**CRAIG B. FIELDS** is a Partner in the New York City office of Morrison & Foerster LLP. **EUGENE J. GIBILARO** is an Associate in the New York City office of Morrison & Foerster LLP.

# *Current Developments in State and Local Tax*

*Overview of Recent Court Decisions Affecting State and Local Taxation in Several States*

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.

## Constitutional Nexus

### Two State High Courts Hold That Imposition of Income Tax on Trusts Violates Due Process

#### *Minnesota*

The Minnesota Supreme Court held that the State's attempt to tax trusts as residents and, thus, on their income from all sources, violated due process inasmuch as the trusts lacked sufficient relevant contacts with Minnesota during the applicable tax year.[1] Minnesota law defines a "resident trust" to include "an irrevocable trust, the grantor of which was domiciled in this state at the time the trust became irrevocable."[2] Here, at the time the trusts became irrevocable in 2011, the grantor was domiciled in Minnesota, making the trusts "resident trusts" subject to Minnesota income tax on their income from all sources.

In 2014, due to their status as resident trusts, the trusts were subject to tax on the full amount of their income from all sources. The trusts argued that Minnesota's taxation of the trusts as resident trusts violated due process inasmuch as the trustee was not a Minnesota resident, the trusts were not administered from Minnesota, the records of the trusts' assets and income were maintained outside of Minnesota, some of the trusts' income was derived from investments with no direct connection to Minnesota, and three of the four trust beneficiaries resided outside of Minnesota.

The court agreed with the trusts, concluding that "allowing the State to look to historical contacts unrelated to the tax year at issue risks leaving taxpayers unaware of whether or when their contacts with Minnesota may justify the imposition of a tax." The court found that the trusts' only relevant contacts with Minnesota in 2014 for purposes of due process were that "questions of law" arising under the trust agreements were to be decided under Minnesota law and trust documents were physically stored in Minnesota. The court held that "[a]ttributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the Trusts from Minnesota during the tax year at issue."

### *North Carolina*

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.[3] North Carolina law imposes tax on the income of trusts and "[t]he tax is computed on the amount of the taxable income of the … trust that is for the benefit of a resident of [North Carolina]."[4] Here, the trust was created in New York, the settlor was a New York resident, and the trust was governed by the laws of New York. During the tax years at issue, the trustee was a resident of Connecticut. The trust's only connection with North Carolina was that the trust's primary beneficiary was a resident of North Carolina.

The court rejected the Department's argument that the North Carolina residency of the trust's primary beneficiaries was a sufficient connection with North Carolina to satisfy due process and ruled that the "trust has a legal existence apart from the beneficiary" and that "the trust itself must have 'some definite link, some minimum connection' with the taxing state by 'purposefully avail[ing] itself of the benefits of an economic market' in that state."[5] The court further observed that "the United States Supreme Court has directed that '"minimum contacts" analysis looks to the defendant's contacts with the forum State itself, not the defendant's contacts with persons who reside there.'"[6] Accordingly, the "[m]ere contact with a North Carolina beneficiary does not suffice" to satisfy due process and the imposition of North Carolina income tax on the trust here was unconstitutional.

## Statutory Nexus

### Alabama—Out-of-State Seller Not Required to Collect Use Tax

The Court of Civil Appeals of Alabama held that the Alabama activities of an out-of-state seller of tangible property did not subject the seller to a use tax collection obligation under the Alabama statutes that were applicable during the tax period at issue.[7] The statute required all sellers of tangible property at retail to collect Alabama use tax if they, among other things, "[e]mploy[ed] or retain[ed] under contract any representative … for the purpose of selling, delivering, or the taking of orders for the sale of tangible personal property," or "[m]aintain[ed] any other contact with [Alabama] that would allow [Alabama] to require the seller to collect and remit the tax due under the provisions of the Constitution and laws of the United States."[8]

Scholastic Book Clubs, Inc. (SBC) sells books and other educational materials by mail order and via the Internet from locations outside of Alabama. Schoolteachers in Alabama may, if they wish, distribute SBC catalogues and order forms to their students, consolidate all student orders into a single master order, collect all monies for the master order, and mail the master order form along with the monies to SBC's offices outside of Alabama. The schoolteacher is then responsible for accepting and distributing the ordered materials to the students, and the teachers who perform these activities receive bonus points that may be redeemed for materials to be used solely in the classroom.

