FTA 2019 Annual Conference

Litigation Updates

Indianapolis, IN

Your Presenters

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The U.S. Supreme Court

2018-2019 Term

Dawson v. Steager

Intergovernmental Immunity and Federal Law

- Federal law, 4 U.S.C. §111 forbids, interpreted consistent with the intergovernmental immunity doctrine, prevents states from taxing the pension benefits of federal marshals while exempting the pensions of some state and local law enforcement officers.
- The court cited the intergovernmental immunity doctrine as preventing the states from imposing discriminatory taxes on the federal government, and vise-versa.
- In this case, Congress had enacted a statute specifically permitting state income taxes to be imposed on federal employees so long as the taxes do not discriminate.

Dawson v. Steager

Intergovernmental Immunity and Federal Law

- Previously, the court struck down:
  - A Michigan tax that discriminated "in favor of retired state employees and against retired federal employees." *Davis v. Michigan Dep't.*
  - A Kansas law that taxed the retirement benefits of federal military personnel at a higher rate than state and local government retirement benefits. *Barker v. Kansas.*
  - A Texas tax scheme that imposed a property tax on a private company operating on land leased from the federal government, but a "less burdensome" tax on property leased from the State. *Phillips Chemical Co. v. Dumas Independent School Dist.*

Washington Dep't of Lic. v. Cougar Den, Inc.

Indian Law and Treaty Rights

- The "right to travel" provision of the Treaty Between the United States and the Yakama Nation of Indians (1855) protects the right of the tribe to import fuel by public highway for sale within the reservation without payment of state tax.
- In large part, the decision came down to the interpretation of state law given by the Washington Supreme Court – finding that the law imposed the tax on importation of fuel into the state via roads, rather than on the possession of fuel at the time it was introduced (by any means) into the state.

Washington Dep't of Lic. v. Cougar Den, Inc.

Indian Law and Treaty Rights

- The justices argued over whether or not the phrasing in the treaty which guaranteed the right to travel (with goods) "in common with Citizens of the United States" meant only that the state could not treat the tribe in a discriminatory fashion.
- This interpretation, however, was inconsistent with the more protective meaning that the Court has long given to treaty provisions, given that the bargaining positions of the federal government and the tribes were often severely mis-matched.

California Franchise Tax Bd. v. Hyatt

Sovereign Immunity from Suit

- Overruled *Nevada v. Hall*, which in 1979 held, for the first time, that a state might be sued in a tort case by a private citizen in the courts of another state despite the defendant state's failure to waive its sovereign immunity in its own state courts.
- What this case does NOT say.
  - It does NOT prevent plaintiffs from suing a state in that state's own courts, provided the state had waived immunity.
  - It does NOT prevent plaintiffs from suing a state in federal court to prevent violation of federal or constitutional law.

California Franchise Tax Bd. v. Hyatt

Sovereign Immunity from Suit

- What the decision does NOT change:
  - States are generally immune from suits for damages in the federal courts under the Eleventh Amendment.
  - Federal courts have no jurisdiction to issue declarative or injunctive relief in state tax matters because of federal law – the Tax Injunction Act.
  - States may impose requirements on their waiver of immunity in tax suits – including, especially, the requirement to exhaust administrative remedies.
  - One state may still attempt to sue another in the U.S. Supreme Court (see below).

California Franchise Tax Bd. v. Hyatt

Sovereign Immunity from Suit

- Commentators on *Hyatt* have focused more on its rationale, rather than its effects on state taxation:
  - When can precedent be overturned? That is, how much weight will the Court give stare decisis. In particular, should the party asking that precedent be overruled have to show not only that the precedent was wrong, but that it has led to unworkable results?
  - What to do when the Constitution is silent on a particular issue?

North Carolina v. The Kaestner Family Trust

Due Process & Minimal Contacts

- DECISION PENDING – The question is whether a resident beneficiary of an irrevocable inter vivos trust is sufficient to tax the trust as a resident trust.
- See also *Bauerly v. Fielding* (Minn.) – involving the question of whether the state can tax the trust as a resident trust if the grantor was resident in the state when the trust was made irrevocable.
- In both states' supreme courts, the states lost.
- The suits below raised commerce clause issues but those are not before the Supreme Court.

