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Current Developments in State and Local Tax

U.S. Supreme Court, the Tax Cuts and Jobs Act of 2017 and Wayfair

By Mary F. Bernard and Mark L. Nachbar

At the time of this writing, there have been no new petitions to the Court for consideration involving state and local tax matters.

The case to watch this term is *Robert C. Steiner, et ux. v. Utah State Tax Commission*,[1] which involved the constitutionality of Utah's income tax treatment of local, interstate, and foreign income earned by a business owned by Utah residents. At issue is whether Utah's tax code discriminates against foreign commerce in violation of the dormant commerce clause. The current tax code extends a credit for income taxes paid to other states but does not extend a similar credit for income taxes paid to foreign countries or make other adjustments for foreign income, resulting in a double taxation of income that state residents earn from foreign commerce. The Utah Supreme Court's reasoning held that individuals are not protected from discriminatory state taxation under the dormant foreign commerce clause, while corporations are protected. The state court also interpreted *Wynne*[2] to hold that the internal consistency test is the only determining factor when considering constitutionality of a tax on individuals. The external consistency test was essentially deemed irrelevant.

The U.S. Supreme Court has set arguments for January 22, 2020, for *Espinoza v. Montana Department of Revenue*.[3] The decision of the Montana Supreme Court under review held that the Montana tax credit program for qualified education contributions violates the Montana Constitution, which prohibits aid used "for any sectarian purpose or to aid any … school … controlled in whole or in part by any church, sect, or denomination."

Sourcing…

Massachusetts Allows Apportionment for Out-of-State Software Use for Sales Tax Purposes

Three businesses that sold or licensed computer software to an entity for use by the entity's employees at various locations inside and outside of Massachusetts were entitled to abatement and refund of sales and use tax consistent with usage data and uncontested apportionment percentages that the purchaser provided. In reaching this conclusion, the Massachusetts Appellate Tax Board found that (1) Massachusetts permits taxpayers to apportion sales tax on the sale or license of taxable software that is "transferred for use in more than one state"; (2) the abatement provisions do not prohibit apportionment through the abatement process after collecting, remitting, and reporting sales tax; (3) the plain terms of the abatement regulation do not dictate a time restriction on the apportionment request; and (4) that both direct pay permit holders or their vendors (*i.e.*, the businesses) could seek apportionment through the abatement process.

In this case,[4] the purchaser paid sales tax on the entire purchase price, later informed the businesses of its intended and actual use of the software in multiple locations, provided data that showed the percentage of use outside of Massachusetts, and then the businesses timely sought apportionment through the abatement process.

Sourcing...

Wisconsin Rejects "Look-Through" Approach to Apportionment of Out-of-State Software Royalties for Franchise Tax Purposes

The Wisconsin Department of Revenue attempted to impose franchise tax liability on software license royalties that Microsoft Corporation received from original equipment manufacturers (OEMs) outside of Wisconsin, by looking through to the OEMs customers as "de facto licensees."

Microsoft Corporation entered into licensing agreements with OEMs that assembled computer systems for sale to retailers and end users. The agreements granted the OEMs the right to copy the Microsoft software to be pre-installed on a computer and the right to distribute that software to customers under the terms of an end-user sublicensing agreement. The sublicensing agreement was between the OEMs and the end users and did not include Microsoft. Microsoft received royalty payments from OEMs based on a "per-system" or "per copy" basis, determined by the number of computers assembled, or copies of the software made for its computers, without regard to whether the computers were ever sold. The royalties were not related to the price at which the computer was sold, and the OEMs were responsible for warranting the product sold, including the installed software.

The Department of Revenue audited Microsoft for 2006 through 2009 tax years and adjusted the situs of royalties received from OEMs to reflect the location of end users in Wisconsin. After the Wisconsin Tax Appeals Commission and the Wisconsin Circuit Court both overturned the $3 million assessment and agreed with Microsoft, the Department of Revenue appealed.

The Wisconsin Court of Appeals[5] rejected all of the Department's arguments in deciding that the apportionment of the royalties was not tied to the sublicensees, as Microsoft was not a party to a contract with end users. Royalties were due on computers whether or not they were actually sold. The language in the statutes[6] discussing apportionment of software used in Wisconsin is limited to "licensees" using software and does not include "sublicensees."

And More Sourcing...

New York ALJ Allows Destination Sourcing to Moody's Corp.