In its appeal, the Department did not argue that the Alabama teachers were employees or contracted representatives of SBC in Alabama, but that SBC's use of the teachers as its implied agents in Alabama constituted "any other contact" with Alabama that permitted Alabama to require SBC to collect its use tax. The court rejected this argument, concluding that if the activities of the Alabama teachers were sufficient to require SBC to collect use tax, then the Alabama statutory provision imposing tax collection obligations based on the activities of employees or contracted representatives would be rendered "a nullity and ineffective."

Finally, after the completion of the record and submission of briefs in this case, but before the case was decided, the U.S. Supreme Court decided *South Dakota v. Wayfair, Inc.*, which overruled the requirement that an out-of-state seller must have a physical presence in a State in order for that State to constitutionally impose a tax collection obligation.[9] However, the Court here did not reach the issue of the permissible reach of Alabama's taxing authority under *Wayfair*, finding that the Alabama taxing statute in this case "did not impose an obligation to collect use tax on SBC based on its activities."

### Oregon—Physical Presence Not Required for Corporate Income Tax Subjectivity

The Oregon Supreme Court held that two banks without a physical presence in Oregon were nonetheless subject to Oregon's corporate income tax inasmuch as the banks derived income from Oregon sources.[10] Oregon law provides that its corporate income tax is imposed upon taxable income "derived from sources within" Oregon and that income from "sources within" Oregon includes: (1) income from tangible or intangible property located in Oregon; (2) income from tangible or intangible property with an Oregon situs; and (3) income from any activities carried on in Oregon.[11] The banks here did not have any property, offices, or employees in Oregon. However, the banks solicited in Oregon and charged their Oregon customers nearly $150 million in fees during each of the tax years in issue.

The court rejected the banks' argument that the three statutory examples of taxable income "derived from sources within" Oregon implied that the statute required that the company have a physical presence in the State. Instead, the court found that "[t]he examples imply only the taxpayer's existence as recipient of the income, and they say nothing about where the taxpayer must be located." The court concluded that the statute requires only that "there must be income from 'sources within this state,' and the taxpayer must receive that income" and "[n]othing about the statutory text or context suggests that the taxpayer must also have some physical presence here."

## Deductions

### Utah—Deduction Permitted for Related Party Royalties at Arm's-Length Price

The Utah Supreme Court held that Utah law grants the Utah State Tax Commission the authority to allocate income between related corporations only when the related corporations engage in transactions that do not meet the arm's-length standards of section 482 of the Internal Revenue Code ("Code Sec. 482").[12] Utah law provides that when two corporations are commonly controlled, "the commission is authorized to distribute, apportion, or allocate gross income or deductions between or among such corporations, if it determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such corporations."[13]

The Commission argued that this provision granted it broad authority to allocate income "whenever it, in its sole discretion, believed it was necessary to prevent tax evasion or to make a corporation's returns clearly reflect its income." The court disagreed, finding that the relevant Utah provision was "modeled" on the federal predecessor to Code Sec. 482 and "when [the] Legislature copies a federal statue, federal interpretations of the statute constitute persuasive authority as to the statute's meaning." Therefore, the court reasoned that, similar to Code Sec. 482, Utah's provision does not permit allocation when commonly controlled corporations engage in transactions at arm's-length prices. Here, as the Commission did not challenge the lower court's finding that the royalties at issue were at an arm's-length price, the Commission "improperly allocated [the taxpayer's] income."

