Tax Court heard oral arguments on July 22, 2014

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Compact Developments

- Minnesota
  - *Kimberly-Clark Corp. v. Commissioner*, Docket No. 08670 (Minn. Tax Court)
  - Filed suit for refund in December 2013
  - Claim based on its election to apportion income under an equally weighted three-factor formula pursuant to the Compact

Compact Developments

- Texas
  - Comptroller's Decision Nos. 107,323 (4/9/13), 106,149 (2012), 105,941(2012), 104,752 and 104,753 (2011) all hold that the Texas Tax Code requires the use of a single-factor apportionment formula and that entities may not elect to use the Compact's three-factor apportionment formula
  - *Graphic Packaging Corp. v. Combs*, Travis Cty. Dist. Ct. – among other allegations, the taxpayer alleges that it properly elected to use the Compact's three-factor formula because the Compact is part of the Texas Tax Code
    - Texas trial court denied the taxpayer's summary judgment motion on January 15, 2014

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Compact Developments

- Legislative Actions to Repeal Compact
  - California
    - S.B. 1015 (6/27/12) repeals Compact provisions and withdraws CA from the MTC
    - Clarifies that federal "doctrine of election" has always been the law
    - Constitutional challenges in the future?
  - Utah
    - S.B. 247 (eff. 7/1/13) repeals and then reenacts the Compact with election and apportionment formula provisions excluded and amends provisions addressing the State Tax Commission's authority related to the MTC and governmental entities
  - Oregon
    - S.B. 307 repeals and then reenacts the Compact with all but the election and apportionment provisions
    - Passed by the legislature and awaiting signature by governor
  - Minnesota
    - H.F. 677 (eff. 5/23/13) (Minn. Omnibus Tax Bill) repeals the Compact

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Has your company had a MTC audit?

1) Yes
2) No

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Did your company find benefit in a MTC audit conducted by a single source?

1) Yes
2) No

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Nexus

Nexus – Unitary Nexus

- *Gore Enterprise Holdings Inc. v. Comptroller*, 437 Md. 492 (Mar. 24, 2014)
  - Nexus cannot be based merely on unitary relationship with in-state affiliate
  - Nexus may be established where out-of-state entity has "no real economic substance" as a separate business entity from the in-state affiliate
  - Even where out-of-state entity is not a sham
  - Apportionment based on in-state affiliate's factors

Nexus – "Reverse" Nexus

- *Allied Domecq Spirits & Wines USA, Inc. v. Comm'r,* 85 Mass. App. Ct. 1125 (June 18, 2014)
  - Subsidiary's transfer of Mass. employees and property to its Parent did not create sufficient nexus to be included in Subsidiary's Massachusetts combined group
  - Court applied sham transaction doctrine
  - Does intent matter for physical presence nexus?

Nexus – LP Interest

- *Village Super Market of PA, Inc. v. Dir., Div. of Taxation*, 27 N.J. Tax 394 (2013)
  - Pennsylvania corporation ("PA") had nexus in New Jersey based on its 99% limited partnership interest in a New Jersey limited partnership ("LP")
  - PA and LP were in same line of business with overlapping officers
  - *BIS LP* case distinguished

Nexus – Corporate Affiliate

- *Rent-A-Center, Inc. v. Dep't of Revenue,* Or. Tax Ct. No. TC-MD 111031D (May 12, 2014)
  - Wholly-owned operating subsidiary not unitary with its parent
  - Subsidiary lacked Oregon corporate excise tax nexus
    - Subsidiary was not "doing business" in Oregon simply by receiving royalties from Oregon franchisees
    - 4-day Oregon visit by 2 employees to inspect franchisee operations and provide training did not amount to doing business in the state

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Nexus – Factor Presence

- *L.L. Bean Inc. v. Levin*, Ohio Bd. Tax App. (Mar. 6, 2014)
  - Upheld commercial activity tax assessment on a retailer with no physical presence in Ohio
  - Retailer had more than $500,000 in gross receipts annually from Ohio customers through online and catalog sales
  - Statutory $500,000 gross receipts threshold exceeded
  - BTA precluded from declaring statute unconstitutional

