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U.S. Supreme Court Update

U.S. SUPREME COURT UPDATE

DEBRA S. HERMAN is a partner and K. CRAIG REILLY is an associate in the New York City office of the law firm Hodgson Russ LLP.

Court Receives Two New Petitions in SALT Cases and Welcomes Justice Neil Gorsuch

***42** On 4/7/17, the U.S. Senate confirmed Judge Neil M. Gorsuch as the 113th Justice of the U.S. Supreme Court. The confirmation occurred after Senate Republicans employed the so-called ‘nuclear option‘ to defeat a filibuster by Senate Democrats, therebylowering the confirmation threshold on Supreme Court nominations from 60 votes to a simple majority. As Justice Gorsuch takes the seat on the bench left vacant by the passing of Justice Antonin Scalia in February 2016, the Court continues to receive challengesin cases involving state and local tax issues, including two recently filed petitions for certiorari.

The first, *Allen v. Connecticut Comm'r of Revenue Services* (Docket No. 16-1192), asks whether the Connecticut Supreme Court violated due process principles when it held that Connecticut may tax income from a nonresident'sexercise of stock options simply because the nonresident received the options as compensation for services performed within the state. In the second new petition received by the Court, *Steager v. CSX Transportation, Inc.* (Docket No. 16-1251),the West Virginia Tax Department asks whether states must offer credits against in-state use taxes for *both* taxes paid to other states *and* taxes paid to out-of-state local municipalities in order to satisfy the requirements of thedormant Commerce Clause.

We also note that eight previously reported petitions remain pending before the Court, including the six related Michigan petitions regarding the state's retroactive repeal of the Multistate Tax Compact. Additionally, the petition in *Dot Foods,Inc. v. Washington Dep't of Revenue* (Docket No. 16-308)—another case involving the retroactive application of state tax laws—also remains pending as this issue of the JOURNAL goes to press. The Court has distributedeach of these petitions for several successive conferences without taking action.

Lastly, as reported in last month's column, on 3/29/17, the Supreme Court appointed the Honorable Pierre N. Leval, of the U.S. Court of Appeals for the Second Circuit as Special Master in *Arkansas v. Delaware*, a case in which the Court has agreedto review a dispute between Delaware and several other states as to which states have priority rights for claiming MoneyGram's uncashed ‘official checks.‘ The appointment provides Judge Leval with the authority to fix the time and conditions for thefiling of additional pleadings, to direct subsequent proceedings, to summon witnesses, to issue subpoenas, and to take such evidence as may be introduced in the case. (For more background on this case, including a detailed discussion of MoneyGram's ‘officialchecks‘ and the general priority rules for unclaimed intangible personal property, see U.S. Supreme Court Update, 26 JMT 42 (September2016).)

Taxpayers Ask If CT May Tax Income from Nonresident's Exercise of Nonqualified Stock Options

****2** On 2/28/17, the Court received a new petition for certiorari in *Allen v. Connecticut Comm'r of Revenue Services*, Docket No. 16-1192, ruling below at 324 Conn. 292 (2016). In their petition, two former Connecticut residents (the 'Allens')ask whether Connecticut may impose its personal income tax on income derived from nonqualified stock options simply as a result of the taxpayer performing services within the state during the year the options were granted and, if so, whether such taxationcomports with due process.

One of the petitioners, Mr. Allen, was previously domiciled in Connecticut and, during his years as a Connecticut domiciliary, performed services for various companies solely within Connecticut. In connection with these services, Mr. Allen received millionsof dollars' worth of nonqualified stock options, which he then exercised after moving out of Connecticut and becoming a nonresident of the state. The Allens paid state tax to Connecticut as nonresidents on Mr. Allen's stock option income but then filed amendedreturns, claiming refunds for the tax paid on that income.

In the case below, the Connecticut Supreme Court first dismissed one of the Allens' refund claims based on the running of a statute of limitations and then addressed two issues with regard to the Allens' remaining claims: (1) whether Connecticut's incometax regulations provided the Connecticut Department of Revenue Services (the 'Department') with the authority to tax income derived from stock options so long as a taxpayer performed services within Connecticut during *either* the year theoptions were exercised *or* the year the options were granted, and (2) whether, if the Department had the authority to impose such a tax, the tax comported with the U.S. Constitution's due process requirements.

CT's regulations impose tax on nonresident's stock option income.

