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Current Developments in State and Local Tax

Developments at the U.S. Supreme Court, the State Courts and Departments of Revenue

By Craig B. Fields and Eugene J. Gibilaro

The following important decisions and developments in State and local tax arose during the past few months.

U.S. Supreme Court Update

The Eighth Amendment's Excessive Fines Clause Applies to the States

The U.S. Supreme Court held that the Excessive Fines Clause of the Eighth Amendment of the U.S. Constitution, which limits the government's authority to extract cash or in kind payments as punishment for an offense, is enforceable against States "according to the same standards that protect those personal rights against federal encroachment."[1] The Court further declined Indiana's invitation to reconsider a prior ruling where the Court held that civil fines that are at least partially punitive in nature are subject to the limitations of the Excessive Fines Clause.

The holding is significant inasmuch as it confirms that State imposition of civil and criminal penalties in tax cases is subject to the limitations of the Excessive Fines Clause. In 2018, the Supreme Court of Appeals of West Virginia held that the Tax Commissioner's imposition of a civil penalty on a cigarette distributor for the unlawful sale of cigarettes equal to 500% of the retail value of the cigarettes unlawfully sold did not violate the Excessive Fines Clause.[2] In reaching this conclusion, the Supreme Court of Appeals analyzed whether the penalty imposed by the Commissioner was grossly disproportionate to the cigarette distributor's offense and considered the following factors that it had identified in one of its prior Excessive Fines Clause cases: (1) the amount of the penalty at issue and its relationship to the authorized penalty; (2) the nature and extent of the offense; (3) the relationship between the penalty for the offense at issue and the penalties

imposed for other offenses; and (4) the harm caused by the offense.

On February 6, 2019, the cigarette distributor filed a Petition for a Writ of Certiorari in the U.S. Supreme Court and invited the Court to affirmatively adopt factors for lower courts to consider when deciding whether a civil monetary penalty violates the Excessive Fines Clause.[3] On March 15, 2019, the Court requested that West Virginia respond to the Petition and West Virginia's brief in opposition was filed on May 15, 2019.

Federal Law Bars Different State Tax Treatment of State and Federal Retirees

The U.S. Supreme Court held that federal law barred West Virginia from taxing the federal pension benefits of a retired U.S. Marshal when the State exempted from tax the pension benefits of retired West Virginia law enforcement employees.[4] The intergovernmental tax immunity doctrine as codified permits States to tax the pay or compensation of officers or employees of the federal government, but only if the "taxation does not discriminate against the officer or employee because of the source of the pay or compensation."[5] It was undisputed in the case that there was no material difference between the powers and duties of a U.S. Marshal and the powers and duties of a West Virginia law enforcement employee.

The Court stated that under the intergovernmental tax immunity doctrine, "what matters isn't the intent lurking behind the law but whether the letter of the law 'treat[s] those who deal with' the federal government 'as well as it treats those with whom [the State] deals itself.'"[6] Here, inasmuch as retired West Virginia law enforcement employees received preferential tax treatment as compared to similarly situated federal retirees, West Virginia unlawfully discriminated against the federal retiree.

Supreme Court Grants Cert in State Tax Nexus Case

The U.S. Supreme Court granted certiorari in a case regarding North Carolina's jurisdiction to tax the income of a trust.[7] In 2018, the North Carolina Supreme Court held that the State's attempt to tax a trust on its income based on the North Carolina residency of the trust's primary beneficiaries violated due process inasmuch as the trust did not have sufficient minimum contacts with North Carolina during the applicable tax years. The North Carolina Supreme Court found that the trust itself must have the requisite minimum contacts in order for due process to be satisfied and the trust's contacts with the North Carolina beneficiaries alone were insufficient to create a constitutional nexus.

Oral argument was held in the case on April 16, 2019.

