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Top 10 Income Tax Cases 2023

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Preemptive Strikes

Uline, Inc. v. Comm'r of Revenue

- The Minnesota Tax Court found that the activities of a business-to-business catalog and internet distributor that sold products into Minnesota had exceeded the scope of P.L. 86-272, which exempts out-of-state businesses from state and local income tax if their in-state activities do not exceed the solicitation of orders for sales of tangible personal property.
- Uline had no place of business in Minnesota, but did have both non-salespeople and sales representatives who solicited sales, occasionally accepted product returns, and complied information from Minnesota customers about purchases from Uline's competitors.

Uline, cont'd

- The court agreed with Uline that the occasional Minnesota presence of Uline non-sales employees for job fairs, and an executive's periodic business calls and emails from his home in Minnesota, were not sufficient to warrant imposition of tax.
- However, the court found that Uline's use of sales representatives to prepare reports documenting the products bought by customers from competitors, which included gathering detailed brand, pricing, and payment information, while facilitating sales in general, not did – as was found critical by the Supreme Court in *Wisconsin v. WM. Wrigley, Jr.*, – "facilitate the *requesting of sales*."

Uline, cont'd

- Therefore, the court held that the sales representatives' activities, which were not *de minimis*," served a separate business purpose independent from Uline's solicitation of orders" that exceeded P.L. 86-272 protection.
- The court did reverse the imposition of penalties, finding that Uline had substantial authority for its tax position, and that case law concerning the application of P.L. 86-272 was sparse and highly fact intensive. Despite sustaining the assessment, the court found that "the 'weight" of definitive supporting authorities cannot be said to favor either party" and set aside the penalties.

Verizon New York Inc. v. New York Division of Tax Appeals

- In a hearing on a petition for redetermination of a deficiency, the Administrative Law Judge (ALJ) determined that receipts from asymmetric digital subscriber line and fiber broadband aggregation and access services constituted Internet access services which were prohibited under the Internet Tax Freedom Act (IFTA).
- The Division had argued that such charges did not qualify under IFTA as they had been provided to other carriers, and not directly to the end-users of the Internet.

Verizon New York, cont'd

- The ALJ noted that the IFTA prohibits a tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access, and regardless of the terminology used to describe the tax.
- The ALJ found that the Division's reliance on language within the Tax Law as support for its definition of "Internet access" was not applicable to the terminology used in IFTA, a federal statute, as the Tax Law had been promulgated well before the Internet had been conceived and was contrary to the intent of the IFTA drafters.

And The Force Shall Bind Them Together

Tractor Supply Co. v. South Carolina Dep't of Revenue

- The South Carolina Administrative Law Court held that the South Carolina Department of Revenue could use the state's alternative apportionment authority to require Tractor Supply and its affiliates to file a combined return, although South Carolina is generally a separate-entity-filing state.
- Tractor Supply Co. of Texas, LP ("TS Texas") and Tractor Supply Co of Michigan, LLC ("TS MI") were subsidiaries of Tractor Supply. Tractor Supply paid TS Texas for purchases of wholesale inventory that TS Texas made on behalf of Tractor Supply pursuant to an Inventory Procurement Agreement, and compensation was determined based on a 482-study.
- Tractor Supply leased employees to and charged a service fee at a markup to TCS MI pursuant to a Master Shared Services Agreement.

Tractor Supply, cont'd

- In a factually intensive decision, including detailed review of competing expert reports and analyses, the ALC found that the Department had met its burden of proving that the company's separate-entity return filings caused a "shift in TSC's income to Texas through the Procurement Agreement" that resulted "in a distortion of TSC's income," and that combined reporting was a reasonable alternative method that fairly reflected the combined group's business activity in the state.
- The ALC noted that the taxpayer's expert had found that the taxpayer's original transfer pricing methodology was "flawed and unreliable," and that the expert's proposed alternative transfer pricing approach was not based on sufficient evidence.

Tractor Supply, cont'd

- The ALC rejected the argument that the statute's use of the singular term "taxpayer" limited the Department's authority to apply combined reporting, and rejected the argument that the Department is limited to only using a different allocation or apportionment method, rather than forcibly applying combined reporting, finding both arguments foreclosed by the South Carolina Supreme Court's decision in *Media General Comm's, Inc. v. South Carolina Dep't of Revenue*, 388 S.C. 138 (2010).
- While the ALC generally agreed with the company's expert that alternative apportionment should only be applied in limited circumstances, it found that the Department was justified in exercising its discretion to require a combined tax return.

