Between a Rock and a Hard Place: Third-Party Enforcement Actions

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With the significant rise of third-party enforcement actions — especially consumer class actions and *qui tam* actions involving state tax questions — corporate taxpayers are being forced to assess a significant set of risks in connection with their compliance obligations.

The risk factors associated with consumer class actions and *qui tam* actions involving state tax questions may not only be unfamiliar considerations for most corporate taxpayers but also may conflict with traditional risk factors corporate taxpayers take into consideration for compliance purposes. For example, given the rise of strict liability penalties and other accuracy-related state tax penalties, corporate taxpayers tend to err more frequently on the side of caution and take positions that are favorable to the state on questions that fall within marginal or gray areas of state tax law. In the context of sales and use taxes, that could lead to the overcollection of tax from consumers and may serve as the catalyst for a consumer class action lawsuit against the company.

Following a review of recent cases and trends involving state tax consumer class actions and *qui tam* actions, we discuss a few scenarios that demonstrate the risks of potential third-party enforcement actions and conclude with practical considerations for corporate taxpayers.

Class Actions

A common thread running through many recent consumer class action cases involving state tax questions is consumer protection law. State-specific consumer protection statutes often serve as the vehicle by which individual consumers arrive at court to challenge the collection of a particular tax by retailers.

State Cases

California: *Loeffler v. Target Corp.*

A coffee drinker relied on three California consumer protection statutes in bringing an action against Target, alleging that the retailer collected excess sales tax on hot coffee ordered to go in violation of those laws and the Revenue and Taxation Code.[1] In *Loeffler v. Target Corp.*, the plaintiff filed a class action lawsuit on behalf of herself and a class of similarly situated taxpayers against the retailer, seeking a refund of prior sales taxes paid and an injunction against future collections.[2] Regarding the latter, the court held that the anti-injunction provision of the California Constitution barred the plaintiffs' recovery under the Revenue and Taxation Code and the consumer protection

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[1]*Loeffler v. Target Corp.*, 173 Cal. App. 4th 1229 (Cal. Ct. App. 2008), *rev. granted*, 216 P.3d 520 (Cal. 2009). The consumer protection statutes at issue in *Loeffler* included section 1750, et seq., of the California Civil Code, the Consumer Legal Remedies Act, which is designed to "protect consumers against unfair and deceptive business practices and to provide efficient and economical procedures to secure such protection"; section 17500 of the California Business and Professions Code, which makes it unlawful for a person, firm, corporation, association, or any employee thereof "with intent directly or indirectly to dispose of real or personal property or to perform services, professional or otherwise, or anything of any nature whatsoever or to induce the public to enter into any obligation relating thereto" by means of advertising, "which is known, or which by the exercise of reasonable care should be known, to be untrue or misleading. . . . "; and section 17200 of the California Business and Professions Code, which defines unfair competition as, and provides a remedy for, "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising." Cal. Civ. Code section 1760; Cal. Bus. & Prof. Code sections 17200 and 17500.

[2]*Loeffler*, 173 Cal. App. 4th at 1237-1238.

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statutes because by seeking to enjoin the retailer from obtaining further tax reimbursement, they impermissibly were seeking to enjoin the collection of a tax.[3] The court explained that the plaintiffs could not circumvent the California Constitution and the sales tax statutes by seeking an injunction, damages, and restitution under California's consumer protection laws.[4]

In rejecting the plaintiffs' refund claim, the California Court of Appeal identified the comprehensive statutory and regulatory procedure for retailers to file sales tax refund claims with the State Board of Equalization.[5] That procedure, the court explained, allowed the BOE to correct mistakes and avoid unnecessary litigation.[6] Although California customers may obtain a refund of excess sales tax reimbursement collected by a retailer, that refund necessarily follows either a determination by the BOE that excess sales tax reimbursement was collected or a successful suit *by a retailer* against the BOE for a refund of overpaid sales taxes, neither of which was present in *Loeffler*.[7] Accordingly, the court found that plaintiffs did not have standing to commence a sales tax refund suit because they are not the taxpayers.[8]

> ***The risk factors associated with consumer class actions and* qui tam *actions involving state tax issues may conflict with traditional risk factors corporate taxpayers take into consideration for compliance purposes.***

Standing can be a significant hurdle in state tax consumer class actions because states provide mechanisms whereby only a *taxpayer* may file a claim for refund with the taxing authority. In California, only taxpayers may file a claim for refund with the BOE.[9] In situations in which consumers are not taxpayers, they have no standing to assert a claim with the BOE.[10] Consequently, those consumers cannot maintain a suit for a sales tax refund because the filing of a claim with the BOE is a prerequisite to such a suit.[11]

