Top Ten Income Tax Cases 2022

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Every Step you Take . . . We'll be Watching You

Schaad v Alder, Ohio Supreme Court No. 2022-0316.

- The Supreme Court of Ohio will review the decision of the 1st Appellate Division of the Ohio Court of Appeals that found that Cincinnati's imposition of local income tax on nonresidents working remotely during the pandemic was not unconstitutional.
- One of several suits brought by the Buckeye Institute to challenge H.B. 197, the legislation passed during the pandemic that deemed work performed at home as being performed at the employees' principal place of work.

Schaad v Alder, con'd

- The appeal claims that Sec 29 of H.B. 197 only applied to the employers' withholding requirements, and was enacted to mitigate changes to employers' municipal withholding processes during the pandemic. It did not change the statutory regime that imposed local tax on where employees services were performed or rendered.
- The appeal also challenges the ability of the General Assembly to impose extraterritorial taxation in violation of the Due Process Clause.
- Recall in *Buckeye,* "Section 29…effectively mandates the fiction that work was performed where it was not."
- Nexus is not appropriate based on the location of the employer, a separate entity.

Schaad v Alder, cont'd

- Plaintiffs have also alleged apportionment issues based on the fourth prong of *Complete Auto*, as the employees' home localities, which provided an increase in services during remote work, did not receive a fair share of tax for the services rendered.
- Similar challenges were raised in *Boles v City of St. Louis*, Case No. 2122-CC00713 which is seeking class action status. Several companies have also filed cases against St. Louis over the City's payroll tax on remote workers.
- In *Morsy v Dumas*, the Cuyahoga County Court held Cleveland cannot collect taxes from a nonresident employed by an Ohio company.

In re Obus v. Tax Appeals Trib., 206 A.D. 3d 1511 (2022)

- The Appellate Division of the New York Supreme Court (NY's intermediate appellate court) overturned the decision of the Tax Appeals Tribunal and held that a New Jersey resident's vacation home could not establish the owner's statutory residence in NY.
- The owner worked in NYC, and was in New York State for more than 183 days. However, the upstate home, which was used at most for three weeks a year, was 200 miles from NYC (outside reasonable commuting distance) and the owner kept no personal effects there.
- The Tribunal had relied on the fact that the owner had the right to reside in and maintained living arrangements at the home, even though he used the home "sparingly."

Obus, cont'd

- The court held that the Department cannot rely solely on the potential use of a property, but must consider all the relevant factors, which here indicated the owner had not "utilized the dwelling in a manner which demonstrates [he] had a residential interest in the property."
- The court found the Tribunal's decision was inconsistent with the legislative intent of the statute, which was to discourage tax evasion by true residents of the state, lacked a rational basis, and reversed.
- The Department of Taxation and Finance is seeking review by the Court of Appeals, New York's highest court.

Diane Zilka v Tax Review Bd. City of Philadelphia, Pa., No. 31 EAL 2022, 7/5/22

- The Pennsylvania Supreme Court will review a Commonwealth Court ruling that denied a refund of Philadelphia Wage Tax for a resident that worked in Wilmington, DE. The taxpayer had lost on her refund challenges at the Philadelphia County Court of Common Pleas and the Philadelphia Tax Review Board.
- For three years, Zilka had claimed a credit for Delaware tax to offset her Pennsylvania Tax. She also claimed a credit for the Wilmington Tax (and the balance of her Delaware tax not utilized) to offset her Philadelphia Wage Tax.

Zilka, cont'd

- The Commonwealth Court had found no basis for a claim of double taxation under the Commerce Clause, nor a violation of the internal consistency test.
- The state Supreme Court has agreed to review the sole question of whether it was unconstitutional for the City not to allow an unapplied credit to her "Wage Tax liability" – i.e., must the City credit both Wilmington and Delaware state taxes paid by the taxpayer.
- Many have argued that local states are merely a subset of state taxes. If so, then under *Comptroller of Maryland v Wynne*, 135 S. Ct 1787 (2015)'s application of the internal consistency test, the combined state and local effective tax rate of an out of state commuter working in Philadelphia should not exceed the effective tax rate of a Philadelphia resident working in the city.
- Justice Ginsburg dissented in *Wynne*, arguing that the internal consistency test should not be applied in the context of income taxes based on sourcing versus residency principles.
- California and Indiana have issued ruling stating they would not credit municipal income taxes paid by their residents.

District of Columbia ex rel. Tributum, LLC v.Michael Saylor, D.C. Superior Court No. 2011-CABSLD 00319B

- Relator Tributum initiated a lawsuit under D.C. False Claim Act (Sec. 2-381.03) to recover taxes and treble damages from MicroSolutions founder Michael Saylor for the failure to pay income taxes.
- The District filed as intervenor on 8/22/22.
- Complaint alleges Saylor has "publicly flaunted his billionaire lifestyle . . . while bragging how he was avoiding District taxes . . ."
- In addition, the Complain alleges Saylor ". . . has become an outspoken proponent of . . . Bitcoin . . ."
- The Relator seeks 25% of any recovery

Does it All Add Up?

