State + Local Tax Insights

To Be Or Not To Be: Nonbusiness Income

By R. Gregory Roberts and Rebecca M. Ulich

In recent years, taxpayers have been confronted with an ever-changing sea of definitions, tests and analyses with respect to nonbusiness income claims. From statutory changes to seemingly more frequent adverse court decisions, taxpayers are increasingly confronted with statutes that have been drafted, or interpreted, to narrow the scope of what constitutes nonbusiness income. In fact, many of the recent court decisions classifying gains as nonbusiness income have come from states that amended their statutes after the tax years involved in the cases.

Although initially 26 states adopted the language of the Uniform Division of Income for Tax Purposes Act ("UDITPA") definition of "business income,"[1] state legislatures, often in response to favorable court decisions for taxpayers, have slowly changed their statutory definitions of business income by: (i) providing that "business income" is all income apportionable under the U.S. Constitution;[2] (ii) modifying the UDITPA definition to provide that "business income" includes income from tangible and intangible property if the acquisition, management or disposition of the

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property constitutes integral parts of the taxpayer's regular trade or business;[3] or (iii) in the case of Pennsylvania, incorporating the changes in both (i) and (ii).[4] Currently, approximately half of the original 26 states have retained the traditional UDITPA definition of business income. Despite these statutory changes and recent adverse court decisions, nonbusiness income claims remain viable and continue to be valuable weapons in a taxpayer's arsenal.

This article begins by identifying and analyzing the most common statutory changes designed to expand the definition of "business income," followed by a survey of recent case law involving nonbusiness income claims under both the traditional UDITPA definition and the modified definitions. Finally, this article concludes by providing a framework for analyzing nonbusiness income claims in this continually-evolving landscape.

Recent Statutory Changes

Since the adoption of UDITPA, many state legislatures have sought to broaden the amount of income that is apportionable to their state by changing the definition of business income, primarily in one of the following three ways:

Establishing a Disjunctive Functional Test

In the 1990s, Tennessee and New Mexico changed their statutory definitions of business income to provide for a disjunctive definition under the functional test, so that their statutes now refer to the "acquisition, management *or* disposition" of property.[5]

Similarly, in 2001, the Alabama Legislature enacted a new statute to define "business income" in an attempt to legislatively overrule *Ex parte Uniroyal Tire Co.*[6] In *Uniroyal Tire*, the Alabama Supreme Court held that the UDITPA definition of business income provided for a transactional test only and that a company's liquidation of its entire partnership interest was nonbusiness income as "[a] complete liquidation and cessation of business do[es] not generate business income under the transactional test . . . because, by definition, such events are most extraordinary; they do not occur in the regular course of the taxpayer's trade or business."[7]

Although the UDITPA definition of business income was left intact, for taxable years beginning after December 31, 2001, the new statute provides in relevant part that:

> "[B]usiness income" means income arising from transactions or activity in the course of the taxpayer's trade or business; or income from tangible or intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer's trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of . . . tangible or intangible personal property, if the property while owned by the taxpayer was operationally related . . . to the taxpayer's trade or business . . . ; or gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business . . . .[8]

U.S. Constitutional Standard

In recent years, several states, including Iowa (effective in 1995), Illinois (effective in 2004), Kansas (effective in 2008), North Carolina (effective in 2002) and West Virginia (effective in 2007), and the District of Columbia (effective in 2004), have amended their definitions of "business income" to provide that "business income" is "all income that is apportionable under the United States Constitution."[9]

Although Minnesota repealed the UDITPA definition of business income in 1987, based on the fact that the statute continued to provide for the allocation and apportionment of income based on whether the income was derived from carrying on a trade or business, the Minnesota Supreme Court, in *Firstar Corp. v. Commissioner of Revenue*, applied the transactional test and held that income from the sale of the taxpayer's headquarters building was nonbusiness income. In reaching its decision, the court looked to: (i) the frequency and regularity of similar transactions; (ii) former business practices; and (iii) the subsequent use of the proceeds.[10]

In response to *Firstar*, the Minnesota Legislature enacted a definition of nonbusiness income, effective for tax years beginning after December 31, 1998, defining "nonbusiness income" as all "income of the trade or business that cannot be apportioned by [Minnesota] because of the United States Constitution . . . includ[ing] income that cannot constitutionally be apportioned to [Minnesota] because it is derived from a capital transaction that solely serves an investment function."[11]

Pennsylvania

In 2001, the Pennsylvania Legislature took a somewhat unique approach and amended its definition of business income by changing the "and" to an "or" in the functional test and adding a provision stating that business income also includes all income that is apportionable under the U.S. Constitution. Currently, "business income" is defined in Pennsylvania as:

> [I]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if *either* the acquisition, the management *or* the disposition of the property constitutes an integral part of the taxpayer's regular trade

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White Sulphur Springs, West Virginia
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July 26
COST Pacific Southwest Regional State Tax Seminar
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Scott M. Reiber
Thomas H. Steele
Andres Vallejo

August 6-7
Georgetown University Law Center, 35th Annual State & Local Tax Institute
Washington, D.C.
Craig B. Fields
Hollis L. Hyans
Philip M. Tatarowicz

October 22
Philadelphia Bar Association, Tax Section
Philadelphia, Pennsylvania
Richard C. Call
Craig B. Fields

October 24
COST, 43rd Annual Meeting & Fall Audit Session
Orlando, Florida
Craig B. Fields
Mitchell A. Newmark

October 24
San Francisco Tax Executives Institute
San Francisco, California
Eric J. Coffill
Scott M. Reiber
Thomas H. Steele
Andres Vallejo
Kirsten Wolf

November 15
The 19th Annual Paul J. Hartman SALT Forum
Nashville, Tennessee
Hollis L. Hyans

November 29-30
New York University's 31st Institute on State and Local Taxation
New York, New York
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> or business operations. The term includes all income which is apportionable under the Constitution of the United States.[12]

Of particular importance, the enacting legislation (the "2001 Act") provided that: (i) the intent of the amendment was to "clarify existing law;" and (ii) the statutory changes applied retroactively to tax years beginning after December 31, 1998.[13]

The 2001 Act was passed largely in response to the Pennsylvania Supreme Court's decision in *Laurel Pipe Line Co. v. Commonwealth*, in which the court held that gain from the sale of an idle pipeline, which the court found to be a liquidation of a discrete segment of the company's business, was not business income under either the transactional or the functional tests.[14] In reaching its decision, the court emphasized that the functional test required that "the acquisition, management, *and* disposition of the property constitute integral parts of the taxpayer's *regular* trade or business operations" to be considered business income.[15]

Recent Case Law Developments

In *In re Kimberly-Clark Corp. v. Dep't of Revenue*, the Alabama Supreme Court sustained the Department of Revenue's argument that gain from the taxpayer's sale of real estate was nonbusiness income because the sale was "most extraordinary (and did) not occur in the regular course of the taxpayer's trade or business."[16] In reaching its determination, the court relied on *Uniroyal* and affirmed that the state's statute, as in effect prior to 2002, provided for only a transactional test.[17]

Similarly, in Kansas, in *In re The Appeal of Chipotle Mexican Grill, Inc.*, under the definition of business income that was in effect prior to 2008, the Kansas Court of Tax Appeals applied only the transactional test in finding that gain resulting from an initial public offering ("IPO") was nonbusiness income because the IPO stock sale was not in the regular and ordinary course of the taxpayer's business operations.[18] In reaching its decision, the court noted that Kansas applied a transactional test to determine whether income is business income and that "[t]he controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income."[19]

In *Crystal Communications, Inc. v. Department of Revenue*, the Oregon Tax Court found that income from the sale of FCC licenses could satisfy the functional test and, therefore, be classified as business income, if the licenses were an integral part of the taxpayer's trade or business at the time of the disposition.[20] In reaching its decision, the court noted that the Oregon Supreme Court recognized the existence of a functional test that is independent from the transactional test and that, if the taxpayer were required to have been engaged in a business that regularly disposed of the type of property in question to satisfy the functional test, the functional test would be "completely redundant or duplicative of the transactional test."[21]

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Shortly after its decision in *Crystal*, the Oregon Tax Court held, in *CenturyTel, Inc. v. Department of Revenue*, that the gain from the sale of stock of a unitary subsidiary, which was treated as a deemed asset sale pursuant to Internal Revenue Code ("IRC") Section 338(h)(10), was business income.[22] Because of the IRC Section 338(h)(10) election, the court explained that the transaction was properly viewed as a disposition of assets and held that the gain was apportionable business income based on its analysis in *Crystal*. Although the court noted that *Crystal* established that there was no liquidation exception to the functional test in Oregon, the court concluded that, because CenturyTel used the proceeds of the sale to continue and expand its existing operations, the gain would have constituted business income even if there were a liquidation exception.[23]

Case Law Developments Under the New Definitions of Business Income

In *Newell Window Furnishing, Inc. v. Johnson*, the first case to interpret Tennessee's amended, disjunctive definition of business income, the Tennessee Court of Appeals held that the gain resulting from a deemed asset sale pursuant to IRC Section 338(h)(10) was business income because "[t]he proper question under the functional test is not whether the disposition of the property was an integral part of the corporation's regular business, but rather, whether the property disposed of was an integral part of the corporation's regular business."[24] As it was undisputed that the assets that were deemed to have been sold were an integral part of the taxpayer's regular business, the court found that the gain was business income.[25]

Subsequently, in *Blue Bell Creameries, LP v. Roberts*, the Tennessee Supreme Court held that capital gain from the taxpayer's one-time acquisition and sale of stock as part of a reorganization was business income.[26] The court observed that, in reaching its decision in *Newell*, the Court of Appeals "clarified that the determinative issue of the functional test is not whether the disposition of the property is an integral part of the taxpayer's regular trade or business operations but whether the property being disposed of constitutes an integral part of the taxpayer's regular trade or business."[27]

In analyzing whether the stock at issue was "integral" to the taxpayer's regular trade or business, the court explained that the term "integral" has multiple definitions, including "of, relating to, or serving to form a whole," "essential to completeness," or "organically joined or linked."[28] Noting that these meanings are not interchangeable and that, as such, the precise meaning of the phrase was uncertain, the court looked to other courts' decisions for guidance.[29] As the capital gain at issue was generated from the acquisition and sale of stock (*i.e.*, an investment) and not from the sale of tangible assets, the court looked for guidance in *Union Carbide Corp. v. Offerman*[30] and *Hoechst Celanese Corp. v. Franchise Tax Board*,[31] both of which involved gains from investments. The Tennessee Supreme Court explained that, under the North Carolina analysis, in order for property to be "integral" the "property must be 'essential to [the] completeness' of the taxpayer's regular trade or business."[32] In contrast, the court explained that, under California's approach, property is "integral" if "the taxpayer's control and use of the property . . . contribute materially to the taxpayer's production of business income so that the property becomes interwoven into and inseparable from the taxpayer's business."[33]

The Tennessee Supreme Court ultimately agreed with the finding and analysis in *Hoechst* because it found that "[t]his approach appropriately includes earnings from property that allows the taxpayer's business operations to prosper while excluding earnings from property that is incidental or unrelated to the taxpayer's business operations."[34] Applying this standard, the court held that the functional test was satisfied because Blue Bell's acquisition and sale of the stock at issue was a necessary step in the reorganization and resulted in increased earnings from the sale of Blue Bell ice cream in Tennessee and elsewhere.

Based on the functional test articulated in *Blue Bell*, the Tennessee Court of Appeals, in *H.J. Heinz Co. v. Chumley*, found that passive income in the form of dividends from a partnership interest constituted business earnings because the income allowed the taxpayer's business operations to prosper.[35]

In *Glatfelter Pulpwood Co. v. Commonwealth*, the Pennsylvania Commonwealth Court held that a taxpayer's sale of timberland generated business income under the functional test because the sale was part of the management or disposition of property constituting an integral part of the taxpayer's regular trade or business operations.[36] The taxpayer's business

MOFO ATTORNEY NEWS

CONGRATULATIONS: ERIC COFFILL has been nominated as one of the "Leading Tax Controversy Advisors in the World" by International Tax Review.

PHILIP TATAROWICZ received the "Special Recognition Award" at the Institute for Professionals in Taxation's Annual Conference.

WELCOME: Morrison & Foerster's State + Local Tax Group would like to welcome **TED W. FRIEDMAN** and **LESLIE J. LAO**. Mr. Friedman joins us as an associate in the New York office. Ms. Lao joins us as an associate in the Sacramento office.

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was to procure pulpwood for its parent company, which was engaged in the manufacture of specialty papers and engineered products.[37] The taxpayer owned timberland in four states, including Delaware.[38] In 2004, pursuant to a divestiture plan, the taxpayer sold approximately 25% of its timberland in Delaware.[39] All of the net proceeds from the sale were distributed to the parent, which used the entire amount to pay debt and to pay dividends to its shareholders.[40]

The taxpayer argued that, because the 2001 Act was intended to "clarify" existing law, cases such as *Laurel Pipe Line* that were decided prior to the amendment were still precedential.[41] In response, the Department of Revenue argued that the Legislature's statement was an improper attempt to interpret the tax code and noted that, in *Canteen*, the Commonwealth Court referred to the language in the 2001 Act as an "amended definition," and therefore, the 2001 Act legislatively overruled *Laurel Pipe Line* and eliminated any argument that an asset that produced business income could result in nonbusiness income upon its disposition.[42]

Without resolving the issue of retroactivity, the court distinguished *Laurel Pipe Line* on the facts and found that the sale of timberland did not meet the liquidation exception articulated in *Laurel Pipe Line* because the taxpayer continued to own substantial timberland acreage in Delaware and its regular business continued.[43]

In a footnote, the court observed that, because it had distinguished the case from *Laurel Pipe Line* on the facts, it did not need to address the issue of whether the 2001 Act resulted in a change or a clarification, but the court did assert that *Canteen* had "held" that the 2001 Act was an amendment and that any attempt by the Legislature to interpret the tax code is beyond the Legislature's power.[44]

Importantly, the court did not address the Department of Revenue's assertion that "[w]hile the present statute embodies the functional and transactional tests, the practical effect is that Pennsylvania has expanded the definition of business income to the extent permissible under the constitution of the United States."[45]