Loeffler is pending before the California Supreme Court. The case is fully briefed and awaiting oral argument on the question whether the California Constitution or the California Revenue and Taxation Code bars a consumer from filing a lawsuit against a retailer under California's consumer protection statutes.[12]

Illinois: *Kean v. Wal-Mart Stores Inc.*

In *Kean v. Wal-Mart Stores Inc.*,[13] a consumer paid sales tax in the collective amount of $2.74 on a $23.33 purchase of a trampoline and related shipping charges of $7.97.[14] The consumer brought suit for refund of the sales tax paid on the shipping charges, claiming that Wal-Mart violated Illinois's Consumer Fraud and Deceptive Business Practices Act[15] and was unjustly enriched to the extent that Wal-Mart did not remit the improperly collected taxes to the taxing authority.[16] The consumer sought damages not only for herself but for a class "consisting of all consumers who purchased an item from Wal-Mart and were charged sales tax on the shipping of that item," as well as a permanent injunction enjoining Wal-Mart from collecting sales tax on shipping charges.[17] Wal-Mart filed a motion to dismiss, claiming that it had a legal obligation to collect the sales tax, that the delivery was an inseparable part of the sale so the shipping was taxable, and that because the sales tax at issue had already been remitted to the state, Wal-Mart had not been unjustly enriched.[18] The Illinois Circuit Court granted the motion to dismiss on the basis that the shipping charges were subject to sales tax, and an appellate court affirmed the judgment.[19] Notably, both the

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[3] *Id.* at 1249; *see also* Calif. Const. Art. XIII, section 32.
[4] *Loeffler*, 173 Cal. App. 4th at 1248, *supra* note 1.
[5] *Id.* at 1240.
[6] *Id.*
[7] *Id.* at 1235; *see also* Calif. Revenue and Taxation Code sections 6901.5, 6904, 6933, and 7054.
[8] *Loeffler*, 173 Cal. App. 4th at 1242, *supra* note 1.
[9] Calif. Revenue and Taxation Code sections 6901 and 6902.
[10] *Id.*

[11] *Loeffler*, 173 Cal. App. 4th at 1242, *supra* note 1.
[12] In a companion case, *Yabsley v. Cingular Wireless, LLC*, 176 Cal. App. 4th 1156 (Cal. Ct. App. 2009), *rev. granted*, 219 P.3d 151 (Cal. 2009), the California Supreme Court deferred further action pending consideration and disposition of the related questions in *Loeffler*.
[13] 235 Ill. 2d 351 (Ill. 2009).
[14] *Id.* at 354.
[15] 815 Ill. Comp. Stat. 505/1 et. seq. The Consumer Fraud and Deceptive Business Practices Act protects consumers, borrowers, and in some circumstances, businesses, against fraud, unfair competition, and unfair or deceptive practices in the conduct of trade or business. *Cripe v. Leiter*, 184 Ill. 2d 185, 190-191 (Ill. 1998).
[16] *Id.* at 353-354.
[17] *Id.* at 354-355.
[18] *Id.* at 355-356.
[19] *Id.* at 360-361. The court, therefore, did not reach the class certification claim.

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Illinois Department of Revenue and the state treasurer filed a motion to intervene as defendants and for leave to file a motion to dismiss the complaint.[20]

On allowing the plaintiffs' petition for leave to appeal, the Illinois Supreme Court examined Illinois sales tax law, noting:

> The line between the provision of a nontaxable service and a taxable retail sale of tangible personal property is not always clear. In determining where that line should be drawn, Illinois courts consider whether the service is an "inseparable" or "indispensable" part of the retail sale.[21]

The state supreme court concluded that "an 'inseparable link' exists between the sale and delivery of the merchandise plaintiffs purchased from Wal-Mart's internet store," where "plaintiffs were required to buy the delivery service."[22] Accordingly, the court affirmed the judgment of the appellate court affirming the dismissal of the plaintiffs' complaints, holding that the shipping charges for the plaintiffs' purchases from Wal-Mart's Internet store were properly included in the "selling price" under the law, and that Wal-Mart properly charged and collected sales tax on the shipping charges.[23]

Rhode Island: *Ricci v. Dell Computer*.