Pfizer, Inc. v. Alabama Dep't of Revenue,

DKT. No. BIT. 18-236-JP (Ala. Tax Tribunal, July 28, 2022)

- The Alabama Tax Tribunal reversed the Department and held Pfizer was entitled to deductions for interest paid to a related entity in Ireland.
- Alabama's statute denies deductions for certain interest and intangible payments made to affiliates, but provides an exception from the disallowance when the related party's interest income was "subject to" a tax based on the related member's net income by a foreign country that has an income tax treaty with the U.S..

Pfizer, cont'd

- The Department argued that the exception did not apply, even though the related entity included the interest payments as income on its Irish tax return, because the entity was permitted under Irish law to deduct large interest payments it in turn made to affiliates based in Luxembourg, reducing its taxable income to $10,000.
- The Tax Tribunal held that "the facts presented in this appeal fit squarely within the subject-to-tax exception to Alabama's add-back statute . . .," even though Irish law allowed deductions that effectively reduced the affiliate's taxable income to a nominal amount.

Pfizer, cont'd

- The Tribunal noted that the statute explicitly provides that the exception applies "even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise." Ala. Code § 40-18-35(b).

Our gain is your loss

Quinn/Clayton v. State of Washington, On appeal to Washington S. Ct. No. 100769-8

- In 1930, Washington adopted a constitutional provision providing all property taxes shall be "uniformly applied" and limited to 1% of property values (Article VII, Sec. 1).
- In 1933, the state supreme court struck down a voter-initiated graduated income tax on the basis that income was "property" and was not taxed uniformly through a graduated rate.
- Subsequent Courts have struggled with whether various taxes are permissible "excise" taxes or impermissible income taxes ("property").
- In 2021, the Legislature passed SB 5096 which imposed a 7% capital gains tax on total gains over $250K; coverage includes sale of TPP within Washington and all capital gains of residents.

Quinn/Clayton, cont'd

- In March 2022, Douglas County District Court struck down as an impermissible income tax (Dkt. No. 21-2-0075-009)
- The Court created a 7-part test focused on the federal tax treatment [paraphrasing] "if it walks like a duck, and quacks like a duck. . . "
- The State argued that previously-upheld taxes on property transfers, e.g., estate taxes, are excise taxes, not income taxes.
- The DOR's fiscal impact report on SB 5096, that cautioned the tax might be struck down as an impermissible tax on income, was admissible as an "admission against interest."
- Intervenors have asked the court to overrule the "*Lochner*-era" *Culliton* decision; Washington voters have on numerous occasions rejected constitutional amendments to allow income taxation.

Apex Laboratories Int'l Inc. v City of Detroit, Mich Tax Tribunal, Dkt No 16-724-R, 8/19/22

- On remand from the Michigan Court of Appeals, the Tax Tribunal found that the taxpayer lacked nexus with the City and was not subject to City Income Tax.
- The Tribunal had been directed by the Court of Appeals (on an Order from the Michigan Supreme Court) to determine whether the USSCT's decision in *South Dakota v Wayfair*, Inc., 138 S.Ct 2080 (2018) would have changed the Tribunal's prior finding on no nexus which was decided prior to *Wayfair* and based upon *Quill's* physical presence standard.
- Apex was a Delaware holding company created to hold the stock of a Canadian operating company which had been purchased by a private equity fund. The closing of the sale occurred in Canada.

Apex Laboratories Int'l Inc., cont'd

- No federal tax was due on the sale pursuant to US/Canada treaty provisions in effect at that time. A companion state corporate income tax case (pre-*Wayfair*) found that although Apex had nexus due to the activities of agents in the state, none of the gain was apportionable to Michigan as the sales factor was zero.
- The City's Income Tax Ordinance specifically excluded the activities of an agent in determining if a company was doing business in the City.
- The Tribunal found Apex had neither a physical nor economic presence within the City.

Apex Laboratories Int'l Inc., cont'd

- While the decision rested on the language of the specific regulation, the Tribunal's analysis established the lack of an economic presence, as Apex did not advertise its services to City residents, had no virtual marketplace, and that the sale of the operating entity occurred in Canada.
- The City has filed a Motion for Reconsideration with the Tribunal on the argument that the exemption for "activities of an agent" only apply to the activities of a statutory resident agent.

Back to The Source

Franklin Templeton Distributors, Inc. Appeal No. 2022-510 (Ohio Bd. Tax App., 4/29/22)

- The Ohio Department of Taxation required Franklin Templeton, a global investment firm, to source its gross receipts from providing asset management services to mutual funds based on the locations of the mutual funds' investors.
- The Ohio Commercial Activity Tax (CAT) requires gross receipts from services to be sourced to Ohio "in the proportion that the purchaser's benefit in [Ohio] …bears to the purchaser's benefit everywhere…" Ohio Rev. Code 5751.033(I).

Franklin Templeton, cont'd

- Franklin Templeton took the position that receipts from its asset management services should be sourced to the locations of the mutual funds as it provided services for the funds themselves, not to the individual shareholders of the funds.
- The Department of Revenue imposed a "look-through" sourcing rule determining that the investors, not the mutual funds, were effectively the "purchasers" of the asset management services, despite the fact that the mutual funds paid the asset management fees directly to Franklin Templeton.