Supreme Court Denies Cert in Commerce Clause Discrimination Case

On May 13, 2019, the Supreme Court denied a Petition for a Writ of Certiorari filed by the taxpayers asserting unconstitutional discrimination against interstate commerce.[8] The issue in the appeal was the constitutionality of an Oklahoma statutory provision that provides a deduction to individuals from their Oklahoma adjusted gross income for capital gains recognized from the sale of stock in an "Oklahoma company," *i.e.*, a company "whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise."[9] The taxpayers here recognized capital gain from the sale of stock in a company that was primarily headquartered in a State other than Oklahoma and asserted that denying them the deduction constituted unconstitutional discrimination against interstate commerce in violation of the Commerce Clause.

In *CDR Systems Corp. v. Oklahoma Tax Commission*, the Supreme Court of Oklahoma found a similar statutory provision to be constitutional.[10] There, the statutory provision at issue required a three-year holding period for assets sold by Oklahoma companies to qualify for the capital gains deduction but required non-Oklahoma companies to meet a five-year holding period to receive the same deduction.[11] However, despite winning the case, the Oklahoma Tax Commission paid a full refund to the taxpayer prior to a petition for certiorari being filed. Therefore, this was the U.S. Supreme Court's first opportunity to consider whether Oklahoma's capital gains deduction is unconstitutionally discriminatory.

Nexus

Ohio—Court Upholds Commissioner's Nexus Assertion

The Court of Appeals of Ohio held that an out-of-state company with no physical presence in Ohio was subject to the Ohio Commercial Activity Tax (CAT) and that the application of the CAT to the company did not violate either the Due Process Clause or the Commerce Clause of the U.S. Constitution.[12] The company was a seller of tangible personal property and its primary customers were large, national retailers that had distribution centers located throughout the United States, including in Ohio.

When an order was placed, the company would prepare the bill of lading and the retailer would arrange for a common carrier to pick up the property at the company's facility located outside of Ohio. Title to the property passed to the retailers once it was loaded onto the common carrier's truck outside of Ohio. The Department of Taxation asserted that the CAT applied to the company's sales that were delivered by common carrier to retailer distribution centers in Ohio.

The company argued that it did not have nexus with Ohio inasmuch as all of its transactions with its retailer customers occurred entirely outside of Ohio. The court disagreed because the company had knowledge that the property the company sold was destined for Ohio distribution centers at the time that the orders were placed and the company satisfied Ohio's bright-line presence threshold of $500,000 of in-state sales based on the application of Ohio's destination-based method of situsing sales.

The company further argued that the application of the CAT to the company violated due process inasmuch as the company had done nothing to purposefully direct sales to Ohio. However, the court found that the company's income from the sales of property destined for Ohio distribution centers was made possible because there is a market for the company's goods in Ohio. Based on "the systemic sale of tangible personal property that is delivered to Ohio," the court concluded that the company "has purposefully taken advantage of the distribution ability of national retailers and knows that its products are shipped to Ohio."[13]

Deductions

New Jersey—Tax Court Orders Full Unreasonable Exception to Royalty Addback

The New Jersey Tax Court held in a published (*i.e.*, precedential) opinion that a royalty payor was not required to add back any portion of the royalties that it paid to a related payee under the unreasonable exception when the payee filed New Jersey Corporation Business Tax (CBT) returns, included the royalties in its CBT income base, and allocated its income to New Jersey under its own allocation factor.[14]

For CBT purposes, a taxpayer is required to add back to its federal taxable income otherwise deductible royalty expenses and costs that are paid, accrued, or incurred to a related party.[15] However, the addback does not apply if the taxpayer can establish that adding back the royalties would be unreasonable.[16] The Division of Taxation's regulation explains that the taxpayer can establish that the addback operates unreasonably "by showing the extent that the payee pays tax to New Jersey on the income stream."[17] Here, the Division argued that the payor was only entitled to a partial exception to the addback, despite the fact that the payee paid tax to New Jersey on the income stream, because the payor's allocation factor was greater than the payee's allocation factor.