In *Tate & Lyle Ingredients Americas, Inc. v. Department of Revenue*, the Alabama Circuit Court, without opinion, granted the taxpayer's motion for summary judgment and thereby upheld the determination of the Chief Administrative Law Judge ("ALJ") that gain from the sale of a subsidiary was nonbusiness income.[46] In reaching his determination, the ALJ noted that the Alabama Legislature amended the definition of business income in 2001 to expressly provide for both a transactional and a functional test, as well as a third "operationally-related" test.[47] Applying the amended definition, the ALJ held that the sale of stock that the taxpayer had held for 45 years was an infrequent transaction that was not in the taxpayer's regular course of business and therefore, clearly was not business income under the transactional test.[48] The ALJ further explained that the gain was not business income under the functional test because the taxpayer and the subsidiary "operated totally separate and independent businesses" and that "[t]he [t]axpayer's purchase, ownership, and/or sale of the . . . stock had nothing to do with the [t]axpayer's business in Alabama or elsewhere."[49] The ALJ then explained that the operationally-related test reflects a statutory adoption of the constitutional operational-function test discussed by the U.S. Supreme Court in *Allied-Signal, Inc. v. Director, Div. of Taxation* and that, to be classified as business income, the statutory test requires that the activities of the corporation from which the taxpayer derived the gain must have been operationally-related to the taxpayer's trade or business.[50] Interestingly, *Tate & Lyle* was decided *before* the U.S. Supreme Court's decision in *MeadWestvaco v. Illinois Department of Revenue*, but *after* the Court had granted *certiorari*.[51] Although the ALJ concluded that the U.S. Supreme Court's holding in *MeadWestvaco* would not affect the outcome of *Tate & Lyle*, the ALJ distinguished the unitary business test from the operational function test and found that the state's statute encompassed only the operational function test.[52]

In Minnesota, despite a legislative bulletin stating that the definition of nonbusiness income "is intended to void the definition of nonbusiness income of *Firstar*,"[53] the Minnesota Tax Court, in *Nadler v. Commissioner of Revenue*, applied the factors set forth in *Firstar* in holding that income from a 2001 sale of stock in an S-corporation that was treated as a deemed sale of assets pursuant to IRC Section 338(h)(10) was nonbusiness income.[54] As an initial matter, the Tax Court rejected the Minnesota Department of Revenue's assertion that the amended definition of nonbusiness income established a purely constitutional standard for Minnesota's apportionment rules because the court found that such a standard would essentially nullify the statutory provisions concerning income not derived from a trade or business.[55] Applying the *Firstar* factors, the court held that the gain was nonbusiness income because: (i) there was no frequency or regularity of similar transactions because the gain from the deemed sale of assets was an isolated transaction in the corporation's history; (ii) based on the taxpayer's former business practices, the corporation was not engaged in the business of selling corporate stock or assets; and (iii) looking at the subsequent use of the proceeds showed that the proceeds were distributed to the taxpayer's shareholders in a deemed liquidation and were not reinvested in the corporation.[56]

Framework for Classifying Gain Going Forward

Even in the face of the recent statutory changes, however, a state's power to tax is not absolute and gains must satisfy certain criteria before they can be classified as apportionable business

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income.

For example, in states that have modified the UDITPA definition of business income to provide for a disjunctive functional test, the asset must still be an *integral* part of the taxpayer's trade or business to generate business income upon its sale or disposition. Thus, as demonstrated in *Tate & Lyle*, where income results from the sale of an asset that was not integral to the taxpayer's trade or business, the income is properly classified as nonbusiness income.[57]

A central issue under these new statutes, therefore, is what constitutes "integral." Although the California Supreme Court's analysis of the functional test in *Hoescht* has led to a line of case law in California and in other states, such as Tennessee and Oregon, that interpret the functional test as requiring a showing that the property sold contributed materially to the taxpayer's production of business income "so that the property becomes interwoven into and inseparable from the taxpayer's business," this interpretation is arguably so broad that it essentially equates the functional test with the constitutional, unitary business requirement.[58] The states' legislatures, in adopting the UDITPA definition of business income rather than a constitutional standard, have demonstrated an intent to distinguish between income that is apportionable under the U.S. Constitution pursuant to the unitary business principle and income that is apportionable under the business income standard; if a state's legislature had intended to impose a purely constitutional standard, it could statutorily adopt such a standard or it could implicitly adopt a constitutional standard by simply not creating a statutory distinction between business and nonbusiness income.[59]

Also, as the Tennessee and California Supreme Courts have acknowledged, there are multiple definitions of the word "integral."[60] The definition of "integral" as "essential to completeness" that was adopted by the North Carolina Supreme Court in *Union Carbide* arguably provides a better standard against which to classify gain than the "contribute[s] materially" standard applied by the courts in California and Tennessee because "essential to completeness" is a standard dictionary definition and, therefore, implements the common and ordinary understanding of the word in accordance with fundamental rules of statutory construction. Further, unlike the "contributes materially" standard, the "essential to completeness" standard does not include, for example, surplus assets or assets that are no longer necessary or essential to the business, but which may have generated business income at some point.[61] Thus, "essential to completeness" provides a narrower standard that preserves the distinction between the statutory standard for business income and the constitutional standard for income from a unitary business.

Another flaw in the reasoning of *Hoechst* and the cases that adopt its analysis is that they completely ignore the nature of the transaction and focus exclusively on the relationship of the asset to the taxpayer's business.[62] Based on the plain language of the functional test—"acquisition, management, or disposition of the property constitute integral parts of the taxpayer's regular trade or business operations"—the nature of the transaction is relevant to an analysis under the functional test.

Furthermore, although unique to Pennsylvania, in *Glatfelter*, by distinguishing *Laurel Pipe Line* on the facts rather than finding that the case had been legislatively overruled by the 2001 Act, the Commonwealth Court left open the possibility that it would continue to recognize the liquidation exception articulated in *Laurel Pipe Line*.[63] Moreover, as the 2001 Act states that the amendment to the definition of business income is intended to clarify existing law, *Laurel Pipe Line* and similar cases interpreting the definition of business income prior to the statutory change arguably should continue to be precedential authority. The Pennsylvania Supreme Court has previously considered clarifying legislation and found that "[s]ince the purpose was to serve as a clarification of the existing language, we cannot infer any intent to change the existing meaning of the law."[64] Further, the Pennsylvania Supreme Court has noted that "[t]he General Assembly has directed in the Statutory Construction Act . . . that the object of interpretation and construction of all statutes is to ascertain and effectuate the intent of the General Assembly."[65]

ANOTHER FLAW IN THE REASONING OF *HOECHST* AND THE CASES THAT ADOPT ITS ANALYSIS IS THAT THEY COMPLETELY IGNORE THE NATURE OF THE TRANSACTION AND FOCUS EXCLUSIVELY ON THE RELATIONSHIP OF THE ASSET TO THE TAXPAYER'S BUSINESS.

Additionally, "[a]nother bedrock principle of statutory construction requires that a statute be construed, if possible, to give effect to all its provisions, so that no provision is mere surplusage."[66] The Pennsylvania Department of Revenue's assertion that the statute's "practical effect" is to define business income as income apportionable to the extent permissible under the U.S. Constitution ignores this principle of statutory construction and renders nugatory the statutory provisions regarding the transactional test and the functional test.

Finally, even in those states that have adopted the constitutional standard for apportionment of income, the U.S. Supreme Court has made it clear that the Due Process and Commerce Clauses of the U.S. Constitution mandate that a state may not, when imposing an income or franchise tax, "tax value earned outside its borders."[67] In *MeadWestvaco*, the Court reaffirmed the applicability of the unitary business principle in analyzing the extent of a state's taxing power.[68] Thus, although in those states that have adopted a constitutional standard it may be more difficult to successfully assert a nonbusiness income claim with respect to certain types of transactions

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conducted in a state, even these states are not free to apportion all income; gains from the sale of an asset that is not unitary with the taxpayer's trade or business remain nonapportionable under *Allied Signal* and *MeadWestvaco*.[69]

1 UDITPA defines "business income" as:

> [I]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business [the "transactional test"] and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations [the "functional test"].

MTC art. IV. § 1(a).

2 *See, e.g.*, D.C. Code § 47-1810.02 (effective 2004); Iowa Code § 422.32(1)(b) (effective May 1, 1995); 35 Ill. Comp. Stat. § 5/1501(a)(1) (effective July 30, 2004); Kan. Stat. Ann. § 79-3271 (effective January 1, 2008); Minn. Stat. § 290.17 (effective for tax years beginning after December 31, 1998); N.C. Gen. Stat. § 105-130.4 (effective January 1, 2002); W.V. Code § 11-24-3a(a)(2) (effective March 10, 2007).

3 *See, e.g.*, Ala. Code § 40-27-1.1 (effective for tax years beginning after December 31, 2002); Miss. Code Ann. § 27-7-23(a)(2) (effective for tax years beginning on or after January 1, 2001); N.M. Stat. Ann. § 7-4-2(A) (effective for the 1999 and subsequent tax years); Tenn. Code Ann. § 67-4-2004(4), *previously codified as*, Tenn. Code Ann. § 67-4-804(a)(1) (effective for tax years ending on or after July 15, 1993).

4 *See* 72 Pa. Stat. § 7401(3)2(a)(1)(A) (effective June 22, 2001, retroactive to tax years beginning after December 31, 1998).

5 *See* Tenn. Code Ann. § 67-4-2004(4), *previously codified as*, Tenn. Code Ann. § 67-4-804(a)(1); N.M. Stat. Ann. § 7-4-2(A).

6 779 So. 2d 227 (Ala. 2000); *see* Act 2001-1113, HB7, 4th Spec. Sess. (Ala. 2001)(stating that the bill "would provide further for the definition of 'business income' for purposes of the Multistate Tax Compact in order to overrule the Alabama Supreme Court decision in *Uniroyal Tire Company v. Alabama Department of Revenue*").

7 779 So. 2d 227 (Ala. 2000).

8 Ala. Code § 40-27-1.1.

9 Iowa Code § 422.32(1)(b); 35 Ill. Comp. Stat. § 5/1501(a)(1); Kan. Stat. Ann. § 79-3271; N.C. Gen. Stat. § 105-130.4; W.V. Code § 11-24-3a(a)(2).

10 575 N.W.2d 835 (Minn. 1998).

11 Minn. Stat. § 290.17 Subd. 6.

12 72 Pa. Stat. § 7401(3)2.(a)(1)(A) (emphasis added).

13 HB 334, 2001-02 Leg., 185th Sess. (Pa. 2001).

14 642 A.2d 472 (Pa. 1994).

15 *Id.* (emphases in original).

16 No. 1070925 (Ala. 2010), *with related at* 69 So. 3d 144 (Ala. 2010), *subsequent decisions regarding requests by the taxpayer for the court to hear constitutional arguments denied at* No. 2100811 (Ala. Civ. Ct. of App. Feb. 17, 2012) (holding that the circuit court correctly denied the taxpayer's motion to remand the action to the Administrative Law Judge for resolution of the taxpayer's constitutional arguments because the Supreme Court had determined that the income was nonbusiness income) (internal quotations and citation omitted).

17 *Id.*

18 No. 2009-9077-DT (Kan. Ct. of Tax App. Oct. 21, 2010).

19 *Id.* (quoting *In re The Appeal of The Kroger Co.*, 12 P.3d 889 (Kan. 2000) (internal quotations omitted)).

20 No. TC 4769 (Or. T.C. July 19, 2010). In *Crystal* and *CenturyTel*, *infra*, the statute at issue was Oregon Revised Statutes Section 314.280, which specifically relates to the allocation of income of financial institutions and public utilities and which incorporates by reference the regulations regarding the definition of business income. Although the UDITPA definition of business income is found in these regulations, the Tax Court in *Crystal* noted that Section 314.280 predated Oregon's adoption of the UDITPA definition and therefore, rejected the idea that the regulations should be construed under UDITPA principles. Despite this finding, the court nevertheless determined that the gain was also business income under the UDITPA definition.

21 *Id.* (internal quotes omitted).

22 No. TC 4826 (Or. T.C. Aug. 9, 2010).

23 With the exception of decisions in California and Tennessee, *see infra*, the Oregon Tax Court's decision in *CenturyTel* is inconsistent with decisions involving IRC Section 338(h)(10) elections, which have "consistently found that gains derived from deemed asset sales are considered 'nonbusiness' income." *See, e.g.*, *McKesson Water Products Co. v. Div. of Tax.*, 974 A.2d 443 (N.J. Super. Ct. App. Div. 2009); *see also Nicor Corp. v. Dep't of Revenue*, Nos. 1-07-1359 & 1-09-1591 (Ill. App. Ct. Dec. 5, 2008); *Chambers v. State Tax Comm'n*, No. 050402915 (D. Utah Jan. 25, 2007), *vacated by joint motion*, No. 2007-467-SC (Ut. 2008); *ABB C-E Nuclear Power, Inc. v. Dir. of Revenue*, 215 S.W.3d 85 (Mo. 2007); *Canteen Corp. v. Commonwealth*, 854 A.2d 440 (Pa. 2004); *Commonwealth v. Osram Sylvania, Inc.*, 863 A.2d 1140 (Pa. 2004).

24 311 S.W.3d 441 (Tenn. Ct. of App. 2008).

25 *Id.*

26 333 S.W.3d 59 (Tenn. 2011).

27 *Id.* citing to *Newell*.

28 *Id.* citing to *Webster's Third New Int'l Dictionary*, 1173 (1993).

29 *Id.*

30 526 S.E.2d 167 (N.C. 2000).

31 22 P.3d 324 (Cal. 2001).

32 *Blue Bell*, 333 S.W.3d 59 (citing to *Union Carbide*).

33 *Id.* (quoting and citing *Hoechst*, 22 P.3d 324) (internal quotations omitted).

34 *Id.*

35 No. M2010-00202-COA-R3-CV (Tenn. Ct. App. June 28, 2011).

36 19 A.3d 572 (Pa. Commw. Ct. 2011), *application for oral arguments before the Pa. Supreme Ct. granted* (Mar. 26, 2012).

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

41 Petitioner's Brief, pg. 21-22.

42 Respondent's Brief, pg. 15-16.

43 *Glatfelter*, 19 A.3d at 578-80.

44 *Id.* Although the court stated that in *Canteen* it had "held" that the statutory change was an amendment, the only discussion of the 2001 Act in *Canteen* is in two footnotes, both of which describe the changes to the definitions of business and nonbusiness income as "amendments" without any discussion of whether the 2001 Act was a clarification or amendment. *Canteen*, 818 A.2d at 598 fns. 9, 10.

45 Respondent's Brief, pg. 24.

46 No. CORP. 07-162 (Admin. Law Div. Jan. 15, 2008), *reaffirmed after petition for rehearing* (June 23, 2008), *motion for summary judgment pursuant to Rule 56 granted* No. CV-2008-900755 (Ala. Cir. Ct. Aug. 4, 2009).

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.*

51 *Id.*

52 *Id.*

53 1999 Minn. Legis. Bull.: Corporate Franchise Tax, Minn. Dep't of Revenue.

54 No. 7736R (Minn. Tax Ct. Apr. 21, 2006).

55 *Id.*

56 *Id.*

57 *See Tate & Lyle*, No. CORP. 07-162.

58 *See Hoescht*, 22 P.3d 324.

59 *See Reynolds Metals Co., LLC v. Dep't of Treasury*, No. 300001 (Mich. Ct. App. Mar. 20, 2012), *unpublished opinion not precedentially binding* (applying the constitutional unitary business standard to determine whether capital gain from the sale of a subsidiary was apportionable in Michigan under the Single Business Tax Act, which did not provide a distinction between business and nonbusiness income); *see also Nadler*, No. 7736R (stating that "to infer a definition of business income that would establish purely constitutional limits to Minnesota's apportionment rules would allow the general provision [defining nonbusiness income] to vitiate the particular provision found in [the provision regarding allocation of income not derived from [the] conduct of a trade or business]," which would be "[e]ffectively concluding that the gain on a sale of assets associated with a business is never subject to allocation [as income not derived from a trade or business], [and] would violate the rule of construction providing that 'the legislature intends the entire statute to be effective and certain'").