Bringing it All Back Home

Moore v. United States, S.Ct. No. 22-800

- Question Presented: Does the foreign earnings repatriation requirement of the TCJA exceed the federal government's taxing power under the 16th Amendment because the taxpayer has not "realized" income from its minority ownership in a foreign corporation?
- The Moores were 12% owners (and director) of CFC subject to tax on accumulated earnings.
- 9th Circuit held that 16th Amendment authorizing unapportioned income taxes does not require a "realization event" separating income from property.

Moore, cont'd

- The *Moore* petition explicitly asked the Court to consider potential future "wealth taxes" in granting *certiorari.*
- History of original prohibition on unapportioned taxes has been heavily debated. Various quasi-income taxes were approved in 18th-19th centuries.
- *Pollock v. Farmer's Loan & Trust Co.,* (1895): federal income tax impermissible tax on property.
- 1913: 16th Amendment passes authorizing unapportioned tax on "income, from whatever source derived."
- *Eisner v. Macomber,* 252 U.S. 189 (1920): tax on stock split an unconstitutional tax on wealth, not income since income not severed from stock ownership. Distinguished but never explicitly overruled.

Moore, cont'd

What is at stake if *Moore* is overruled?

Definitely:

- Repatriation (IRC 965) as applied to individuals. State SOL's likely closed for 2017 tax year, so state refunds unlikely.
- Future "mark to market" federal wealth taxes;

Likely: Subpart F income (deemed dividends of U.S. shareholders of CFCs); PFIC Rules;

Possibly: Partnership distributive share income; GILTI.

We Have to Factor This in

Sunoco, Inc. (R&M) and Affiliates v. New York Division of Tax Appeals

- Submitted on briefs, the Division of Tax Appeals addressed whether gross amounts attributable to the sale side of buy/sell transactions should be included in the receipts factor of Sunoco's business allocation percentage (BAP) for New York corporate franchise tax for 2007-2010. The Taxpayer had filed amended returns including such amounts which diluted the BAP.
- Buy/sell transactions occur when pursuant to a third-party purchase, oil companies may engage in "buy" and "sell" inventory activities (same type and volume of oil) to swap for inventory that is closer to the destination of the buyer.
  - This is done to reduce transportation costs and pricing is at market.

Sunoco, cont'd

- The Division of Tax Appeals analyzed the computation of BAP and found that the buy/sell agreements were not receipts from the sales of tangible personal property; rather, the Division found there was merely an exchange of inventory which was included in the cost of goods sold.
- The Division further found that such exchange did not constitute a receipt that should be included in the receipts factor.

Chevron U.S.A. Inc. v Oregon Dep't of Revenue

- Before the Oregon Tax Court on second motions for summary judgment was the issue of whether the Taxpayer could include gross receipts from commodities hedging in the sales factor under ORS 314.665(6) in effect for 2011-2013.
  - The statute includes receipts derived from Taxpayer's "primary business activity."
  - The Court had previously found that the receipts were from the "sale, exchange, redemption or holding of intangible assets," also required by the statute.

Chevron U.S.A., cont'd

- The Taxpayer had provided testimony that its use of derivative commodity instruments was to manage risks related to price volatility, and that its "financial traders" worked side-by-side with its "physical traders" to daily manage commodity sales and purchases.
- These hedging transactions were instructed by the physical traders and the Taxpayer alleged that the two transactions were inextricably linked and inseparable.

Chevron U.S.A., cont'd

- The Department claimed the hedging transaction was for risk management and was not the Taxpayer's "primary business activity."
- The Tax Court, relying upon its understanding of the plain meaning of "primary" and prior Oregon case law, found that the receipts did not derive from or arise from its primary business activity of developing and producing crude oil.
- "The fact that an activity is *central* to the Taxpayer's primary business, does not mean it *is* the primary business activity." The activity merely played a supportive role.

Billmatrix v. Fla. Dep't of Revenue

- A Florida Circuit Court has held that the Florida rule sourcing services to where the income producing activity occurs, based on costs of performance, requires those sales to be sourced to where the activities of the taxpayer were performed, and not to customer locations.
- The audit reports made it clear that the Department was interpreting the term "income producing activity" to allow a market-based approach, and the Department sourced receipts to where Billmatrix's customers were located.

Billmatrix, cont'd

- The court rejected this approach as violating the plain language of the Department's rule, which required the receipts to be sourced to the location of the income-producing activities. The court held "the Department must look at the transactions and activity the *taxpayer* directly engages in … rather than looking at the actions or location of the *customer.*"
- The court cited *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 source to where the service company was performing the services.

In re Microsoft Co. & Subsidiaries, California OTA No. 21037336

- Under IRC 965, Microsoft repatriated $109 billion in accumulated foreign earnings in 2017 tax year;
- California taxes 25% of Subpart F "dividend" income; allows 75% deduction for water's edge filers; includes the 25% in sales factor denominator;
- Microsoft argues that 100% of dividends should go into receipts factor denominator as "gross receipts", similar to gross receipts from ordinary sales of services or TPP;
- California: apportionment formula should match net income actually subject to tax, not gross amounts on return.