However, the Tax Court agreed with the payor that it was entitled to a full unreasonable exception to the addback and ordered the Division to issue the remainder of the payor's refund, concluding that once the payee filed CBT returns and reported the royalties paid to it by the payor, "the legislative concerns of income shifting/exporting machinations … are allayed," and a discrepancy in allocation factors, "*without more*," does not establish that the payor is only entitled to a partial exception to the addback statute.[18] As it ruled for the payor on statutory grounds, the Tax Court did not address the payor's constitutional arguments.

Texas—Taxpayer's Cost of Goods Sold Deduction Partially Disallowed

The Court of Appeals of Texas upheld the Comptroller's disallowance of a percentage of certain costs deducted by the company on the grounds that such costs did not qualify as deductible costs of goods sold (COGS) for Texas franchise tax purposes.[19] The company manufactured readymixed concrete using mixer-trucks. On the date of a delivery, the company's driver would load materials into the drum of the mixertruck and rotate the drum at "mixing speed" to mix the concrete. When the driver was satisfied with the consistency of the concrete, they would slow the drum's rotation to "agitate speed" and drive to the delivery site. Keeping the drum rotating while the concrete was transported to the delivery site prevented the concrete from settling while it was in transit.

Texas permits a COGS deduction for "all direct costs of acquiring or producing the goods" and for 4% of indirect or administrative overhead costs.[20] In computing its COGS deduction, the company deducted all of its costs related to its mixer-trucks, drivers, and dispatchers who oversaw the orders for ready-mixed concrete. However, the Comptroller disallowed 70% of the mixer-truck costs and 41% of the driver costs, and capped the dispatcher costs at 4% after concluding that these costs were indirect or administrative overhead costs.

The company argued that because the mixer-truck's drum rotates constantly until delivery, the manufacturing process is ongoing while the concrete is transported to the delivery site and all costs related to the company's mixer-trucks, drivers, and dispatchers are direct costs of manufacturing the concrete. However, the court affirmed

the lower court's finding that while the company's drivers manufacture concrete when rotating the drum at "mixing speed," no manufacturing occurs while the mixer-truck is driven to the delivery site and its drum rotates at "agitate speed." Therefore, costs associated with driving the mixer-truck to the delivery site and rotating the drum at "agitate speed" are nondeductible transportation costs or nondeductible costs of delivery.

Finally, the court concluded that the activities of dispatchers, which included communicating with drivers and customers, were indirect costs of manufacturing subject to the 4% cap. The court reasoned that inasmuch as the dispatchers took customers' orders, at least some of what they did was not direct manufacturing.

Apportionment

Virginia—Court Finds Failure of Proof in Alternative Apportionment Case

The Virginia Supreme Court held that the company failed to prove that use of the State's statutory cost of performance methodology for sourcing sales resulted in an unconstitutional or inequitable apportionment of the company's income to Virginia.[21] The company, an advisory firm, was headquartered in Virginia. Most of its revenue came from subscription fees for access to its online content. All of the company's online content was developed in Virginia and was housed on the company's servers located in Virginia. The servers were managed and controlled by the company's employees in Virginia. However, less than 5% of the company's subscribers were located in Virginia.

Applying Virginia's cost of performance methodology resulted in the company sourcing nearly 100% of its sales to Virginia. Moreover, the company contended that it paid corporate income taxes in 23 States besides Virginia that required the company to source its sales using a destination-based method of sourcing, resulting in over 100% of its sales being apportioned. The company argued that Virginia's cost of performance methodology operated unconstitutionally under these facts because it "wholly disregards the existence of interstate commerce" in a manner that resulted in substantial double taxation.[22] The court disagreed, finding that the U.S. Constitution does not require one of two taxing States to yield when both have lawful taxing regimes that tax the same income. Here, inasmuch as all of the company's online content was developed, housed, managed and controlled from Virginia, the company failed to prove that the statutory cost of performance method taxed income that was not fairly attributable to its economic activity in Virginia.