60 *See Blue Bell*, 333 S.W.3d at 66; *Hoechst*, 22 P.3d at 339-40.

61 *See Blue Bell*, 333 S.W.3d at 68; *Hoechst*, 22 P.3d at 340-44; *Union Carbide*, 526 S.E.2d at 171.

62 *See Hoechst*, 22 P.3d at 339.

63 *See Glatfelter*, 19 A.3d at 578-80.

64 *Commonwealth v. Rosenbloom Fin. Corp.*, 325 A.2d 907 (Pa. 1974) (discussing a proposed legislative revision that was not reported out of committee).

65 *Commonwealth v. Gilmour Mfg. Co.*, 822 A.2d 676 (Pa. 2003) (internal citations omitted).

66 *Id.* (internal citations and quotations omitted).

67 *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982).

68 *Id.*

69 *See, e.g.*, *Reynolds Metal*, No. 300001 (Mich. Ct. App. Mar. 20, 2012).

The Unitary Business Principle Applies to More Than Corporate Net Income Taxes: *Reynolds Metals Company v. Department of Treasury*

By Paul H. Frankel, Craig B. Fields, Michael A. Pearl and Richard C. Call

Recently, in *Reynolds Metals Company v. Department of Treasury*, the Michigan Court of Appeals held that the unitary business principle applies to Michigan's Single Business Tax (the "SBT").[1] Although the court's decision comes as no surprise, it is significant inasmuch as it reinforces the fact that the unitary business principle applies to more than corporate net income taxes, *i.e.*, it applies to gross receipts taxes or value-added taxes ("VAT") as well. Long before corporate net income taxes were commonly used by states, the U.S. Supreme Court developed the rationale of a unitary business to ensure that a state did not tax value or activity occurring outside of the state. That rationale applies equally to VATs, gross receipts taxes, net worth taxes or other business activity taxes. In the following pages, we review and analyze the court's decision in *Reynolds Metals* and discuss its application to taxes other than the SBT.

The Michigan Court of Appeals Holds That Michigan May Not Tax the Gain on the Sale of a Non-Unitary Entity

The SBT, which was repealed for years after 2007, is a VAT that uses the federal income tax system as its starting point.[2] A taxpayer then makes various required additions and subtractions to federal taxable income to convert the base into a consumption-type VAT base (the "SBT tax base").[3]

Reynolds Metals Company ("Reynolds Metals") is a manufacturer, distributor and marketer of aluminum products. At issue in *Reynolds Metals* was the Michigan Court of Claims' decision that precluded the Department of Treasury ("Department") from including in the SBT tax base capital gains recognized by Reynolds Metals from the sale of an interest in a foreign joint venture that was based in Australia.[4] The foreign joint venture was established by Reynolds Metals and three other aluminum companies for the mining and refining of alumina, a product used to produce aluminum.

The Michigan Court of Appeals sustained the lower court's decision that held that the capital gains were not includable in the SBT tax base. The evidence showed that no functional integration existed inasmuch as there was no sharing of managerial or operational resources between Reynolds Metals and the joint venture, no sharing of research and development, Reynolds Metals was unable to control the joint venture and transactions and agreements between Reynolds Metals and the joint venture were negotiated at arm's-length. Reynolds Metals and the foreign joint venture did not have centralized management inasmuch as Reynolds Metals had less than a majority control of the foreign joint venture's executive committee (comparable to a board of directors) and day-to-day operations were run by an independent management company that had its own facilities, resources, employees and accounts and that reported to the executive committee. Finally, no economies of scale were present because no joint purchasing or production occurred and any alumina produced by the joint venture and sold to Reynolds Metals was sold at arm's-length terms.

The Michigan Court of Appeals Affirms That the Unitary Business Principle Applies to Michigan's SBT

In sustaining the lower court's decision, the Michigan Court of Appeals rejected the Department's argument that the unitary business principle does not apply to the SBT. The Department based its argument on two premises: (1) "the unitary business principal[sic] is not applicable to the SBT because the SBT is a value-added tax, and no court has ever ruled that the unitary business principal[sic] is applicable to value-added taxes;" and (2) prior Michigan case law had held that the unitary business principle does not apply to the SBT.[5] The first of these arguments is addressed below.[6]

In holding that the unitary business principle applies to the SBT, the Michigan Court of Appeals addressed the nature of a VAT, stating that "[v]alue-added taxes are designed to measure and tax the *activity* and contribution an economic enterprise adds to the economy, as opposed to an income tax, which taxes the return received from supplying those resources to the economy."[7] The court then explained that "[i]n *Mobil Oil Corp*. . . ., the United States Supreme Court reiterated that a state may not tax value earned outside of its borders; however, businesses operating in interstate commerce are not immune from fairly apportioned state taxation."[8] Further, "for purposes of satisfying the Due Process Clause, 'the linchpin of apportionability in the field of state income taxation is the unitary-business principle.'"[9] The Court of Appeals then stated:

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> While the unitary business principle is frequently applied to test the constitutionality of the apportionment of income-based taxes, no case has held that the unitary business principle is only applicable to income-based taxes; nor would such a holding reasonably follow from the line of cases applying the unitary business principle.[10]

The Michigan Court of Appeals relied in part on the U.S. Supreme Court's description of the SBT in *Trinova Corp.*, in which the U.S. Supreme Court held that the SBT was constitutional. In *Trinova*, "[t]he Court explained that in the case of both value-added taxes and income-based taxes, the 'discrete components' of a state tax 'may appear in isolation susceptible of geographic designation.'"[11] However, "the Court 'recognized the impracticality of assuming that all income can be assigned to a single source'" and noted that "added value often cannot be assigned to a single source" because of "'factors such as functional integration, centralization of management, and economies of scale . . . .'"[12] Based on the above rationale, the Michigan Court of Appeals concluded that:

> [T]he unitary business principle applies to value-added taxes, such as the SBT, because the underlying realities of both income-based and value-added taxes require apportionment, and the United States Supreme Court has made it clear that the apportionment of taxes is constitutionally permitted only if the business is unitary.[13]

U.S. Supreme Court Precedent Confirms That the Unitary Business Principle Applies to VATs

The Michigan Court of Appeals correctly decided *Reynolds Metals*. The unitary business principle does apply to the SBT. For similar reasons, the unitary business principle should apply to other apportioned state taxes that are not corporate net income taxes, such as gross receipts taxes, net worth taxes and business activity taxes.

THE MICHIGAN COURT OF APPEALS CORRECTLY DECIDED *REYNOLDS METALS*. THE UNITARY BUSINESS PRINCIPLE DOES APPLY TO THE SBT.

The court's holding is consistent with *Complete Auto*, which summarized the U.S. Supreme Court's analytical framework for evaluating the constitutionality of state taxes as follows:

1. The tax is applied to an activity with a substantial nexus with the taxing state;
2. The tax is fairly apportioned;[14]
3. The tax does not discriminate against interstate commerce; and
4. The tax is fairly related to the services provided by the state.[15]

Interestingly, the U.S. Supreme Court articulated these four prongs in the context of what it labeled as a "sales tax," but which was actually a tax on "gross income" as applied to the taxpayer in the case.[16]

Since *Complete Auto*, the U.S. Supreme Court has explained that the underlying rationale of the fair apportionment prong of *Complete Auto* is to prohibit a state from taxing *value* or *activity* outside of the state's border. In *Mobil Oil*, the Court expounded on the fair apportionment prong of *Complete Auto* and stated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle."[17] In *Allied-Signal, Inc. v. Director, Division of Taxation*, the U.S. Supreme Court explained that the unitary business principle is a constitutional restraint "on a State's power to tax *value* earned outside of its borders."[18] The *Allied-Signal* Court further explained that "[i]n a Union of 50 States, to permit each State to tax *activities* outside its borders would have drastic consequences . . . ."[19]

To the extent that the unitary business principle restrains a state's power to tax "value" or "activity" outside of the state, such rationale supports applying the unitary business principle to more than corporate net income taxes. States levy a variety of taxes on multistate businesses. Many measure the taxable value differently. That is, some states measure value in terms of corporate net income while others measure value using gross income or receipts, net worth, a VAT or some combination of the foregoing. Regardless of the computational method used, one common constitutional concern with each is whether it taxes "value" or "activity" outside of the state. Fair apportionment and the unitary business principle ensure that a state does not tax such out-of-state values or activities.

The history of the unitary business principle supports a conclusion that the unitary business principle applies to more than just corporate net income taxes inasmuch as the U.S. Supreme Court developed the unitary business principle long before corporate net income taxes were widely used by the states. In fact, the unitary business principle originated in property tax cases that involved railroads and telegraph companies operating in interstate commerce.[20] In these cases, the U.S. Supreme Court recognized "the difficulty that what makes such a business valuable is the enterprise as a whole, rather than the track or wires that happen to be located within a State's borders."[21]

Moreover, the U.S. Supreme Court's jurisprudence with respect to the SBT supports a holding that the unitary business principle applies to more than corporate net income taxes. In *Trinova*, the U.S. Supreme Court all but explicitly stated that the unitary business

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principle applies to the SBT. The *Trinova* Court addressed whether three-factor apportionment is constitutional in the context of a VAT.[22] First, the U.S. Supreme Court approached the case on the understanding that the activity to be taxed was a "unitary enterprise" and that with respect to the SBT "the[] elements of value added are inextricable, codependent variables."[23]

Second, the U.S. Supreme Court likened the SBT to a corporate net income tax and based its decision in large part on U.S. Supreme Court decisions that applied the unitary business principle to corporate net income taxes. In one comparison, the *Trinova* Court stated, "[a]s with a VAT, the discrete components of a state income tax may appear in isolation susceptible of geographic designation. Nevertheless . . . we have recognized the impracticability of assuming that all income can be assigned to a single source."[24] The Court continued: "The same factors that prevent determination of the geographic location where income is generated, factors such as functional integration, centralization of management, and economies of scale, make it impossible to determine the location of value added with exact precision."[25] Inasmuch as these three factors are the identical three factors that the Court has identified as indicia of a unitary business, *Trinova* supports the proposition that the unitary business principle applies to the SBT.

The Unitary Business Principle Applies to All Apportioned Taxes

Reynolds Metals reaffirms the applicability of the unitary business principle to more than corporate net income taxes. Taxpayers seeking to argue that the unitary business principle applies to more than corporate net income taxes may find its rationale applicable to their issues. This topic is relevant inasmuch as some states have adopted taxes other than corporate net income taxes and others have considered adopting such taxes. In fact, since Michigan repealed the SBT, Michigan has adopted two new taxes. The first was the Michigan Business Tax Act, which consisted of a corporate net income tax and a gross receipts tax and the second is a more traditional corporate income tax.[26] Other states such as Ohio, Texas and Washington also have business activity or gross receipts taxes in lieu of corporate net income taxes.[27] Additionally, some states impose franchise or net worth taxes that seek to tax an apportioned share of a taxpayer's value.[28]

TO THE EXTENT THAT TAXES OTHER THAN CORPORATE NET INCOME TAXES ARE IMPOSED ON A MULTISTATE BUSINESS, THE U.S. CONSTITUTION REQUIRES APPORTIONMENT AS WELL AS THE APPLICATION OF THE UNITARY BUSINESS PRINCIPLE TO SUCH TAXES.

To the extent that taxes other than corporate net income taxes are imposed on a multistate business, the U.S. Constitution requires apportionment as well as the application of the unitary business principle to such taxes. In some cases, state law explicitly recognizes this fact. For example, the Texas statutes regarding the Margin Tax explicitly recognize the unitary business principle for purposes of combined reporting.[29] Nevertheless, specific fact patterns may arise in which a state taxing authority argues that the unitary business principle does not apply. Thus, *Reynolds Metals* and the U.S. Supreme Court cases described above provide a helpful framework from which to rebut such arguments. ■

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1 No. 300001 (Mich. Ct. App. Mar. 20, 2012), *unpublished opinion not precedentially binding*.

2 *Mobil Oil Corp. v. Dep't of Treasury*, 422 Mich. 473, 496-97 (1985).

3 *Id.* at 496-97 (footnote omitted).

4 No. 300001.

5 *Id.*

6 The Michigan Court of Appeals dismissed the second argument inasmuch as the case upon which the Department relied held that the unitary business principle did not allow multiple entities to be treated as one taxpayer, not whether the unitary business principle limits what income of a multistate corporation may be taxed. *Id.*

7 *Id.* (emphasis added).

8 *Id.* (internal citation omitted) (citing *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 436 (1980)).

9 *Id.* (citing *Mobil Oil*, 445 U.S. at 439).

10 *Id.*

11 *Id.* (citing *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 377-78 (1991)).

12 *Id.* (citing *Trinova Corp.*, 498 U.S. at 378-79).

13 *Id.*

14 Later U.S. Supreme Court jurisprudence modified the applicability of the fair apportionment requirement to sales and use taxes. *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

15 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

16 *Id.* at 275.

17 *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 439 (1980).

18 504 U.S. 768, 784 (1992) (emphasis added).

19 *Id.* at 777-78 (emphasis added).

20 *State R. Tax Cases*, 92 U.S. 575 (1876); *Mass. v. W. Union Tel. Co.*, 141 U.S. 40 (1891); *Maine v. Grand Trunk Ry. Co.*, 142 U.S. 217 (1891); *see also Allied-Signal*, 504 U.S. 778-79.

21 *Allied-Signal*, 504 U.S. at 778.

22 *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 377-78 (1991).

23 *Id.* at 376.

24 *Id.* at 377-78.

25 *Id.* at 379.

26 The Michigan Business Tax Act is codified at Michigan Compiled Laws Section 208.1301 *et seq.* Michigan Compiled Laws Section 206.623 imposes the new corporate income tax.

27 Ohio Rev. Code Ann. § 5751.01 *et seq.*; Tex. Tax Code § 171.0001 *et seq.*; Wash. Rev. Code § 82.04.010 *et seq.*

28 *See, e.g.*, La. Rev. Stat. Ann. § 47:601 *et seq.*; N.C. Gen. Stat. § 105-114 *et seq.*

29 Tex. Tax Code §§ 171.0001, 171.1014; Tex. Admin. Code § 3.587.

Thoughts on California Residency

By Eric J. Coffill and Leslie J. Lao

In all but the most rudimentary cases, determining California residency for personal income tax purposes is not an easy task. Upon first impression, one might be puzzled by this statement because the California statutory scheme is not complex on its face. Indeed, for purposes of California's personal income tax, the legal standard for residency is defined in a mere 32 words in a single section of the California Revenue and Taxation Code.[1] However, bright-line standards and formal guidelines are next to nonexistent. Instead, the residency analysis has grown in practice to involve a nearly limitless number of variables, all of which are potentially relevant and none of which are controlling. Truly, "the devil is in the details" when it comes to determining California residency for personal income tax purposes.

