The SALT Cases of 2017

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Attempts to overturn the landmark remote seller case *Quill Corp. v. North Dakota* (504 U.S. 298 (1992)) dominated the state and local tax legal landscape in 2017. Twenty-five years after the U.S. Supreme Court issued *Quill* and reaffirmed the *Bellas Hess* (386 U.S. 753 (1967)) requirement that retailers have a physical presence in a state before they can be compelled to collect and remit sales tax, South Dakota has generated litigation that may finally topple *Quill*.

Ready for *Quill*

The nation's highest court has before it *South Dakota v. Wayfair* (Docket No. 17-494) and a dozen amicus briefs. Most amici are urging the Court to take the case — some because they are strong proponents of allowing states to collect sales tax from remote sellers, and others because the issue has lingered too long and deserves a resolution.

In *Quill*, the justices invited Congress to clarify the circumstances under which states may require remote sellers to collect and remit tax, but as decades passed with no action, states have grown frustrated and have increasingly taken matters into their own hands. No state did more so than South Dakota, which in March 2016 enacted S.B. 106. The statute requires remote sellers with at least 200 separate transactions in South Dakota or with $100,000 in sales per year to collect and remit tax. Sponsored by state Sen. Deb Peters (R), president of the National Conference of State Legislatures, the law is a simple and direct challenge to *Quill*. Even before the law took effect, the state commenced litigation.

South Dakota sued Wayfair Inc. and two other large online retailers, Overstock.com and Newegg Inc., for failing to comply with S.B. 106. Both a state circuit court and the South Dakota Supreme Court (2017 S.D. 56) ruled for the retailers, stating that under *Quill*, S.B. 106 is unconstitutional. South Dakota appealed, and now the case is with the U.S. Supreme Court, where the state and others have hoped it would land all along. The next issue is whether the Supreme Court will grant certiorari.

U.S. Supreme Court Review

The country's highest court denied certiorari in several state and local tax cases this year.

Compact

The Supreme Court on May 22 declined to hear challenges to the Michigan Court of Appeals decision in *Gillette Commercial Operations North America v. Department of Treasury* (878 N.W.2d 891 (Mich. Ct. App. 2015)), which upheld the state's 2014 retroactive repeal of the Multistate Tax Compact. Numerous corporations doing business in Michigan had argued that retroactively rescinding the state's membership in the compact, which prohibited the corporations from using a previously available apportionment formula, violated the state and federal constitutions.

Dot Foods

The Court also refused to hear a challenge to the Washington Supreme Court ruling in *Dot Foods Inc. v. Department of Revenue* (215 P.3d 185 (Wash. 2009)) that legislation retroactively narrowing a business and occupation tax exemption was constitutional. The Legislature amended the exemption after the Washington Supreme Court found that the DOR's narrow interpretation of the statute was impermissible and granted Dot Foods the exemption.

CSX

In a win for taxpayers, the Supreme Court on October 2 declined to review the West Virginia Supreme Court of Appeals decision in *Matkovich v. CSX Transportation Inc.* (No. 15-0935 (W.Va. 2016)) that the dormant commerce clause requires the state to allow sales tax credit for both state and

local sales taxes on fuel paid to other states by a railroad carrier.

Fred Nicely of the Council On State Taxation said full credit should be available for taxes paid to another state when it imposes taxes that are not apportioned. "This applies not only to income taxes, but also sales, use, and other similar excise taxes imposed by the states," he said, adding that a tax must be "internally consistent so that if every state imposed the same tax there would be no duplicative taxation."

Patrick Reynolds, also of COST, predicted the decision could affect how other states deal with credits. Citing Indiana and Kentucky, Reynolds said it "will be interesting to see what action other states . . . take that only provide credit for another state's state-level sales and use taxes but not other states' local-level sales and use taxes."

Constitutional Challenges

This year saw all types of constitutional cases, from those challenging cigarette and vehicle taxes to fights over soda, gun, and income taxes.