In *Matter of Moody's Corporation & Subsidiaries*,[7] Administrative Law Judge (ALJ) Dennis M. Galliher of the New York Division of Tax Appeals determined that Moody's was entitled to a discretionary adjustment, allowing the company to source credit rating receipts based on destination sourcing to the commercial domicile location of the debt issuer customers.

The Division of Taxation adjusted the business allocation percentage for years 2011 through 2014 for Moody's to source credit ratings receipts on a cost of performance sourcing basis. However, for tax year 2014, the Division applied a letter that granted the company's request for alternative allocation and permitted sourcing based on the customers' locations. The same letter denied the alternative sourcing request for 2011 though 2013. The sole reason for denying this treatment for 2011 through 2013 was that Moody's allegedly failed to make a request for those years prior to filing the franchise tax reports. The Court found this argument disingenuous as Moody's repeatedly requested alternative sourcing relief over the years at issue, to which the Division never replied. The approval letter of 2014 granting the adjustment specifically admits that a "fair and proper allocation" of credit rating receipts for 2014 "is best achieved" by sourcing such receipts to the commercial domicile of the customer. Consistency considerations supported applying the 2014 adjustment to all years.

Maryland Cannot Deny Federal Net Operating Losses

The Maryland Tax Court reversed the denial of federal net operating losses claimed by Sunbelt Rentals Inc. for tax years 2011, 2012, and 2013. The federal net operating losses were denied because they were generated by an acquired subsidiary that had not filed Maryland tax returns during the years of the losses. Sunbelt relied on its understanding of Tax-General §10-304, which provides that Maryland modified income is equal to the federal taxable income of each corporation. The Court stated: "Maryland law permits modifications to federal taxable income in a few limited and specifically identified statutes, Maryland Annotated Code, Tax-General §§ 10-304 through 10-308. The Comptroller's efforts to create a modification through the use of definitions out of context is not permissible without the authority of the Maryland Legislature."[8]

Chuck E. Cheese Denied Texas Sales Tax Exemption on Gaming Equipment

The Texas Court of Appeals for the Third District upheld a lower court ruling denying CEC Entertainment, Inc. (CEC) a sale-for-resale exemption on restaurant gaming equipment. CEC owns and operates Chuck E. Cheese restaurants, which provide food, beverages, and entertainment, including coin-operated machines of video games and kiddie rides available for use through depositing coins or tokens in the machines. Texas sales and use tax law allows for an exemption from tax for sales for resale, which includes sales of tangible personal property "for the purpose of transferring it … as an integral part of a taxable service." CEC argued that because it transferred the coin-operated machines to its customers as part of its provision of amusement services, its purchases of the coin-operated machines and component parts were exempt. In disagreeing with this interpretation, the court noted that "transfer" means "to make over or negotiate the possession or control of …" the transferred item. The court did not agree that the taxpayer provided its customer with possession or control over the gaming equipment. Although the customer may have some control while playing a game, CEC controls the volume, the length of play, and the skill level. The customers must use the games and their settings as they are presented by CEC. They cannot change the settings, even when they have paid to play or ride. CEC determines where the equipment is placed, and customers are not allowed to move the equipment. Customers do not have access to the equipment outside of Chuck E. Cheese's operating hours, and they do not have access to the equipment's internal parts, including those areas where the coins, tickets, and software are located. CEC employees are responsible for maintaining, cleaning, and repairing the machines, and they also supervise customer's use of the machine, correcting inappropriate behavior when necessary.

The court concluded that customers do not get possession or control of the equipment when depositing coins or tokens, but rather limited access to enjoy games or rides offered on the equipment. As such, the equipment did not qualify for sale-for-resale exemption.

New York Disallows Royalty Addback Exception in IBM

The New York Division of Tax Appeals determined[9] that IBM was not entitled to exclude royalties received from foreign affiliates from its entire net income (ENI) calculation.

IBM, a New York corporation, owns 100% of the stock of IBM World Trade Corp. (WTC), a Delaware corporation. WTC was included in IBM's combined New York State report. WTC served as a holding company for IBM's alien affiliates of locally incorporated entities in 170 countries. These alien affiliates engaged in sales to third-party customers.

During the periods at issue, the alien affiliates paid IBM and WTC a percentage of their revenue for rights under IBM's patents, trademarks, *etc*., to use, distribute, and market IBM's software programs, sell hardware, and provide related services to its customers. For federal income tax purposes, payments received pursuant to these contract arrangements were treated as gross royalties. These alien affiliates were not included in IBM's combined New York report, nor did they file separate New York state corporation franchise tax returns.