In *Ricci v. Dell Computer Corp.*,[24] the plaintiffs brought a class action alleging that Dell violated the Deceptive Trade Practices Act (DTPA)[25] by improperly and negligently collecting sales tax on optional service contracts and shipping and handling fees although those contracts and fees were not taxable under Rhode Island law.[26] Plaintiff Ricci purchased a Dell computer in December 2000 with an optional service contract for her own personal or household use, paying a total of $1,722.26, including $16.31 designated as tax on a taxable amount of $233.[27] Although Ricci's order acknowledgment provided that the tax shown related only to third-party service contracts, the listed line-item price for the optional service contract was $0.[28] At the time, when a customer purchased a service contract, Dell allocated a specific value to the optional service contracts for accounting and business purposes, charged sales tax on the optional service contracts, and paid the collected tax either directly to Rhode Island or to a third-party servicer with Rhode Island nexus that then remitted the tax to the state.[29]

On Dell's motion for summary judgment, the plaintiffs argued that the service contract was an intangible right to receive services contingent on requiring them, and not taxable, tangible personal property.[30] Dell argued that taxation was a reasonable, good-faith interpretation of the law that service contracts not separately stated were taxable.[31] The court found that Dell improperly charged the plaintiffs sales tax on the optional service contract.[32] The court also held that the collection of sales tax was not exempt from the DTPA.[33] Nevertheless, the court granted Dell's motion for summary judgment, holding that the collection did not violate the DTPA.[34] The court said it was "aware of the gray areas in applying the tax law" and that "Dell's honest misinterpretation of a delicate area of the state tax law cannot be held to be an unfair act."[35] The court concluded:

> Finding a DTPA violation here, where there is no evidence of intent to mislead the consumers to pay a tax they do not have to pay and no evidence of immoral, unethical, oppressive, or unscrupulous behavior, would essentially make improper collection of taxes a per se violation of the DTPA. This Court is not convinced that the DTPA was intended to resemble a strict liability statute under which a company could be liable for any unintended error.[36]

Furthermore, the court held there was no duty owed by Dell to plaintiffs regarding the collection of sales tax, and therefore the plaintiffs had no cause of action in negligence.[37]

Class Certification

Class certification can serve as a barrier to maintaining a successful lawsuit. The Federal Rules of Civil Procedure (FRCP) sets forth four class action

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[20] *Id.* at 356. The circuit court likewise granted these motions to dismiss. *Id.* at 360.

[21] *Id.* at 373-374 (citations omitted).

[22] *Id.* at 376.

[23] *Id.* at 377.

[24] 2012 R.I. Super. LEXIS 50 (R.I. Super. Ct. 2012).

[25] The DTPA declares unlawful "unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce." R.I. Gen. Laws section 6-13.1-2.

[26] *Ricci*, 2012 R.I. Super. LEXIS at *7-*8. Although the case was brought as a class action, the class had not been certified, leading the court to consider Dell's motion for summary judgment on the facts and claims of the individually named plaintiffs and not those of any purported class. *Id.* at *12. The suit had already survived a motion to compel arbitration and a motion to dismiss for lack of subject matter jurisdiction. *See DeFontes v. Dell, Inc.*, 984 A.2d 1061, 1062 (R.I. 2009) (describing the matter in affirming denial of motion to stay and compel arbitration); *see generally, Long v. Dell, Inc.*, 984 A.2d 1074 (R.I. 2009) (affirming denial of motion to dismiss).

[27] *Id.* at *6.

[28] *Id.* at *6-*7.

[29] *Id.* at *5.

[30] *Id.* at *15.

[31] *Id.*

[32] *Id.* at *48.

[33] *Id.* at *28.

[34] *Id.* at *48-49.

[35] *Id.* at *45.

[36] *Id.* at *48.

[37] *Id.* at *41.

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"prerequisites" that apply to all types of class actions.[38] A class action suit must satisfy the following: "(1) the class is so numerous that joinder of all members is impracticable"; "(2) there are questions of law or fact common to the class"; "(3) the claims or defenses of the representative parties are typical of the claims or defenses of the class"; and "(4) the representative parties will fairly and adequately protect the interests of the class."[39] More commonly, those four prerequisites are known as numerosity, commonality, typicality, and adequate representation, respectively.[40]