Soda Taxes

Backed by the American Beverage Association and retailers in Philadelphia and in Cook County, Illinois, legal challenges to soda taxes fell flat, as courts upheld the localities' right to tax sweetened beverages. In *Illinois Retail Merchants Association v. Cook County Department of Revenue* (2017L050596 (Cook Cnty. Cir. Ct. 2017)), retailers and the beverage association breathed a sigh of relief when a court prevented the county's implementation of the tax in June. But the joy was short-lived as the temporary injunction on the implementation of the soda tax was lifted, paving the way for Cook County to tax sweetened beverages.

In Philadelphia, the latest ruling in *Williams v. Philadelphia* (No. 2077 C.D. 2016 (Pa. Commw. Ct. 2017)) upheld the 1.5-cent-per-ounce excise tax, rejecting arguments denouncing the measure as double taxation in violation of the state constitution. The court ruled the excise and sales taxes distinct from each other, dashing hopes courts would reject the measure. While Cook County repealed the sweetened beverage tax in October, Philadelphia continues to face pressure from unions and retailers to do the same.

Oklahoma: Cigarette and Vehicle Taxes

The Oklahoma Supreme Court was asked to determine whether several statutes enacted at the end of the 2017 legislative session were revenue bills and therefore unconstitutional. The state constitution requires revenue bills to be approved by three-fourths of both chambers and prohibits the bills from being passed during the final five days of the legislative session.

The court unanimously determined in *Naifeh v. Oklahoma* (2017 OK 63) that a law described as a smoking cessation and prevention statute was a revenue bill because the only provision providing a meaningful change was the revenue-generating provision.

The court held 5-4 in *Oklahoma Automobile Dealers Association v. Oklahoma* (2017 OK 64) that a partial repeal of the sales tax exemption for motor vehicles was not a revenue bill because it did not levy a new tax but removed an exemption from an already existing tax.

With one dissent, the court struck down a registration fee on electric and hybrid vehicles in *Sierra Club v. Oklahoma* (2017 OK 83), finding that the bill had a principal object of raising revenue.

Seattle: Gun and Income Taxes

Meanwhile Seattle enacted an income tax on its wealthiest residents, which it is now defending in court. The city is scheduled to impose a 2.25 percent levy on income over $250,000 for individuals and $500,000 for joint filers beginning tax year 2018, but the tax may be struck down if courts rule against the city in *Kunath v. Seattle* (Docket No. 17-2-18848-4 SEA, King Cnty. Sup. Ct.). Opponents argue the tax is prohibited by both the state constitutional provision that property be taxed uniformly and a state law prohibiting local income taxation.

A split Washington Supreme Court in *Watson v. Seattle* (No. 93723-1 (Wash. 2017)) upheld Seattle's gun violence tax of $25 per firearm and 2 to 5 cents per round of ammunition sold, finding the tax was not an attempt to regulate firearm sales and was authorized by the broad grant of taxing authority delegated to cities.

Cable vs. Satellite

Florida

The nation's two largest satellite television providers, DirecTV and Dish Network Corp., are fighting side-by-side against what the companies claim is an onerous communications services tax that is levied at lower rates against cable companies. The companies argued in *Department of Revenue v. DirecTV* (No. SC15-1249 (Fla. 2017)) that cable companies have lobbied the Florida Legislature to increase taxes on satellite television providers but not on cable providers, who pay the tax at a lower rate but also pay local franchise fees. The state supreme court held in April that different tax treatment of satellite and cable television providers did not violate the commerce clause, despite the companies being similarly situated. The supreme court concluded that the cable companies were not in-state interests and that, as a result, the satellite companies' discriminatory effect claim must fail. The court also rejected the companies' discriminatory purpose argument.