Taxpayers seeking clarity in changing from resident to nonresident, from nonresident to resident or from resident to part-year resident status will find little comfort in this lack of certainty. The California personal income tax is imposed on the entire taxable income of residents of the state.[2] Thus, a residency determination often involves substantial amounts of money and significant tax consequences for the taxpayer, especially when a significant gain (*e.g.*, sale of a business) is involved.

It is our experience that careful due diligence, interpretation and analysis allow the taxpayer to manage the seemingly unmanageable body of California residency law. In this article, we will summarize the major principles of residency law in California, including the statutory scheme and administrative and judicial tests used to determine residency for purposes of personal income tax. We will also explore possible reasons, based on current laws and trends, which may contribute to the increasing challenges involving California residency.

California's current economic crisis arguably exacerbates the California Franchise Tax Board's ("FTB") already aggressive enforcement and interpretation of California residency law. Personal income tax represents 61% of total California general fund revenue sources, compared to 21% from sales tax and only 10.6% from corporate taxes.[3] Over the past four decades, personal income tax revenues to the general fund have also increased dramatically, rising from 27% to 51% of general fund revenues.[4] Moreover, the top 1% of income earners pay up to 50% of all California personal income taxes.[5] Thus, it should come as no surprise that California's overall tax burden (combined state and local taxes) is higher than all neighboring states and, of major states, only New York's tax burden is considerably higher.[6]

IT SHOULD COME AS NO SURPRISE THAT CALIFORNIA'S OVERALL TAX BURDEN (COMBINED STATE AND LOCAL TAXES) IS HIGHER THAN ALL NEIGHBORING STATES

State tax reform, potentially generating even higher personal income tax rates, also has emerged as a key issue in the upcoming November 2012 California election. Currently, the top graduated California personal income tax rate is 9.3%, plus an additional 1% tax on taxable income over $1 million.[7] With a top marginal rate of 10.3%, California currently has the second highest marginal tax rate in the United States.[8] Despite California's already aggressive taxation scheme, California Governor Brown and the California Federation of Teachers have qualified an initiative for the November ballot which would "temporarily" increase the personal income tax rate by 1% for single filers with taxable income over $250,000; by 2% for taxable income above $350,000; and by 3% for taxable income above $500,000.[9] The amounts for joint filers would be double the amounts for single filers.[10] Activist Molly Munger has also qualified a separate initiative for the November ballot which would add an income tax surcharge to the existing personal income tax and the 1% "millionaire's tax," including an increase of 2.2% for taxpayers earning over $2.5 million.[11] Even the magnitude of recent Silicon Valley IPOs, such as Facebook's $16 billion IPO in May 2012, are seen as offering California a glimmer of hope for much needed revenue – and cause for worry for some taxpayers.[12] Governor Brown's office has estimated sales of Facebook stock will generate $1.9 billion of additional revenue, spread over two fiscal years, from the capital gains of Facebook's newly-minted millionaires.[13] As California seeks to balance its budget, the complex and challenging factual inquiry of California residency will move to the forefront of more taxpayers' minds.

Ignoring for the moment the intensely factual aspect of residency, there is a single overriding statutory legal standard under which those facts are to be evaluated. The legal analysis of residency always must begin with Section 17014(a), which defines "resident" to include (1) "Every individual who is in California for other than a temporary or transitory purpose"; and (2) "Every individual who is domiciled in California who is outside the state for a temporary or transitory purpose." Conversely, any individual who is not a California resident is a "nonresident."[14]

Regulations promulgated by the FTB echo the language of Section 17014 to define residency: "[t]he term resident,

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as defined in the law, includes (1) every individual who is in the State for other than a temporary or transitory purpose, and (2) every individual who is domiciled in the State who is outside the State for a temporary or transitory purpose."[15] Again, note the absence of any statutory bright-line rule or specified metric for determining residency. The closest to a bright-line rule in the entire body of California residency law, by statute or regulation, is a *rebuttable* presumption of California residency when an individual is present within California for more than nine months of a taxable year.[16] However, no presumption of *non*residency arises when a taxpayer spends *less* than nine months of the year in California.[17] Indeed, FTB's regulation states, "It does not follow, however, that a person is not a resident simply because he does not spend nine months of a particular taxable year in this State. On the contrary, a person may be a resident *even though not in the State during any portion* of the year."[18]

Unfortunately, there is a lack of judicial case law addressing the general question of California residency or interpreting either Section 17014 (or its counterpart in FTB's regulations). In 2004, for the first time in decades, a California Court of Appeal issued a published decision interpreting Section 17014 in *Noble v. Franchise Tax Board*.[19] Prior to *Noble*, the most significant and most cited judicial residency case was the 1964 Court of Appeal decision in *Whittell v. Franchise Tax Board*.[20] There have been no published Courts of Appeal residency decisions subsequent to *Noble* in 2004. As such, both cases carry significant weight in the history of California residency law.

The definition of residency under Section 17014 is closely linked to the concept of domicile. The Court of Appeal in *Whittell* defined "domicile" as the "one location with which for legal purposes a person is considered to have the most settled and permanent connection, the place where he intends to remain and to which, whenever he is absent, he has the intention of returning."[21] Similarly, FTB Regulation 17014(c) defines domicile as "the place where an individual has his true, fixed, permanent home and principal establishment, and to which place he has whenever he is absent, the intention of returning," as well as "the place where an individual has fixed his habitation and has permanent residence without any present intention of permanently removing therefrom."

"Residence" and "domicile" are nonetheless separate and distinct concepts for California tax purposes. "Domicile" denotes the one location with which a person has the most settled and permanent connections and where the person intends to remain. "Residence" denotes any factual place of abode of some permanency, that is, "more than a mere temporary sojourn."[22] A taxpayer may have several residences simultaneously, but a taxpayer will have only *one* domicile at any given time.[23] Once acquired, a domicile is presumed to continue until it is shown to have changed.[24]

"RESIDENCE" AND "DOMICILE" ARE NONETHELESS SEPARATE AND DISTINCT CONCEPTS FOR CALIFORNIA TAX PURPOSES.

In order to change one's domicile, the California State Board of Equalization ("SBE")[25] has required a showing that a taxpayer: (1) left the state without any intention of returning; and (2) was located elsewhere with the intention of remaining there indefinitely.[26] In determining the taxpayer's intent, "the acts and declarations of the party must be taken into consideration."[27] In *Noble,* the court confirmed the significance of the taxpayer's physical acts in determining intent, holding: "To the extent residence and domicile depend upon intent, 'that intention is to be gathered from one's acts.'"[28] The *Noble* court further clarified the two indispensable elements to accomplish a change of domicile: (1) actual residence in the new locality; and (2) the intent to remain there for an indefinite period of time.[29] Consistent with *Noble,* the SBE cautions that the determination of residency "cannot be based *solely* on the individual's subjective intent, but must instead be based on objective facts."[30]

FOR CALIFORNIA DOMICILIARIES, THE FOCUS OF THE INQUIRY IS UPON WHETHER THE TAXPAYER IS ABSENT FROM CALIFORNIA FOR A TEMPORARY OR TRANSITORY PURPOSE.

When domicile is an issue in a residency case – the typical scenario – domicile is always decided first.[31] For California domiciliaries, the focus of the inquiry is upon whether the taxpayer is absent from California for a temporary or transitory purpose. If so, the taxpayer is a California resident.[32] For non-California domiciliaries, the inquiry is whether the taxpayer is in California for other than a temporary or transitory purpose.[33] Whether a purpose is temporary or transitory in character "will depend to a large extent upon the facts and circumstances of each particular case."[34] The analysis under California tax law should be the same regardless of the taxpayer's state of domicile. As discussed above, the case law on California residency is scarce.[35] Accordingly, much of the body of law regarding the determination of California residency is found at the administrative level.

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One might discern two independent tests from administrative and judicial decisions to address the residency question. The first test, and the most widely known and used, is commonly referred to as the "Closest Connections Test."[36] This test compares the taxpayer's contacts with his or her new place of abode to the contacts with his or her former place of abode. A number of factors traditionally have been included in the "closest connections" analysis, and as usual, are considered with the facts and circumstances peculiar to each case. Neither FTB's publications nor FTB's regulations attempt or purport to provide a complete list of such factors.[37] To its credit, in 2003, the SBE, in *Appeals of Stephen D. Bragg*, recognized the complexity of the residency question in light of the diverse factual contexts in which the issue could arise.[38] Confronted with the near impossibility of creating a universal test, the SBE set forth a list of 19 items, now commonly referred to as the *Bragg* factors, to help determine a taxpayer's closest connections:

1. The location of all of the taxpayer's residential real property and the approximate sizes and values of each of the residences;
2. The state wherein the taxpayer's spouse and children reside;
3. The state wherein the taxpayer's children attend school;
4. The state wherein the taxpayer claims the homeowner's property tax exemption on a residence;
5. The taxpayer's telephone records (*i.e.*, the origination point of taxpayer's telephone calls);
6. The number of days the taxpayer spends in California versus the number of days the taxpayer spends in other states and the general purpose of such days (*i.e.*, vacation, business, etc.);
7. The location where the taxpayer files his tax returns, both federal and state, and the state of residence claimed by the taxpayer on such returns;
8. The location of the taxpayer's bank and savings accounts;
9. The origination point of the taxpayer's checking account transactions and credit card transactions;
10. The state wherein the taxpayer maintains memberships in social, religious and professional organizations;
11. The state wherein the taxpayer registers his automobiles;
12. The state wherein the taxpayer maintains a driver's license;
13. The state wherein the taxpayer maintains voter registration and the taxpayer's voting participation history;
14. The state wherein the taxpayer obtains professional services, such as doctors, dentists, accountants and attorneys;
15. The state wherein the taxpayer is employed;
16. The state wherein the taxpayer maintains or owns business interests;
17. The state wherein the taxpayer holds a professional license or licenses;
18. The state wherein the taxpayer owns investment real property; and
19. The indications in affidavits from various individuals discussing the taxpayer's residency.[39]

Although not codified in the statutory scheme of residency or set forth in any judicial case law, the *Bragg* factors are utilized by the SBE as a benchmark for determining residency.[40] However, lest one think *Bragg* provides certainty, the SBE freely admits this 19-factor list is not "exhaustive" or exclusive and that these factors "serve merely as a guide" in determining residency.[41] The focus of the *Bragg* examination is "to determine where an individual is present for other than a temporary or transitory purpose" and satisfaction of a majority or a significant number of the factors is not necessarily dispositive.[42] According to *Bragg*, the weight given to any particular factor also depends on the totality of the circumstances.[43]

THE *BRAGG* FACTORS ARE UTILIZED BY THE SBE AS A BENCHMARK FOR DETERMINING RESIDENCY.

The second approach to residency is referred to as the "Identifiable Purpose Test." In order to determine whether a taxpayer is in or out of California for other than a temporary or transitory purpose, the SBE examines if the taxpayer is in a location for an identifiable purpose and the length of time necessary to fulfill that purpose. "[W]here an individual expects to be out of California for an indefinite period of time which is expected to last more than two years, such individual will be expected to be out of the state for an indefinite period of substantial duration" and, therefore, is no longer considered a resident of California.[44] While Section 17014 makes no distinction with respect to employment, the SBE has suggested that when a Californian is employed outside California, his absence will be considered for other than a temporary or transitory purpose if the position is expected to last a long, permanent or indefinite time.[45]

The SBE's attempts to clarify California residency standards with an "Identifiable Purpose Test" or a "Closest Connections Test" are admirable. However, a dearth of formal guidance or direction in the form of agency materials contributes to the difficulties facing taxpayers confronted with FTB residency audits or who are attempting to plan their arrival into or departure from California for personal income tax purposes. As discussed above, the California Courts of Appeal have issued only *two* published California residency decisions since 1964.[46] Even

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with the *Bragg* factors, a taxpayer's ability to grasp the details of California residency is further limited because of insufficient written precedential SBE decisions interpreting California residency law.

Without written precedential decisions from the SBE to offer further and consistent insight as to its interpretation of the *Bragg* factors in varying factual contexts, the factors provide only limited guidance. That is because not only are the *Bragg* factors nonexclusive, they are too easily and often conditioned on subjective interpretations. Some factors now seem to be anachronisms. For example, one *Bragg* factor looks to the "location" of the taxpayer's bank and savings accounts. In today's modern society of interstate banking, where ATMs and bank branches are available on nearly every street corner and accessible from almost everywhere, is it necessary or even logical for a taxpayer to need to physically close an account at one "location" and open another in a new location? Some factors are overly subjective. For example, one *Bragg* factor addresses the number of days the taxpayer "spends" in California versus the number of days the taxpayer "spends" in other states. Further, all factors present issues involving comparative value. For example, should a taxpayer's state of employment carry the same weight in the *Bragg* analysis as the state in which a vehicle is registered? Should the location of a taxpayer's residence carry the same weight as where his doctors, dentists, accountants and attorneys are located? Such questions abound.

Thus, while at first glance appearing objective, *Bragg*'s application in practice is a subjective calculation in a sea of ambiguity. Further written and precedential guidance from the SBE (or, ideally, from the courts) in terms of explaining and weighting the *Bragg* factors would prove extremely beneficial – both to taxpayers and the FTB. Unfortunately, the number of published opinions issued by the SBE has plummeted in recent years. During the 1980s, the SBE published an average of 161.5 formal opinions each year, while during the period 2000 to 2010, the SBE only published an average of 3.2 formal opinions each year.[47]

To make matters worse, there is a plethora of procedural issues accompanying a typical FTB residency audit. For example, tax cases are to be decided, year by year, on their own merits and their own facts, without regard to other years.[48] The implication is that a determination of residency (or nonresidency) for any given year does not and may not preclude a similar FTB inquiry for the succeeding (or preceding) year. Further, unlike judicial proceedings, formal rules of evidence do not govern FTB residency audits, leading to the legal equivalency of food fights over whose evidence is more convincing. FTB's regulation simply provides that the type and amount of evidence necessary to rebut or overcome a presumption of California residency and to establish nonresidency "cannot be specified by a general regulation, but will depend largely on the circumstances of each particular case."[49]

DURING THE 1980s, THE SBE PUBLISHED AN AVERAGE OF 161.5 FORMAL OPINIONS EACH YEAR, WHILE DURING THE PERIOD 2000 TO 2010, THE SBE ONLY PUBLISHED AN AVERAGE OF 3.2 FORMAL OPINIONS EACH YEAR.

Declarations, affidavits or testimony of a taxpayer, his or her friends, employers or business associates, however, are most certainly relevant and may overcome the presumption to establish nonresidency and must be a part of any well-developed residency case.[50]

Clearly, the California residency determination is a complex inquiry, and without written formal guidance or statutory or objective tests, it is uncertain how much is "enough" to establish residency or nonresidency under the existing body of law. Query, how can a taxpayer be expected to navigate a California residency case with certainty in light of such a vague framework?

