Looking Back: Significant State and Local Tax Decisions of 2017

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In this edition of From the Front Lines, the authors review noteworthy state tax litigation of 2017 in areas such as nexus, deductions and addbacks, combined reporting, apportionment, business/nonbusiness income, and discrimination.

This article highlights court and tribunal decisions that addressed key concepts such as nexus, apportionment, and others.

I. Nexus

Nexus continues to be an overarching issue for income taxes and sales and use taxes. In 2017 many states attempted to circumvent and, in some instances, directly challenge the U.S. Supreme Court's decisions in *National Bellas Hess Inc. v. Department of Revenue of Illinois* [1] and *Quill Corp. v. North Dakota*.[2]

A. California

In *Swart Enterprises Inc. v. Franchise Tax Board*, the California Court of Appeal held that an out-of-state corporation holding an interest in a California limited liability company was not subject to state franchise tax.[3] The corporation, which was headquartered in Iowa and operated a farm in Kansas, had no physical presence or sales in California, and was not registered to do business in the state. Its only connection to California was a 0.2 percent interest in a California LLC that operated a capital equipment business. The court held that under those circumstances, the corporation was akin to a limited partner and could not be deemed "doing business" in California for franchise tax purposes.

B. Colorado

In *Target Brands Inc. v. Department of Revenue*, the Colorado District Court held that a company had substantial nexus based on its ownership of intangible property.[4] The company licensed intangible property to its corporate parent, a retailer, who paid royalties to the company based on its sales in Colorado and elsewhere. The company had no physical presence in Colorado and, because it was an 80/20 company, was not includable in the corporate parent's Colorado combined return. Nevertheless, the court held that the company had substantial nexus with Colorado because of its "conscious decision to exploit" the state's market.

C. Georgia

In *Scholastic Book Clubs Inc. v. Georgia Department of Revenue*, the Georgia Tax Tribunal

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[1] 386 U.S. 753 (1967).

[2] 504 U.S. 298 (1992).

[3] 212 Cal. Rptr. 3d 670 (Cal. Ct. App. 2017).

[4] No. 2015CV33831 (Colo. Dist. Ct. Jan. 27, 2017).

held that a corporation had substantial nexus with Georgia and was, therefore, required to collect use tax from its Georgia customers.[5] The corporation sent catalogs and order forms for books and other educational materials to teachers in Georgia, who then distributed them to their students. The corporation fulfilled the orders from locations outside Georgia and shipped the products to the teachers who submitted the orders. The teachers earned bonus points for orders that they submitted and could redeem the points for educational materials to be used in their classrooms. The tribunal held that the corporation was statutorily required to collect use tax. The tribunal further held that the statutory requirement was valid under the commerce clause since the teachers' activities in Georgia were "significantly associated with [the corporation's] ability to establish and maintain a market in Georgia."

D. Iowa

In *Romantix Holdings Inc. v. Iowa Department of Revenue*, the Iowa Court of Appeals held that a parent corporation could not be included in a consolidated return with its subsidiaries because it lacked nexus with Iowa.[6] The subsidiaries operated adult bookstores and used intellectual property owned by the parent corporation in Iowa. The subsidiaries sought to include the parent in their consolidated return to use its interest expense deductions. However, the court held that the parent corporation's ownership interest in the subsidiaries and its intangible property were insufficient to create nexus with Iowa.

E. Massachusetts

In *American Catalog Mailers Association v. Heffernan*, the Massachusetts Superior Court of Suffolk County ruled that a Department of Revenue directive requiring internet vendors to collect and remit sales and use tax was invalid.[7] The directive required an internet vendor with a principal place of business located outside Massachusetts to collect and remit sales and use tax if it had more than $500,000 in Massachusetts sales and made sales for delivery into the state in 100 or more transactions. The court held that the directive was invalid because it announced a new policy that substantially altered the rights and interests of the regulated parties and, therefore, had to be promulgated under the Massachusetts Administrative Procedures Act, which the DOR had not followed.

The DOR revoked the directive on the same day that this decision was issued. On September 22 the DOR promulgated a regulation requiring internet vendors to collect sales and use tax based on the same criteria provided in the directive.[8]

F. New Jersey

In *Preserve II Inc. v. Division of Taxation*, the New Jersey Tax Court found that an out-of-state corporation that was a limited partner in two partnerships that acquired land and built homes in New Jersey had nexus with the state for corporation business tax purposes.[9] The court found that the corporation had nexus with New Jersey based on evidence that the lines between the corporation, the partnerships, and their general partners were "completely blurred."

