Current Developments

An Update on Recent Court Cases and Statutory Changes

By Mary F. Bernard and Mark L. Nachbar

U.S. Supreme Court Update

After several postponements, on May 22, 2017, the U.S. Supreme Court has denied *certiorari* in several cases challenging Michigan's retroactive legislation that eliminated a taxpayer's ability to elect to be taxed based on an equally weighted three-factor apportionment formula as provided under the Multistate Tax Compact ("MTC apportionment formula"). The Court also did not take up the appeal regarding a Washington state case involving a retroactive tax change.[1]

Diversified Ingredients, Inc. ("Diversified") challenged Ohio's economic nexus standard asserting that Ohio was prohibited from assessing its Commercial Activities Tax (CAT) under P.L. 86-272. The Eighth Circuit Court of Appeals held against the taxpayer reasoning that P.L. 86-272 only prohibits a state legislature from enacting a law that imposes an income tax on a taxpayer whose in-state activity is limited to the solicitation of sales.[2] The opinion noted that, as enacted, the CAT is an annual tax on "the privilege of doing business" and that the CAT "statute expressly provides that the CAT is 'not subject to' the IIA." Diversified appealed to the U.S. Supreme Court, and on June 12, 2017, the Court denied certiorari in the matter.

MARY F. BERNARD, CPA, CMI, is a Director in the State Income and Franchise Tax practice in the Providence, Rhode Island office of Ryan, LLC.

MARK L. NACHBAR, Esq., CPA, is a Principal in the State Income and Franchise Tax practice in the Los Angeles, California office of Ryan, LLC.

New Jersey Tax Court Rules in "Unreasonable" Exception to Addback Rule

On May 24, 2017, the New Jersey Tax Court ruled that the taxpayer was not required to add back a royalty paid to its parent.[3] In this case, the subsidiary, BMC Distribution Inc., licensed its parent's prewritten software to unrelated third parties. The subsidiary paid the parent a percentage of its license and maintenance revenue as a royalty. The subsidiary's payments were substantially similar to payments made by third-party distributors of the software and were supported by independent transfer pricing studies.

The Court extensively analyzed the nature of the payments and concluded that they were in fact royalties, thus coming under the addback rules of N.J.S.A. 54:10A-4.4.b. The addback rules were developed to prevent the shifting of income by related parties to avoid tax.[4] The New Jersey Tax Court then considered whether the payments met any of the exceptions to the addback rules contained in 54:10A-4.4.c. The taxpayer contended that the recipient of the royalties paid tax on the income by using its net operating loss (NOL) to offset the income. In addition, it claimed that the expense to the subsidiary and income to the parent was not motivated by tax avoidance purposes. These positions did not persuade the Court that the addbacks were "unreasonable."

While the decision is very fact-specific, there is now precedent at the New Jersey Tax Court to analyze an intercompany payment and conclude that adding back the payment to income would be unreasonable.

However, the court found it persuasive that the royalties between the subsidiary and the parent were substantially similar to the royalty payments between third-party distributors, who also licensed the software, and the parent company. In addition, the payment made by the subsidiary was supported as an arm's-length payment by an independent transfer pricing study. Based on these two findings, the New Jersey Tax Court held that the "unreasonable" test was met and that the subsidiary was not required to add back the royalty payment to its income.

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Texas MTC Challenge

Is the Texas Franchise Tax an income tax subject to the Multistate Tax Compact's (MTC's) elective income apportionment provisions? The petition for review of *Graphic Packaging Corp. v. Hegar*[5] at the Texas Supreme Court was granted on June 16, 2017, to decide this issue.

Under the MTC, taxpayers can elect to apportion income under the equally weighted, three-factor apportionment formula, rather than the statutory single-factor gross receipts method for purposes of apportioning the margin subject to the Texas Franchise Tax. As Texas is a member of the MTC, taxpayers should be allowed to use the elective apportionment formula. The state, however, maintains that the franchise tax is not an income tax, and the MTC formula was "impliedly repealed" in the enactment of the franchise tax provisions.

Graphic Packaging is appealing a Third Court of Appeals of Texas ruling from 2015 that determined that the elective formula does not apply to the franchise tax as it is not an income tax.

