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PAUL J. HARTMAN

STATE AND LOCAL TAX FORUM

Top 10 Income Tax Cases 2024

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Agenda

- We Won’t Reveal our Source
- State Lines . . . Just a State of Mind
- Charity Begins at Home
- It May Sound Foreign, but Consider the Alternatives
- None of Your Business (Purpose)
- It’s Never Too Soon . . . To Sue

We Won’t Reveal our Source

Apple Inc. v. Florida

- Apple has filed a complaint in Florida Circuit Court challenging the Florida Department of Revenue's audit adjustments that sourced service revenue to the location of Apple's customers.
- By regulation, Florida sources service revenue to where the income producing activity occurs, based on costs of performance. Rule 12C-1.1055(2)(l)
- The Department's decision on Apple's initial appeal, while quoting the regulation, nonetheless concluded that "the income producing activity is sourced to the customer location because the services are consumed by the customers."

Apple Inc. v. Florida

- Apple argues that "[t]he Department's 'market sourcing' apportionment approach …must be rejected, and that the Department's approach "improperly ignores all activity directly engaged in by Apple to generate" its revenue, as required by" the actual language of the regulation.
- In *Billmatrix v. Fla. Dep't of Revenue*, No. 2020 CA 000435 (Fla. 2d Cir. Ct. Mar. 1, 2023), a Florida Circuit Court held that the Florida sourcing rule requires service revenue to be sourced to where the activities of the taxpayer were performed, and not to customer locations.
- That decision also relied in part on *Target Enterprise, Inc. v. Fla. Dep't of Revenue*, Fla. Cir. Ct. No. 2021-CA-002158 (Nov. 28, 2022), in which the court had rejected the Department's attempt to source the revenues of a subsidiary that provided services to Target's stores based on a percentage of retail square footage in Florida over total store square footage, finding that the services must be sourced to where the service company was performing the services.

In re Jefferies Group LLC & Subsidiaries

State of New York Division of Tax Appeals

- Jefferies Group LLC is an investment advisor and broker serving primarily institutional customers, with 82% of its business conducted through regulated investment advisors (RIA's) who in turn represent institutional investors such as hedge funds, pension funds and mutual funds.
- Former New York Tax Law 210(3)(a)(9) provided that the "customer" for purposes of sourcing receipts from investment services and income such as brokerage fees, management fees and interest were the institutional investors.
- Because many of these institutional investors were located in New York, the taxpayer's NY apportionment percentage pursuant to statute was approximately 22%.

In re Jefferies Group LLC & Subsidiaries

- The taxpayer argued that it should be entitled to “look through” to the institutional investors’ customers, using New York’s population percentage of approximately 6.4%.
- The tax department objected, arguing that any petition for alternative apportionment must be based on the unique characteristics of the taxpayer, and not characteristics applicable to the entire institutional investment brokerage/advising industry.
- The Board of Tax Appeals disagreed, holding that nothing in former Tax Law 208 limited the discretionary authority to impose an alternative apportionment to unique situations.
- The Board concluded that the failure to allow look-through sourcing would constitute an unconstitutional over-representation of the taxpayer’s earnings in New York.

Mastercard International Inc. v. South Carolina

- The South Carolina Administrative Law Court held that Mastercard's receipts from its bank customers for processing credit card transactions should be sourced to South Carolina based on the percentage of credit card transactions that were initiated in South Carolina.
- S.C. Code Ann. Sec. 12-6-2295(A)(5) provides that revenue from services is sourced to SC "to the extent the income-producing activity is performed within the State."
- Mastercard argued that cardholders were not its customers (since it received no fees or other revenue from them), and that its income-producing activity began where the electronic signals from credit card transactions first reached the Mastercard network, either at its data center in Missouri or the locations of the Mastercard Interface Processors located at banks' data processing centers, none of which were in South Carolina.

Mastercard

- Mastercard also relied in part on the S.C. Court of Appeals decision in DirectTV, *Inc. v. S.C. Dep't of Revenue*, 421 S.C. 59, 77 (Ct. App. 2017), in which the Appellate Court found that "DIRECTV's primary income-producing activity is the delivery of the signal to the customer because this activity actually generated income for DIRECTV," as support for its position that its income-producing activity was the exchange of information with its bank customers.
- The ALC rejected all these arguments, and found instead that Mastercard's income-producing activity is facilitating transactions between merchants and customers. It noted that Mastercard's revenue from banks was measured by fees based on the number of transactions, and found that "[w]ithout the cardholders purchasing goods and services from Merchants and the parties employing the Mastercard Network to consummate these transactions, none of Mastercard's … streams of income would exist."