The U.S. Supreme Court arguably strengthened that barrier in its recent decision in *Wal-Mart Stores, Inc. v. Dukes*.[41] In *Wal-Mart*, a putative class of approximately 1.5 million current and former female Wal-Mart employees sought to bring an action against the retailer for workplace discrimination.[42] However, on examining the FRCP Rule 23 prerequisites, the Court held that the allegedly aggrieved plaintiffs failed to meet the requirements for certification because they did not present "significant proof" that Wal-Mart "operated under a general policy of discrimination," and therefore failed to show the existence of any common question of law or fact.[43] What proof plaintiffs did offer — sociological expert testimony, statistical evidence (two studies), and anecdotal evidence (120 affidavits out of 1.5 putative plaintiffs) — was insufficient, suggesting that the size of the class affects the amount of evidence required to be put forth to demonstrate that commonality and typicality exist among the class members.[44] Further undermining commonality was the plaintiffs' contention that all Wal-Mart managers exercised some discretion in making pay and promotion decisions.[45] That discretion, the Court said, "is just the opposite of a uniform employment practice that would provide the commonality needed for a class action," but is rather "a policy against having uniform employment practices."[46] Accordingly, the Court said, "without some glue holding the alleged reasons for all those decisions together, it will be impossible to say that examination of all the class members' claims for relief will produce a common answer to the crucial question *why was I disfavored*."[47] Moreover, the Court unanimously rejected the argument that claims for individualized monetary relief may be certified under Rule 23(b)(2).[48]

Despite the decision in *Wal-Mart*, the certification barrier is by no means insurmountable, and class actions — and class action certifications — proceed apace. Indeed, on September 5 the U.S. Court of Appeals for the Sixth Circuit in *Young v. Nationwide Mutual Insurance Co.* affirmed the certification of plaintiff subclasses in a suit in which the plaintiffs alleged that they were assessed incorrect charges for local government premium taxes as a result of the defendant insurance companies' failure to correctly identify the taxing jurisdiction in which the insured risks of each of the policyholders were located.[49] On review of the district court's certification under FRCP Rule 23(a) and (b)(3) of statewide plaintiff subclasses, a unanimous panel concluded that the district court met the Rule 23(a) prerequisites of numerosity, commonality, typicality, and adequate representation, satisfied the Rule 23(c) requirements that common questions predominated over the individual ones,[50] and that class litigation was superior.[51] The court also rejected the defendant insurance companies' attacks on the administrative feasibility of a class action based on the number of insurance policies at issue, stating that the "specific

[38]Three types of class actions are provided for under the FRCP:

> (1) prosecuting separate actions by or against individual class members would create a risk of . . . inconsistent or varying adjudications with respect to individual class members . . . or . . . as a practical matter, would be dispositive of the interests of the other members not parties to the individual adjudications or would substantially impair or impede their ability to protect their interests;
> (2) the party opposing the class has acted or refused to act on grounds that apply generally to the class . . . ; or
> (3) the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.

Fed. R. Civ. Proc. 23(b).

[39]Fed. R. Civ. Proc. 23(a).

[40]*See, e.g.*, *General Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 156 (1982).

[41]131 S. Ct. 2541 (2011).

[42]*Id.* at 2544.

[43]*Id.* at 2553 (quoting *Falcon*, *supra*, 457 U.S. at 159, n. 15).

[44]*Id.* at 2555-2556.

[45]*Id.* at 2554.

[46]*Id.*

[47]*Id.* at 2552 (emphasis in original).

[48]*Id.* at 2560-2561.

[49]*Young v. Nationwide Mutual Insurance Co.*, 2012 U.S. App. LEXIS 18625 (6th Cir. 2012).

[50]The court found that the defendants' potential individual inquiries, which the defendants claimed would relieve them of responsibility for an incorrect premium tax charge, did not defeat the predominance of common questions where plaintiffs proceeded on the theory that certain verification processes would catch most types of errors and that the defendants caused each class members' injury simply by failing to use those processes. *Id.* at *31-*32.

[51]The court found that the district court did not abuse its discretion in finding that class litigation was a superior method of adjudicating the plaintiffs' claims given the unlikelihood that many injured policyholders will discover, let alone attempt to vindicate, their injury individually through the administrative process in Kentucky. *Id.* at *35.