Possible Future Cases

Alabama Dep't of Rev. v. CSX Transportation, Inc.
"Discrimination" Under the 4-R Act

- PETITION PENDING – The 11th Circuit court ruled that Alabama did not violate the 4-R Act by imposing separate "roughly equivalent" taxes on fuel used by railroads and truckers, but that it did violate the Act by exempting fuel used by interstate water carriers.
- Although CSX prevailed below—because the ruling on the water carriers results in it receiving a 100% refund of its taxes paid on fuel—it filed a conditional cross-appeal of the ruling that the tax imposed on truckers is roughly equivalent.

Arizona v. California

Due Process – Passthrough Entities

- Arizona is challenging California's application of due process to impose a minimum tax on entities that hold a passive investment in a passthrough entity doing business in California.
- Arizona is pursuing the purported rights of its citizens against California tax enforcement efforts in the state.
- The U.S. Supreme Court has original jurisdiction in this case but may choose not to exercise that jurisdiction where there is an alternative means of resolving the dispute.

Arizona v. California

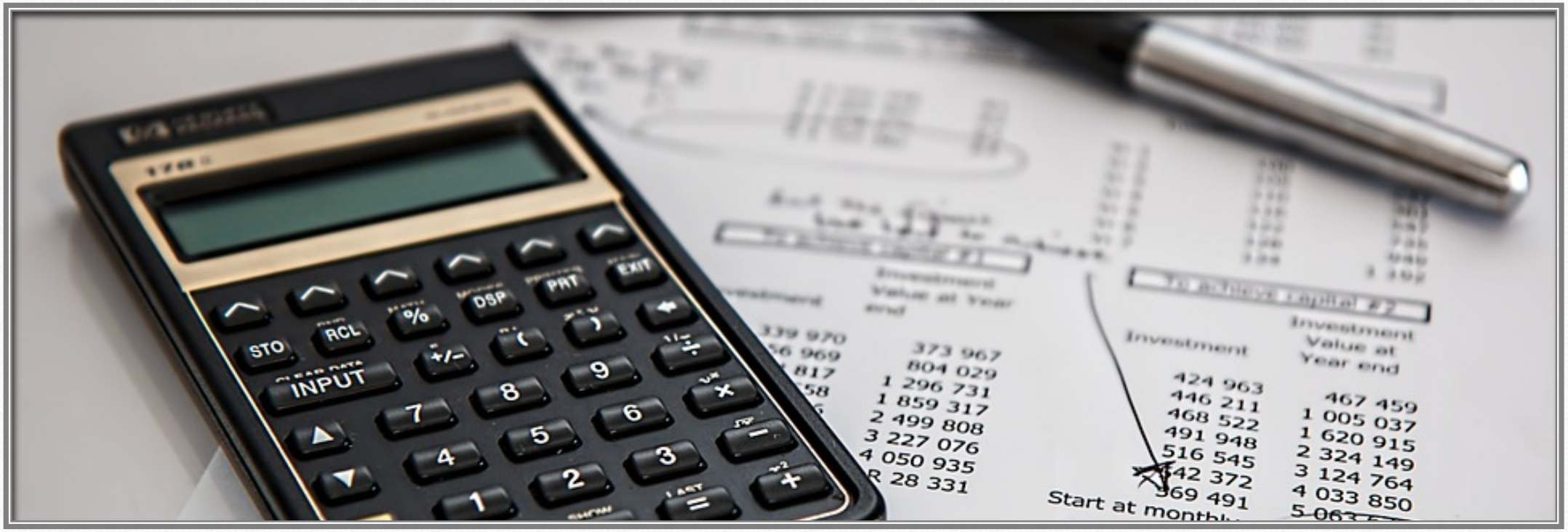
Due Process – Passthrough Entities

- Normally, a state, like any other plaintiff must either show injury or must bring the suit as *parens patriae* (the protector of the rights of its citizens), but the Court has only entertained suits involving state taxation in the past where the state plaintiff argued that the state defendant either interfered with its taxing authority or engaged in discriminatory taxation that affected the plaintiff state directly.
- California argues that taxpayer challenges can be brought in California.
- Arizona argues that this does not provide a sufficient remedy.

