Multistate Taxation

By Philip M. Tatarowicz and Ted W. Friedman

Developments in Multistate Taxation

U.S. Supreme Court

On August 23, 2013, an online retailer filed a petition for a *writ of certiorari* with the U.S. Supreme Court seeking review of the New York Court of Appeals' determination that a New York statute that subjects online retailers without physical presence in the state to New York sales and compensating use taxes does not, on its face, violate the Due Process or Commerce Clauses of the U.S. Constitution.[1] The New York Court of Appeals found that an online retailer may be presumed to have nexus in the state when a link to the retailer's website is hosted on the website of a New York resident who is compensated on a commission basis.

U.S. Court of Appeals for the Tenth Circuit

The U.S. Court of Appeals for the Tenth Circuit held that the Tax Injunction Act divested the U.S. District Court for the District of Colorado of jurisdiction over a marketing association's Commerce Clause claims and that it, therefore, had no jurisdiction to reach the merits of the Colorado Department of Revenue's appeal.[2] The district court had granted a permanent injunction against the enforcement of Colorado's statute imposing a use tax reporting requirement on out-of-state retailers who do not collect sales tax and had held that the statute violates the Commerce Clause of the U.S. Constitution because it: (i) directly regulates and discriminates against out-of-state retailers and interstate commerce; and (ii) imposes an undue burden on interstate commerce. The Tenth Circuit remanded the case to the district court to dismiss the marketing association's Commerce Clause

Philip M. Tatarowicz is Of Counsel to Morrison & Foerster LLP in Washington, D.C., and a Professor of Law, Graduate Tax Program, at Georgetown University Law Center.

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

claims for lack of jurisdiction and to dissolve the permanent injunction.

Indiana

The Indiana Department of Revenue ruled that the income a corporation received from the sale of a subsidiary constituted business income under the "functional test" contained in the state's "business income" statute.[3] The corporation specialized in science and technology disciplines, including high-performance materials, specialty chemicals and products in certain specialized industries. The Department explained that, under the functional test, the focus is on the property being disposed of and the relationship between the property at issue and a corporation's business operations. The Department reasoned that the acquisition and management of the subsidiary were "integral" to the corporation's business operations in its specialized industry line of business because the assets of the subsidiary were "essential to the creation" of the line of business and, therefore, that the proceeds from the sale of the subsidiary qualified as business income.

In addition, the Department disallowed certain interest expense deductions taken by the corporation in relation to an intercompany loan from a different subsidiary. According to the audit, the interest rate on the loan was approximately twice that of the prime rate during the audit years, there was no timely expectation of repayment, and the loan was "apparently structured in such a way as to gain a substantial and disproportionate state tax advantage." The Department concluded that the loan was "not in substance a loan" and that the corporation could not "utilize the interest expense deduction to distort its Indiana income tax obligations by unfairly reducing its taxable Indiana income."

South Carolina

The South Carolina Department of Revenue ruled that an engineering service business should apportion its income using gross receipts based on where its engineering services are performed.[4] The Department also ruled that engineering services performed for the business' customers by independent contractors, as well as employees, in South Carolina should be considered in determining the business' gross receipts sourced to the state for apportionment purposes.

Texas

The Texas Comptroller of Public Accounts determined that a company engaged in the business of selling prepaid cell phone cards was not entitled to a cost of goods sold ("COGS") deduction for the cost of purchasing the calling cards in calculating its taxable margin.[5] The Comptroller stated that the company's customers "are paying for the telecommunication services embedded in the calling card, and not for the card itself." The Comptroller determined that prepaid telephone calling cards are not tangible personal property and, therefore, are not "goods" that may be included in the calculation of the COGS deduction.

Virginia

The Virginia Tax Commissioner ruled that a wholesale distributor of computer cables and related parts was not entitled to an industrial manufacturing exemption for manufacturing machinery that the distributor purchased.[6] The distributor purchased machinery that was used by its sister corporation to produce specialized items for sale only to the distributor. The sister corporation had no employees, payroll or capital equipment, but paid a management fee to the corporation for the use of certain production employees hired by the distributor to operate the machinery. The distributor contended that it qualified for Virginia's industrial manufacturing exemption on the basis that it was the alter ego of its sister corporation, that its sister corporation was a manufacturer eligible for the industrial manufacturing exemption and that it purchased the contested machinery for exempt use in the production process of its sister corporation. However, the Commissioner reasoned that, while the distributor purchased the machinery, there was no indication that it manufactured or processed products for sale or that it used the machinery in its own industrial production process during the audit period. The Commissioner also reasoned that, because the manufacturing activities were performed by a separate legal entity, they must be treated as separate activities apart from the corporation's business. Therefore, the Commissioner concluded that the distributor was not engaged as an industrial manufacturer or industrial processor during the audit period and was not eligible for an exemption.

Endnotes

[1] *Amazon.com, LLC v. Dep't of Tax'n & Fin.*, NY Ct. App., 965 N.Y.S.2d 61 (2013), *petition for cert. filed*, SCt, No. 13-259 (Aug. 23, 2013).

[2] *Brohl v. Direct Marketing Ass'n*, CA-10, No. 12-1175 (Aug. 20, 2013).

[3] Letter of Findings No. 02-20120140 (Ind. Dep't of Rev., Aug. 28, 2013).

[4] SC Private Letter Ruling #13-3 (S.C. Dep't of Rev., Aug. 7, 2013).

[5] Decision, Hearing Nos. 108,113-108,115, STAR No. 201307741H (Tex. Comptroller of Pub. Accounts, Jul. 6, 2013).

[6] Rulings of the Comm'r, No. 13-152 (Va. Dep't of Tax'n, Aug. 2, 2013).