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program used by Plaintiffs has been approved by the Kentucky Department of Insurance (KDI) as one verification program among several that the KDI now mandates insurers utilize."[52] Furthermore, as a practical matter, the court explained that it "is often the case that class action litigation grows out of systemic failures of administration . . . that result in small monetary losses to large numbers of people" and that to "allow that same systemic failure to defeat class certification would undermine the very purpose of class action remedies."[53]

The ABA Responds

The American Bar Association, for its part, has drafted and adopted the Transaction Tax Overpayment Model Act (herein, the Model Act) to balance the conflicting interests of sellers, purchasers, and state and local governments in questions regarding seller liability and purchaser remedy procedures for overpaid transaction tax.[54] The Model Act "is intended" to apply "to all transaction taxes that [a] seller is required to add to the sales price of taxable goods, products or services, collect from the purchaser, and remit to the taxing jurisdiction" and "could also apply to fees and other impositions that have these characteristics."[55] The Model Act provides that a purchaser seeking a refund of overpaid transaction tax may file a written claim for refund with either the taxing jurisdiction or the seller.[56]

> **Kean *and* Ricci *demonstrate the reality of the ABA's concern that a nontax tribunal will decide threshold tax questions, including those in the gray area.***

If adopted by the states, those statutory procedures would limit the ability of purchasers to assert legal claims against a seller in connection with any alleged overpayment of tax. The Model Act also sets forth a procedure to notify similarly situated purchasers, ostensibly heading off a need for class action suits. When a taxing jurisdiction approves three or more refund claims from purchasers and determines that there are "numerous similar transactions with respect to which tax should not have been collected," the taxing jurisdiction shall notify "all affected registered sellers advising them not to collect tax on such transactions" and post procedures on its official website whereby affected purchasers may request a refund.[57]

In preparing the Model Act, the ABA examined the growing trend of cases in the area of seller liability for transaction tax collection duties and identified recurring themes.[58] The ABA noted how most of the recent cases are class actions, with the plaintiffs/purchasers suing the defendant/seller for improperly collecting a state or local transaction tax from the plaintiffs/purchasers; the typical forum is a state trial court of general jurisdiction, not a tax tribunal; the taxing authority is not typically a party to the case; and the court often decides the threshold tax question without the input of the taxing authority.[59] Both *Kean* and *Ricci*, discussed above, demonstrate the reality of the ABA's concern that a nontax tribunal will decide threshold tax questions, including those in the gray area. Although the courts in those two cases ultimately ruled for the retailer, leaving corporate taxpayers to articulate the vagaries of state tax law to a nontax tribunal may not always be as successful and certainly will be costly.

Qui Tam Actions

Qui tam actions are another area of untraditional potential exposure that taxpayers should be aware of in determining their state tax compliance obligations. Typically brought under a state's False Claims Act, *qui tam* lawsuits often involve "corporate insiders" or other whistleblowers who are seeking to recover damages for the government resulting from the filing of an allegedly false tax claim. Under most state False Claims Act statutes, those damages can equal up to three times the amount of the tax allegedly owed. As an incentive to come forward under those laws, whistleblowers stand to be rewarded up to one-third of the damages recovered. For a more in-depth discussion of the trend toward using False Claims Acts to enforce state tax laws, see Sutherland's A Pinch of SALT article titled "Applying False Claims Acts in State Taxation."[60]

Various aspects of *qui tam* actions alter the playing field in favor of the government when it comes to enforcing state tax laws. First, after the whistleblower commences the action, the state's attorney general may take over the case and prosecute the matter as an enforcement action. That places the attorney general in complete control of the litigation, which brings the full force of the government and its resources to bear against the taxpayer.

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[52]*Id.* at *21.
[53]*Id.* at *18.
[54]ABA Report accompanying Model Act and Resolution.
[55]Model Act section 3(f), n. 1 (Feb. 2011).
[56]Model Act section 5(a) (Feb. 2011).
[57]Model Act section 5(h) (Feb. 2011).
[58]ABA report accompanying Model Act and resolution.
[59]*Id.*
[60]Jack Trachtenberg, Jeffrey A. Friedman, and Eric S. Tresh, "Applying False Claims Acts in State Taxation," *State Tax Notes*, May 7, 2012, p. 373, *Doc 2012-8812*, or *2012 STT 88-5*.

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Second, unlike most administrative audits and appeals, *qui tam* proceedings are public. Frequently, that means that the attorney general will issue press releases accusing the taxpayer of fraud (even though fraud does not have to be shown), thereby creating significant reputational risks. It also means that the taxpayer's otherwise confidential tax return information will become available for public inspection. Finally, and as noted above, *qui tam* actions expose taxpayers to treble damages, plus statutory penalties.

Various aspects of* qui tam *actions alter the playing field in favor of the government when it comes to enforcing state tax laws.