UNLIKE JUDICIAL PROCEEDINGS, FORMAL RULES OF EVIDENCE DO NOT GOVERN FTB RESIDENCY AUDITS, LEADING TO THE LEGAL EQUIVALENCY OF FOOD FIGHTS OVER WHOSE EVIDENCE IS MORE CONVINCING.

Against this backdrop of ambiguity, it should come as no surprise that some states have statutorily adopted more objective tests to determine residency for personal income tax purposes. For example, in New York, a provision commonly known as the "183 Day Rule" defines a statutory resident as an individual who is not domiciled in the state, but: (1) maintains a permanent place of abode in New York, and (2) spends in the aggregate more than 183 days of the taxable year in New York, carving out an exception for active military personnel.[51] Recall also that the Section of Taxation of the California State Bar proposed in a preliminary report, over 20 years ago, that California should provide an objective standard based on the taxpayer's presence in California for a minimum number of days.[52] It may not be necessary for California to adopt such a stringent and single-minded objective test for residency, but take note of the added ease by which a properly constructed bright-line rule could be administered, as well as the added guidance and certainty it would

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provide to taxpayers and the FTB. In California, the complexity and nuances of residency law discussed above may have significant consequences for a taxpayer who faces a residency audit or who may simply have questions about his or her residency status. With FTB auditors aggressively pursuing residency audits for the possibility of reaping rewards of substantial revenue for the state, a taxpayer may face an uphill battle without clearer guidance from judicial and statutory authorities. Vague and ambiguous administrative and judicial tests are available, yet as discussed here, such analyses are subject to factual debates and interpretation. A similar predicament follows those taxpayers who are seeking to move into or depart from California for personal income tax purposes. With careful due diligence and expert analysis, however, it is possible for a taxpayer to successfully navigate this seemingly unmanageable body of California residency law. ■

1 Cal. Rev. & Tax. Code § 17014(a).

2 Cal. Rev. & Tax. Code § 17041. A credit may then be given for taxes paid to another state. *See* Cal. Rev. & Tax. Code § 18001 *et seq*.

3 Dep't of Finance, GOVERNOR'S BUDGET SUMMARY, at 17, *available at* http://www.ebudget.ca.gov/pdf/BudgetSummary/SummaryCharts.pdf.

4 Mac Taylor, Legis. Analyst's Office, CAL FACTS (2011), at 20, *available at* http://www.lao.ca.gov/reports/2011/calfacts/calfacts_010511.pdf.

5 *Id*. at 21.

6 *Id*. at 9. This comparative tax burden is especially evident when one considers that two nearby states – Nevada and Washington – have *no* personal income tax.

7 Cal. Rev. & Tax. Code §§ 17041, 17043 (codifying the Mental Health Services Act).

8 Nick Kasprak, *Monday Map: Top State Marginal Income Tax Rates, as of January 1st, 2012*, Tax Foundation, Feb. 27, 2012, http://taxfoundation.org/blog/monday-map-top-state-marginal-income-tax-rates-january-1st-2012. Only Hawaii has a higher marginal tax rate at 11%.

9 Qualified Statewide Ballot Measures, June 2012 Statewide Ballot Measures, http://www.sos.ca.gov/elections/ballot-measures/qualified-ballot-measures.htm. This initiative also proposes increasing the general sales and use tax rate by 0.25%. *See also* California Taxpayers Ass'n, *Initiative Update: Governor and Molly Munger Complete Signature-Gathering for Tax Measures*, May 4, 2012, http://www.caltax.org/homepage/050412_initiative_update.html.

10 *Id.*

11 *Id*.

12 Stacy Cowley, *Facebook Employees Face $4 Billion Tax Bite*, CNNMONEY, May 9, 2012, http://money.cnn.com/2012/05/09/technology/facebook-tax-bill/index.htm; Barbara Ortutay, *Facebook's $16 billion IPO one of world's largest*, YAHOO! NEWS, May 17, 2012, http://news.yahoo.com/facebooks-16-billion-ipo-one-worlds-largest-212520548--finance.html.

13 Chris Megerian, *Facebook's stock price dives, and California could take hit*, L.A. TIMES, May 30, 2012, http://latimesblogs.latimes.com/california-politics/2012/05/facebook-california-budget.html; California Taxpayers Ass'n, *CalTaxletter* Vol. 24, No. 20, May 25, 2012, at 2-3. The budget estimates are predicated on the growth of the price per share from the public offering price of $38 to $45 in six months.

14 Cal. Rev. & Tax. Code § 17015; *see also* 18 Cal. Code of Regs. § 17014(a).

15 18 Cal. Code of Regs. § 17014(a).

16 Cal. Rev. & Tax. Code § 17016; 18 Cal. Code of Regs. § 17016.

17 *Appeal of Walter R. and Ida J. Jaffee,* Cal. St. Bd. Of Equal., July 6, 1971.

18 18 Cal. Code of Regs. § 17016 (emphasis added).

19 118 Cal.App.4th 560 (2004).

20 231 Cal.App.2d 278 (1964).

21 *Id.* at 284.

22 *Whittell*, 231 Cal.App.2d at 284; *Smith v. Smith*, 45 Cal.2d 235, 239-240 (1955).

23 *Whittell*, 231 Cal.App.2d at 284.

24 18 Cal. Code of Regs. § 17014(c); *Murphy v. Travelers Ins. Co.,* 92 Cal.App.2d 582, 587 (1949).

25 The five elected board members of the SBE hear administrative appeals from final FTB decisions on personal income tax (and corporate tax) "protests" filed by taxpayers who have been audited and assessed by FTB. Cal. Rev. & Tax. Code §§ 19045-19047.

26 *See Appeal of Terance and Brenda Harrison*, Cal. St. Bd. of Equal., June 25, 1985; *see also Estate of Peters* 124 Cal.App. 75, 77 (1932).

27 *Appeal of Joe and Gloria Morgan*, Cal. St. Bd. of Equal., July 30, 1985; *see also Appeal of Harrison*, Cal. St. Bd. of Equal., June 25, 1985 (stating "[i]t is the 'intent' of the person that determines domicile"); *Estate of Phillips*, 269 Cal. App.2d 656, 659 (1969); *Chapman v. Superior Court*, 162 Cal.App.2d 421, 426 (1958).

28 118 Cal.App.4th at 567-568 (quoting *Chapman*, 162 Cal.App. at 426).

29 118 Cal.App.4th at 568 (quoting *DeMiglio v. Mashore*, 4 Cal.App.4th 1260, 1268 (1992) and *Estate of Weed*, 120 Cal. 634, 639 (1898)).

30 *Appeals of Stephen D. Bragg*, Cal. St. Bd. of Equal., May 28, 2003 (emphasis added).

31 *Estate of Phillips*, 269 Cal.App.2d 656, 659 (1969); *Aldabe v. Aldabe,* 209 Cal.App.2d 453, 466 (1962).

32 18 Cal. Code of Regs. § 17014(a).

33 *Id.*

34 18 Cal. Code of Regs. § 17014(b).

35 *See Noble*, 118 Cal.App.4th at 560; *Whittell v. Franchise Tax Board*, 231 Cal.App.2d 278 (1964).

36 18 Cal. Code of Regs. § 17014(b) (emphasis added). The Closest Connections Test relies on the underlying theory of Sections 17014 through 17016 that the state with which the person has the closest connection during the taxable year is the state of his residence.

37 *See, e.g.*, California Franchise Tax Board, FTB Publication 1031: Guidelines for Determining Resident Status – 2011 (2011); 2011 California 540NR Tax Booklet; Instructions for Form 540/540A; Instructions for Long Form 540NR.

38 Cal. St. Bd. of Equal., May 28, 2003.

39 *Id*.

40 Since *Bragg*, the SBE has issued numerous Letter Decisions and Summary Decisions (both nonprecedential) in which it referenced the *Bragg* factors as applicable law. *See, e.g.*, *Appeal of Robert A. Poll and Gail D. Poll*, Case No. 523625, Feb. 28, 2012; *Appeal of Constance L. Maples,* Case No. 382846, Jan. 21, 2009; *Appeal of Jeremiah S. Ryder,* Case No. 399886, June 9, 2009; *Appeal of David W. Sanders, et al.*, Case No. 400374, Aug. 19, 2008; *Appeal of James F. and Diane Montgomery,* Case No. 309423, Aug. 21, 2008; *Appeal of Robert and Maureen Fouts*, Case No. 383284, May 19, 2008; *Appeal of Kenneth Banks,* Case No. 327922, Apr. 9, 2008; *Appeal of Gregory B. Duro,* Case No. 354992, Feb. 28, 2008; *Appeal of Larry and Rhoda Geisel,* Case No. 358724, June 25, 2007; *Appeal of William F. and Susan J. Grun,* Case No. 337066, June 25, 2007; *Appeal of Brian K. Shaw,* Case No. 341954, Mar. 1, 2007; *Appeal of James and Jean A. Bagley,* Case No. 217274; Feb. 1, 2006.

41 *Bragg,* Cal. St. Bd. of Equal., May 28, 2003.

42 *Id.*

43 *Id.*

44 *Appeal of Crozier*, Cal. St. Bd. of Equal., Apr. 23, 1992.

45 *Appeal of David A. Abbot,* Cal. St. Bd. of Equal., June 10, 1986; *Bragg,* Cal. St. Bd. of Equal., May 28, 2003.

46 *Noble*, 118 Cal.App.4th at 560; *Whittell*, 231 Cal. App.2d at 278.

47 *State Board of Equalization: administration: opinions:* Hearing on AB 2323 Before the Assemb. Comm. on Revenue and Tax'n, 2001-12 Leg., Reg. Sess. (Cal. 2012). AB 2323, currently pending in the California Legislature, would require the SBE to publish and make available on its website a written formal legal opinion or a written memorandum opinion for each case in which the amount in controversy is $500,000 or more.

48 *See Appeal of Duane H. Laude,* Cal. St. Bd. of Equal., Oct. 6, 1976; *Appeal of Swift & Co.*, Cal. St. Bd. of Equal., Apr. 7, 1970; *Appeal of Allied Properties,* Cal. St. Bd. of Equal., Mar. 17, 1964.

49 18 Cal. Code of Regs. § 17014(d)(1).

50 18 Cal. Code of Regs. § 17014(d)(1); *Appeal of Raymond H. and Margaret R. Berner*, Cal. St. Bd. of Equal., Aug. 1, 2002. We observe that FTB has been chided for improperly refusing such affidavits and declarations, which are permitted under SBE rules and FTB regulations. *See id*.

51 N.Y. Tax. Law § 605(b)(1)(B).

52 David S. Boyce, *California Residency: Should the 'Temporary or Transitory Purpose' Test Be Replaced?*, 1 J. Cal. Tax'n 4, pp. 30, 35 (1990).

Comity Stalls Challenge to New York City Parking Tax Exemption

By Hollis L. Hyans and Amy F. Nogid

Late in 2011, in *Joseph v. Hyman*, the Second Circuit Court of Appeals dismissed a complaint in which various parties challenged as unconstitutional an exemption from the New York sales tax on parking services.[1] The Court of Appeals relied on the doctrine of comity to narrow even further a taxpayer's ability to bring a constitutional challenge to a tax in federal court.[2]

In New York City, a New York State law provides for the imposition of a 10.375% sales tax on parking services (composed of a 4% state tax, a 6% city tax, and a 0.375% Metropolitan Commuter Transportation District tax) and authorizes New York City as a city "of one million or more" to impose a "Manhattan surcharge," an additional 8% sales tax if the parking services are rendered in Manhattan.[3] The law also includes an exemption from the 8% Manhattan surcharge for some residents who purchase long-term parking (the "Residential Exemption").[4] Therefore, in Manhattan, the total parking tax for those not entitled to the Residential Exemption amounts to 18.375%.

In *Joseph*, a civil rights class action suit commenced in August 2009, the plaintiffs were primarily commuters who parked their cars in the city and they asserted that the Residential Exemption was discriminatory and violated the Commerce, Equal Protection and Privilege and Immunities Clauses of the U.S. Constitution, and Article 1, Section 11 of the New York State Constitution.[5] Estimates of the revenue effect of the Residential Exemption varied from $3 million to $22 million annually. Also, the plaintiffs cited *Lunding v. New York Tax Appeals Tribunal*[6] and *City of New York v. State*[7] to support their position that the various state and city defendants "violated clearly established constitutional law" and "failed to act in an objectively reasonable manner" and that the state and city defendants were not therefore entitled to qualified immunity.[8] The plaintiffs argued that because the defendants were various state and city government officials and were acting under color of state law, the defendants' actions violated 42 United States Code Section 1983 ("Section 1983") and accordingly, the plaintiffs were entitled to attorneys fees under 42 United States Code Section 1988.[9]

CONGRESS ENACTED THE TIA IN 1937 BECAUSE OF CONCERNS THAT FEDERAL COURTS WERE INTERFERING IN THE COLLECTION OF STATE TAXES, AND THE ENACTMENT WAS GROUNDED IN PRINCIPLES OF FEDERALISM.

Two significant potential barriers to the plaintiffs' position were the Tax Injunction Act (the "TIA")[10] and the comity doctrine. The TIA bars federal courts from taking any action to "enjoin, suspend or restrain the assessment" of a state tax when "a plain, speedy and efficient remedy" is available in state court.[11] Comity, which comes from the Latin "comitas," meaning friendly,[12] stands for the proposition that courts of one jurisdiction may accede or give effect to the decisions of another jurisdiction. Also, abstention doctrines and federal statutes–of which there are many–require federal courts to refrain from involvement in some matters, and to allow those matters to be resolved by state courts. For example, Congress enacted the TIA in 1937 because of concerns that federal courts were interfering in the collection of state taxes, and the enactment was grounded in principles of federalism. Other enactments include the Anti-Injunction Act[13] and the Federal Tax Injunction Act.[14] Abstention doctrines, which are generally known by the name of the case from which they hail, include the *Pullman*,[15] *Younger*,[16] *Burford*,[17] *Colorado River*[18] and *Rooker-Feldman*[19] abstention doctrines.

At the time of the briefing to the district court in *Joseph v. Hyman*, two U.S. Supreme Court cases, *Fair Assessment in Real Estate Association, Inc. v. McNary*[20] and *Hibbs v. Winn*,[21] set the framework for determining whether the TIA or principles of comity would bar federal court review of a constitutional challenge to a state tax.