G. South Dakota

In *South Dakota v. Wayfair Inc.*, the South Dakota Supreme Court held that South Dakota's law requiring remote sellers to collect sales and use tax was unconstitutional.[10] The law requires a remote seller with more than $100,000 of gross receipts or 200 or more separate transactions in the state to collect sales and use tax from South Dakota customers — even if it has no physical presence in the state. The court held that the law violated the commerce clause, reasoning that it was bound to follow *Quill*.[11] On January 12, 2018, the U.S. Supreme Court granted the state's petition for certiorari.[12]

[5] No. 1552367 (Ga. Tax Trib. Feb. 14, 2017).

[6] No. 16-0416 (Iowa Ct. App. May 3, 2017).

[7] No. SUCV2017-1772 BLS1 (Mass. Super. Ct. June 28, 2017).

[8] 830 Mass. Code regs. 64H.1.7.

[9] Nos. 010921-2013 *et al.* (N.J. Tax Ct. Oct. 4, 2017).

[10] 901 N.W.2d 754 (S.D. 2017).

[11] 504 U.S. 298 (1992).

[12] U.S. Supreme Court No. 17-494.

H. Texas

In *ETC Marketing Ltd. v. Harris County Appraisal District*, the Texas Supreme Court held that a county could constitutionally impose an ad valorem tax on a company's natural gas.[13] The natural gas was held at a storage facility until the company ordered that it be shipped to downstream customers. The court held that the county where the storage facility was located could impose an ad valorem tax on the natural gas because the natural gas had substantial nexus with Texas. The court acknowledged that the natural gas would lack substantial nexus with the county if it were "in transit," but concluded that the natural gas was not "in transit" because it was not held in the county as a necessary stop in the gas's interstate journey, but to ensure that the company could meet peak demand for its product.

On December 11 the U.S. Supreme Court denied the company's petition for certiorari.

II. Deductions and Addbacks

A. Indiana

In *E.I. DuPont de Nemours & Co. v. Indiana Department of State Revenue*, the Indiana Tax Court held that a company properly deducted its intercompany interest expenses.[14] The company received loans from its affiliates; interest accrued while the loans were outstanding, but the company was not required to pay any interest until the loans came due. The company deducted the interest expense that accrued while the loans were outstanding in computing its Indiana tax liability. The court held that the state could not disallow the deduction, based on its finding that the loans giving rise to the interest had a business purpose and economic substance.[15]

B. New Jersey

In *BMC Software Inc. v. Division of Taxation*, the New Jersey Tax Court held that a company was not required to add back royalty payments made to its corporate parent. The parent corporation entered into a licensing agreement with the company that granted it a nonexclusive right to license, market, and distribute the parent's software.[16] In exchange, the company paid a royalty equal to 55 percent of its revenue derived from the company's licensing of the parent's software to third parties. The court held that it would be unreasonable to require the company to add the royalties back to its federal taxable income, as the transaction between the company and the parent corporation was "substantively equivalent to an unrelated party transaction."

C. Pennsylvania

In *Nextel Communications of the Mid-Atlantic Inc. v. Commonwealth of Pennsylvania*, the Pennsylvania Supreme Court held that the state's flat cap on net operating loss deductions violated the Pennsylvania Constitution's uniformity clause.[17] The uniformity clause provides that "all taxes shall be uniform, upon the same class of subjects."[18]

For the 2007 tax year Pennsylvania permitted a taxpayer to deduct from its taxable income net losses limited to the greater of $3 million or 12.5 percent of its taxable income. Thus, taxpayers with $3 million or less of net income could eliminate their entire tax liability using an NOL deduction, whereas taxpayers with more than $3 million of net income could not.

The court found that the flat $3 million cap distinguished between two classes of taxpayers: taxpayers with net incomes of $3 million or less and taxpayers with net incomes of more than $3 million. The court further found that this classification was unreasonable and arbitrary because it was based solely on the value of the property (that is, income) involved and, on that basis, violated the uniformity clause.

D. Texas

In *American Multi-Cinema Inc. v. Hegar*, the Texas Court of Appeals held that a company

[13] 528 S.W.3d 70 (Tex. 2017).

[14] 79 N.E.3d 1016 (Ind. T.C. 2017). Note that Morrison & Foerster was lead counsel for E.I. DuPont de Nemours & Co. in this matter.

[15] This case also involved a business/nonbusiness income issue that is discussed later in this article.

[16] 30 N.J. Tax 92 (Tax Ct. 2017).

[17] No. 6 EAP 2016 (Pa. Oct. 18, 2017).