MTC challenges in other states, such as Minnesota, Michigan, and California, have been largely unsuccessful. At this time, only Texas and Oregon are considering pending cases. The date set for oral arguments in the Texas case is September 13, 2017.

Alabama vs AT & T

AT & T affiliates have been pursuing refunds from Alabama of improperly collected taxes on behalf of its customers since a 2010 class-action settlement in federal litigation. The taxes were improperly imposed on Internet access which violated a federal ban. As part of the settlement, AT & T and its affiliates agreed to request refunds of mobile telecommunication taxes from states, including Alabama, on behalf of their customers.

The Alabama Court of Civil Appeals determined that the joint petition filed by AT & T and its customers satisfied the requirements of the state's Taxpayer Bill of Rights, which allowed the Montgomery County Circuit Court opinion to stand, affirming the $9.9 million refund. The Department of Revenue then requested that the Supreme Court reverse this determination on procedural grounds. Without statutory compliance, no right to a refund exists. This appeal was denied by the appellate court, which maintained that AT & T acted on behalf of its customers, as previously authorized under the federal litigation. Now that the Alabama Supreme Court has denied review of the case (May 12, 2017), the case will be returned to the Montgomery County Circuit Court, where it could face a lengthy discovery process according to the Department of Revenue's attorney, David Avery, due to the large volume of customer records to review.

Alabama vs CSX

In March, the federal District Court for the Northern District of Alabama dismissed CSX Transportation's lawsuit[6] challenging the application of Alabama's 4% sales tax to diesel fuel. In 2008, four railroad companies sued the Alabama Department of Revenue claiming that the application of the state's general 4% sales tax to the railroads' purchases of diesel fuel was discriminatory because neither trucks nor barges that transport goods across state lines pay the tax on their purchases of diesel. The railroads were attempting to bar the tax on future sales, as well as seeking to return millions of dollars previously paid by the railroads.

In its ruling, the district court determined that Alabama was justified in not applying the sales tax to trucking companies, as trucks were subject to the much higher motor fuels tax (19 cents/gallon). Similarly, interstate barges were subject to federal fuels tax of 29.1 cents per gallon. The court also found that CSX was not harmed by Alabama's exemption for interstate barges because the barges with which CXS competes purchase their diesel fuel outside Alabama.

Based on this ruling, the state will seek the estimated $10 million in sales tax withheld by CSX during the ongoing litigation, as well as the taxes related to the other railroad companies whose cases were held pending this resolution. It is not known at this time if CSX will appeal this latest ruling.

Bright Line Nexus for Sales Tax Update

With economic nexus for sales tax sweeping across the country, states continue to challenge the physical presence requirement of *Quill*.[7] Recently, Alabama, Massachusetts, Vermont, Wyoming, South Dakota, and Tennessee are challenging *Quill* by issuing regulations and administrative directives. The Tennessee Chancery Court, however, suspended enforcement of the state's bright line nexus rule.[8] Some states are following Vermont's lead by establishing an effective date of the "first day of the first quarter after a controlling court decision or federal legislation abrogates the physical presence requirement contained in *Quill*."[9]

Interestingly, a Subcommittee of the U.S. House Judiciary Committee will hold a hearing July 25 on a bill to codify the physical presence requirement in *Quill*. The bill regarding this issue is sponsored by Rep. F. James Sensenbrenner, R-Wis. The most recent states to jump on the bandwagon are Indiana and North Dakota.

Indiana

Effective July 1, 2017, certain retail merchants without physical presence in Indiana are required to collect and remit sales tax and follow all applicable procedures and requirements as if the merchant had a physical presence in the state. The new provisions will apply once the merchant meets one of the following thresholds in the previous or current calendar year:

1) The retail merchant's gross revenue from any combination of the sale of tangible personal property that is delivered into Indiana, a product transferred electronically into Indiana, or a service delivered in Indiana exceeds $100,000; or
2) The retail merchant sells any combination of tangible personal property that is delivered into Indiana, a product transferred electronically into Indiana or a service delivered in Indiana in 200 or more separate transactions.[10]

This legislation also establishes procedures allowing the department to bring declaratory judgment action in state court against a retail merchant to validate the obligation to collect sales tax. This action operates as an injunction while the action is pending and prohibits the state from enforcing the new statute against any merchant who does not affirmatively consent or remit sales tax on a voluntary basis. The legislation also included a detailed explanation of why the new collection provision is necessary—primarily the erosion of the sales tax base by the advantages of remote sellers and the growth of the online retail industry.