At issue was whether or not the royalty payments could be properly excluded from the calculation of ENI. The applicable statute[10] provides that: "For purposes of computing entire net income … a taxpayer shall be allowed to deduct royalty payments … received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under paragraph two of this paragraph or other similar provision of this chapter."

IBM contended that under the plain wording of the statute, the alien payments would have to be added back if the alien affiliates were New York taxpayers because they did not meet the combined reporting exception, the conduit exception, or the tax treaty exception. IBM maintained that the Legislature intended the royalty income exclusion to apply regardless of whether the payer was a taxpayer or not.

The Division, on the other hand, argued that since the alien affiliates were not New York taxpayers nor were they federal taxpayers, the alien payments would never have to be added back to taxable income, and therefore, the exceptions do not apply. Under IBM's interpretation, the royalty income would escape taxation altogether, which was clearly not legislative intent.

Following the reasoning in the previously issued *Walt Disney*[11] decision, the court agreed with the Division.

Chicago Streaming Tax Upheld

In *Labell v. City of Chicago*,[12] the Liberty Justice Center (LJC) challenged the City of Chicago's tax on subscriptions to streaming entertainment services such as Netflix and Spotify—the first tax of its kind in the country.

Chicago's "amusement tax" has long imposed a 9% tax on certain forms of entertainment, such as theaters, concerts, and sporting events, and on certain recreational activities, such as amusement park admissions, bowling, and billiards.

In June 2015, the city comptroller issued a "Ruling" extending the amusement tax to cover new services—Internet-based streaming video, music, and gaming services, such as Netflix, Spotify, and XBox Live—even though the ordinance itself doesn't authorize taxation of those services.

The LJC filed a lawsuit that challenged the tax on behalf of Chicago taxpayers who subscribe to various Internet-based streaming services and are, therefore, subject to the new tax on those services.

LJC's lawsuit challenged the tax on numerous grounds:

- The city's amusement-tax ordinance doesn't specifically authorize taxation of Internet-based streaming entertainment services.
- The tax applies to activities outside the city's jurisdiction; it applies to anyone with a Chicago billing address, even if they only use a service while outside of the city.
- The tax violates the federal Internet Tax Freedom Act because it discriminates against online entertainment by taxing tickets for certain live theatrical and musical performances at a lower rate than it would tax access to those same performances if they were streamed online.
- The tax violates the Illinois Constitution's Uniformity Clause, which requires the state and local governments to tax similar things at the same rate.

The appellate court disagreed on all counts, stating that the tax did not violate the state's uniformity clause. The court indicated that there was a "real and substantial difference between residents and nonresidents" and a reasonable relationship existed between the tax and the city residents. The court indicated that the remaining arguments lacked authoritative support. A subsequent motion for rehearing was denied, but the court issued a modified opinion in November 2019. The court's original reasoning that the ordinance did not exceed city borders and did not violate home rule provision was retained but removed discussion concerning the use of a billing address as a determination of residency. The original opinion that the law did not violate the state constitution's uniformity clause remains intact.

Short Takes—Recent Updates

Indiana

The Indiana Department of Revenue adopted an emergency rule implementing last year's legislation to align apportionment sourcing rules with the Multistate Tax Commission model regulations. Market-based sourcing rules were enacted in 2019, retroactive to January 1, 2019. The emergency rule includes a provision stating that it generally does not apply to receipts from repatriated foreign dividends under Code Sec. 965 or global low-taxed intangible income under Code Sec. 951A. The emergency rule is also retroactive to January 1, 2019.

Hawaii

Hawaii recently released proposed rules[13] relating to market-based sourcing of gross receipts from services and intangibles. *In lieu* of Hawaii's "cost of performance" sales factor sourcing provisions, Hawaii enacted market-based sourcing of services and intangibles, effective January 1, 2020. These new rules require sourcing receipts from services and intangibles to the seller's market, as opposed to where the business activity occurred. These rules are effective from January 1, 2020, until the effective date of the adoption of the final form of the administrative rules.