Franklin Templeton, cont'd

- The Department rejected the company's reliance on *Defender Security Company v. McClain*, 162 Ohio St. 3d 473 (2020), in which the Ohio Supreme Court held that a marketer and installer of ADT's security services should source its receipts to the location of ADT, the purchaser of the contracts, and not to the Ohio locations where the systems were installed.
- The Department found: the investors "ultimately" pay for the investment management services, as the mutual funds pay fees to Franklin Templeton out of the funds' assets' income; the individual investors contact Franklin Templeton with questions; and the mutual funds are not operated as stand-alone businesses.

Franklin Templeton, cont'd

- The Department distinguished Ohio's statute (which focuses on where the purchaser ultimately uses or receives the benefit of the services) from the Minnesota statute in *Lutheran Brotherhood Research Corporation v. Commissioner,* where the Minnesota Supreme Court held the "consumer" of management services provided to the mutual fund was the fund itself, not the ultimate investors as a "fixed location of a business was "paramount" to sourcing services under Minnesota law.
- A contrary result was reached in *TD Ameritrade, Inc.* DTA No. 829523 (N.Y.S. Div. of Tax App., Apr. 28, 2022) which found that a securities broker-dealer should source its fees to the location of the banks who paid the fees, not to the locations of the brokerage clients.

Don’t Look Behind the Curtain

NBC Universal, Inc. v. Oregon DOR, *ABC, Inc. & Consolidated Affiliates v. Oregon DOR*, TC MD 170037 (8/17/22); TC MD 170364N (4/20/22)

- The taxpayers in both cases argued that they were not "broadcasters," as they merely provided content to actual broadcasters.
- The taxpayers also argued that audience-factor should not apply to apportion entire receipts of multi-media conglomerates' activities but only to direct broadcasting activity.
- The Magistrate Court rejected both arguments, citing to the legislative history of broadcasting apportionment statute, as well as to *Comcast v. DOR*, 423 P.3d 706 (2018).

NBC Universal, cont'd

- Further, the Magistrate Court rejected the argument that broadcasting apportionment statute implicitly adopts *Finnigan* combined reporting methodology;
- The court held that ESPN's nexus under due process clause would require further fact-finding, and denied cross motions for summary judgment.

A Day Late . . .

Dine Brands Global Inc. v Rachael Eubanks, The Walt Disney Co v Rachael Eubanks

Nos. 2021-189420-CZ, 2021-189464-CZ (Mich Cir Ct, 1/24/22)

- In a case of first impression, a Michigan Circuit Court held that the commencement of an unclaimed property audit does not toll the state's statute of limitations to demand unclaimed funds, which is "no more than 10 years after the duty arose, or five years for transactions between commercial parties."
- The audit had commenced in 2013 and was conducted by Kelmar Associates LLC. Michigan was one of over a dozen participating states. In 2020, Kelmar notified the Plaintiffs that it had determined AP credits and payroll checks, issued between 2002 – 2014, were unclaimed property. In response, both Plaintiffs raised the expiration of the SOL as a defense. The state rejected the defense and sent a demand letter.

The Walt Disney Co, cont'd

- The Plaintiffs filed an action in Circuit Court which had exclusive jurisdiction to hear unclaimed property cases. After the State tried unsuccessfully to move the case to the Court of Claims, the Plaintiffs filed motions for summary disposition, arguing that the claim for alleged amounts discovered during the audit was time barred as the state waited too long to demand such amounts.
- The State argued that the notice of the audit 1) tolled the statute (although no tolling language was evident in the statute, and that 2) the commencement of the audit constituted an "action or proceeding," such that any demand during the course of the audit was timely.

The Walt Disney Co, cont'd

- The Circuit Court agreed with the Plaintiffs' analysis that the commencement of an audit does not constitute "the commencement of an action or proceeding" for purposes of the SOL, and that the state was responsible for conducting the audit on a timely basis. The Court confirmed that an audit was not the same as an action to enforce a finding.
- The Court noted that a contrary interpretation "places holders in definite jeopardy" and requires them to "maintain documents in perpetuity" which "is untenable."
- Treasury has appealed to the Michigan Court of Appeals.

Double Secret Bonus Case

It [Still] Ain't Easy Being Cheesy

PepsiCo, Inc. & Affiliates v. Illinois Dep't of Revenue, Illinois Ind. Tax Trib. Nos. 16 TT 82 & 17 TT 16

- In 2021, the Ill. Independent Tax Tribunal held that Frito Lay North America's holding company, PMG, LLC, did not qualify as a domestic 80/20 company and should have been included on PepsiCo's water's edge combined return.
- In September, 2022 the same judge on cross motions for summary upheld the imposition of a 20% penalty, finding that the taxpayer failed to demonstrate it acted in good faith or exercised ordinary business care in creating PMG and excluding it from the combined return.
- "Despite the sophistication of the tax department…not a single internal memorandum, document, or even a scribbled note reflecting any deliberative process or legal research was generated that questioned or tested PGM LLC's viability."

THANK YOU