[18] Pa. Const. art. VIII, section 1.

operating movie theaters sold tangible personal property and could deduct costs associated with its movie theater auditoriums.[19] Under Texas law, a taxpayer may deduct its costs of goods sold in calculating its franchise tax base, and the term "goods" includes tangible personal property. The court held that the films the company exhibited were tangible personal property, which it sold to customers who viewed the films in the company's auditoriums. Further, the court held that the company could deduct its expenses associated with exhibiting films in its auditoriums as costs of goods sold. The state has appealed the decision to the Texas Supreme Court.[20]

E. Virginia

In *Kohl's Department Stores Inc. v. Virginia Department of Taxation*, the Virginia Supreme Court, in a 4-3 decision, held that the subject-to-tax safe harbor to the royalty addback is ambiguous and applies only to the extent that the royalties are actually taxed by another state.[21] Also, the court agreed with the company's alternative argument that a portion of the royalties qualify for the safe harbor when:

- the royalties are taxed by states that require the royalty payor to add back the royalty payments; or
- the royalties are taxed by states that require combined or consolidated reporting.

Three justices dissented and agreed with the company that the subject-to-tax safe harbor does not require that the royalties actually be taxed. On September 25 the taxpayer filed a petition for rehearing.

III. Combined Reporting

A. Colorado

In *Agilent Technologies Inc. v. Department of Revenue*, the Colorado Court of Appeals — affirming a Denver District Court decision — held that the state could not forcibly combine a corporation's subsidiary that derived its income solely from investments in foreign entities.[22] The appellate court held that a state statute requiring the inclusion of a corporation in a Colorado combined return if more than 20 percent of its property and payroll are within the United States precluded combination of the corporation's subsidiary. According to the court, the state's regulation, which provides that a corporation without its own property or payroll cannot be in a combined return, was not limited to foreign sales corporations and supported the court's interpretation. The appellate court also ruled that neither a Colorado antiabuse statute nor the economic substance doctrine gave the state authority to include the subsidiary in its parent's combined return.

B. Minnesota

In *Ashland Inc. v. Commissioner of Revenue*, the Minnesota Supreme Court held that a corporation may include in its combined report an entity organized under foreign law that elects to be treated as a disregarded entity for federal income tax purposes.[23] The entity at issue, an SARL organized under the laws of Luxembourg, elected to be classified as a disregarded entity for federal income tax purposes. The court held that the corporation could include the SARL in its combined report because the SARL did not exist for federal income tax purposes and, therefore, was not a foreign entity required to be excluded under Minnesota's water's-edge statute.

IV. Apportionment

A. California

In *JetSuite Inc. v. County of Los Angeles*, the California Court of Appeal held that Los Angeles County could impose a property tax on the entire value of a company's jets that traveled across state lines.[24] The jets at issue spent roughly 60 percent of their time in California. The court stated that under the federal due process clause, a state having situs over personal property may tax all

[19] No. 03-14-00397-CV (Tex. App. Jan. 6, 2017).

[20] Texas Supreme Court No. 17-0464.

[21] 803 S.E.2d 336 (Va. 2017). Note that Morrison & Foerster was lead counsel for Kohl's Department Stores Inc. in this matter.

[22] No. 16CA0849 (Colo. App. Nov. 2, 2017). Note that Morrison & Foerster was lead counsel for Agilent Technologies Inc. in this matter.

[23] 899 N.W.2d 812 (Minn. 2017).

[24] 16 Cal. App. 5th 10 (Cal. Ct. App. 2017).

that property's value unless one or more other states also have situs over that property. Based on this standard, the court concluded that Los Angeles could tax the jets' entire value because the company did not show that its jets' contacts with states other than California were sufficiently habitual, regular, or systematic to create a taxable situs in other states.

B. Minnesota

In *Associated Bank NA v. Commissioner of Revenue*, the Minnesota Tax Court held that the Department of Revenue could not rely on alternative apportionment to disregard a combined group's corporate structure and include in the group's apportionment factors loans that had been transferred to two LLCs.[25] (Businesses treated as partnerships, like those LLCs, are not financial institutions for Minnesota tax purposes and therefore apportion their income using the general apportionment formula, which excludes interest income and intangible property from the factors.)

The court acknowledged that Minnesota's apportionment scheme created a loophole, but concluded that it was the Legislature's prerogative to close a loophole that it created. The Minnesota Supreme Court granted the DOR's petition for certiorari and oral argument was heard November 1.[26]

C. New York

In the *Matter of Catalyst Repository Systems Inc.*, a New York state administrative law judge determined that a company's receipts were derived from services and therefore must be sourced outside New York.[27] The company, based in Colorado, provided litigation support services. Under New York law for the years at issue, New York receipts include receipts derived from services performed in New York. The ALJ found that the receipts at issue were service receipts and, because the company performed the services in Colorado, they could not be sourced to New York. The ALJ rejected the state's argument that the receipts were not service receipts because they were derived without human involvement. The state has appealed the decision to the New York State Tax Appeals Tribunal.