Wisconsin

Taiwan-based electronics manufacturer Foxconn Technology Group was promised more than $4 billion in state and local tax incentives in 2017 to invest $10 billion and create 13,000 jobs over 15 years, building a 20-million-square-foot campus between Milwaukee and Chicago. This lucrative deal is currently in jeopardy because of Foxconn's change in production plans of the next generation of liquid crystal displays. The original plan was a Generation 10.5 facility that would produce larger panels for TV screens. The project has since been downsized to Generation 6, which would produce small screens for mobile phones, tablets, notebooks, and wearable devices.

Wisconsin Governor Tony Edwards has repeatedly requested proposed changes to the agreement, and Foxconn representatives have stated that they are in compliance with the terms of the agreement as negotiated with the Wisconsin Economic Development Corp. and that they are in discussions with the state.

Tax Cuts and Jobs Act of 2017

Iowa

The Iowa Department of Revenue provided guidance related to its delayed conformity to Code Sec. 163(j). As of January 1, 2019, Iowa fully conforms to the interest limitations contained in the Tax Cuts and Jobs Act (TCJA). Since the Act was effective for tax years ending December 31, 2018, taxpayers may need to reduce any federal carryforward for disallowed interest by the amount of interest taken in Iowa in 2018 in excess of the federal limitation. In addition, adjustments will need to be made for differences between federal consolidated and Iowa separate or consolidated income.

In November 2019, Iowa also issued guidance on its conformity to the Global Intangible Low-Tax Income (GILTI) and Foreign Derived Intangible Income (FDII) provisions or the TCJA. For years beginning January 1, 2019, taxpayers are required to include GILTI and allowed to take FDII deductions, in the computation of taxable income. The amount of GILTI included in Iowa net income is the net amount of GILTI after applying the GILTI deduction at the federal level. In addition, certain adjustments may be necessary if the taxpayer files a consolidated return and the consolidated group differs from the federal group. In addition, taxpayers are required to use GILTI income in the calculation of their apportionment factor to the extent arises out of the taxpayer's ownership interests in Controlled Foreign Corporations (CFCs). Other taxpayers may be eligible to elect not to include GILTI income in their apportionment factor.

Georgia

On October 21, 2019, the Georgia Department of Revenue issued information related to the annual Internal Revenue Code update. For years beginning on or after January 1, 2019, Georgia has adopted all the provisions of the TCJA, except for the following:

- Code Sec. 179 deduction for certain real property;
- Code Sec. 199A 20% qualified business income deduction;
- Code Sec. 163(j) limitation on business interest; and
- Code Sec. 118 rules relating to contributions to capital.

Indiana

On October 1, 2019, the Indiana Department of Revenue issued guidance regarding the treatment of bonus depreciation and expensing. In general, if a taxpayer makes an election to claim a federal Code Sec. 179 Allowance, Indiana caps the overall Indiana Code Sec. 179 Allowance at $25,000 against such property. Effective for taxable years 2018 and later, a portion of bonus depreciation is allowable equal to the Code Sec. 1031 Income on the property reduced by the federal Code Sec. 179 Allowance claimed on the same property, but not below zero.

Louisiana

The Louisiana Department of Revenue issued a Revenue Information Bulletin on October 8, 2019, regarding GILTI. Corporate taxpayers will be entitled to take a 100% dividend received deduction for GILTI income.

Montana

Slightly late to the party, the Montana Department of Revenue issued guidance on Code Sec. 965 income repatriation, GILTI, and FDII on October 4, 2019, for years ending on December 31, 2017, and all subsequent tax years. The advice provides special rules for Code Sec. 965 income repatriation for water's-edge, worldwide, and separate filers as well as the inclusion of income from 80/20 companies and "tax haven" companies. The release also provides that GILTI will be treated as a foreign dividend for Montana income tax purposes. FDII also allowed a deduction for Montana income tax purposes, and the guidance indicates the treatment of the deduction for water's-edge, worldwide, and separate filers.

New Jersey

On October 31, 2019, the New Jersey Department of Revenue replaced TB-85(R) with TB-92(R), providing guidance on the treatment of GILTI and FDII. Both items are includable in the calculation of New Jersey CBT. However, they will not be treated as dividends. For most taxpayers, GILTI will also be included in the denominator of the New Jersey allocation factor.

New York City

The New York City Department of Finance issued a memorandum on interest deduction limitations under Code Sec. 163(j). The memo, issued on October 7, 2019, delineated the methodologies that taxpayers should use to determine the amount of interest to be deducted for carry forwards of previously limited deductions as well as limitations on interest deductions for the current tax year. The memo describes procedures to determine the deductions under the Business Corporation Tax, General Corporation Tax, Banking Corporation Tax, and Unincorporated Business Tax.