The company also argued that the statutory cost of performance method operated inequitably in violation of Virginia's statutory alternative apportionment provision. According to the Department of Taxation's regulation, the statutory method is inequitable when it results in double taxation and the inequity is attributable to Virginia, rather than a unique method of apportionment employed by another State.[23] The court found that the double taxation here was not attributable to Virginia, but rather to the more recent apportionment law changes by other States adopting single-sales factor apportionment and destination-based sourcing. Moreover, the court found that while these other States have adopted apportionment methods that are conceptually similar to each other, the methods often differ in their details considerably. Therefore, the taxpayer failed to prove that the methods employed by these other States are not unique.

Sales Tax

California—Customers Cannot Compel Retailers to Seek a Refund

The California Supreme Court held that customers who have paid sales tax on purchases they believe to be tax exempt cannot file a lawsuit to compel the retail sellers to seek a tax refund from the Department of Tax and Fee Administration when there has been no determination by the Department or a court that the purchases are exempt.[24] California retailers are required to pay the sales tax and may either charge customers a "sales tax reimbursement to the sales price," or pay the tax themselves and build the cost into the price that they charge to customers.[25] A retailer that believes that it has paid more sales tax than what is legally due may file a refund claim with the Department.[26] If it is ascertained that the customer has paid the retailer more sales tax than the retailer owes, the retailer is required to return the excess sales tax collected to the customer.[27] However, a customer who has overpaid sales tax has no statutory remedy to obtain a refund directly from the Department.

In a prior case, the California Supreme Court authorized a judicial remedy for customers when it had already been determined by the State taxing authority (at that time, the California Board of Equalization) that the customers were entitled to a refund.[28] Here, conversely, while the customers believed that their purchases were exempt, neither the Department nor a court had resolved the issue of taxability. The court declined to extend its prior holding to the facts here and instead held that in order to be eligible for a judicial remedy, customers must show as

a threshold requirement that a prior legal determination has established their right to a refund.

The court acknowledged as a concern that the State could potentially be unjustly enriched in the absence of a judicial remedy for customers, but found that when the taxability issue is disputed there is also a countervailing interest in the orderly administration of the sales tax. Finally, the court found that given the countervailing interests at stake and that nothing in the sales tax statutes establishes a customer's vested right to applicable sales tax exemptions, "due process does not require that tax exemptions flow to consumers in a more perfect manner."[29]

Massachusetts—eFax Service Is a Taxable Telecommunication Service

The Massachusetts Appellate Tax Board held that the company's eFax service was a taxable telecommunications service and the service was not exempt under the Federal Internet Tax Freedom Act (ITFA).[30] The company's eFax service begins when a sender sends a facsimile to a direct inward dial number (*i.e.*, a telephone number used only for incoming calls) assigned by the company to its customer and associated with the customer's email address. The facsimile is sent over the public switched telephone network to the customer's number using the sender's own equipment and telecommunications carrier. After the facsimile is routed to one of the company's servers, the server converts the facsimile into a portable document file (PDF), creates an email message to the customer containing the PDF, and delivers the email to the Internet, where it is delivered to the customer by an Internet service provider.

Massachusetts defines a taxable telecommunications service as "any transmission of messages or information by electronic or similar means, between or among points by wire, cable, fiberoptics, laser, microwave, radio, satellite or similar facilities but not including cable television."[31] The Board found that the company's eFax service constituted a telecommunications service inasmuch as "the critical component of the eFax service was transmission of messages or information—the facsimile—between points."[32] The Board rejected the company's attempt to distinguish between its eFax service and "traditional" facsimile services, finding that "[n]either the statute nor regulation nor any of the Commissioner's public written statements make a distinction between a traditional or non-traditional facsimile service."[33] The Board also rejected the company's argument that the eFax service was an exempt resale of Internet access under the ITFA inasmuch as the Board found that "the eFax service did not constitute the resale of Internet access and the appellant's provision of a hosted email address and personal electronic storage capacity did not place the eFax service within the ITFA definition of Internet access."[34]