Before the case below reached the Connecticut Supreme Court, the Department denied the Allens' refund claim based on its interpretation of section 12-711(b)-18(a) ***43** of the state's income tax regulations. Section 12-711(b)-18(a) provides that in determininga nonresident's Connecticut source income, which is then taxed by the state, the nonresident must include his or her 'income recognized under section 83 of the Internal Revenue Code inconnection with a nonqualified stock option if, during the period beginning with the first day of the taxable year of the optionee during which such option was granted and ending with the last day of the taxable year of the optionee during which such optionwas exercised . . ., the optionee was performing services within Connecticut.' The dispute between the Allens and the Department as to how to interpret this regulation turned on the parties' reading of the word 'during.'

According to the Allens, the regulation's use of the word 'during' requires that a taxpayer be 'performing services in Connecticut at the time of exercising the options, *as well as* at the time the options were awarded, in order forthe income derived therefrom to be subject to taxation.' In other words, the Allens argued that in order for Connecticut to rightfully tax a nonresident's stock option income, the taxpayer must have continuously performed services within the state throughoutthe period in which the options were granted and then subsequently exercised.

****3** The Connecticut Supreme Court, however, disagreed with the Allens' interpretation, noting that such a construction would lead to 'bizarre results.' According to the court below, the 'practical consequence of this construction' would be thata taxpayer who 'takes one month of leave could claim that he was not performing services 'throughout the continuance or course of' the relevant period,' thereby escaping taxation of the option income. Moreover, the court noted that '[p]erhapsa similar claim could be made for a week of leave, or even a day.' This reading of the regulation, the court concluded, was 'unreasonable and does not give effect to the intention of' the regulation.

Instead, the Connecticut Supreme Court held that the only reading of the word 'during' that furnishes a 'reasonable construction of the regulatory language at issue' is to read the word as meaning 'at some point in the course of.'Under this construction, the court reasoned that 'if at any point during the taxable year in which the options were granted and the taxable year in which

the options were exercised the taxpayer [was] performing services in Connecticut, the incomederived from the exercise of the options would be includable in‘ the nonresident taxpayer's Connecticut adjusted gross income. Thus, under the court's reading of section 12-711(b)-18(a), the Department had properly applied its regulation by taxing theAllens' stock option income.

Taxation of stock option income ‘comports comfortably with . . . due process.‘

The Allens also claimed in the case below that the Department's application of its regulation violated the Due Process Clause of the U.S. Constitution by improperly taxing the income of a nonresident. But, again, the Connecticut Supreme Court disagreed.According to the Connecticut high court, ‘[i]n order to determine whether a state tax comports with the constraints of the due process clause, a reviewing court shall examine ‘whether the taxing power exerted by the state bears a fiscalrelation to protection, opportunities and benefits given by the state.‘‘

The ‘simple but controlling question,‘ the court continued, ‘is whether the state has given anything for which it can ask return.‘ Moreover, the court below noted that this standard has been ‘refined to a two part test‘—*i.e.*,the Due Process Clause demands that (1) ‘there exist some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax‘ and (2) there must be a ‘rational basis between the tax and the values connectedwith the taxing state.‘

With regard to the first prong of the test, the minimum connection requirement, the Connecticut Supreme Court held that the ‘jurisdictional fact that [Mr.] Allen earned the stock options while performing services in Connecticut serves, forpurposes of the due process clause, as a sufficient ‘minimum connection, between a state and the person, property or transaction it seeks to tax . . . . ‘‘ In other words, because Mr. Allen was awarded the stock options at issue as compensationfor the performance of employee services within Connecticut, the court held that there existed a ‘sufficient jurisdictional nexus for Connecticut to impose a tax on the compensation.‘

****4** As for the second prong of the due process test, the requirement that a ‘rational relationship‘ exist between ‘the tax and the values connected with the taxing state,‘ the court noted that this prong's ‘principal application has beenin cases in which a state seeks to attribute to its tax base some portion of the property or income of a multistate business enterprise that does business in the state.‘ Because, however, it was undisputed in the case below that Mr. Allen was awarded hisstock options for performing services solely within Connecticut, the court ‘perceive[d] this prong to be inapplicable to the constitutional analysis‘ and, as a result, held that Connecticut's application of its income tax regulations didnot violate the Allens' due process rights.

Question presented.