D. South Carolina

In *DIRECTV Inc. v. South Carolina Department of Revenue*, the South Carolina Court of Appeals held that a satellite television provider was required to source 100 percent of its subscription receipts from South Carolina customers to the state.[28] Under South Carolina law, service receipts are sourced to South Carolina to the extent the income-producing activity is performed in the state.

The court found that the company's income-producing activity was the delivery of signals, rejecting the company's argument that its income-producing activity included its four "value drivers": content development, marketing, broadcast operations, and customer service — which the court characterized as "income-anticipatory" activities. The court then concluded that sourcing 100 percent of the company's subscription receipts from South Carolina customers to South Carolina best reflected the company's activity in the state.

E. Virginia

In *Corporate Executive Board v. Virginia Department of Taxation*, the Circuit Court of Arlington County held that Virginia's statutory apportionment method as applied to a company was constitutional, and that the company was not entitled to use an alternative apportionment method.[29]

The company sold subscriptions to web-based data that it created, developed, and improved at its Virginia headquarters. Service receipts are sourced based on costs of performance and, as a result, nearly all the company's receipts were sourced to Virginia. The company argued that its receipts should be sourced based on its customers' billing addresses because the statutory apportionment method, as applied, resulted in a

[25] No. 8851-R (Minn. T.C. Apr. 18, 2017).

[26] Minn. Supreme Court No. A17-0983.

[27] No. 826545 (N.Y.S. Div. of Tax App. Aug. 24, 2017).

[28] 804 S.E.2d 633 (S.C. Ct. App. 2017).

[29] No. CL 16-1525 (Va. Cir. Ct. Sept. 1, 2017).

tax on income generated outside Virginia's borders, thereby violating the U.S. Constitution.

The court disagreed, finding that the company failed to prove by clear and cogent evidence that its income attributed to Virginia under the statutory method was all out of proportion with its Virginia activities, or that the statutory apportionment method led to a grossly distorted result. The court also rejected the company's argument that it was entitled to relief under Virginia's alternative apportionment statute, finding that the company failed to prove that the statutory formula created an inequitable result.

V. Business/Nonbusiness Income

A. California

In *Fidelity National Information Services Inc. v. Franchise Tax Board*, the California Court of Appeal upheld a trial court's decision that stock owned by a company was integral to that company's business, but remanded the case on the issue whether the stock was an integral part of the company's business when it was sold.[30] The company owned 29 percent of another business's stock, which the company had purchased to reduce the costs of its operations. However, the company ultimately sold the stock for a gain. In determining whether the gain was apportionable business income, the court held that the relevant inquiry was whether the stock was integral to the company's business when it was sold, not whether the stock had been integral to the company's business at any point in time.

B. Indiana

In *E.I. DuPont de Nemours & Co v. Indiana Department of State Revenue*, the Indiana Tax Court held that a company's gain from its sale of partnership interests was nonapportionable business income.[31] The partnership at issue operated independently from the company, maintaining its own management team, research and development activities, employees, policies, and procedures. The court held that the company's gain from the sale of its partnership interests was nonapportionable under Indiana's statute because neither the functional nor transactional tests were satisfied. Further, the court held that the gain was nonapportionable under the U.S. Constitution because the company and the partnership were not unitary.

VI. Discrimination

It is amazing how many discriminatory statutes have been and continue to be enacted by state lawmakers. While many discrimination challenges are successful, that was not the result in two cases in 2017.

A. Florida

In *Florida Department of Revenue v. DIRECTV Inc.*, the Florida Supreme Court held that Florida's communications services tax (CST) did not discriminate against interstate commerce.[32] Florida imposed a CST rate on satellite television providers that was higher than the CST rate imposed on cable television providers. The court found that this difference in rates did not violate the commerce clause of the U.S. Constitution because cable companies were not local interests, as Florida's four largest cable companies were not headquartered in Florida and did not produce anything in the state.

On September 8 one of the parties challenging the CST — EchoStar Satellite LLC, n/k/a Dish Network LLC — filed a petition for certiorari with the U.S. Supreme Court.[33] On January 8, 2018, the Court denied the petition.