Those additional hazards mean that taxpayers must assess their tax compliance obligations in a new risk environment. The concern, however, is that taxpayers may become too conservative, particularly regarding sales and use taxes. As is illustrated by the discussion above, if taxpayers default to collecting and remitting sales tax to avoid potential False Claims Act exposure, they may be exposed to class action lawsuits by consumers. That places sellers between a rock and a hard place when it comes to determining compliance obligations, particularly regarding myriad outdated, confusing, and ambiguous sales tax provisions that are present in many state tax codes.

For this and other reasons, many are calling for limitations to be placed on the use of *qui tam* actions and consumer class action lawsuits in the area of state taxation. Most notably, the Council On State Taxation has asked the Multistate Tax Commission to consider developing model administrative procedures that would minimize vendor exposure to *qui tam* and class action lawsuits that bypass traditional state tax administration processes. Also, as discussed above, the ABA has adopted the Model Act.

Likely Scenarios

Technology Transfer Agreements

An area of state taxation now rife with controversy in California involves the taxability of property transferred under a technology transfer agreement (TTA) for purposes of California's Sales and Use Tax Law. Despite the California Court of Appeal's broad, taxpayer-favorable holding in *Nortel Networks, Inc. v. State Bd. of Equalization*,[61] the state continues to narrowly interpret the TTA provisions, leaving corporate taxpayers in a precarious situation for assessing risk not only for compliance purposes but for purposes of avoiding both consumer class actions and *qui tam* actions.

Under California Sales and Use Tax Law, a TTA is defined as "any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or use a process that is subject to a patent or copyright interest."[62] California's TTA provisions exclude from the definitions of "sales price" and "gross receipts" for sales and use tax purposes the amount charged for intangible personal property transferred with tangible personal property in any TTA, if the TTA separately states a reasonable price for the tangible personal property.[63]

In *Nortel*, the court addressed the question whether sales tax applies to the license of software, including prewritten software, by Nortel to operate telephone switching equipment in a transaction involving both the license of software and sale of hardware.[64] The court concluded that the value of software, including prewritten software, is excluded from the sales price on meeting the elements of a TTA.[65] The TTA statutory provisions include the right "to make and sell a product" or (that is, disjunctive) "to use a process" that is subject to the patent or copyright interest.[66] Invalidating the BOE's related regulation to the extent that it excluded prewritten computer programs from TTA qualification,[67] the court held that a "process" includes prewritten software.[68]

The *Nortel* decision significantly affects the interpretation of the term "process" under California's TTA provisions. As set forth in the decision, "even if Pacific Bell does not make and sell a 'product,'

[61]191 Cal. App. 4th 1259 (Cal. Ct. App. 2011).

[62]Calif. Revenue and Taxation Code sections 6011(c)(10)(D) and 6012(c)(10)(D).

[63]Calif. Revenue and Taxation Code sections 6011(c)(10)(A) and 6012(c)(10)(A). Even if a price for the tangible personal property is not separately stated, the fair market value of the tangible personal property subject to tax may be established by the price at which the tangible personal property was previously sold, leased, or offered to third parties. *Id.*, sections 6011(c)(10)(B) and 6012(c)(10)(B). If the TTA does not separately state a reasonable price for the tangible personal property, and the tangible personal property or like tangible personal property has not been previously sold, leased, or offered to third parties, the retail fair market value of the tangible personal property shall be equal to 200 percent of the cost of materials and labor used to produce the tangible personal property. *Id.*, sections 6011(c)(10)(C) and 6012(c)(10)(C).

[64]*Nortel*, 191 Cal. App. 4th at 1265-1266.

[65]*Id.* at 1264.

[66]Calif. Revenue and Taxation Code sections 6011(c)(10)(D) and 6012(c)(10)(D).

[67]*See* 18 Cal. Code Regs. section 1507.

[68]*Nortel*, 191 Cal. App. 4th at 1275-1276.

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Nortel *licensed the right to use patented 'processes'* within the meaning of the TTA statutes."[69] Under the court's interpretation of the TTA statutory provisions, any right "to use a process" that is subject to a patent interest that is transferred under a TTA by the appropriate holder of that patent interest is potentially subject to exclusion for sales and use tax purposes.

The ramifications of *Nortel* are profound and potentially far-reaching. Take, for example, software developed for application and use in a smartphone. There is a strong likelihood the software is "licensed" and "loaded onto the equipment" (that is, the smartphone), and that the "patented processes are used" to allow functionality of all different sorts on the smartphone. If the smartphone is purchased directly from the manufacturer and the manufacturer holds the licensing rights to the software embedded on the smartphone, it stands to reason that the entire value of the prewritten software should be excluded from the taxable purchase price and only the value of the tangible personal property components of the smartphone should be subject to sales or use tax.