> *MTC challenges in other states, such as Minnesota, Michigan, and California, have been largely unsuccessful. At this time, only Texas and Oregon are considering pending cases.*

North Dakota

The legislation in North Dakota is fairly similar to Indiana. Remote sellers without physical presence in North Dakota would be required to collect and remit sales tax if they meet one of the following provisions in the previous or current calendar year:

1) The seller's gross sales from the sale of tangible personal property and other taxable items delivered in North Dakota exceed $100,000; or
2) The seller sold tangible personal property and other taxable items for delivery in North Dakota in 200 or more separate transactions.[11]

The effective date of this legislation is the date that the U.S. Supreme Court issues an opinion overturning *Quill* or otherwise confirming that a state may constitutionally impose sales or use tax upon an out-of-state seller in circumstances discussed above.

Iowa Discontinues Issuing Letter Rulings

The Iowa Department of Revenue decided that too much time was spent issuing nonbinding letter rulings for unique and specific fact patterns. The announcement was made by the Department Director, Courtney Kay-Decker, at the annual meeting of the Federal Tax Administrators in Seattle in June. Her team of lawyers was spending so much time on these nonbinding policy letters that they were effectively doing all the work required for binding declaratory rulings. In addition, the letter rulings were often so couched in caveats that they effectively offered little guidance.

With economic nexus for sales tax sweeping across the country, states continue to challenge the physical presence requirement of Quill.

In the future, Kay-Decker said that the department will reach out to taxpayers and practitioners to ask where new rules or guidance is needed. This will also allow the department to focus on issuing formal guidance, rulemaking, and binding declaratory orders.

Iowa Excludes Parent from Consolidated Filing

In two recent cases, Iowa courts have excluded a parent company from a consolidated filing claiming that the parent was not subject to Iowa tax or did not receive any taxable Iowa income.

In *Myria Holdings, Inc. v. Iowa Dep't of Revenue,*[12] the Iowa Supreme Court upheld a District Court decision that the group's parent company did not receive any taxable Iowa income as the activities of the parent consisted solely of owning and controlling subsidiaries. This activity does not rise to the level of establishing nexus in Iowa.

Under Iowa law, a corporation can join in the filing of a consolidated return if it has nexus with the state and has taxable net income. A corporation exempt from tax cannot be included in the consolidated return. The state provides an exemption from corporate income tax where the only corporate activity is limited to "owning and controlling a subsidiary corporation" and the entity lacks physical presence in Iowa related to its ownership and control. As the parties agreed that there was no physical presence for the parent, the dispute related to whether the parent's activities were limited to owning and controlling subsidiaries. The parent argued that through a third party, it provided significant managerial, administrative, financial, and strategic planning to its subsidiaries. The Iowa Supreme Court determined that these activities were considered routine activities related to the parent's ownership and control of subsidiaries. The Iowa Supreme Court also rejected arguments that providing working capital under a tax allocation plan was not distinct from routine functions of ownership and control. The parent's additional argument that it had intangible property with a situs in Iowa which provided nexus was also rejected. The court concluded that the parent did not have nexus in Iowa and could not be included in the combined return.

Shortly after the *Myria* decision, in *Romantix Holdings, Inc. v. Iowa Dep't of Revenue,*[13] the Court of Appeals of Iowa affirmed the Department of Revenue's finding that a parent holding company was ineligible to be included in a consolidated Iowa income tax return because the holding company was not subject to Iowa income tax.

RM Holdings was a holding company that owned and operated several Iowa subsidiaries along with the Romantix trademark. The subsidiaries were adult bookstores that used RM Holdings' intangible property—trademarks—to promote their Iowa businesses. Similar to the rationale in *Myria*, the Court determined that the activities of the holding company were consistent with activities related to "owning and controlling a subsidiary corporation" and, therefore, the parent was not eligible to be included in the consolidated filing.