## Apportionment

### Texas—Taxpayer Properly Reported Its Apportionment Factors

The District Court of Travis County, Texas concluded that the taxpayer, a satellite radio provider, properly apportioned its subscription revenues to Texas during the years in issue.[14] Texas law provides that service revenue is apportioned to Texas if the service is performed in Texas.[15] The Comptroller's regulation further explains that "[i]f services are performed both inside and outside Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas."[16]

Here, the taxpayer apportioned its subscription revenues to Texas based on the locations where its primary production facilities were located, none of which were in Texas. The Comptroller audited and determined that the taxpayer was required to source its subscription revenues to Texas to the extent that its satellite transmissions were received by the taxpayer's subscribers in Texas. The taxpayer offered expert testimony that the Comptroller was seeking to impose market-based sourcing in this case, despite the applicable Texas statute requiring that service revenue be sourced to where the service is performed. The court agreed with the taxpayer, concluding that its subscription revenues should be apportioned to Texas based upon the "fair value" of the service performed in Texas and reversed the Comptroller's adjustments.

## Combination

### California—Combined Reporting Withstands Constitutional Challenge

The Court of Appeal of California held that California's disparate treatment of interstate unitary businesses and intrastate unitary businesses was not unconstitutional because California had a legitimate reason for the disparate treatment that could not be served by reasonable nondiscriminatory alternatives.[17] Under California law, interstate unitary businesses are required to report their income using the combined reporting method, while intrastate unitary businesses may report their income using either the combined reporting method or separate accounting.[18] In a prior decision in this case, the Court of Appeal held that California's statutory scheme was facially discriminatory and remanded for a determination of whether the disparate treatment could withstand strict scrutiny, that is, whether the statutory scheme "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives."[19]

The trial court found that California's statutory scheme withstood strict scrutiny and the Court of Appeal agreed. The trial court found that California had a legitimate interest "in requiring combined reporting for interstate unitary businesses in order to accurately measure and fairly apportion the income from all functionally integrated entities, and to prevent the manipulation and hiding of taxable income," and the taxpayer did not dispute this finding. Rather, the taxpayer argued that reasonable nondiscriminatory alternatives to the disparate treatment existed, namely, either permitting interstate businesses to use separate accounting or requiring intrastate businesses to use combined reporting.

The Court of Appeal disagreed, stating that separate accounting was not appropriate for interstate unitary businesses because "it 'ignores or captures inadequately' the transfers of value that take place among the many entities that can make up a unitary enterprise, and can lead to 'the manipulation and hiding of taxable income.'"[20] The court also found that requiring intrastate unitary businesses to use combined reporting was not a reasonable alternative because "[a]ll income earned by an intrastate unitary business is taxed by California, without apportionment" and they "have less opportunity for hiding and manipulating taxable income among separate entities, because all of their income is earned and value added within the state's borders."

## Sales Tax

### Tennessee—Imposition of Sales Tax on Rail Carrier Does Not Violate Federal Law

The U.S. Court of Appeals for the Sixth Circuit held that Tennessee's statutory scheme imposing sales or use tax on rail carriers when they purchased or consumed diesel fuel but exempting motor carriers did not discriminate against rail carriers in violation of the Railroad Revitalization and Regulatory Reform Act ("4-R Act") because Tennessee imposed "another, comparable fuel tax" on motor carriers.[21] The 4-R Act prohibits States from imposing a tax "that discriminates against a rail carrier providing transportation."[22] The U.S. Supreme Court recently held that a tax that treats similarly situated groups differently is discriminatory under the 4-R Act unless there is a "sufficient justification" for the differential treatment and "an alternative, roughly equivalent tax is one possible justification that renders a tax disparity nondiscriminatory."[23]

Tennessee imposed a 7% sales or use tax on the retail price of a rail carrier's purchase or use of diesel fuel in Tennessee.[24] Similarly situated motor carriers were exempt from the sales and use tax on diesel fuel, but instead paid a fixed diesel tax of 17 cents per gallon on fuel they consumed in Tennessee.[25]

The Sixth Circuit concluded that taxes are "roughly equivalent" when they "impose similar rates." The lower court examined the respective taxes on diesel fuel that rail carriers and motor carriers paid from 1941 through 2014 and found that motor carriers paid more taxes per gallon of diesel fuel in every year except when fuel prices spiked in 2008 and between 2011 and June 2014. However, the Sixth Circuit found that, even if it only focused on the tax rates in the most recent seven-year period, the tax rates differed "by between less-than-half-of-one cent and approximately five cents per gallon" and this minimal difference was sufficient to conclude that the two taxes were "roughly equivalent" and Tennessee had not discriminated against rail carriers in violation of the 4-R Act.