In re Microsoft Co. & Subsidiaries, cont'd

Meanwhile, the OTA has issued a precedential decision that bodes ill for FTB's arguments:

Matter of S. Minnesota Beet Sugar Coop.; OTA Case No. 19034447; 2023 – OTA – 342P

- Minnesota Co-op files combined return with California C corporation; most of the Co-op's gross income is deductible as sales to members;
- OTA rules that full apportionment factors of Co-Op must be included in combined return despite lack of net income;
- Holds that FTB legal ruling 2006-01 is inapposite and would contradict statutory language if applicable; matching principle is not statutory.

Microsoft, cont'd

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You Should Have Thought of That Before

Kent Chandler v. Foresight Coal Sales, LLC

- The Sixth Circuit Court of Appeals found that an Illinois coal producer was likely to succeed on the merits of its claim that a Kentucky statue discriminated against interstate commerce and was unconstitutional.
- The law required Kentucky utilities to evaluate the reasonableness of coal bid prices after subtracting severance taxes from the actual bid price, including Kentucky's own severance tax.
- The Court held that the law was discriminatory in practice, making coal from states with severance taxes, like Kentucky, cheaper for Kentucky utilities by the amount of the severance taxes.

Foresight Coal Sales, cont'd

- The Court noted that the Public Service Commission "itself has offered only one purpose for SB 257: to 'even out the playing field' between Kentucky coal and competing coal from non-severance tax states."
- The Court found that Kentucky "artificially discounts its own coal, and coal from other severance-tax states, by the amount of the tax." Because non-severance-tax state coal gets no such discount, the effect was "to make Illinois coal relatively more expensive." The discrimination was not alleviated by the fact that some states already impose severance taxes or that other states may choose to impose such taxes in the future. According to the Court, a state's "policy is discriminatory if its claim to neutrality depends on another state enacting the same policy."

Foresight Coal Sales, cont'd

- Because the court only determined that Foresight was likely to succeed on the merits of its claim that the Kentucky law unconstitutionally discriminated against interstate commerce, the case was remanded to the district court for it to consider the remaining preliminary injunction factors. Meanwhile, the Public Service Commission sought review by the United States Supreme Court. A conference was scheduled for September 26.

What Happens in CT Doesn’t Seem to Stay in CT

Edward A. and Doris Zelinsky

- Back again before the New York Appeals Tribunal, Professor Zelinsky is addressing the unconstitutionality of the imposition of the convenience of the employer test during periods affected by COVID-19 mandated business closures. See, *Zelinsky v. Tax Appeals Tribunal*, 1 N.Y. 3d (2003), cert. denied, 541 U.S. 1009 (2004)
- This time around, Prof. Zelinsky emphasizes New York's constitutional obligation to apportion his salary when Cardozo Law School had been shuttered by Gov. Cuomo's Executive Orders.
  - The State continued to tax 100% of his salary during 2020.

Zelinsky, cont'd

- Addressing the inapplicability of the rule during mandated closures, Prof. Zelinsky cites to 20 N.Y.C.R.R 132.4(b), which holds that "compensation for personal services rendered by a nonresident *wholly without* New York State is *not* included in New York adjusted gross income, regardless of the fact that the payment may be made from a point in New York or that the employer [is resident in the State]".

Zelinsky, cont'd

- The Division argues that Prof. Zelinsky's services rendered were not significantly different during the last nine months of 2020, and thus, the entire tax year "must be viewed as a whole."
- The Division has failed to fully address the constitutional issues raised regarding the need for a tax to be fairly apportioned, nor the holding of Shaffer v. Carter which limits a state's ability to tax to a nonresident to "income earned within the state."
- Instead, the Division argues that *Wayfair* addresses these constitutional concerns and permits taxation based on the Professor's "virtual presence" in New York and contends that Prof. Zelinsky receives ephemeral New York benefits while working from his home.
- A decision is expected later this year.

Do You Wanna Make a Federal Case Out of It?

Quinn v. State of Washington, S.CT. No. 23-171 (On Pet. for Cert.)

- Washington Supreme Court upholds tax on capital gain income of residents as an excise tax, not subject to state's constitutional uniformity requirement.
- Petition for Certiorari claims tax is often imposed on out-of-state transactions, violating due process and commerce clause as extra-territorial tax impositions;
- State has been ordered to file BIO to Petition;
- Are there limits to states' residency-based taxation powers in an excise tax context?

THANK YOU