The Allens now challenge Connecticut's due process analysis, asking the U.S. Supreme Court to consider whether the lower court ‘violated [the principles of due process] and widen[ed] a conflict among the lower courts when it heldthat Connecticut may tax income from a nonresident's exercise of stock options because he supposedly realized that income when he received [stock] options as compensation for work in Connecticut and not when, as a nonresident, he exercised the options?‘

W. Va. Seeks Ruling on Requiring S&U Tax Credits for Taxes Paid to Other States' Cities and Counties

On 4/17/17, the U.S. Supreme Court also received a new petition for certiorari in *Steager v. CSX Transportation*, Docket No. 16-1251, ruling below at 238 W. Va. 238 (2016), in which the Commissioner of the West Virginia State Tax Department (the‘Commissioner‘) asks whether a state must credit out-of-state sales taxes against its in-state use taxes or, alternatively, whether the state can satisfy the requirements of the dormant Commerce Clause by other means, ***44** such as apportioning a use taxto reach only intrastate activity. In the ruling below, the Supreme Court of Appeals of West Virginia held that the dormant Commerce Clause of the U.S. Constitution required that the Commissioner offer CSX Transportation (‘CSX‘), an operator of aninterstate rail transportation system, full credit against its West Virginia use tax obligations for the sales taxes CSX paid on motor fuel to both other states and to the subdivisions of those other states.

The primary issue in the case below was whether West Virginia's credit for sales taxes paid to other jurisdictions, as authorized under former section 11-15A-10a of the West Virginia Code, mandated a tax credit for all sales taxes paid to other states' cities,counties, and municipalities, or, conversely, whether the credit was limited to taxes paid to other states only. West Virginia's credit statute provided that ‘a person is entitled to a credit against the [use] tax imposed by this article on theuse of a particular item of tangible personal property . . . equal to the amount, if any, of sales tax lawfully paid to another state for the acquisition of that property . . . . ‘ The statute goes on to define the term ‘state‘ to ‘include[]

**5 the District of Columbia but does not include any of the several territories organized by Congress.‘

Based on their reading of this statute, both the West Virginia Office of Tax Appeals (‘OTA‘) and a West Virginia circuit court held that CSX was entitled to a credit under W. Va. Code § 11-15A-10a for the sales tax it paid on motor fuel purchasedfrom the cities, counties, and other municipalities of neighboring states. Moreover, both the OTA and the circuit court ‘opined [that] a denial of such credit would unconstitutionally discriminate against interstate commerce in violation of thedormant Commerce Clause.‘

On appeal to the West Virginia Supreme Court of Appeals, the Commissioner argued that the lower tribunals erred in their determination as to the constitutionality of crediting only taxes paid to other states. However, applying the four-pronged *CompleteAuto* test (*see Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)), the Supreme Court of Appeals upheld the lower tribunals' rulings. Specifically, the West Virginia high court noted that, under the *Complete Auto* test,a state tax on interstate commerce will not be sustained unless it: ‘(1) has a substantial nexus with the State; (2) is fairly apportioned; (3) does not discriminate; and (4) is fairly related to the services provided by the State.‘ The West Virginiacourt found that if the Commissioner were to credit only taxes paid to other states (and not taxes paid to subdivisions of those states), West Virginia's use tax would fail both the fair apportionment and discriminationprongs of the *Complete Auto* test.

With regard to fair apportionment, the court noted that in order for a tax to be fairly apportioned, it must qualify as both internally and externally consistent. ‘Internal consistency,‘ according to the court, ‘is preserved when the impositionof a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear.‘ External consistency, on the other hand, ‘looks not to the logical consequences of cloning, butto the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State.‘ Focusing on the internal consistencytest, the court concluded that West Virginia must offer a credit against its use tax for all municipal taxes paid in order for the tax to be fairly apportioned.

According to the Supreme Court of Appeals, the ‘easiest way‘ to support its finding was ‘through a simple math analysis.‘

‘If, for example, CSX is required to pay a 5% use tax on all motor fuel it uses in this State and if it is allowed a corresponding sales tax credit for all fuel it has purchased out of state, such sales tax credit serves as an offset to CSX's use taxliability. Thus, in this example, if CSX pays 5% sales tax to State A, it would receive a 5% sales tax credit that completely offsets its use tax liability.‘