Mastercard

- Even though Mastercard received no revenue from cardholders, the ALC stated it "believes…that Merchants and Cardholders are also Mastercard's customers as they are the true fee generators…, " noting that Mastercard promotes its cards and services to them and generates income based on their activities. However, the ALC opinion does not specify exactly what income-producing activity is actually performed by Mastercard itself at the location where the cards are used.
- The court upheld the imposition of tax, license fees, and $1.56 million in interest, but it did partially waive the failure to file penalties, citing the complexity of the issues in the case and Mastercard's "good faith" reliance on DIRECTV.

State Lines . . . Just a State of Mind

Sakowski v Mass. Dep't of Revenue; Zelinsky v New York

- Massachusetts' 2020 emergency regulation required out-of-state nonresident employees who worked remotely during the pandemic to continue to apportion their income as Massachusetts income. Two options:
  - (1) Percentage of work performed in MA during January & February 2020, or
  - (2) if employed by the same employer, the percentage used in 2019.
- Scott Sakowski was a New Hampshire resident who worked for NOAA; he challenged the regulation under the Due Process and Commerce Clauses.
- The Massachusetts Appellate Tax Board upheld the regulation.

Sakowski; Zelinsky

- The Massachusetts Appellate Tax Board cited *South Dakota v Wayfair* for the proposition that “times have changed” to support Massachusetts’ ability to tax activities outside its borders.
- In New York, the longstanding “convenience of the employer” rule is being challenged by Prof. Edward Zelinsky for the third time.
  - During the period being contested, Prof. Zelinsky was fully remote in Connecticut. Prior challenges were for periods in which he worked partially in New York and at home.

Sakowski; Zelinsky

- The *Zelinsky* case challenges the convenience of the employer rule on constitutional grounds, which had not been addressed in his earlier challenge.
- Oral argument is expected by the end of the year.
- Amanda Hiller, acting Commissioner, has acknowledged that the life of the rule enacted in the 1950's may need to be revised.
- Both New Jersey and Connecticut are offering credits for residents who successfully get a New York refund to encourage claims against the state.

What Do the Cases Sakowski v. Massachusetts and Loper Bright v. Raimondo have in common?

Rick Pomp was an expert witness in both cases

0%

New Hampshire tried to intervene in both cases

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Both cases touched on regulation of Massachusetts' fishing industry

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Wayfair v. South Dakota was cited in both cases

0%

None of the above

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Craig Welch v. C.I.R. (Massachusetts)

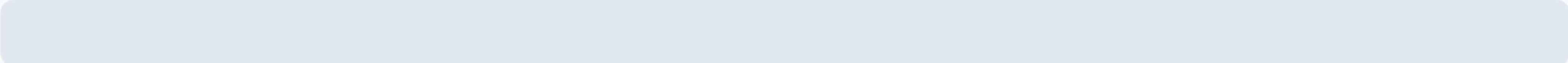
- Craig Welch founded AcadiaSoft, Inc., a Delaware C corporation, in 2003. Mr. Welch was a resident of Massachusetts at the time and remained a resident until early 2015.
- AcadiaSoft developed financial software management tools for institutional investors. Early on, Mr. Welch was one of only two employees, reporting a small salary. In 2009, the business reincorporated in Delaware and brought in outside investors; Mr. Welch's salary significantly increased while his ownership percentage was reduced to 13%.
- By 2014, AcadiaSoft had 24 employees - all in Massachusetts.
- In 2015, Mr. Welch agreed to sell his remaining shares. He became a New Hampshire resident in April of 2015 and completed the sale of his shares that fall, resulting in a substantial capital gain.

Craig Welch v. C.I.R. (Massachusetts)

- GL c. 62 Sec. 5 is a broad imposition of tax on income derived from activity in Massachusetts. It includes income derived from a non-resident's active participation in a business even though the non-resident was no longer active in the year income is recognized.
- The Tax Appeals Board upheld the state's assessment despite the fact that Welch was not actively engaged in AcadiaSoft's business in 2015. The Board likened the capital gain to deferred salary earned from 2003-2009 and beyond.
- On appeal, Welch argues that the Board should have followed Regulation 830 CMR 62.5A.1(3)(c)8, which provides that GL c. 62, Sec. 5 "generally will not apply" to capital gains from the sale of stock of a C corporation, unless the stock is a form of compensation.
  - Welch also argues that the Board confused the active conduct of a business by AcadiaSoft with Welch's activities.
  - The taxpayer did not challenge the assessment on constitutional grounds. See *VAS Holdings, Inc. v. C.I.R.* (*Ma. S.J.Ct.* 2022).