South Carolina

DirecTV also faced a loss in *DirecTV Inc. v. Department of Revenue* (Op. No. 5513 (S.C. 2017)). The court held that the signal delivered by the satellite TV provider constituted an income-producing activity taxable by the state, despite DirecTV's assertion that it lacks a presence in the state. A similar case, *Dish DBS Corp. v. Department of Revenue,* is also being litigated. Alysse McLaughlin of McDermott Will & Emery said the court had more leeway to rule the way it did because it didn't take into account cost of performance. McLaughlin said taxpayers should note the penalties DirecTV was assessed. "It was the most surprising part of this case," McLaughlin said. DirecTV was assessed about $1.25 million in penalties despite not having much guidance on the key issue.

Addback Cases

Virginia

In Virginia, a split supreme court handed the state a victory in *Kohl's Department Stores Inc. v. Department of Taxation* (No. 160681 (Va. 2017)), ruling that royalty payments by a company to a Kohl's affiliate must actually be taxed by another state for Virginia's addback safe harbor exception to apply. The company argued that because its royalty payments were subject to taxes it didn't have to add them back when calculating its Virginia tax obligations, but the court said it wasn't enough to be subject to the tax if the entity wasn't actually taxed. The majority pinned the blame on the legislature for making the controlling statute ambiguous.

Despite the taxpayer's loss, the decision provided guidance to companies, McLaughlin said. Like other practitioners, McLaughlin questioned the court's struggle in determining whether the statute was ambiguous. "The lower court ruled that the statute was unambiguous and ruled for the state, the supreme court said it was ambiguous and ruled for the state, while the dissent said it was unambiguous and would have ruled for the department store," McLaughlin said, adding that she didn't find the statute ambiguous.

Michael Lurie of Reed Smith LLP summed up the debate: "It shows ambiguity is in the eye of the beholder and that there is no real judicial standard to determine whether a statute is ambiguous."

New Jersey

The New Jersey Tax Court in *BMC Software Inc. v. Director, Division of Taxation* (No. 000403-2012 (N.J.T.C. 2017)) held that royalty payments made to a parent were deductible for corporate business tax (CBT) purposes despite usually being disallowed. The court held that the taxpayer had established that disallowing the exception to the addback would be unreasonable because the payments under the software licensing agreement between the parent and the subsidiary were substantively equal to transactions with unrelated parties. Practitioners, while applauding the overall holding, expressed disappointment that the court rejected the argument that the parent had paid tax on the royalty income as it used net operating losses and therefore paid more CBT in subsequent years.

Apportionment

A case pending before Minnesota's highest court is *Associated Bank NA v. Commissioner of Revenue* (Docket No. A17-0923), in which the tax court ruled in April that the commissioner could not require the use of alternative apportionment

to add interest income from two limited liability companies to a bank's combined unitary report. Acknowledging that the bank had created the partnerships to take advantage of a tax loophole and lower its state corporate tax liability, the Minnesota Tax Court nevertheless held that the Legislature was responsible for closing loopholes, not the commissioner or the courts.

Christopher Doyle of Hodgson Russ LLP explained that if the Minnesota Supreme Court affirms the lower court's decision, it would counter what he describes as a "pretty horrible" Tennessee decision in *Vodafone Americas Holdings Inc. v. Roberts* (486 S.W.3d 496 (Tenn. 2016)). "As I am a firm believer in the adage that laws should be written by the legislative branch and not by the executive branch, I find exercises of discretionary authority in favor of the administration and to the detriment of a taxpayer to be troubling," Doyle explained. But it wouldn't be all bad if that happened, Doyle continued. "On the other hand, I have little trouble accepting the wisdom of exercises of discretion in favor of a taxpayer when the statute results in unforeseen consequences," he said.

Practitioners' Corner

SALT practitioners and experts tell us which cases caught their eyes this year.

Utah

Jon Maddison of Reed Smith took a closer look at the transfer pricing case *Tax Commission v. See's Candies Inc.* (No. 140401556 (Utah Dist. Ct. 2016)). Maddison said the district court held that the tax commission could not apply its transfer pricing statute — which is nearly identical to IRC section 482 — without considering the regulations accompanying the federal statute. "This is because the Utah Legislature adopted language nearly identical to the federal provision," Maddison said, pointing to the court's conclusion that "Utah made an affirmative determination that it would adopt federal interpretation on the subject."