Wayfair Updates

Illinois

Starting January 2, 2021, Illinois will require marketplace facilitators to collect local taxes at the rate imposed at the destination of the sale. Ordinarily, Illinois imposes tax at the sale's place of origin. Therefore, the Legislature needed to change the sourcing mechanism for marketplace sales to destination. However, the sourcing for intrastate sales will remain origin based.

Kansas

On September 30, 2019, the Kansas Attorney General (AG) issued an opinion that the Department of Revenue's (DOR's) policy to require remote sellers to collect and remit sales tax is invalid. The DOR had been applying its collection requirement to all out-of-state retailers regardless of the amount of sales made into Kansas. Without a safe harbor for small sellers, the AG concluded that was not lawfully adopted.

Louisiana

On January 29, 2020, the Louisiana Supreme Court ("Court") released its opinion in *Normand v. Wal-Mart.com USA LLC*.[14] In a 4-3 decision, the Court reversed both lower-court rulings and held that Wal-Mart.com and its online marketplace is not a "dealer" obligated to collect and remit sales tax on sales made by third-party retailers through its website.

Taking a position contrary to that of the Louisiana Department of Revenue and the 63 other parishes in the state, the Jefferson Parish Tax Collector alleged that Wal-Mart.com, as a marketplace facilitator, was a "dealer" under La. R.S. 47:301(4)(l) and, therefore, responsible for collecting and remitting local sales tax on all Jefferson Parish sales made through its website, including those made by third-party retailers.

According to the Court, "there is no indication the legislature intended to tax intermediaries that are only tangentially involved in sales transaction, such as a marketplace facilitator relative to sales by third-party retailers." The Court reasoned that if an intermediary transmits funds to a seller, that fact does not relieve the seller of tax collection obligations nor does it cause the intermediary to assume the seller's obligation to collect taxes.

Michigan

On December 12, 2019, Michigan Governor Gretchen Whitmer signed two pieces of legislation. One change requires remote sellers to collect and remit sales tax. The second requires marketplace facilitators to collect and remit sales and use tax as well. The nexus thresholds for both remote sellers and marketplace facilitators are sales exceeding $100,000; or 200 or more separate transactions in the state. Remote sellers are required to collect and remit the tax for taxable sales made after September 30, 2018. Effective January 1, 2020, marketplace facilitators are required to pay sales or use tax on their sales or sales they facilitate through their marketplace to Michigan purchasers. However, because the economic nexus requirement is effective for transactions completed on or after October 1, 2018, a marketplace seller may have a filing requirement for 2019 if the seller's activity between October 1, 2018 and December 31, 2018 exceeds the economic nexus threshold. Beginning in 2020, that marketplace seller may no longer have a filing requirement to the extent that all of its activity must be reported by a marketplace facilitator with nexus with Michigan.

ENDNOTES

1 *Robert C. Steiner, et ux. v. Utah State Tax Commission*, Docket No. 19-755.

2 *Comptroller of the Treasury of Maryland v. Wynne*, SCt, 575 US ___ (2015).

3 *Espinoza v. Montana Department of Revenue*, Docket No. 18-1195.

4 *Oracle USA, Inc. et al. v. Mass. Comr. of Rev.*, Nos. C318441, C318442, and C327798 (Mass. App. Tax Bd. November 27, 2019).

5 *Wisconsin Department of Revenue v. Microsoft Corporation*, Appeal No. 2019AP2024 (Wis. Ct. App. October 31, 2019).

6 Wis. Stat. Section 71.25(9)(df).

7 Determination Numbers 828094 and 828203, New York State Division of Tax Appeals.

8 *Sunbelt Rentals, Inc. v. Comptroller of Maryland*, case number 18-IN-00-0241.

9 *Matter of International Business Machines Corp.*, DTA No. 827825 (N.Y. Tax App, Div. December 19, 2019).

10 Former NY Tax L §208(9)(o)(3).

11 *Matter of Walt Disney Company*, DTA No. 828304 (N.Y. Tax App. Div. May 20, 2019), currently on appeal.

12 Case Number 1-18-1379, Appellate Court of Illinois, First District.

13 *See* Tax Information Release (TIR) No. 2020-01.

14 *Normand v. Wal-Mart.com USA LLC*, No. 2019-C-00263.