### Washington—Chemicals Exempt from Sales Tax as Machinery and Equipment

The Court of Appeals of Washington held that chemicals used by a company to manufacture hydrogen peroxide were exempt from sales tax inasmuch as the chemicals met the definition of exempt "machinery and equipment."[26] The chemicals at issue are used by the manufacturer to create a "working solution" that does not become a part of the final product (*i.e.*, the hydrogen peroxide), but "provide[s] a reactive surface for combination of the atoms/molecules that will become the final product."[27] Washington's sales tax does not apply "to sales to a manufacturer — of machinery and equipment used directly in a manufacturing operation."[28] Washington defines "machinery and equipment" to mean "industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts."[29]

The court looked to the plain meaning of the word "device" and found that the "working solution" fit the dictionary definition inasmuch as it is "formed or formulated by design" and "is designed to serve a special purpose or perform a special function." Moreover, the Department's definition of "device" in its regulation included software as an example and the Department further explained in an advisory opinion that software is an exempt "device" when it "perform[s] a task in the manufacturing operation."[30] The court reasoned that the "working solution" here is similar to exempt software because it "perform[s] an important role in the manufacturing process."

The court rejected the Department's argument that the machinery and equipment exemption did not apply here because other statutory provisions specifically address the sales tax treatment of chemicals and the chemicals at issue here did not qualify for an exemption under those provisions. The court stated that "[a]n additional exemption for chemicals used in manufacturing with different specific requirements does not convince us that chemicals can never qualify under the [machinery and equipment] exemption." Finally, the court found that the company had complied with all its duties under the sales tax law by providing its sellers with use tax exemption certificates in February 2017 for purchases made between January 2008 and November 2012 inasmuch as "[n]either the statute nor the rule requires a purchaser to provide a seller with an exemption certificate at the time of sale."

## Personal Income Tax

### New York—Taxation of Statutory Residents Not Unconstitutional

The Supreme Court of New York, Appellate Division held that New York's personal income tax scheme was not unconstitutional as applied to the taxpayers, who were taxed on all of their intangible income without credit by both New York, where they were "statutory residents," and Connecticut, where they were domiciled.[31] In New York, residents are taxed on all of their income wherever earned and a "resident" is defined as either: (1) an individual domiciled in New York; or (2) an individual not domiciled in New York but who "maintains a permanent place of abode in [New York] and spends in the aggregate more than one hundred eighty-three days of the taxable year in [New York]" (*i.e.*, a "statutory resident").[32] Residents are permitted a credit against tax due "for any income tax imposed for the taxable year by another state … upon income … *derived therefrom*."[33] However, the taxpayers here did not receive a credit for income taxes paid to Connecticut on their intangible income inasmuch as the intangible income had no situs and, therefore, was not derived from Connecticut.

In *Tamagni v. Tax Appeals Tribunal*, New York's highest court considered this issue and held that New York's tax scheme was not unconstitutional as applied to statutory residents who were taxed twice on their intangible income.[34] However, the U.S. Supreme Court's recent decision in *Comptroller of the Treasury v. Wynne* held that Maryland's tax scheme, which did not permit residents a credit against a portion of their Maryland income tax for income taxes paid to other States, unduly burdened interstate commerce and was unconstitutional under the Commerce Clause.[35] The taxpayers argued that *Wynne* abrogated *Tamagni*.