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"Click Through" Nexus

- *Amazon.com, LLC v. New York State Department of Taxation and Finance*, 987 N.E. 2d 621 (N.Y. 2013), *cert. denied*, 134 S. Ct. 682 (2013)
  - New York's highest court held that the "click-through affiliates" presumption of in-state sales referrals to out-of-state sellers does not violate the Commerce Clause because the seller can always rebut the presumption if there is insufficient solicitation
  - U.S. Supreme Court denied cert. on Dec. 2, 2013

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Affiliate Nexus

- *New Mexico Taxation & Revenue Dep't v. Barnesandnoble.com LLC*, 303 P.3d 824 (N.M. 2013)
  - The New Mexico Supreme Court found that an out-of-state online retailer had nexus based on affiliate's ownership of in-state stores and in-state efforts on behalf of online retailers
    - Same trademarks
    - Sales of brick & mortar stores of gift cards redeemable by online affiliate
    - Brick & mortar accepts returns of products purchased online

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- *Direct Marketing Assoc. v. Brohl*, 735 F.3d 904 (10th Cir. 2013)
  - Court of Appeals held that federal courts lack jurisdiction under the Tax Injunction Act to address DMA's challenge to Colorado's use tax notice and reporting provisions
  - Colorado requires that out-of-state vendors to (1) provide transactional notices to customers, (2) provide information about sales to customers, (3) provide annual reports re customer information to the State.
  - On July 1, 2014, the U.S. Supreme Court agreed to review the 10th Circuit decision

Apportionment

Apportionment – Throwout

- *Lorillard Licensing Co., LLC v. Dir., Div. of Taxation,* N.J. Tax Ct. No. A-2033-13T1 (Jan. 14, 2014)
  - For throwout purposes, company is "subject to tax" in another state based on "economic nexus" standard upheld in *Lanco*
  - Out-of-state licensing affiliate received royalties from tobacco sales in all 50 states
  - Affiliate was thus subject to tax in all other states and throwout rule did not apply to any of its sales

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Apportionment – Goodwill

- *Tektronix, Inc. v. Dep't of Revenue*, 354 Or. 531 (2013)
  - Taxpayer properly excluded from the Oregon sales factor the value attributed to goodwill in sale of its printer division
  - Oregon law excludes gross receipts from the sale of "intangible assets" that are not derived from a taxpayer's "primary business activity"
  - Taxpayer was in the business of developing/selling test, measurement and monitoring equipment

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Apportionment – Alternative Method

- *Equifax, Inc. v. Dep't of Revenue*, 125 So. 3d 36 (Miss. 2013), *cert. denied* (U.S. June 30, 2014)
  - Mississippi Supreme Court held that taxpayer bears burden of proof showing that Department's use of alternative formula is unreasonable
  - Department used market-based sourcing as an alternative apportionment method instead of cost of performance as provided by statute
  - Effective 2015, Mississippi Legislature enacted legislation (HB 799) regarding use of alternative apportionment and burden of proof

Apportionment – Alternative Method

- *Vodafone Americas Holdings Inc. v. Roberts*, Tenn. Ct. App. (June 23, 2014)
  - Upheld Commissioner's imposition of market-based sourcing as an alternative apportionment method instead of cost of performance as provided by statute
  - Under cost of performance, Vodafone's sales factor included only its sales of tangible personal property to Tennessee, excluding all revenues from its delivery of wireless services to Tennessee customers
  - Commissioner acted within scope of discretion

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Combined Reporting

Combined Reporting – Insurance Sub

- *Wendy's International, Inc. v. Hamer*, 996 N.E.2d 1250 (Ill. App. Ct. 2013)
  - Court held that Wendy's was not required to include its captive insurance subsidiary in its Illinois combined corporate income tax returns
  - Insurance subsidiary's business was the provision of insurance, even though it owned a disregarded entity that earned royalty income from the licensing of intangibles