Despite the court's potentially sweeping holding in *Nortel*, the state has maintained the position that some portion of the value of the intangible should be allocated to the value of the tangible personal property.[70] Accordingly, corporate taxpayers with transactions falling squarely within the TTA provisions and the court's holding in *Nortel* nevertheless remain in a difficult situation given the state's current position, and must weigh the risks of overcollection of sales tax against the likelihood of third-party consumer litigation.

Digital Goods

Another area of concern arises from the virtual realm. Although most states tax sales of tangible personal property and enumerated services, a number of states are moving toward taxation of digital goods.[71] Washington state, for instance, imposes sales tax on "digital products," a term that includes digital goods. Digital goods are defined as "sounds, images, data, facts, or information, or any combination thereof, transferred electronically, including, but not limited to, specified digital products and other products transferred electronically not included within the definition of specified digital products."[72] The definition of digital goods, however, does not include prewritten or custom computer software.[73]

The Colorado Court of Appeals recently issued a decision that highlights the shifting and often unpredictable application of sales and use tax laws to digital transactions. In *Ball Aerospace & Technologies Corp. v. City of Boulder*,[74] the taxpayer acquired downloaded software, as well as maintenance and support services for previously acquired software, and also purchased online access to databases and a calendar hosting service.[75] Reversing the trial court's grant of summary judgment in favor of the taxpayer, the court held that the city's use tax applies to both the electronically downloaded software and the data information services purchased by the taxpayer.[76] Regarding the former, the court concluded that the downloaded software was taxable regardless of the means of conveyance because the taxpayer exercised the right, power, dominion, or control over software contained on machine-readable form.[77] Regarding the latter, the court concluded that by paying to access the online data services, the taxpayer purchased the right to use, from a remote location, the computer software contained on the service providers' servers, and thus the purchase of that right was taxable under the city's governing statute.[78]

That trend raises many compliance questions. Corporate taxpayers must now answer traditional questions in a new and developing context. (For example, is the customer exempt? Is the type of good or service taxable? Is the purchase for resale? Was a tax in effect and, if so, at what rate? What is the tax jurisdiction? How was the good delivered?) Suffice it to say, the average consumer of a digital good will not readily know the answer to those questions when he receives a bill charging tax on his purchase. Thus, the potential for consumer class action regarding the taxation of digital goods requires that corporate taxpayers perform due diligence and take whatever steps are possible to limit that exposure. As an example, contracts for the sale of digital goods should address remedies or indemnification for billing errors, and address how subscribers will be made whole in the event of such an error, as well as whether tax adjustments will be made as part of a

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[69]*Id.* at 1275.

[70]*See* BOE Initial Discussion Paper, "Regulation 1507, Technology Transfer Agreements," pp. 10-14 (6/27/12).

[71]*See, e.g.*, Ky. Rev. Stats. section 139.200(1)(b); Wis. Stats. section 77.52(1)(d).

[72]Wash. Rev. Code section 82.04.192(6)(a). The term "specified digital products" means electronically transferred digital audio-visual works, digital audio works, and digital books. Wash. Rev. Code section 82.04.192(9).

[73]Wash. Rev. Code section 82.04.192(6)(b)(ii).

[74]2012 COA 153 (Colo. Ct. App. Sept. 13, 2012).

[75]*Id.* at P2-P3.

[76]*Id.* at P24, P28.

[77]*Id.* at P22-P24.

[78]*Id.* at P26-P28.

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settlement process or considered separate and distinct transactions. Traditional compliance obligations aside, knowing how a digital good is taxed (or anticipating how a digital good is likely to be taxed) will help corporate taxpayers fend off a third-party legal challenge.

Local Taxing Jurisdictions

The Sixth Circuit's decision in *Young*[79] highlights yet another area in which corporate taxpayers should tread carefully lest they invite a consumer action. As explained above, Kentucky authorizes local governments to impose a tax on insurers for the premiums the insurer collects on its sale of certain insurance products.[80] Insurers are authorized, in turn, to pass the tax itself on to the insured by way of a "reasonable collection fee."[81] The class action in *Young* arose because the defendant insurance companies failed to identify the relevant taxing jurisdictions for purposes of imposing the collection fees.