**6 ‘If, however, CSX pays 3% sales tax to State A and 2% sales tax to the City of Metropolis in State A, it still is paying 5% out-of-state sales tax but, under the Tax Commissioner's interpretation of the sales tax credit, CSX would pay substantially moreuse tax than a taxpayer who had not paid sales taxes to another state's subdivision. This is so because CSX is assessed the same 5% use tax, which is offset by the 3% State A sales tax and yields a residual 2% use tax liability. Because, in this scenario,CSX did not receive a sales tax credit for the additional 2% sales tax it paid to the City of Metropolis, however, CSX essentially is paying 7% in total taxes, *i.e.*, 5% use tax (which is partially offset by 3% credit for sales tax paid to StateA) + 2% sales tax paid to City of Metropolis (for which Tax Commissioner did not grant it a sales tax credit) = 7%, simply because CSX transacted business interstate in a jurisdiction that allowed its subdivisionsto charge a sales tax. Strictly in-state taxpayers would not incur this additional tax liability, nor would out-of-state taxpayers who paid sales taxes assessed only by states and not their subdivisions.‘

Thus, ‘because disallowance of the sales tax credit for sales taxes imposed by the subdivisions of other states would produce a ‘total tax burden on interstate commerce [that] is higher’ than a purely intrastate transaction, ‘ theWest Virginia court, citing the U.S. Supreme Court's recent decision in *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015), found the Commissioner's interpretation of West Virginia's sales tax credit rule to be ‘violativeof the dormant Commerce Clause.‘

Additionally, the court also noted that, for reasons similar to those explained in its internal consistency inquiry, the Commissioner's interpretation of the credit statue also ‘unfairly discriminates against interstate commerce.‘ Accordingly, thecourt found that the ‘proper, and constitutionally sound, construction to be afforded to this provision requires that it apply with equal force to grant a credit for sales taxes paid *both* to other states *and* to sales taxes paidto the municipalities of other states on purchases of motor fuel therein.‘

Questions presented.

Arguing that the West Virginia Supreme Court of Appeals' decision ‘exacerbates [an] existing split among state courts of last resort about whether a State must credit out-of-state sales taxes against use taxes or whether it can satisfy thedormant commerce clause by other means,‘ the Commissioner presents two questions for review in the petition for certiorari:

1. Does the dormant commerce clause require a State that imposes a fairly apportioned use tax to also credit sales taxes paid to other States?

2. Does the dormant commerce clause require a State that does not impose county or municipal use taxes to provide a credit for sales taxes paid to other States' counties or municipalities?

Petitions Still Pending

****7 *46** The following eight petitions for certiorari remained pending before the Court as this issue of the JOURNAL went to press.

Court requests response to petition challenging West Hollywood building permit fees. On 3/15/17, the Court received a new petition for certiorari in *616 Croft Avenue LLC v. City of West Hollywood*, Docket No. 16-1137, ruling belowat 3 Cal. App. 5th 621 (Cal. Ct. App. 2016). In the petition, a group of California property developers ask the U.S. Supreme Court to consider whether a West Hollywood ordinance that requires builders to either sell/rent a portion of newly developed housingunits at below-market rates, or, alternatively, to pay an ‘in lieu‘ fee that is used to fund the construction of other low-income housing violates the Takings Clause of the Fifth Amendment of the U.S. Constitution.

In the case below, the developers chose to pay the in-lieu fee, but the developers faced significant delays in their construction schedule, such that when they requested their final building permits in 2011, the city's proposed in-lieu fee payment had nearlydoubled from what the city had proposed at the time of their original application. The developers eventually paid the fees ‘under protest,‘ and later sued the city, alleging, in part, that the fees were both facially unconstitutional and also unconstitutionalas applied to their permit application under the Fifth Amendment's ‘unconstitutional conditions doctrine,‘ which, the developers argue, is set out in two U.S. Supreme Court cases: *Dolan v. City of Tigard*, 512 U.S. 374 (1994) and *Nollanv. California Coastal Commission*, 483 U.S. 825 (1987).

In their petition for certiorari, the developers argue that the ordinance ‘imposes the fee automatically as a condition on the approval of a building permit, without any requirement that [West Hollywood] show that the project creates a needfor low-cost housing.‘ The developers therefore ask the Court whether ‘a legislatively mandated permit condition is subject to scrutiny under the unconstitutional conditions doctrine as set out in [*Nollan* and *Dolan*]. ‘On 4/25/17, the Court requested a response to

the developers' petition. (For more background on this case, including a detailed discussion of the West Hollywood ordinance and the lower court's ruling, see U.S. Supreme Court Update, 27JMT 43 (June 2017).)