In *Fair Assessment*, the U.S. Supreme Court held that comity barred a suit brought in federal court to review a local property tax assessment, even though the action was brought under Section 1983 alleging that the taxpayers were deprived of equal protection and due process of law because of unequal taxation of real property.[22] As Section 1983 authorizes federal courts to hear cases challenging the constitutionality of state laws, the Court needed to reconcile that federal law with: (1) the TIA, which barred federal court access with respect to injunctive relief; (2) the prohibition, based on comity principles, against issuing declaratory judgments in state tax challenges;[23] and (3) the notion that comity does not apply if a Section 1983 violation is alleged.[24] The Court held that comity precluded the commencement in federal court of Section 1983 cases challenging state

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tax systems, as long as the state court remedies were "plain, adequate and complete."[25]

However, in *Hibbs*, in a decision by Justice Ruth Bader Ginsburg, the U.S. Supreme Court held that neither the TIA nor principles of comity barred a suit challenging a state tax credit under the establishment clause on the basis that the credit improperly channeled public funds to pay for parochial schools, because the relief sought did not implicate enjoining the collection of a tax or contesting the validity of a tax imposition, but rather only challenged a credit and the success of the plaintiff's action would result in greater, rather than diminished, state tax collections.[26] In *Hibbs*, the Court stated in footnote 9 that it "relied upon 'principles of comity' to preclude original federal-court jurisdiction only when plaintiffs have sought district-court aid in order to arrest or countermand state tax collection."[27] Relying on that footnote, the First, Sixth, Seventh and Ninth Circuits applied narrow views of the comity doctrine and a broad view of the route left open in *Hibbs* and allowed certain actions to proceed in federal court.[28] The decision in *Hibbs* was regarded as an opening of the door to federal courts when challenging certain state tax provisions.

"IT'S SOMETIMES HARD TO BE ABLE TO KNOW, WHEN YOU'RE IN THE TRENCHES, WHAT IS A RUN-OF-THE-MINE TAX CASE."

However, on November 2, 2009, the U.S. Supreme Court agreed to hear the Sixth Circuit case, *Commerce Energy, Inc. v. Levin*.[29] On June 4, 2010, the Court, in another opinion by Justice Ginsburg, reversed the Sixth Circuit, held that the comity doctrine was "more embracive" than the TIA and barred a challenge in federal court to Ohio's taxation of gas marketers, which was alleged to be discriminatory.[30] The Court in *Levin* found the "comity calculus" presented was different from that presented in *Hibbs*, as the economic legislation implicated in *Levin* "does not involve any fundamental right or classification that attracts heightened judicial scrutiny or impinge on fundamental rights," the litigation was intended to "improve [plaintiffs'] competitive position," and the state courts are better positioned to address "state legislative preferences" and could craft remedial options that would impact tax collection and would therefore be unavailable to federal courts.[31]

Oral argument in *Joseph* was held on July 23, 2010 and the district court judge asked right off the bat why *Levin* was not a "game-changer."[32] Judge Richard J. Sullivan said, "I think you may have some interesting arguments and creative arguments . . . I just think that . . . after *Levin*, you probably should be across the street."[33] In response to the city's argument that *Levin* established that the comity principle applied to plain vanilla or "run-of-the-mine" tax cases, Judge Sullivan noted that "one man's vanilla is another man's tutti-frutti" and recognized that "it's sometimes hard to be able to know, when you're in the trenches, what is a run-of-the-mine tax case."[34] In an attempt to come within *Hibbs*, the plaintiffs in *Joseph* argued that because they were seeking to "enhance rather than deplete state coffers," the TIA did not prohibit federal court review.[35] The district court recognized that the plaintiffs were attempting to "slip the restraints" of the TIA, but dismissed the case under the comity doctrine, finding that no fundamental right is implicated in the parking tax exemption, that plaintiffs were not third-party challengers of the tax but were "objecting to their own tax burden, however indirectly" and that the state court is "better suited than this Court to identify and implement the remedial option that best comports with the legislative will."[36] The court also noted that the plaintiffs had not alleged that the state remedies were insufficient.[37]

In affirming the district court's decision, the Second Circuit added little to the analysis, but did address the plaintiffs' assertion that New York courts could not fashion remedies different from those available to district courts, concluding that state courts could, if necessary, prevent enforcement of discriminatory tax provisions, even if the result was a decrease in state tax revenue.[38] The case was dismissed without prejudice and resort to the state courts remains available to challenge the exemption.[39]

THE BAR TO GAIN ENTRY TO THE FEDERAL COURT SYSTEM HAS BEEN RAISED AND ONLY THOSE PLAINTIFFS WHOSE CLAIMS INVOLVE FUNDAMENTAL RIGHTS, OR WHO CAN DEMONSTRATE THAT THE STATE REVIEW SYSTEM IS INADEQUATE, WILL PASS THE HURDLE.

Status of Comity After *Levin*

As recognized by *Joseph*, after *Levin* the bar to gain entry to the federal court system has been raised and only those plaintiffs whose claims involve fundamental rights, or who can demonstrate that the state review system is inadequate, will pass the hurdle.[40] Reliance on the notion that a credit or an exemption provision is implicated, rather than an assessment, or that a suit is commenced by a nontaxpayer, is unlikely to provide the entry ticket.

In some respects, raising the bar was appropriate. Litigants should not be able to cast about for plaintiffs to avoid the prohibition against directly enjoining the collection of tax, that is by naming

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as plaintiff someone who is not actually a taxpayer, such as an employer who reimburses an employee for taxes paid. Likewise allowing a challenge to the grant of credits or exemptions of a particular tax, but not to tax assessments, may be too nuanced an approach to determine whether jurisdiction exists, particularly given the goal of the TIA and the comity doctrine, which is to keep most state tax challenges in state courts.

However, it remains true that litigating constitutional issues in state courts can be burdensome and unrewarding. *ANR Pipeline Co. v. Louisiana Tax Commission* highlights the need for federal jurisdiction and shows how easy it may be for a state to establish that the state court process has met the "plain, speedy, and efficient" requirement, thereby thwarting taxpayers' resort to federal courts and any meaningful challenge to unconstitutional statutes.[41] ANR Pipeline challenged as unconstitutional Louisiana's taxation of interstate and intrastate natural gas pipelines at different assessment ratios.[42] The Louisiana trial court had ruled that the tax ratio differential was unconstitutional on due process and equal protection grounds; the court did not reach the commerce clause challenge.[43] However, the trial court also concluded that the fair market value would need to be redetermined, a process that would involve revaluations for each year and for each of the 52 parishes in which the pipeline was located. ANR Pipeline challenged the revaluation as violating its due process rights, but neither the Louisiana Court of Appeals, Louisiana Supreme Court nor the U.S. Supreme Court would hear the case, even though ANR Pipeline indicated to the U.S. Supreme Court that the review procedure could generate 1,500 new proceedings and that the company faced the possibility that instead of refunds they would receive assessments.[44] ANR Pipeline's fears proved correct. As a result of the revaluations, ANR Pipeline received assessments that more than eliminated the refunds to which it would have been entitled if the reduced valuation ratio had been applied to the fair market value originally reported–clearly a case of "no good deed goes unpunished." ANR Pipeline then sought review by the trial court, which enjoined the revaluation proceedings and ordered refunds, but the Louisiana Court of Appeal vacated the trial court order and directed that the revaluation proceeding continue. ANR Pipeline appealed the revaluations–resulting in additional assessments of $15.7 million–and the Louisiana Tax Commission granted ANR Pipeline relief. Twenty parishes appealed the tax commission ruling in their home districts and ANR Pipeline sued in Louisiana's first, second and third circuit courts of appeal.[45] The second and third circuit courts of appeal denied the writs (the action in the third circuit court of appeal is still pending), allowing the 20 separate actions to proceed.

ANR Pipeline then sought the aid of the federal district court, requesting injunctive relief and damages under Section 1983. ANR Pipeline stressed that instead of refunds for their constitutional injuries, it received an additional $15.7 million in assessments and that there had been a "perversion and abuse" of the revaluation process. The federal district court referred to the *Rooker-Feldman* abstention doctrine, which prohibits lower federal court review of state decisions and said that the doctrine would not apply if an independent claim were presented, even if a ruling on the independent claim would be contrary to the state court decision. Because the state trial court never decided the commerce clause question that ANR Pipeline had raised, the court held that that issue could be viewed as an exception to the *Rooker-Feldman* abstention doctrine. However, the federal district court ruled that the Section 1983 claim grounded in the commerce clause was time-barred and further held that the TIA, the Anti-Injunction Act and the comity doctrine precluded its exercise of jurisdiction. The court noted that ANR Pipeline had available a plain, speedy and efficient remedy in the state courts, even if federal courts would have provided a "better" remedy.[46] Regarding ANR Pipeline's post-judgment claims of due process violations and to the conclusion that such action violated the TIA, the Anti-Injunction Act and principles of comity, the court found that ANR Pipeline had failed to allege that the defendants acted under a policy or custom, a necessary element to establish a Section 1983 due process claim, and it dismissed that claim as well. The Fifth Circuit affirmed the Louisiana federal district court decision, thus allowing Louisiana's onerous property tax review procedures to continue, even though the revaluations appeared to have been applied in a retaliatory manner and even though ANR Pipeline would need to defend 20 home-parish review proceedings, finding that this was somehow an "adequate scheme" of state review.[47] Years after the initial decision in *ANR Pipeline*, the issues remain unresolved.

YEARS AFTER THE INITIAL DECISION IN *ANR PIPELINE*, THE ISSUES REMAIN UNRESOLVED.

The perception that state courts may be more overly protective of state fiscs than federal courts–regardless of whether that is borne out by empirical evidence–is one that hails from the early days of this country and is one held by many taxpayers. As recognized by Chief Justice John Marshall in a 1809 decision of the U.S. Supreme Court: "the constitution itself either entertains apprehensions on this subject, or views with such indulgence the possible fears and apprehension of suitors, that it has established national tribunals."[48] Justice Joseph Story confirmed just a few years later that "[t]he constitution has presumed (whether rightly or wrongly we do not inquire) that state attachments, state prejudices, state jealousies, and state interests might sometimes obstruct, or control, or be supposed to obstruct or control, the regular administration

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IT IS NOT UNCOMMON FOR STATE COUNSEL TO MELD THE LEGALLY IRRELEVANT FINANCIAL IMPLICATIONS OF A TAXPAYER-FAVORABLE OPINION INTO BRIEFING AND ARGUMENT

of justice."[49] Not much has changed in nearly 200 years. The notion of state court protectionism was recently acknowledged by the Iowa Supreme Court in its decision in *KFC Corp. v. Iowa Dep't of Revenue*, in which the court observed that "it might be argued that state supreme courts are inherently more sympathetic to robust taxing powers of states than is the United States Supreme Court."[50] It is not uncommon for state counsel to meld the legally irrelevant financial implications of a taxpayer-favorable opinion into briefing and argument, further supporting the perception. States also may harbor fears that they might not fare as well under federal court scrutiny; it is telling that 44 states and the District of Columbia supported Ohio as *amici* before the U.S. Supreme Court in *Levin*.[51] Another concern is the U.S. Supreme Court's extraordinarily limited docket, which may be insufficient to provide taxpayers with protection from state tax actions that transcend constitutional boundaries. Generally, the Court grants fewer than 100 cases per term; less than 1% of the cases in which petitions are filed.[52]

Federal Court Review Not Entirely Foreclosed

Although resort to federal court may be more restrictive after *Levin*, as confirmed by some recent decisions, opportunities remain for federal court review. For example, in *Amazon.com LLC v. Lay*, the federal district court retained jurisdiction and held that the North Carolina Department of Revenue's request for purchaser-specific detailed information, made in connection with its audit of Amazon, violated the First Amendment and the Video Privacy Protection Act.[53] The federal district court distinguished *Levin* and observed that Amazon's request was not a broad request to enjoin the collection of tax or argue that the state's tax scheme was invalid.[54] Interestingly, the court also found that the North Carolina procedure governing subpoenas was "not plain," stressing that the Department of Revenue could not point to any set of procedural rules to govern tax subpoena disputes.[55] The court was, however, concerned with principles of comity and promised to "fashion the most appropriately narrow relief possible."[56] Likewise, challenges to recently enacted revisions to New Jersey's abandoned property law–not a tax law–were allowed to proceed in federal court over New Jersey's assertion that the *Buford* abstention doctrine, which provides that federal courts should refrain from exercising jurisdiction if state policy is implicated, would dictate dismissal.[57]

GENERALLY, THE COURT GRANTS FEWER THAN 100 CASES PER TERM; LESS THAN 1% OF THE CASES IN WHICH PETITIONS ARE FILED.

Another interesting twist to federal court jurisdiction in tax cases was raised in *Swift Frame v. City of San Diego*, in which San Diego sought removal to federal court of the case commenced in a California state court by a taxpayer seeking a tax refund and the taxpayer–not San Diego–filed a motion for abstention.[58] Once in federal court, San Diego moved to dismiss the case on the basis of the TIA and principles of comity.[59] The city's motion was granted and the request by taxpayer to remand the case to state court was not addressed;[60] if the case is not remanded, it is unclear whether the taxpayer's state court remedies would now be barred on statute of limitations grounds.

There is no question that taxes are vital to state governments' survival. There is also no question that sometimes tax systems and the actions of government officials violate federal constitutional protections. It is highly questionable whether, given the TIA and the principles of comity, there are adequate protections available to taxpayers. An alternative federal judicial venue that can hear appeals from final decisions in state tax matters that the U.S. Supreme Court does not have the capacity to hear would provide a welcome safeguard.[61] ■

Previously published in substantially similar form in State Tax Notes, March 19, 2012.

1 659 F.3d 215 (2d Cir. 2011).

2 *Id.*

3 The city requires enabling legislation from the state to impose taxes. The enabling legislation is contained in New York Tax Law sections 1210 (for a 6% sales tax) and 1212-A(a)(1) (for the 8% surtax for parking services rendered in Manhattan). Under those enabling provisions, the city's tax on parking services is imposed by New York City Administrative Code sections 11-2001(a) (6% sales tax) and 11-2049 (8% surtax). In addition, New York Tax Law section 1105(c)(6) imposes a 4% state sales tax and New York Tax Law Section 1109 imposes a 0.375% sales tax if the transaction occurs within the Metropolitan Commuter Transportation District (the city, and Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk and Westchester Counties as provided by New York Public Authorities Law section 1262).

4 The exemption is limited to those whose primary residence is in Manhattan and only for one noncommercial vehicle registered or leased to an individual residing at that primary address.

5 The plaintiffs included three New Jersey residents and a Nassau County resident who paid the tax, a limited liability company that reimbursed the tax paid by one of the New Jersey residents and a Queens resident who was "denied the benefits of revenues unlawfully forgone by the administration of" the exemption. *Joseph*, Amended Complaint at paras. 6-11.

6 522 U.S. 287 (1998) (holding that the denial to nonresidents of the right to deduct alimony payments when residents could do so was discriminatory and unconstitutional).

7 94 N.Y.2d 577 (2000) (striking down the New York City nonresident earnings tax, also known as the "commuter tax," which applied to those who worked in New York City but lived outside the city, when an amendment was made to exempt state residents from the tax, that is, so that when it would only apply to out-of-state residents).

Comity Stalls Challenge

8 *Joseph*, Amended Complaint.