If affirmed by the Utah Supreme Court, the case would signal to other states that they do not have unbridled authority to apply their versions of IRC section 482, Maddison explained. "With a growing number of states addressing what they perceive to be distortive intercompany transactions — and the MTC's SITAS [Multistate Tax Commission's State Intercompany Transactions Advisory Service] Committee seeking to gain steam with its members — this case should signal to states that their authority is restricted by federal regulations," Maddison said.

Wisconsin

Patrick Reynolds of COST pointed to an opinion by the Wisconsin Tax Commission in *Microsoft Corp. v. Department of Revenue* (Docket No. 13-1-042), in which the commission found for the computer giant and ruled that software royalties tied to the licensing of Microsoft software to out-of-state manufacturers wasn't an income-producing activity. "The Wisconsin Tax Appeals Commission correctly held that the department could not look through the sales Microsoft's customers made to their customers to distort Microsoft's Wisconsin sales factor," Reynolds said.

Nicely added that the state's attempt to use a look-through argument could have implications on other states with gross receipts taxes. "The focus should only be on the sales a business makes to its customers, otherwise due process clause and commerce clause issues are implicated by a state trying to impose a tax on a sale the business has no control over because the subsequent sale is made by one of its customers," he said.

Pennsylvania

Nicely pointed to the property tax case *Valley Forge Towers Apartments v. Upper Merion Area School District* (No. 49 MAP 2016 (Pa. 2016)), in which the Pennsylvania Supreme Court curtailed a taxing district from selectively appealing some property valuations often used by school districts to raise revenue. "We tend to forget about states' uniformity clause provisions that often prohibit a state from unfairly administrating or imposing a tax differently on similarly situated taxpayers," Nicely said. He added that "this type of appeal process is inequitable and inefficient." Reynolds said that Pennsylvania's uniformity clause doesn't just apply to property taxes but also corporate income taxes, noting the recent decision in *Nextel Communications of the Mid-Atlantic Inc. v. Department of Revenue* (No. 6 EAP 2016 (Pa. 2016)).

New York

A double ruling by the New York Tax Appeals Tribunal caught the attention of Doyle, who said it highlighted the importance of international tax treaties to states. "We state tax professionals often sell-short international tax treaties because they do not explicitly cover state taxes," he said. "But these cases highlight that the nondiscrimination provisions in some of these treaties may have a significant impact on state taxation."

In *Matter of Bayerische Beamtenkrankenkasse AG* (DTA No. 842762) and *Landschaftliche Brandkasse Hannover* (DTA No. 825517), the tribunal ruled that the Department of Taxation & Finance properly applied the statute when it assessed additional Article 33 Insurance Company Franchise Tax on two non-U.S., non-life, unauthorized insurers that had nexus in New York. "But then the tribunal determined that, had taxpayers been similarly situated U.S. corporations instead of non-U.S. corporations, their tax bills would have been lower than that asserted by the department," Doyle said. The tribunal ultimately found that the German insurance companies were being discriminated against, and noting the antidiscrimination provision in the German-U.S. tax treaty, canceled the assessment.

"The treaty discrimination analysis should now be de rigueur whenever one considers a matter involving a non-U.S. person or business," Doyle said.

Keep Your Eyes On. . .

Timothy Noonan of Hodgson Russ said that state and local tax practitioners should keep their eyes on two cases challenging New York's tax scheme as unconstitutional for taxing out-of-state residents, in light of the U.S. Supreme Court's landmark decision in *Comptroller of the Treasury of Maryland v. Wynne* (575 U.S. ___ (2015)). "This year, two separate New York Supreme Court judges ruled that New York's scheme was constitutional, even in light of Wynne," Noonan said. He said the two cases, *Chamberlain v. Department of Taxation and Finance* (No. 174-16 (Albany Cnty. Sup. Ct. 2017)) and *Edelman v. Department of Taxation and Finance* (No. 156415-2016 (N.Y. Cnty. Sup. Ct.)), are on appeal with the state court of appeals. ■