If you are in an airplane approximately 200 miles west of St. Petersburg, Florida, over the Gulf of Mexico, are you in

Mexico



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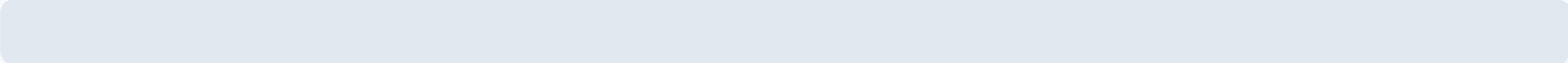
International waters



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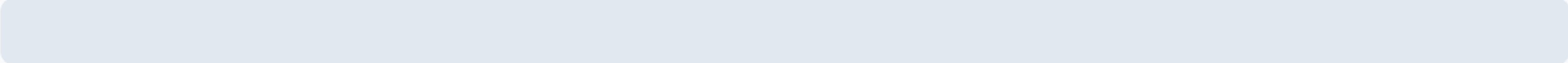
The Bermuda Triangle



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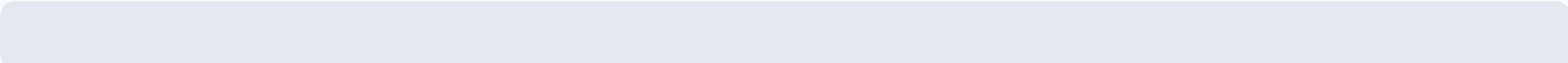
Florida



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Jet Blue v. Florida

- Jet Blue has filed a complaint in Florida Circuit Court alleging that Florida's method of determining how much of a commercial airline's income is taxable in the state violates the state and federal constitutions.
- Florida law requires an air or sea transportation company to apportion its income to Florida based on the proportion of "revenue miles" flown in Florida over "revenue miles" flown everywhere.
- Florida statutes provide a geographical "box" describing the area it deems to include revenue miles in the state, defined by latitude and longitude.
- That box includes international waters and portions of other states.

JetBlue v. Florida

Jet Blue v. Florida

- JetBlue calculated the miles it flew within the state's actual geographical boundaries. The Florida Department of Revenue assessed additional income tax and interest for 2019-2021, based on the statute's definition of its boundaries.
- JetBlue claims that this method of apportionment violates the state and federal constitutions by extending the state's territorial jurisdiction into international waters, as well as into parts of Alabama and Georgia.
- It also alleges violations of the federal commerce clause because "[a]ircraft flying outside the geographic boundaries of the state of Florida are not engaged in an activity having the requisite substantial nexus with the state of Florida."

Charity Begins at Home

Catholic Charities Bureau Inc. v Wisconsin Labor and Industry Review Commission

- The CCB is the social ministry arm of the Roman Catholic dioceses in Wisconsin. They operate charitable programs via subentities to assist with elder and disabled care, poverty, and disaster relief.
- In 2015, one subentity was determined to be entitled to a religious purposes exemption from unemployment contributions. Other subentities were denied the exemption. CCB challenged the exemption denial.
- In February 2023, the Wisconsin Court of Appeals held that the state unemployment compensation act's religious purposes exemption does not apply to the CCB and its subentities as their activities are charitable rather than religious.
- The Wisconsin Supreme Court upheld the denial of the exemption in a 4-3 decision, focusing on the primary operations. CCB has filed for cert with the USSC.

Catholic Charities Bureau

- The Wisconsin Legislature has filed an amicus brief urging the USSC to take the case arguing that the state's Supreme Court decision harms religious minorities by excluding all but "typical" religious organizations from the statutory exemption.
  - ". . . A highly consequential case concerning the very nature of religion itself."
- Amicus briefs are aplenty - International Society for Krishna Consciousness, Sikh Coalition, Lutheran Church, Nat'l Ass'n of Evangelicals, Baptist Convention, Jewish Coalition, Islam and Religious Freedom Action Team.

Catholic Charites

- Petitioner's claim that allowing the decision to stand would permit state bureaucrats to determine what is a typical religious practice and would result in discrimination. Highlights:
  - Courts lack the authority to determine the religiosity of faith-driven activity.
  - Interferes with religious organizations' internal affairs.
- Petitioner also alleges that the Wisconsin high court has "effectively rewritten the statute" to require groups to either proselytize or provide religious worship services.

Which of the below is not a recognized world religion with at least 1 million followers?

Option	Result
Tenrikyo	0%
Animism	0%
Cao Dai	0%
Rastafari	0%

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It May Sound Foreign, but Consider the
Alternatives

Microsoft Corp. v. DOR (Oregon)

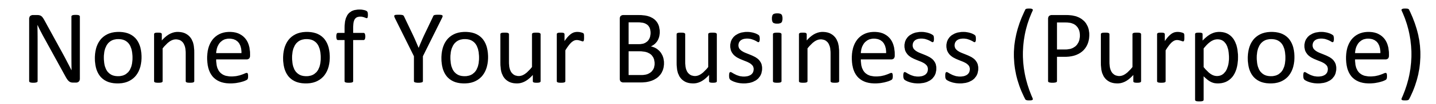
- Microsoft repatriated $110 billion in 2018 under TCJA's IRC 965 deemed repatriation provision.
- Oregon includes 20% of dividends (including subpart F) in the apportioned tax base and instructs that no amount is included in the sales factor denominator.
- Microsoft filed a refund claim based on the inclusion of 100% of repatriated income in the denominator;
- Microsoft argued that the inclusion is necessary to avoid extra-territorial taxation and more fairly reflect income in the state.