Simply keeping current regarding one's own tax liability is no easy task for a multistate corporate taxpayer operating in several state and local jurisdictions. *Young* serves as another cautionary reminder that compliance is not the only thing a corporate taxpayer should be concerned about. Increasingly, passthrough and recovery fees must be assessed with pinpoint accuracy to safeguard against third-party class actions.

Practical Considerations

With the rise of consumer class action lawsuits and *qui tam* actions, ambiguous state and local transaction tax laws increasingly present unique conundrums for even the most diligent of corporate taxpayers. To avoid administrative deficiencies and penalties, there is a natural tendency toward simply collecting and remitting what is usually a passthrough tax. That exposes the taxpayer to consumer class action lawsuits.

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However, if there is a desire to avoid consumer-based lawsuits and a reasonable basis exists to conclude that tax should not be charged, the taxpayer opens itself up to a *qui tam* action. The only winners seem to be enterprising or opportunistic whistleblowers, plaintiffs' attorneys, and state governments that stand to unduly profit from the state's failure to provide clarifying and accurate guidance regarding gray areas of the law.

That is not the way to effectively, fairly, and efficiently administer state taxes, especially when it comes to taxpayers who are simply trying to figure out whether they have a compliance obligation in the first place. The ABA, COST, and the MTC are all to be commended for considering whether and how constraints should be placed on class action lawsuits in the tax area.

> ***Reliance on written advice from the taxing authorities charged by law with interpreting the tax code could provide a defense to liability in a consumer class action or* qui tam *lawsuit.***

In the meantime, what are taxpayers to do?

A first crucial step is to undertake a review of past practice and future compliance determinations in light of the new risk environment created by the rise in consumer class action and *qui tam* lawsuits. Companies should involve counsel experienced in substantive state and local tax questions, as well as state tax litigation, to help determine whether the liability requirements and other unique risks associated with class action and *qui tam* lawsuits warrant a conclusion contrary to the traditional "tax only" risk assessment.

Taxpayers should also consider using state advisory opinion and private letter ruling processes to obtain written guidance when there are gray areas of law. Reliance on written advice from the taxing authorities charged by law with interpreting the tax code could provide a defense to liability in a consumer class action or *qui tam* lawsuit, or at least present a basis for reducing damages.

Also, in appropriate situations, companies should consider notifying their customers of any potential overcollection of tax and advise the customers of their right to seek a refund from the state. Alternatively, a company may make its customers whole by repaying the overcollected tax and seeking a refund itself.[82] Those steps may head off a consumer class

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[79]*Supra* note 49.

[80]Ky. Rev. Stat. section 91A.080.

[81]Ky. Rev. Stat. section 91A.080(4).

[82]Some states do not give taxpayers a choice. In Massachusetts, for example, a vendor must establish that any excess sales or use tax collected from a purchaser and remitted to the state was (or will be) repaid or credited by the vendor to the purchaser, with interest, *before* the vendor will receive a refund. 830 Code Mass. Regs. section 62C.37.1(6)(b). Such a process places the risk of overpayment entirely on the seller.

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action lawsuit, while at the same time placing the substantive tax question back in the traditional administrative process.

Corporate taxpayers should also consider including a mandatory arbitration clause (precluding class arbitration) in the terms and conditions of sale contracts as an alternative means of heading off class action lawsuits. That course of action was recently affirmed by the U.S. Supreme Court in *AT&T Mobility LLC v. Concepcion*.[83]

Finally, regarding potential exposure to *qui tam* lawsuits, companies should consider using any state-based voluntary disclosure programs that are available. For example, in New York, a state in which the attorney general has begun to aggressively apply the False Claims Act to ambiguous tax provisions, there is a permanent statutory voluntary disclosure program that provides for a limited look-back, penalty abatement, and minimum statutory interest. Although the statute does not specifically immunize those who come forward from *qui tam* liability, doing so in good faith and at the appropriate time (that is, before a False Claims Act investigation has begun) may immunize against liability or reduce damages. ✰

[83]131 S. Ct. 1740 (2011). In *Concepcion*, the Court held that the Federal Arbitration Act preempted a California rule that purported to invalidate as unconscionable class action waivers in consumer contracts of adhesion. *Id.* at 1753.

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Sutherland's SALT Practice is composed of 30 attorneys who focus on planning and controversy associated with income, franchise, sales and use, unclaimed property, and property tax matters. Sutherland's SALT Practice also monitors and comments on state legislative and political efforts.

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