B. Nevada

In *Southern California Edison v. State of Nevada Department of Taxation*, the Nevada Supreme Court held that a company was not entitled to a refund of a use tax that discriminated against interstate commerce.[34] A Nevada statute provides that proceeds from mines in Nevada (but not elsewhere) are exempt from use tax. Although the statute discriminates against interstate commerce,

[30] No. C081522 (Cal. Ct. App. July 27, 2017).

[31] 79 N.E.3d 1016 (Ind. T.C. 2017). Note that Morrison & Foerster was lead counsel for E.I. DuPont de Nemours & Co. in this matter.

[32] 215 So. 3d 46 (Fla. 2017).

[33] U.S. Supreme Court No. 17-379.

[34] 398 P.3d 896 (Nev. 2017).

the court held that the company was not entitled to a refund of tax paid on its use of coal mined outside the state because the company failed to show the existence of similarly situated competitors that benefited from the statute's exemption.

On January 16, 2018, the U.S. Supreme Court denied the company's a petition for certiorari.[35]

VII. Miscellaneous

A. Illinois

In *Hertz Corp. v. City of Chicago*, the Illinois Supreme Court struck down a Chicago regulation imposing use tax collection obligations on car rental locations outside the city's borders.[36]

Chicago taxes the use of leased personal property within city limits. The city comptroller's office issued a regulation (Ruling 11) that applied to car rental locations within 3 miles of Chicago's border and created a presumption that cars leased to Chicago residents — as indicated on their driver's licenses — are subject to the city's use tax, and cars leased to non-Chicago residents are not subject to that tax. The presumption could be rebutted by obtaining a written statement from the lessee stating whether the lessee planned to use the rental primarily in Chicago.

The court held that Ruling 11 violated the Illinois Constitution's home rule provision because it imposed a tax on a transaction that occurred outside the city's jurisdiction.

B. New Jersey

In *State of New Jersey ex rel. Campagna v. Post Integrations Inc.*, the New Jersey Superior Court, Appellate Division, affirmed the trial court's dismissal of the plaintiff's complaint, which alleged that several companies violated New Jersey's False Claims Act (FCA) by knowingly concealing obligations to pay the alternative minimum assessment as well as assessments and fees imposed by the New Jersey Business Corporation Act.[37] The defendants, out-of-state credit card processors, moved to dismiss, arguing that the FCA specifically bars suits regarding taxes. The trial court ruled in favor of the defendants, and the appellate court affirmed. The appellate court found that it was the "clear" intent of the Legislature to exclude taxes from the purview of the FCA.

C. New York

In *Matter of Stephen C. Patrick, et al.*, a New York state ALJ held that the former chief financial officer of Colgate-Palmolive — who was based in New York City while CFO but retired and moved to Paris to be with his wife, a French domiciliary with whom he rekindled a relationship after more than 40 years apart — clearly established that he was no longer domiciled in New York, and therefore could no longer be taxed as a New York state and city resident.[38] The ALJ based its decision largely on the individual's "credible" and "unequivocal" testimony that he thereafter considered Paris to be his home. His retention of a New York City apartment, and the fact that he continued to spend considerable time in the city, mostly for medical treatment, did not negate his clear intent.

D. Oklahoma

In *In re Hare*,[39] the Oklahoma Supreme Court held that an individual owning interests in passthrough entities could deduct a capital gain arising from the entities' sales of substantially all their assets.

The individual owned 2 percent interests in two Oklahoma S corporations that sold substantially all their assets to a third party. As a result, the individual realized a capital gain for federal tax purposes. Oklahoma permits individual taxpayers to deduct from their taxable income capital gains arising from sales of direct or indirect ownership interests in Oklahoma companies (that is, companies with headquarters in Oklahoma).

The court held that the S corporations' sales of their assets constituted sales of indirect ownership interests in Oklahoma companies by

[35] U.S. Supreme Court No. 17-755.

[36] 77 N.E.3d 606 (Ill. 2017).

[37] 166 A.3d 1177 (N.J. Super. Ct. App. Div. 2017).

[38] DTA Nos. 826838 and 826839 (N.Y.S. Div. of Tax App., June 15, 2017). Note that Morrison & Foerster represented Patrick in this matter.

[39] 398 P.3d 317 (Okla. 2017).

the individual. The court noted that if the individual had sold his stock in the S corporations, he would have been eligible for the deduction, and concluded that whether a transaction is structured as a sale of assets or a sale of stock, the tax treatment of the gain should be the same.

VIII. Conclusion

This past year saw decisions on an array of important issues, and we were happy to play a role. With many of these decisions having been appealed, and many more important cases in the pipeline, we are looking forward to 2018. ■