9 *Joseph*, 659 F.3d at 215. Section 1983 provides in part: "Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress." Section 1983, which originated from section 1 of the Civil Rights Act of 1871, also known as the Ku Klux Klan Act (17 Stat. 13), was intended to protect recently freed slaves living in the South from a breakdown of law and order in the Southern states and provide a civil remedy to address the abuses. Section 1983 was not originally envisioned as a means to address abuses by state officials until *Monroe v. Pape*, 365 U.S. 167, 173-75 (1961), wherein the U.S. Supreme Court said, based on the debates during the passage of the act, that the "three main aims" of the act were to: "override certain kinds of state laws;" provide a "remedy where state law was inadequate;" and provide "a federal remedy [which] though adequate in theory, was not available in practice." In *Monroe*, the Court held that actions of state officials, even if contrary to state law, were still actions taken "under color of state law" and that the act was intended to provide a supplemental remedy, so that an injured individual had a separate state right that did not foreclose resort to Section 1983.

10 28 U.S.C. § 1341.

11 *Joseph*, 659 F.3d at 218.

12 *American College Heritage Dictionary* (3d ed. Houghton Mifflin 1997).

13 28 U.S.C. § 2283 (enacted by Act of Mar. 2, 1793, ch. 22 section 5, 1 Stat. 335) (stating "[a] court of the United States may not grant an injunction to stay proceedings in a State court except as expressly authorized by Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments").

14 26 U.S.C. § 7421(a) (stating "[e]xcept as provided in sections 6015(e), 6212(a) and (c), 6213(a), 6225(b), 6246(b), 6330(e)(1), 6331(i), 6672(c), 6694(c), and 7426(a) and (b)(1), 7429(b), and 7436 no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed").

15 *R.R. Comm'n of Tex. v. Pullman Co.*, 312 U.S. 496, 501 (1941) (holding that federal courts should "exercise [their] wise discretion by staying their hands" if a state law is ambiguous and has not yet been interpreted by state courts).

16 *Younger v. Harris*, 401 U.S. 37 (1971) (holding that in the absence of special circumstances, such as prosecutorial bad faith or deliberate unconstitutional construction, a criminal defendant cannot enjoin a pending state prosecution).

17 *Burford v. Sun Oil Co.*, 319 U.S. 315 (1943) (holding that federal courts should abstain from involvement in questions of state policy).

18 *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800 (1976) (holding that a federal court may abstain only under exceptional circumstances).

19 *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923) and *District of Columbia Court of Appeals v. Feldman*, 460 U.S. 462 (1983) (holding that lower federal courts are barred from exercising appellate jurisdiction over state court judgments).

20 454 U.S. 100 (1981).

21 542 U.S. 88 (2004).

22 *Fair Assessment*, 454 U.S. at 100.

23 *See Great Lakes Dredge & Dock Co. v. Huffman*, 319 U.S. 293 (1943).

24 *See Monroe v. Pape*, 365 U.S. 167 (1961).

25 *Fair Assessment*, 454 U.S. at 100.

26 542 U.S. at 88.

27 542 U.S. at 107 n9.

28 *Coors Brewing Co. v. Mendez-Torres*, 562 F.3d 3 (1st Cir. 2009); *Commerce Energy, Inc. v. Levin*, 554 F.3d 1094 (6th Cir. 2009), *rev'd* __ U.S. __, 130 S. Ct. 2323 (2010); *Levy v. Pappas*, 510 F.3d 755 (7th Cir. 2007); *Wilbur v. Locke*, 423 F.3d 1101 (9th Cir. 2005).

29 *Levin v. Commerce Energy, Inc.*, __ U.S. __, 130 S. Ct. 2323 (2010).

30 *Id.*

31 *Id.*

32 Transcript at 3, *Joseph v. Hyman*, No. 09-CV-07555(RJS) (July 23, 2010).

33 *Id.* at 5.

34 *Id.* at 14.

35 Plaintiffs' Memorandum of Law in Opposition to Defendants' Motions to Dismiss the First Amended Complaint, at 1 (S.D.N.Y. Mar. 1, 2010).

36 *Joseph v. Hyman*, No. 09-CV-07555(RJS) (S.D.N.Y. Aug. 30, 2010).

37 *Joseph*, 659 F.3d at 215.

38 *Id.*

39 *Id.*

40 *See id.*

41 646 F.3d 940 (5th Cir. 2011).

42 *Id.*

43 *ANR Pipeline Co. v. Louisiana Tax Comm'n*, 774 So.2d 1261 (La. App. 1 Cir. 2000), *appeal after remand at*, *remanded by* 815 So.2d 178 (La. App. 1 Cir. 2002), *aff'd by*, *remanded by*, 851 So.2d 1145 (La. 2003), *decision reached on appeal*, 923 So.2d 81 (La. App. 1 Cir. 2005), *writ denied*, 925 So.2d 547 (La. 2006), *cert. denied*, 549 U.S. 822 (2006), *writ denied*, 957 So.2d 160 (La. 2007), *remanded by*, 997 So.2d 92 (La. App. 1 Cir. 2008), *related proceeding*, 2011 U.S. Dist. Ct. LEXIS 5976 (E.D. La. Jan. 18, 2011), *aff'd*, 646 F.3d 940 (5th Cir. 2011).

44 2011 U.S. Dist. LEXIS 5976 at *17.

45 Louisiana has 40 judicial districts; each composed of at least one parish and served by at least one district judge. http://louisiana.gov/Government/Judicial_Branch/. There currently are five courts of appeal in Louisiana. *Id.*

46 2011 U.S. Dist. LEXIS 5976 at *49.

47 646 F.3d at 947 (citations omitted).

48 *Bank of the United States v. Deveaux*, 9 U.S. 61, 87 (1809).

49 *Martin v. Hunter's*, 14 U.S. 304, 347 (1816).

50 792 N.W.2d 308, 322 (Iowa 2010), *cert. denied*, __ U.S. __, 132 S. Ct. 97 (2011).

51 *Amicus* brief filed by states in *Levin v. Commerce Energy, Inc.*, 2009 U.S. Briefs 223 (2009).

52 The rate for granting certiorari is, however, greater for paid cases than cases filed by indigents (those who file *in forma pauperis* cases). During the Court's October 2010 Term, 90 petitions for certiorari were granted (76 in paid cases and 14 in *in forma pauperis* cases). Of the 9,066 cases disposed of during the 2010 Term, 0.99% of petitions were granted overall; 4.01% of the paid cases had petitions granted. Oct. 2010, Journal of the Supreme Court of the U.S. Available at http://www.supremecourt.gov/orders/journal/jnl10.pdf.

53 *Amazon.com LLC v. Lay*, 758 F. Supp. 2d 1154 (W.D. Wa. 2010).

54 *Id. at* 1164.

55 *Id. at* 1166.

56 *Id.*

57 *Am. Express Travel Related Servs. Co. v. Sidamon-Eristoff*, 755 F. Supp. 2d 556 (D.N.J. 2010), *aff'd* 669 F.3d 374 (3d Cir. 2012).

58 No. 11cv46 (S.D. Cal. Sept. 20, 2011).

59 *Id.*

60 *Id.*

61 In connection with Congress's enactment of Public Law 86-272, which provided protections from net income tax impositions where the only in-state activity consists of solicitation of sales, Congress ordered the House Judiciary Committee and the Senate Finance Committee to study "all matters pertaining to the taxation of interstate commerce by the States, territories, and possessions of the United States, the District of Columbia, and the Commonwealth of Puerto Rico, or any political or taxing subdivision of the foregoing." Public L. No. 86-272, Title II, 73 Stat. 555, 556 (1959). Responsibility for the study was assigned to an 11-person subcommittee headed by U.S. Rep. Edwin E. Willis and the four-volume report issued as a result of the study is usually referred to as the Willis Commission Report. The Willis Commission Report's transmittal letter stated: "This study represents a landmark in our constitutional history. For 175 years, the courts have had to shoulder the entire responsibility for balancing the conflicts between the tax policies of the States and the national policy of assuring the free flow of commerce." H.R. Rep. No. 88-1480, vol. 1, at III (1964). The Willis Commission found that the states' tax systems were "unreasonable because of the jurisdictional reach and fragmentation of liability resulting from the prevalence of market-oriented sales factors." H.R. Rep. No. 88-952, vol. 4, at 1157 (1965). In response to the Willis Commission Report, Congress proposed legislation. H.R. 11798, 89th Cong., 1st Sess. (1965). The bill included a physical nexus standard, a two-factor apportionment formula composed of property and payroll, full apportionment of all corporate income and federal oversight over state corporate income taxation through the Treasury secretary. Title V of H.R. 11798 proposed the formation of an "Apportionment Board" within the Treasury Department to address interstate apportionment disputes arising from assessments; the taxpayer would not be a party in the disputes, but would be given notice and an opportunity to be heard. Appeals from the Apportionment Board would be taken to the U.S. Tax Court and further judicial review would be available to the U.S. District Court of Appeals for the District of Columbia and a petition for certiorari could be filed in the U.S. Supreme Court.

State Taxation of Multinational Businesses

By Craig B. Fields and Richard C. Call

Multinational businesses face a variety of state tax issues. Many non-U.S. corporations[1] conduct business in the United States using various business structures such as branches or subsidiaries. Additionally, when U.S. corporations have operations abroad, changes in such foreign operations may have effects on the state taxation of the business.

In this article, we compare the United States federal income tax laws regarding subjectivity to tax with state corporate net income tax laws regarding subjectivity and nexus. We highlight instances in which a non-U.S. corporation may be subject to a state corporate tax but not to the federal income tax. We then address tax base computational issues, including whether the worldwide income of a multinational business is subject to tax for state corporate tax purposes. Finally, we analyze business structures that may limit the state tax exposure of a multinational business.

Subjectivity and Tax Base

Federal Subjectivity – Permanent Establishment

The business profits of a non-U.S. corporation that is a resident of a foreign country that has a bilateral income tax treaty with the United States are subject to the federal income tax only if the corporation has a permanent establishment in the United States.[2]

A non-U.S. corporation may have a permanent establishment in the United States if it has some types of physical presence in this country. Under the United States model tax treaty (the "Model Treaty"), a "permanent establishment" is "a fixed place of business through which the business of an enterprise is wholly or partly carried on . . ." and includes: "(1) a place of management; (2) a branch; (3) an office; (4) a factory; (5) a workshop; and (6) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources."[3]

SIGNIFICANTLY, THE MODEL TREATY SPECIFICALLY PROVIDES THAT IT ONLY APPLIES TO FEDERAL TAXES. THUS, STATE LAW CONTROLS WHETHER A CORPORATION IS SUBJECT TO TAX (LIMITED, OF COURSE, BY THE U.S. CONSTITUTION AND U.S. STATUTES).

Although a permanent establishment exists if a corporation has a certain type and level of physical presence (*i.e.*, employees or property) in the United States, not all types of physical presence create a permanent establishment. The Model Treaty provides a list of activities that will not create a permanent establishment. These include:

1. The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
2. The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
3. The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
4. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
5. The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; and
6. Any combination of the above provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[4]

State Subjectivity and Nexus – Taxability With and Without Physical Presence

Significantly, the Model Treaty specifically provides that it only applies to federal taxes.[5] Thus, state law controls whether a corporation is subject to tax (limited, of course, by the U.S. Constitution and U.S. statutes).

Most states impose corporate taxes on a corporation that has a physical presence in the state – such as owning or renting property in, maintaining an office in, or having employees located in or working in the state.[6] Additionally, some states impose tax on corporations that do not have property or employees (*i.e.*, physical presence) in the state. Some of the fact patterns under which states impose tax absent a physical presence include:

1. The licensing of intangibles to a third party that operates in the state;[7]
2. Soliciting and conducting of a credit card business or providing consumer lending to customers located within a state;[8] and
3. Making sales that are sourced to a state in excess of a certain threshold (*e.g.*, $500,000).[9]

Most state statutes do not distinguish between U.S. corporations and non-U.S. corporations on their face when imposing the state's tax.[10] However, the Connecticut "economic nexus" statute distinguishes between U.S. corporations and non-U.S. corporations with respect to economic nexus (*i.e.*, subjectivity to tax) and does not assert economic nexus on certain non-U.S. corporations. Connecticut General Statute Section 12-216a provides:

> Any company that derives income from sources within this

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> state and that has a *substantial economic presence* within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, without regard to physical presence, and to the extent permitted by the Constitution of the United States, shall be liable for the [Connecticut corporation business tax].
>
> . . .
>
> The [above-cited provisions] shall not apply to any company that is treated as a foreign [*i.e.*, non-U.S.] corporation under the Internal Revenue Code and has no income effectively connected with a United States trade or business.

Therefore, certain non-U.S. corporations would not be subject to tax in Connecticut even if they conducted the same activities with respect to the state that a U.S. corporation conducted.

Non-U.S. Corporations with No Permanent Establishment May Still Be Subject to State Corporate Taxes

Because the Model Treaty does not apply to state taxes, a non-U.S. corporation may be subject to a state tax on its business profits even though its business profits are not subject to the federal income tax because the corporation does not have a permanent establishment. Moreover, a non-U.S. corporation with no physical presence in a state may nevertheless be subject to a corporate tax as the result of some other contact with the state. Consider the following examples:

Example 1

Physical Presence That Does Not Constitute a Permanent Establishment – A non-U.S. corporation maintains a stock of goods or merchandise in New York that belongs to the corporation solely for the purpose of storage, display or delivery. The company's activities do not create a permanent establishment.[11] However, the corporation is subject to tax in New York because it owns property in New York.[12]

A NON-U.S. CORPORATION WITH NO PHYSICAL PRESENCE IN A STATE MAY NEVERTHELESS BE SUBJECT TO A CORPORATE TAX AS THE RESULT OF SOME OTHER CONTACT WITH THE STATE.

Example 2

No Physical Presence in a State – A non-U.S. corporation with no permanent establishment in New Jersey derives income from the licensing of intangibles to an entity that operates in New Jersey. The Division of Taxation would likely assert that the corporation is subject to tax in New Jersey.[13]

Furthermore, a taxpayer may have a permanent establishment in one state, but may be subject to tax in several other states as a result of activities in those states that are insufficient to constitute a permanent establishment. Consider the following example:

Example 3

Permanent Establishment in One State With Physical Presence in Surrounding States – A non-U.S. corporation maintains an office and has a permanent establishment only in New York. The corporation's employees regularly perform work functions in Massachusetts, New Jersey and Pennsylvania that exceed solicitation as described in P.L. 86-272. The corporation is subject to tax in New York. The corporation is also subject to tax in Massachusetts, New Jersey and Pennsylvania.[14]

Computation of the Tax Base

Various issues exist with respect to a multinational business' computation of state taxable income. For instance, must a corporation report more than its federal taxable income to a state, *e.g.*, must it report foreign source income that it does not include in federal taxable income? Additionally, how does a non-U.S. corporation that is not subject to federal income tax determine its state taxable income if state taxable income is tied to federal taxable income? The states' laws vary in whether and how such issues are addressed. We review below the federal income tax laws regarding the tax base of non-U.S. corporations with a permanent establishment in the United States and then analyze a few states' laws regarding the tax base of multinational businesses below.