Also at the Court or Headed There Soon . . .

Cases Testing Deference to Agency Rules

- Two main kinds of deference to federal agency regulations in the federal courts:
  - *Chevron* – deference to the interpretation of federal statutes where the agency's filling in of the "gaps" is reasonable.
  - *Auer* – deference to the interpretation of the agency of its own regulation, where that regulation does not clearly answer the question at issue.
- *Kisor v. Wilke* – now pending before the Court addresses *Auer* deference.
- These cases may not have a direct impact on the states but will be influential.



Important Personal Income Tax Cases

2018 - 2019

Steiner v. Utah Tax Comm'n

Utah Supreme Court - Case No. 20180223-SC

- DECISION PENDING:
- Taxpayers, residents of Utah, own passthrough entities operating in the U.S. and foreign jurisdictions.
- Taxpayers argue that the Utah credit for state taxes paid is insufficient and they are entitled, instead, to apportion their business income, both their domestic and foreign income.
- Alternatively, taxpayers argue that they are entitled to a foreign tax credit against their state taxes, even though they were allowed a full federal credit against their federal taxes.

Smith v. Robinson

265 So. 3d 740 (La. 2018)

- On rehearing, the Louisiana Supreme Court held that the state could not limit the credit for taxes paid by residents to another state to states that provided a reciprocal credit for Louisiana taxes.
- The court also held that Considering the current Texas franchise tax an "income tax" because it is calculated on an income base and it did not matter that the Texas tax was imposed on the passthrough entity rather than on the owner.

Chamberlain v. N.Y. State Dep't of Taxation & Fin.

166 A.D.3d 1112 (App Div, 3d Dept 2018) (review denied)

- The New York intermediate appellate court ruled (again) that the state does not violate the commerce clause or *Wynne* when it taxes intangible income of statutory residents and does not give a credit for taxes paid to another state.

Important Sales and Transaction Tax Cases

2018 - 2019

Walgreens Specialty Pharmacy, LLC v. Comm'r of Rev.

916 N.W.2d 529 (Minn. 2018)

- Taxpayer had a wholesale prescription drug business operating through pharmacies and employees outside the state with customers inside the state.
- Minnesota supreme court held that taxpayer was "delivering" the drugs for resale or use in the state when it shipped them into the state via common carrier.
- The court also held that the tax was not internally inconsistent—given that the drugs would have to be received for resale or use in the state in order to be taxed.

Russell Cty. Cmty. Hosp., LLC v. Dep't of Rev.

Alabama Supreme Court Dkt. No. 1180204, 05/17/19

- The state supreme court ruled that "all software, including custom software created for a particular user, is 'tangible personal property' for purposes of Alabama sales tax."
- The court relied on an earlier decision from 1996 involving canned software, which suggested in the court's opinion that the "information [making up canned software] itself is tangible once it is recorded somewhere."
- The court also held, consistent with DOR regulations, that service components of designing software might not be taxable if properly invoiced.

Russell Cty. Cmty. Hosp., LLC v. Dep't of Rev.

Alabama Supreme Court Dkt. No. 1180204, 05/17/19

- Interestingly, this case raises the issues of how agency regulations are to be treated. The judges that heard the case below were split as to how to apply the regulation or whether it was clear. The dissenting justice on the state supreme court would have found the regulation's assertion that custom software is not taxable to be binding on the state—with the only question being how to interpret the regulation's definition of custom software.
- In particular – the questions about the regulation centered around the phrase "custom software *programming*" and how that differed from custom software.

Online Travel Company Cases

- The devil is in the specific statutory language:
  - Town of Breckenridge v. Egencia, LLC, Colo., No. 18SC186, 05/28/19 (OTC is not a "renter" or "lessor").
  - State v. Priceline.com, Inc., 206 A.3d 333 (N.H. 2019) (OTC is not an "operator").
  - Phoenix v. Orbitz, Arizona Sup. Ct., Dkt. No. CV-18-0275-PR (decision pending) (are the OTCs "operators" or "brokers"?)