Court moves conference date in MI Multistate Tax Compact cases. As reported in last month's column, on 3/13/17, the state of Michigan filed its Brief in Opposition to the six related petitions for certiorari that the Court had received challengingMichigan's retroactive repeal of its statute enacting the Multistate Tax Compact and its three-factor apportionment formula. The previously reported petitions are *Goodyear Tire Rubber Co. v. Michigan Dep't of Treasury* (Docket No. 16-699); *InternationalBusiness Machines Co. v. Michigan Dep't of Treasury* (Docket No. 16-698); *Gillette Commercial Operations N. Am. v. Michigan Dep't of Treasury* (Docket No. 16-697); *Skadden, Arps, Slate, Meagher & Flom LLP v. Michigan Dep't of Treasury* (DocketNo. 16-688); *Sonoco Products Co. et. al. v. Michigan Dep't of Treasury* (Docket No. 16-687); and *DirectTV Group Holdings LLC v. Michigan Dep't of Treasury* (DocketNo. 16-736).

****8** Each of the petitions stem from a September 2015 Michigan Court of Appeal's decision (*Gillette Commercial Operations N. Am. & Subs. v. Michigan Dep't of Treasury*, 878 N.W.2d 891 (Mich. Ct. App. 2015), *cert. pending*, No. 16-697),in which the lower court reviewed the Michigan Legislature's response to the Michigan Supreme Court's previous decision in *International Business Machines Corp. ('IBM') v. Michigan Dep't. of Treasury*, 496 Mich. 642, 852 N.W.2d 865 (2014).

Specifically, in *IBM*, the Michigan Supreme Court held that for tax years 2008 through 2010, Michigan's Legislature had not implicitly repealed the Compact's three-factor apportionment formula by enacting its own single-sales factor apportionmentscheme in 2011. The court therefore concluded that several taxpayers, including IBM, were entitled to use a three-factor apportionment formula for the years at issue. In response to the Michigan Supreme Court's ruling, however, the Michigan Legislature expresslyrepealed the Compact's apportionment provisions and largely negated the court's ruling by expressly giving the law retroactive effect, beginning January 1, 2008.

Various taxpayers with business operations both within and outside of Michigan (including the taxpayers in the petitions referenced above) challenged the Legislature's actions, and the case eventually reached the Michigan Court of Appeals, which issued itsopinion as *Gillette Commercial Operations N. Am.& Subs. v. Michigan Dep't of Treasury.* In *Gillette*, the Michigan Court of Appeals held that (1) Michigan was free to repeal the Compact's apportionment provisions and (2) the state's retroactive repeal of the Compact did not violate the Due Process Clauses of either the state or federal Constitutions or Michigan's rules regarding retrospective legislation. Many of those same taxpayers now challenge the lower court's ruling and ask theU.S. Supreme Court to review the Michigan courts' acceptance of the state's retroactive law change. The Court has distributed each of these petitions for several successive conferences without taking action.

Court asked whether WA's retroactive application of amendments to the state's B&O Tax comports with due process. In *Dot Foods, Inc. v. Washington Dep't of Revenue*, Docket No. 16-308, ruling below at 372 P.3d 747 (Wash. 2016),the Washington Supreme Court held that the Washington Department of Revenue's retroactive application of an amendment to the state's 'direct seller's representative' exemption under the Business and Occupation ('B&O') Tax comported withthe Due Process Clause of the U.S. Constitution. Accordingly, the court denied a refund claim by Dot Foods, an Illinois-based food reseller, for B&O taxes paid under protest in the four years prior to the state's amendment.

Dot Foods now petitions the U.S. Supreme Court for review, arguing that the Court has 'never endorsed a retroactive period of more than a year or two—that is, a period covering the year preceding the legislative session in which the law was enacted'—andasking the Justices 'whether, or under what circumstances, imposing additional tax beyond the year preceding the legislative session in which the law was enacted violates due process.'

****9** The Court was originally scheduled to consider Dot Foods' petition during its 1/19/17 conference, but on 1/10/17, the Court rescheduled its conference date to coincide with the Court's review of the Michigan petitions discussed above. This scheduling changehas led some practitioners (including the authors of this column) to speculate that the Justices have linked the *Dot Foods*

petition with the Michigan Multistate Tax Compact retroactivity cases in order to potentially consider the retroactive taxissue jointly. The *Dot Foods* petition has also been distributed for several successive conferences without action being taken.

Former residents ask whether Connecticut may impose its tax on income derived from nonqualified stock options simply as a result of the taxpayer performing services within the state.

The primary issue is whether West Virginia's credit for sales taxes paid to other jurisdictions mandated a tax credit for all sales taxes paid to other states' cities, counties, and municipalities.

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