Federal Income Tax – Tax Base Limited to Business Profits

Operating through a permanent establishment in the United States does not cause the worldwide income of a multinational business to be subject to federal income tax in the United States. Instead, the federal income tax base of a corporation that is a resident of a foreign country and that has a permanent establishment includes "only so much of [the profits of the corporation] as are attributable to that permanent establishment."[15] The Model Treaty further provides that "[e]ven when a [non-U.S.] corporation conducts

OPERATING THROUGH A PERMANENT ESTABLISHMENT IN THE UNITED STATES DOES NOT CAUSE THE WORLDWIDE INCOME OF A MULTINATIONAL BUSINESS TO BE SUBJECT TO FEDERAL INCOME TAX IN THE UNITED STATES.

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business in the United States" the profits to "be attributed to that permanent establishment [are] the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions."[16]

State Tax Base – Worldwide Income of a Multinational Corporation

Whether a state requires a corporation to include in the state tax base income in addition to its federal taxable income is a state-specific question. However, the U.S. Supreme Court has held that a state may tax the worldwide income of both U.S. and non-U.S. corporations as long as the income is derived from the taxpayer's unitary business.[17] The following highlights a few states' laws regarding computation of the tax base.

Under current New York tax law, a corporation includes income in addition to its federal taxable income in the New York tax base.[18] In 2007, a non-U.S. corporation argued that under New York tax law only the income that it reported to the U.S. could be included in entire net income (*i.e.*, the New York tax base).[19] The applicable statute provides:

> The term "entire net income" means total net income from all sources, which shall be *presumably* the same as the entire taxable income . . . which the taxpayer is required to report to the United States treasury department [*i.e.*, federal taxable income]. . . . Entire net income shall include income within and without the United States.[20]

In interpreting the above statute, the New York State Tax Appeals Tribunal explained that "[t]he statute's use of the word 'presumably' appears to indicate that the starting place for the calculation of entire net income is not always Federal taxable income."[21] The Tax Appeals Tribunal held that the foreign source income of a non-U.S. corporation that is not included in federal taxable income is nevertheless included in the New York tax base.[22]

In contrast to New York, Maine only taxes a corporation's federal taxable income (with certain additions and subtractions).[23] The Maine statutes impose tax on "income," which is defined as "the corporation's net income."[24] "Net income," in turn, means "the taxable income of that taxpayer for that taxable year under the laws of the United States" with statutory modifications.[25] The Supreme Judicial Court of Maine has interpreted these statutes to mean that a taxpayer's income "begin[s] with figures derived from corporations' federal taxable income, which is limited to income derived from United States business."[26]

A recent New Jersey case, *Crestron, Inc. v. Director, Division of Taxation*, indicates that, like Maine, the New Jersey tax base does not include worldwide income that is not included in federal taxable income.[27] *Crestron* involved the tax computation of a U.S. corporation and the question before the court was whether extraterritorial income, as defined by the Internal Revenue Code, should be included in New Jersey's definition of "entire net income."[28] The applicable New Jersey statute provided:

> "Entire net income" shall mean total net income from all sources, whether within or without the United States, and shall include the gain derived from the employment of capital or labor, or from both combined, as well as profit gained through a sale or conversion of capital assets.
>
> . . .
>
> For the purpose of this act, the amount of a taxpayer's entire net income shall be deemed prima facie to be equal in amount to the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report . . . to the United States Treasury Department for the purpose of computing its federal income tax . . . .[29]

The New Jersey statutes also listed explicit additions and subtractions to federal taxable income to arrive at entire net income, none of which addressed extraterritorial income for the tax years at issue.[30]

The New Jersey Tax Court held that extraterritorial income was not included in the definition of "entire net income" because the Corporation Business Tax ("CBT") ties directly to federal taxable income except with respect to certain explicit statutory modifications and none of these modifications addressed extraterritorial income. The court explained that the "statute couples entire net income [for New Jersey tax purposes] to line 28 of the federal income tax return which is entitled 'Taxable income before net operating loss deduction and special deductions.'"[31] The court continued that "[a]fter linking entire net income for CBT purposes to line 28 of the federal return, the statute provides that '[e]ntire net income shall be determined without the exclusion, deduction of credit of' and lists more than a dozen exceptions – both additions and subtractions – to federal tax statutes that define federal taxable income."[32]

BASED ON *CRESTRON*, FOREIGN SOURCE INCOME THAT IS NOT INCLUDED IN FEDERAL TAXABLE INCOME IS LIKELY NOT INCLUDABLE IN THE NEW JERSEY TAX BASE

The court's interpretation in *Crestron* of the New Jersey statutes may affect whether a multinational business must include foreign source income in the

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New Jersey tax base. Based on *Crestron*, foreign source income that is not included in federal taxable income is likely not includable in the New Jersey tax base unless the New Jersey statutes explicitly add such income to federal taxable income to compute entire net income.

Computation of Income When a Taxpayer Is Not Subject to the Federal Income Tax

Where a state uses federal taxable income as the starting point for computing the state's taxable income and the non-U.S. corporation is not subject to federal tax, the question arises as to whether the corporation has any state taxable income, even where some or all of that income is United States source income and would be included in federal taxable income if the non-U.S. corporation had a permanent establishment in the United States.

The Montana statutes specifically address such a scenario, providing that:

> The term 'gross income' means all income recognized in determining the corporation's gross income for federal income tax purposes. . . . Any corporation not subject to or liable for federal income tax but not exempt from the corporation license tax . . . shall compute gross income for corporation license tax purposes in the same manner as a corporation that is subject to or liable for federal income tax according to the provisions for determining gross income in the federal Internal Revenue Code.[33]

Unlike Montana, the Maine and New Jersey statutes discussed above do not directly address how a non-U.S. corporation that is not subject to federal income tax computes its state tax base.

SOME BUSINESS STRUCTURES MAY LIMIT THE STATE TAX EXPOSURE OF A MULTINATIONAL BUSINESS EVEN WHEN THE CORPORATION IS SUBJECT TO TAX IN A STATE.

Under *Crestron* and *Irving Pulp & Paper, Ltd. v. State Tax Assessor*, the respective state tax bases of a corporation are directly tied to federal taxable income (as statutorily modified). Accordingly, these two cases support the position that in Maine and New Jersey a non-U.S. corporation that is not subject to the federal income tax does not have entire net income except to the extent that one of the statutory modifications apply.[34] Consequently, a non-U.S. corporation with no permanent establishment could be subject to tax in Maine or New Jersey but have little or no entire net income in its tax base, even if it derived United States source income.[35]

Limiting Exposure to State Taxes

Some business structures may limit the state tax exposure of a multinational business even when the corporation is subject to tax in a state. For example, conducting business in the United States as a separate legal entity rather than a division may limit a multinational corporation's tax base in some states, including combined reporting states.

Operating as a Division or a Separate Entity

Operating as a separate legal entity in a state may limit the amount of a multinational corporation's income that is subject to tax. For example, in *Reuters Ltd. v. Tax Appeals Tribunal*, the New York Court of Appeals addressed whether New York could subject to apportionment "the worldwide net income of a single multijurisdictional business enterprise" that operated through a branch office in New York.[36] The Court of Appeals upheld the lower court's ruling that the worldwide income of a non-U.S. corporation could be subject to apportionment without violating the Foreign Commerce Clause.[37] The court also stressed that the unitary business principle allows taxation of an entity's worldwide income if the income is derived from the taxpayer's unitary business.[38]

Presumably, a company like the taxpayer in *Reuters* could limit its exposure to New York tax by operating as a separate legal entity in New York rather than as a branch or division. Under current New York tax law, a multinational business that conducts its United States operations in a separate legal entity would be taxable on only that entity's income, in this case, the income from its United States operations. Furthermore, New York's mandatory forced combination law would not apply to the worldwide income of affiliates formed outside of the United States because New York combined groups do not include "corporations that are formed under the laws of another country."[39]

Division or Separate Entity Considerations In Unitary Combined Reporting States

A multinational business' decision to segregate its United States operations into a separate entity rather than a branch or division may limit the business' liability in unitary combined reporting states primarily because of water's-edge combined reporting. Most, if not all, states that require combined reporting either require or permit a combined group of corporations to report income on a water's-edge basis. To the extent that a multinational business conducts its worldwide activities in entities that are not part of the water's-edge group, the taxpayer may limit its state tax exposure.

The mechanics of a water's-edge filing vary state to state. The states' definitions of a water's-edge group vary

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and some states include in a water's-edge group more than just the income of entities that are organized under the laws of the United States. For example, a Massachusetts water's-edge combined group includes unitary entities that are "incorporated in the United States or formed under U.S. laws, any state, the District of Columbia, or any U.S. territory or possession."[40] In some circumstances, the Massachusetts water's-edge group also includes the income and apportionment factors of the following entities (assuming that the entities are unitary):

1. Other entities regardless of the country of organization if the average of the entity's property, payroll, and sales factors within the U.S. is 20% or more; and
2. Any entity "that earns more than 20 per cent of its income, directly or indirectly, from intangible property or service-related activities" that are provided to other members of the combined group, "but only to the extent of that income and the apportionment factors related thereto."[41]

Other states include the income of entities organized under the laws of "tax haven" countries in the water's-edge combined group.[42]

Conclusion

Multinational businesses face unique state tax issues. In particular, differences in the laws regarding subjectivity to the federal income tax and subjectivity and nexus for state corporate tax purposes may result in a non-U.S. corporation being subject to a state corporate tax but not subject to the federal income tax. Whether a multinational corporation's worldwide income is included in the tax base for state corporate tax purposes is a state-specific question. Furthermore, various business structures exist that may limit a multinational business' exposure to state taxes. ■

1 As used in this article, "non-U.S. corporation" means a corporation that is organized under the laws of a country other than the United States.

2 United States Model Income Tax Convention of November 15, 2006, Art. VII. The permanent establishment rule exists in many United States tax treaties. Publication 901, U.S. Tax Treaties (Internal Revenue Service Revised April 2011); Kuntz & Peroni, U.S. International Taxation ¶ C4.05 (2012). To the extent that a bilateral income tax treaty does not contain the permanent establishment rules, some analysis of this article may be inapplicable to non-U.S. corporations to which such treaty applies.

3 *Id.* at Art. V. The activities of a person, other than an independent agent acting as such, that has and exercises an authority to conclude contracts that are binding on an enterprise may also create a permanent establishment. *Id.*

4 *Id.*

5 *Id.* at Art. 11.

6 *See*, *e.g.*, N.J. Stat. Ann. § 54:10A-2; N.Y. Tax Law § 209; 830 Code Mass. Regs. § 63.39.1(4)(b).

7 *See Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176 (2006); New Jersey Tech. Adv. Mem. 2011-6 (N.J. Div. Tax. Jan. 10, 2011).

8 *Id.*; *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 231 (W. Va. 2006).

9 Ohio Rev. Code Ann. § 5751.01(H), (I); Ohio Rev. Code Ann. § 5751.02.

10 For example, the California statutes impose a corporate income tax on "*every corporation doing business* within the limits of [California]." Cal. Rev. & Tax Code § 23151 (with the exception of banks and financial corporations) (emphasis added). The North Carolina statutes impose the corporate net income tax on "every C Corporation doing business in [North Carolina]." N.C. Gen. Stat. § 105-130.3. Some state statutes that impose a corporate tax use the terms "domestic corporation" and "foreign corporation." *See*, *e.g.*, N.J. Stat. Ann. § 54:10A-2; N.Y. Tax Law § 209(1). In New Jersey and New York, "domestic corporation" means a corporation organized under the laws of New Jersey or New York, respectively, and "foreign corporation" means a corporation organized under the laws of a state other than New Jersey or New York, respectively. See N.J. Stat. Ann. § 14A:1-2.1(g), (i); N.Y. Bus. Corp. Law § 102(a)(4), (a)(7). "Foreign corporation" as used in such statutes would include a non-U.S. corporation.

11 United States Model Income Tax Convention of November 15, 2006, Art. V.

12 N.Y. Tax Law § 209(1).

13 New Jersey Tech. Adv. Mem. 2011-6 (N.J. Div. Tax. Jan. 10, 2011).

14 *See* 830 Mass. Code Regs. § 63.39.1(4)(b); N.Y. Tax Law § 209(1); N.J. Admin. Code § 18:7-1.9(b); 72 Pa. Cons. Stat. § 7402(a)(2).

15 United States Model Income Tax Convention of November 15, 2006, Art. VII.

16 *Id.*

17 *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

18 *Matter of Infosys Technologies Ltd.*, DTA No. 820669 (N.Y.S. Tax. App. Trib. Feb. 21, 2008).

19 *Id.*

20 N.Y. Tax Law § 208(9) (emphasis added).

21 *Infosys*, DTA No. 820669.

22 *Id.* The Tax Appeals Tribunal also noted that prior decisions of the New York Court of Appeals (New York's highest court) and the United States Supreme Court had upheld the imposition of tax on a non-U.S. corporation's worldwide income. *Id.* (citing *Matter of Reuters Ltd. v. Tax Appeals Tribunal*, 82 N.Y.2d 112 (1993); *Bass, Ratcliff & Gretton, Ltd., v. State Tax Comm'n*, 266 U.S. 271 (1924)).

23 36 Maine. Rev. Stat. § 5200-A. Taxpayers report income to Maine on a combined basis.

24 36 Maine. Rev. Stat. § 5200(3).

25 36 Maine. Rev. Stat. § 5102(8).

26 *Irving Pulp & Paper, Ltd. v. State Tax Assessor*, 879 A.2d 15, 20 (Me. 2005) (citing *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 83 (Me. 1996)).

27 26 N.J. Tax 102 (N.J. Tax 2011).

28 *Id.*

29 N.J. Stat. Ann. § 54:10A-4(K).

30 *Id.*

31 *Crestron*, 26 N.J. Tax at 109.

32 *Id.*

33 Mont. Stat. § 15-31-113.

34 *See Crestron*, 26 N.J. Tax at 102; *Irving Pulp*, 879 A.2d at 15.

35 Some corporations may be subject to tax in New Jersey on a tax base other than entire net income such as the alternative minimum assessment or the minimum tax. *See*, *e.g.*, N.J. Stat. Ann. §§ 54:10A-5(e), 54:10A-5a.

36 82 N.Y.2d 112, 114 (1993), *cert. denied*, 512 U.S. 1235 (2004).

37 *Id.*

38 *Id.* at 116-117.

39 N.Y. Tax Law § 211(4)(a)(5); TSB-M-06(2)(C), p. 7 (N.Y.S. Dep't of Tax'n and Finance Mar. 3, 2008).

40 Mass. Gen Laws ch. 63, § 32B(c)(3).

41 *Id.* at (c)(3)(iii).

42 *See*, *e.g.*, Mont. Stat. § 15-31-322.

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Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
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American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Express, Inc. v. New York
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General Mills v. California
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GTE v. Kentucky
Hair Club of America v. New York
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