Important Business Tax Cases

2018 - 2019

Greenscapes Home & Garden Prods. v. Testa

2019-Ohio-384 (Feb. 7, 2019) (review denied)

- The Ohio appeals court ruled that a company in Georgia that had national retailers pick up and ship its products to distribution centers around the country had nexus in Ohio for purposes of the states Commercial Activity Tax.
- Ohio has a sales-threshold standard of $500,000.
- Taxpayer argued that despite its goods being shipped to Ohio, it had not purposefully availed itself of the Ohio market.

Combined Reporting – 80/20 Companies

- Dep't of Revenue v. Oracle Corp., Colo., No. 18-SC-3, 5/28/19; and
  Dep't of Revenue v. Agilent Technologies , Colo., No. 17-SC-840, 5/28/19.
  - Under state law and regulations, companies with no property or payroll in the U.S. cannot be included in the combined group because they would not have at least 20% of their property and payroll in the state.
  - In both cases, U.S. holding companies recognized foreign gains.
  - Colorado's governor recently signed legislation (S.B. 233) to make clear that U.S. holding companies without property or payroll must be included in the combined corporate income tax return.

Intercompany Addback Issues

- *Lorillard Tobacco Co. V. Director, Division of Taxation*, N.J. Tax Court Dkt. No. 008305-2007, (2/2019).
  - The New Jersey Tax Court held that Lorillard Tobacco was not required to add back any portion of the royalties that it paid to an affiliate under the unreasonable exception to the addback requirement. The state could not limit the exception to the addback because the licensor and the licensee had different state allocation (apportionment) factors.
- *Daimler Investments US Corp. v. Dir., Div. of Taxation*, N.J. Tax Court Dkt. No. 008165-2016, (1/2019).
  - Where the payee of the intercompany charge is taxable in combined filing states, the addback exception is computed based on the payee's pro-rata share of its parent's total tax obligation to those jurisdictions.
  - The Tax Court also rule that payments made pursuant to a tax sharing agreement are not subject to addback.

Transfer Pricing Issues

See's Candies, Inc. v. Utah State Tax Comm'n, No. 20160910 (Utah Supreme Court, Oct. 5, 2018)

- See's Candies deducted IP royalty payments made to an insurance company also owned by Berkshire-Hathaway.
- The Tax Commission argued that it could adjust See's income for the royalty payments based on the State's 482-style adjustment statute without reference to federal rules.
- The lower court found the Utah statute was ambiguous and therefore looked to I.R.C. § 482 and the regulations thereunder.
- The Utah Supreme Court agreed: "absent evidence of a contrary legislative intent, when our Legislature copies a federal statute, federal interpretations of the statute constitute persuasive authority as to the statute's meaning."
- While the statute grants the Tax Commission "broad authority to allocate income," this discretion is not "untethered to any identifiable standard."

Income Producing Activity & Cost of Performance

- *Dish DBS Corporation, Pennsylvania Board of Finance and Revenue*, Dkt. No. 171344 (5/2018).
  - The state Board of Finance and Revenue held that receipts from satellite television broadcasting could be sourced to the state, in part, because the taxpayer's cost of performance method did not include the receiving equipment leased to customers and other instate service equipment.
- *Texas Comptroller of Public Accounts of the State of Texas v. Sirus XM Radio, Inc.*, Dkt. 03-18-00573-CV.
  - The circuit court permitted the taxpayer to source receipts from subscribers to the state based on the fair value of services performed in the state, rather than on the "market" method used by the Comptroller that sourced receipts based on the location of the subscriber.
- Comcast Holdings Corp. v. Dep't of Revenue, Tenn. Ct. App., No. M2017-02250-COA-R3-CV, 04/25/19.
  - The court of appeals held that Comcast had not properly identified the "earning producing activity which gave rise to the receipt" and so had not proven that the "greater proportion of income producing activity" was performed outside the state.

Alternative Apportionment

- Corp. Exec. Bd. Co. v. Va. Dep't of Taxation, 822 S.E.2d 918 (Va. 2019).
  - The Supreme Court of Virginia denied a taxpayer's request to use an alternative method of apportionment.
  - The taxpayer claimed the costs of performance sourcing rule did not reflect income earned in the state because it resulted in all of the taxpayer's receipts from sales of services being sourced to Virginia even though 95% of its market was located outside. This did not violate the constitutional standard for fair apportionment, the court concluded.

QUESTIONS

(See us at the break.)

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