Finally, the Board approved the Commissioner's calculation of the company's Massachusetts taxable sales by taking its total revenue as reported on its Federal Form 1120 and multiplying that amount by the percentage of the total U.S. population attributable to Massachusetts. Inasmuch as the company had not kept adequate records to otherwise determine its Massachusetts sales, the Board found the Commissioner's calculation to be "a reasonable alternative method."[35]

ENDNOTES

1. *Timbs v. Indiana*, SCt, 139 SCt 682, 687 (2019) (citation omitted).
2. *Ashland Specialty Co. v. Steager*, 818 SE2d 827 (W. Va. 2018), *petition for cert. filed*, No. 18-1053 (U.S. Feb. 6, 2019).
3. Petition for a Writ of Certiorari, *Ashland Specialty Co. v. Steager*, No. 18-1053 (U.S. Feb. 6, 2019).
4. *Dawson v. Steager*, SCt, 139 SCt 698 (2019).
5. 4 USC §111(a).
6. *Dawson*, 139 SCt at 704 (alterations in original) (citation omitted).
7. *Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep't of Revenue*, 814 SE2d 43 (N.C. 2018), *cert. granted*, 139 SCt 915 (2019).
8. *Baskins v. Okla. Tax Comm'n*, No. 18-807 (U.S. Apr. 8, 2019).
9. Okla. Stat. tit. 68, §2358(F).
10. 339 P3d 848 (Okla. 2014).
11. Okla. Stat. tit. 68, §2358(D).
12. *Greenscapes Home & Garden Prods., Inc. v. Testa*, No. 17AP-593, 2019 Ohio App. LEXIS 404 (Ohio Ct. App. Feb. 7, 2019), *appeal docketed*, No. 2019-0439 (Ohio Mar. 25, 2019).
13. *Id.*, at *35.
14. *Lorillard Tobacco Co. v. Dir., Div. of Taxation*, No. 008305-2007, 2019 N.J. Tax LEXIS 5 (N.J. Tax Ct. Feb. 27, 2019). Morrison & Foerster LLP represented the payor in this case.
15. N.J. Stat. Ann. §54:10A-4.4(b).
16. *Id.*, at (c)(1)(b).
17. N.J. Admin. Code §18:7-5.18(b)(3).
18. *Lorillard Tobacco Co.*, 2019 N.J. Tax LEXIS 5, at *2.
19. *U.S. Concrete, Inc. v. Hegar*, No. 03-17-00315-CV, 2019 Tex. App. LEXIS 2400 (Tex. App. Mar. 28, 2019).
20. Tex. Tax Code Ann. §171.1012.
21. *Corp. Exec. Bd. Co. v. Va. Dep't of Taxation*, 822 SE2d 918 (Va. 2019).
22. *Corp. Exec. Bd.*, 822 SE2d at 926
23. 23 Va. Admin. Code §10-120-280(B)(4)(b).
24. *McClain v. Sav-On Drugs*, 435 P3d 424 (Cal. 2019).
25. Cal. Rev. & Tax. Code §6051; Cal. Civ. Code §1656.1.
26. Cal. Rev. & Tax. Code §6901.
27. *Id.* §6901.5.
28. *Javor v. State Bd. of Equalization*, 527 P2d 1153 (Cal. 1974).
29. *McClain*, 435 P3d at 431.
30. *J2 Cloud Servs., Inc. v. Comm'r of Revenue*, No. C325426, 2019 Mass. Tax LEXIS 12 (Mass. App. Tax Bd. Feb. 27, 2019).
31. Mass. Gen. Laws ch. 64H, §1.
32. *J2 Cloud Servs., Inc.*, 2019 Mass. Tax LEXIS 12, at *20.
33. *Id.*, at *21.
34. *Id.*, at *22.
35. *Id.*, at *45.