Combined Reporting – Arizona

- *Home Depot USA, Inc. v. Arizona Dept. of Rev.*, 233 Ariz. 449 (Ariz. Ct. App. 2013)
  - Retailer was required to file a combined report with its subsidiary that owned and licensed trademarks to the retailer
  - Arizona's narrower unitary test under *Talley* requires operational integration at the revenue-producing level
  - Retailer and its subsidiary considered to be unitary because their basic operations were "substantially interrelated"

Combined Reporting – New York

- *Matter of IT USA, Inc.* (N.Y.S. Tax App. Trib., Apr. 16, 2014)
  - Parent properly filed combined reports with two of its subsidiaries for tax years 2002-2004, despite the state's attempt to decombine them
  - Parent and subsidiaries engaged in a unitary business
  - Intercompany provision of management, corporate, administrative and logistical services at cost were found to be distortive

Combined Reporting – New York

- *Matter of SunGard Capital Corp.* (N.Y.S. Div. of Tax App., Apr. 3, 2014)
  - ALJ determined that the SunGard group was not allowed to file combined reports for tax years 2005-2006
  - ALJ found insufficient connections to establish a unitary relationship or existence of distortion
  - Lack of arm's length reimbursements for intercompany services did not give rise to distortion sufficient to permit combined reporting

Combined Reporting – New York

- *Matter of Knowledge Learning Corporation and Kindercare Learning Centers, Inc.* (N.Y.S. Div. of Tax App., June 27, 2013)
  - Affiliated companies were decombined because companies failed to establish that they had "substantial intercorporate transactions" under 2007 statutory change
  - ALJ found lack of documentation to support the transfer of employees between affiliates
  - ALJ also held that distortion is no longer the proper analysis in light of the 2007 statutory change

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Business/Nonbusiness Income

Business/Nonbusiness Income

- *ComCon Production Services I, Inc. ("Comcast") v. FTB (Mar. 6, 2014*)
  - Superior court held that Comcast was not unitary with QVC, a television channel in which Comcast had a 57% ownership interest
  - No centralization of management, functional integration, or economies of scale between the two entities
  - Court rejected FTB's arguments that because Comcast carried QVC and entered into certain joint ventures with QVC, there was a flow of value amongst the two companies
  - Termination fee

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Business/Nonbusiness Income

- *C.V. Starr & Affiliates v. FTB, San Francisco Superior Court No. CGC-13-527952*
  - On January 11, 2013, taxpayer filed suit regarding issue whether dividend and capital gain resulting from its acquisition and subsequent sale of AIG common stock is business or nonbusiness income.
  - Trial was set for June 9, 2014
  - FTB filed summary judgment motion on Feb. 18, 2014
  - Stipulation of Settlement was filed on May 29, 2014

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Business/Nonbusiness Income

- *Oracle Corp. v. Dept. of Rev.,* No. MD 070762C (Or. Tax Ct. Jan. 19, 2012) (Duty of consistency?)
- *Levi Strauss*, SBE No. 547505 (Classification of interest expense)
- *Pacific Bell Telephone*, SBE No. 521312 (Foreign investments)

Interest/Royalty Addback

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Interest/Royalty Addback

- *Beneficial New Jersey, Inc. v. Director, Div. of Taxation*, CCH NJ Tax Rptr. ¶ 401-530 (2010)
  - Interest paid to parent finance company met "unreasonable exception" and not subject to addback

- *Apple, Inc. v. FTB*, 199 Cal.App. 4th 1 (2011)
  - Interest expense deduction not disallowed under RTC section 24425
  - Impact on foreign investment interest offset

Interest/Royalty Addback

- *Kimberly-Clark Corp. v.* Commissioner, Docket No. 11-P-632 (MA Ct. App. 2013), *review denied*
  - The court affirmed the Appellate Tax Board and held that taxpayer was not entitled to interest expense deductions relating to cash management system because there was not true debt and denied the taxpayer's royalty payment deductions because the payments lacked economic substance and business purposes

Interest/Royalty Addback

- Virginia H.B. 5001 limits the addback exemptions for tax years beginning on or after **January 1, 2004**:
  - Signed into law on April 1, 2014
  - Changes made to the addback exceptions
    - "Subject to tax" exception
    - "Unrelated third-party revenues" exception

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