The Appellate Division disagreed with the taxpayers and found *Wynne* and *Tamagni* distinguishable because: (1) *Wynne* did not involve individuals who were domiciliaries of one State and statutory residents of another State; and (2) the income subject to tax in *Wynne* was business income that was traceable to an out-of-state source, whereas the income at issue in *Tamagni* was intangible income that "has no identifiable situs" and was not "out-of-state income." The court concluded that *Wynne* did not abrogate the "core holding" of *Tamagni* that "[w]here Commerce Clause scrutiny reveals that the statute at issue does not affect interstate commerce, there is no need for a test determining whether the statute unduly burdens interstate commerce."

**ENDNOTES**

1 *Fielding*, 916 N.W.2d 323 (Minn. 2018).
2 Minn. Stat. §290.01, subd. 7b(a)(2).
3 *Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep't of Revenue*, 814 S.E.2d 43 (N.C. 2018), *petition for cert. filed*, No. 18-457 (US Oct. 9, 2018).
4 N.C. Gen. Stat. §105-160.2.
5 (Alteration in original) (citation omitted).
6 (Citation omitted.).
7 *Ala. Dep't of Revenue v. Scholastic Book Clubs, Inc.*, No. 2161077, 2018 Ala. Civ. App. LEXIS 147 (Ala. Civ. App. Sept. 7, 2018).
8 Ala. Code §40-23-68(b)(3), (9).
9 *South Dakota v. Wayfair, Inc.*, 138 SCt 2080 (2018).
10 *Capital One Auto Fin. Inc. v. Dep't of Revenue*, 423 P.3d 80 (Or. 2018).
11 Or. Rev. Stat. §318.020.
12 *Utah State Tax Comm'n v. See's Candies, Inc.*, 2018 UT 57 (Utah Oct. 5, 2018).
13 Utah Code Ann. §59-7-113.
14 *Sirius XM Radio Inc. v. Hegar,* Cause No. D-1-GN-16-000739 (Tex. Dist. Ct. Travis Cty. Aug. 14, 2018). On September 4, 2018, the Comptroller appealed the decision to the Texas Court of Appeals.

  

[15] Tex. Tax Code Ann. §171.103.

[16] 34 Tex. Admin. Code §3.591(e)(26).

[17] *Harley-Davidson, Inc. v. Franchise Tax Bd.*, 27 Cal. App. 5th 245 (Ct. App. 2018).

[18] *Harley-Davidson, Inc. v. Franchise Tax Bd.*, 187 Cal. Rptr. 3d 672 (Ct. App.), *review denied*, No. S227652, 2015 Cal. LEXIS 6266 (Cal. Sept. 16, 2015).

[19] *Id.* (citing *Or. Waste Sys., Inc. v. Dep't of Envtl. Quality*, 511 US 93, 101 (1994)).

[20] (Citation omitted.).

[21] *Ill. Cent. R.R. Co. v. Tenn. Dep't of Revenue*, No. 17-5553, 2018 U.S. App. LEXIS 24823 (6th Cir. Aug. 31, 2018).

[22] 49 USC §11501(b)(4).

[23] *Ala. Dep't of Revenue v. CSX Transp., Inc.*, 135 SCt 1136, 1143 (2015).

[24] Tenn. Code Ann. §67-6-201 *et seq.*

[25] *Id.* §§67-6-329(a)(2), 67-3-202, 67-3-1204.

[26] *Solvay Chems., Inc. v. Dep't of Revenue*, 4 Wash. App. 2d 918 (Ct. App. 2018).

[27] (Alteration in original) (citation omitted).

[28] Wash. Rev. Code §82.08.02565(1)(a).

[29] *Id.* at (2)(a).

[30] Wash. Admin. Code §458-20-13601(2)(c); Wash. Dep't of Revenue, Excise Tax Advisory 3121.2009, *Manufacturers' Machinery and Equipment Exemption—Devices* (Feb. 2, 2009).

[31] *Edelman v. N.Y. State Dep't of Taxation & Fin.*, 80 N.Y.S.3d 241 (App. Div. 2018).

[32] N.Y. Tax Law §§612, 605(b).

[33] *Id.* §620(a) (emphasis added).

[34] 695 N.E.2d 1125 (N.Y. 1998).

[35] *Comptroller of the Treasury v. Wynne,* 135 SCt 1787 (2015).