The holding in the *Romantix* case would seem to be directly at odds with the nexus determination in *KFC*[14] and *Jack Daniels.*[15] In *KFC*, the presence of an intangible in Iowa was determined to establish nexus in Iowa. The *Jack Daniels* decision held that the out-of-state use of an intangible to manufacture a product sold in Iowa created nexus for the intangible owner. Of course, in both *KFC* and *Jack Daniels,* the nexus determination increased the tax liability of the parties. While in *Myria* and *Romantix*, a finding of nexus would have decreased the taxpayers' liability in Iowa.

Mobile Workforce Act Update

The U.S. House of Representatives passed the Mobile Workforce State Income Tax Simplification Act of 2017 (H.R. 1393) in June. This is the third time that this legislation has been cleared through the House. The companion Senate Bill, S. 540, is still pending action.

If passed, this legislation would set a 30-day safe harbor from personal state income tax and withholding obligations for traveling employees and their employers. When traveling to a nonresident state for less than 30 days, an employee would not incur any personal state income tax liability in the nonresident state. The employer would not be required to withhold taxes during this period.

California State Board of Equalization Reorganization

On June 27, 2017, California Governor Edmund G. Brown, Jr. signed Assembly Bill 102, the Taxpayer Transparency and Fairness Act of 2017, which would effectively shift nearly all administrative and appeal functions from the Board of Equalization (BOE) to two new departments: the California Department of Tax and Fee Administration (CDTFA) and the Office of Tax Appeals (OTA).

The BOE will continue to perform the duties assigned by the state constitution, which include administering programs related to property taxes, insurance taxes, and excise taxes on alcohol. The BOE will continue to hear taxpayer appeals on all types of tax and fee matters through December 31, 2017. Beginning January 1, 2018, however, the BOE will only hear appeals related to the programs it will continue to administer. At that time, the OTA will hear appeals on all other tax and fee matters, such as franchise and personal income tax appeals, sales and use tax, and other special taxes and fees. During the transition, all requirements to register, file, and pay taxes, as well as all forms, schedules, and payments, will generally remain the same.

The CDTFA will assume the BOE's administrative and regulatory functions for sales and use tax, business and excise taxes, and certain fees. The appeals related to these taxes will be settled through the OTA.

ENDNOTES

[1] *Dot Foods Inc. v. Washington Dep't of Revenue*, Washington Supreme Court, No. 92398-1, March 17, 2016.

[2] *Diversified Ingredients, Inc. v. Testa*, No. 16-2791 (8th Cir. Jan. 23, 2017).

[3] *BMC Software, Inc. v. Div. of Taxation*, New Jersey Tax Court, Release Date: May 24, 2017 (Doc 2017-55860).

[4] Business Tax Reform Act L. 2002, c. 40, Statement to Assembly No. 2501 (June 27, 2002).

[5] *Graphic Packaging Corp. v. Hegar, Tex., No. 15-0669.*

[6] *CSX Transportation, Inc. v. Alabama Dep't of Revenue*, DC-AL, No. 2:08-cv-00655, March 29, 2017.

[7] *Quill v. North Dakota*, SCt, 504 US 298, 112 SCt 1904 (1992).

[8] *American Catalog Mailers Assn. v. Tennessee Dep't of Revenue*, Tennessee Chancery Court, No. 17-307-IV, order preventing enforcement of Rule 129, April 10, 2017.

[9] H. 873, Laws 2016.

[10] IND. CODE Section 6-2.5-2-1(c).

[11] S.B. 2298, Sections 1, 2. These provisions will be codified as new sections in N.D. CENT. CODE Ch. 57-39.2 (sales tax) and 57-40.2 (use tax).

[12] *Myria Holdings, Inc. v. Iowa Dep't of Revenue*, Iowa Supreme Court, No. 15-0296, March 24, 2017.

[13] *Romantix Holdings, Inc. v. Iowa Dep't of Revenue*, No. 16-0416 (May 3, 2017).

[14] *KFC Corp. v. Iowa Dep't of Revenue*, DC-IA, 792 NW2d 308 (Dec. 30, 2010).

[15] *Jack Daniels Properties, Inc. v. Dep't of Revenue Department of Inspections and Appeals*, July 28, 2011.

