Multistate Taxation

By Phil Tatarowicz and Ted W. Friedman

Developments in Multistate Taxation

Idaho

The Idaho State Tax Commission ("Commission") ruled that a corporation could not use its gross receipts from inventory buy/sell agreements to calculate the sales factor in its Idaho apportionment formula.[1] The corporation had agreed to deliver a certain grade, quality and quantity of a product at a future date to a party and, in return, receive an equivalent grade, quality and amount at that time or some other specified date. The Commission stated that, under its administrative income tax rules, amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code ("the Code") do not constitute gross receipts.

The Commission reasoned:

- the buy/sell agreements were an exchange of inventory in which there was no recognition of gain or loss;
- the swap was not the culmination of the earnings process;
- any value or cost differentials resulting from the exchange were treated as inventory and cost of goods sold adjustments; and
- any gain resulting from the exchanges was not recorded until the commodity was sold to a third party.

Consequently, the Commission determined that the gross amounts from the inventory buy/sell agreements did not meet Idaho's definition of gross receipts and could not, therefore, be used to calculate the corporation's sales factor.

Michigan

The Michigan Court of Appeals held that a manufacturing corporation's application of proprietary coatings to automobile parts constituted the sale of

Phil Tatarowicz is Of Counsel to Morrison & Foerster in Washington, D.C. and Professor of Law and Distinguished Visitor from Practice at Georgetown University Law Center.

Ted W. Friedman is an Associate at Morrison & Foerster LLP in New York, New York.

tangible personal property under Michigan's Single Business Tax (SBT) and should be sourced accordingly for purposes of determining the corporation's SBT liability.[2] The court reasoned that the corporation annually purchased tens of thousands of gallons of chemicals that it held in inventory and used to formulate its proprietary coatings and that the inventory and the proprietary coatings could be "seen, weighed, measured, felt, or touched." The court also reasoned that when the corporation applied its coatings to its customers' automotive parts it transferred title to the coatings to its customers and that such a transfer fell squarely within the definition of "sales" of "stock in trade," "indicating that the [corporation's] sales should be considered sales of tangible personal property." In addition, the court determined that the corporation's coating application services were incidental to the sales of its proprietary coatings. Accordingly, the court held that the corporation's business activity was properly characterized as the sale of tangible personal property.

* * *

The Michigan Court of Appeals held that a professional basketball team did not have to include royalties it received from national broadcasters in its tax base under Michigan's SBT because the royalties constituted income attributable to a separate entity whose activities were taxable under the SBT.[3] Along with 28 other teams, the basketball team had entered into an agreement which described the rights and regulations of the National Basketball Association (NBA) as a joint venture, under which the NBA's net income was credited equally to each team. The court determined that the income from the national broadcasters was attributable to the NBA because the NBA had entered into a contract pursuant to which it received royalties for allowing the national broadcasters to record and broadcast live games. Further, the court determined that the NBA was a joint venture, and not an agent of the basketball team, and was therefore subject to the SBT.

Therefore, the court held that the royalties from the national broadcasters were excludible from the basketball team's tax base under the SBT. With respect to the royalties received from the basketball team's local broadcast contract, the court held that such royalties constituted payments for "program matter" and, therefore, were specifically excluded from the SBT provision permitting deductions for royalties to the extent royalties are included in federal taxable income. Finally, the court held that the basketball team was allowed to apportion the revenue from its local broadcast contract based on home and away games.

New York

The New York Division of Tax Appeals, Administrative Law Judge Unit, held that two corporations sufficiently established that the filing of franchise tax reports on a separate basis would distort their true income and tax liability and, therefore, the corporations' filing of returns on a combined basis with their parent company was proper.[4] After concluding that the capital stock and unitary business requirements for the filing of a combined report had been satisfied, the Administrative Law Judge (ALJ) examined New York's "distortion" requirement. The ALJ found that, by demonstrating the existence of a cash management system, unreimbursed loans, unreimbursed services and funding provided to the corporations by the parent company, and the unreimbursed use of office and fashion show space, the corporations had met their burden of establishing that they were not conducting their unitary business with their parent corporation on arm's-length terms.

North Carolina

The North Carolina Department of Revenue adopted regulations regarding the Secretary of Revenue's authority to adjust a corporation's net income or to require the filing of a combined corporate income tax return for tax years beginning on or after January 1, 2012.[5] The regulations provide that a corporation has the burden of proving that a transaction has both reasonable business purposes and economic effects beyond the creation of state income tax benefits. The regulations also provide that the Secretary must rely on general principles of the common law economic substance doctrine as established under federal and state case law in applying the economic substance test and list facts and circumstances that must be considered in making an economic substance determination.

In addition, the regulations set forth provisions regarding centralized cash management systems, the determination of whether transactions are made at fair market value, alternative apportionment requests and combined return tax credits.

Oregon

The U.S. Bankruptcy Court for the District of Delaware held that the Oregon Department of Revenue's imposition of excise tax obligations on a parent company, whose only connection to Oregon was the use of its intellectual property (IP) by its subsidiaries in the State, violated both the Due Process and Commerce Clauses of the U.S. Constitution.[6] With respect to the Due Process Clause, the court reasoned that the parent company did not have sufficient "minimum contacts" with Oregon because it conducted no business activity within, or directed towards, the State. In addition, the court reasoned that the Oregon tax was not "rationally related to values connected with the taxing State" because the use of the parent company's IP by its subsidiaries was the parent company's only connection with Oregon, and it did not earn any income from the subsidiaries' use of the IP. With respect to the Commerce Clause, the court reasoned that the use of the parent company's IP in Oregon did not establish a "substantial nexus" with the State because it received no royalty payments, license fees or any other income from its subsidiaries for the use of the IP.

ENDNOTES

1 Decision, Idaho Tax Comm'n, Dkt. No. 21626 (Aug. 17, 2012) (released Dec. 19, 2012).
2 *PFG Enters. v. Dep't of Treasury,* Mich. Ct. App., No. 305948 (Dec. 27, 2012).
3 *Davidson v. Dep't of Treasury,* Mich. Ct. App., No. 308175 (Dec. 13, 2012).
4 *IT USA, Inc.*, N.Y.S. Div. Tax. App., DTA Nos. 823780 and 823781 (Dec. 20, 2012).
5 17 N.C. Admin. Code 05F .0101-.0601 (eff. Jan. 31, 2013).
6 *In re Washington Mutual, Inc.,* Bankr. D. Del., No. 08-12229 (Dec. 19, 2012).