Microsoft Corp. v. DOR (Oregon)

- The Tax Court held that under ORS 314.665, receipts derived from primary business activity are included in sales factor at net, allowing 20% of the repatriation income in the sales factor.
- The Tax Court denied Microsoft's claims of extra-territorial taxation, discrimination and request to use alternative apportionment to more fairly reflect income.
- Legislative history from the 1985 elimination of WWCR indicated exclusion of 80% of foreign dividends was intended as a proxy for factor representation of foreign subsidiary activity.

Microsoft Corp. v. DOR (Oregon)

- The Tax Court found that the taxation of repatriation did not discriminate against foreign commerce, nor constitute extra-territorial taxation.
  - The appropriate comparison was Microsoft's potential in-state taxable income under WWCR for the previous 18 years ($872 million) versus liability under water's edge reporting with 20% foreign dividends included ($734 million).
- **Compare:**
  - In 2023, Microsoft convinced California's Office of Tax Appeals that 100% of repatriated income should be included in the sales factor, although the state deducted 75% of such income.
  - The OTA concluded that deductible amounts go into factor, but not exempt amounts, and also denied California's attempt to utilize alternative apportionment.
  - The Legislature then retroactively "clarified" that only taxed amounts are included in the sales factor.


None of Your Business (Purpose)

Skechers USA, Inc. v Wisconsin Dep't of Revenue

- The Wisconsin Tax Appeals Commission previously upheld the Department's assessment that Skechers' licensing activity with its wholly owned subsidiary (SKII) lacked a valid business purpose and economic substance and disallowed the royalty expense paid to SKII.
  - The WTAC noted that the company did not engage a law firm or anyone else to develop a plan of reorganization to justify the creation of SKII.
  - There was no evidence to showing any non-tax benefits, nor was there any changes to business practices, profitability or intellectual property.
  - The intercompany agreements were prepared by the accounting firm that had approached the company with "State Tax Minimization" services.

Skechers USA, Inc.

- The Wisconsin Circuit Court upheld the WTCA's decision, dismissing the taxpayer's arguments that the transactions were between viable business entities, noting that Wisconsin courts, unlike Massachusetts, had not adopted such test, and that the transactions were a "near textbook example" of what Wis. Stat. 71.30(2) was designed to prevent.
- Now on appeal to the Court of Appeals, Skechers' counsel argues that there are "logistically sound reasons for not requiring business purpose" where a reorganization results in a viable business entity, engaged in substantive business activity.

It’s Never Too Soon . . . to Sue

American Catalogue Mailers Ass’n v FTB; Paychex v New York State Dep’t of Taxation and Finance

- These cases were filed to challenge the validity of guidance and regulations, seeking a declaratory judgment.
  - The California case challenged the FTB’s P.L. 86-272 guidance (TAM 2022-01 and Publication 1050) for failing to comply with the California Administrative Procedures Act which applies to regulations promulgated by state agencies.
  - The New York case has been filed in state court (prior to exhausting administrative remedies), and claims NYS’s regulations amending the corporate tax formula pervert the statutory method for determining a corporation’s tax liability. The regulations sought to exclude a significant portion of a PEO’s revenue as a “receipt” and apply such interpretation retroactively back to 2015.

ACMA & Paychex

- The ACMA had filed suit against the FTB in 2022 alleging that the guidance was invalid as,
  - The guidance contradicts the U.S. Constitution and P.L. 86-272;
  - The FTB failed to follow the provisions of the state APA; and
  - If valid, only prospective treatment should be permitted.
- The Superior Court (S.F.) found that both the TAM and the Publication constituted general application rules, and hence, were required to comply with the APA, and having failed to do so, were invalid.
  - The FTB's Motion for Reconsideration was denied; the ACMA was awarded legal fees

ACMA & Paychex

- Paychex had repeatedly raised its concerns with the proposed regulation during its drafting. Its concerns were not formally responded to and the Department promulgated the regulations without changes on December 27, 2023.
- Paychex determined that its declaratory action was necessary to have the regulations annulled and declared void as a matter of law, given the inconsistency with the plain language of the statute which uses the term "gross receipts," the potential liability for current and future years, and the retroactive nature of the regulation.

Thank you