OCTOBER 2021

THE BR STATE + LOCAL TAX SPOTLIGHT

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CONTENTS

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Note from the Editor

By Eugene J. Gibilaro

Welcome to the October 2021 edition of *The BR State + Local Tax Spotlight.* We understand the unique demands of staying on top of important State + Local Tax developments, which happen frequently and across numerous jurisdictions. Staying updated on significant legislative developments and judicial decisions helps tax departments function more efficiently and improves strategy and planning. That is where *The BR State + Local Tax Spotlight* can help. In each edition, we will highlight for you important State + Local Tax developments that could impact your business. In this issue, we will be covering:

- A recent Michigan appeals court decision that reaffirmed an alternative method of apportionment was necessary to avoid unconstitutional distortion from including a large gain from the sale of a corporation's business in its tax base while excluding it from the sales factor;
- A recent New York trial court decision to dismiss a False Claims Act lawsuit brought by the state's Attorney General over allegedly fraudulent sales tax returns; and
- A recent Washington Supreme Court decision that upheld the application of the state's Business & Occupation tax on 153 financial institutions.

We invite you to share *The BR State + Local Tax Spotlight* with your colleagues and visit Blank Rome's State + Local Tax webpage for more information about our team. Click here to add State + Local Tax to your subscription preferences.

Editor, *The BR State + Local Tax Spotlight*

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CRAIG B. FIELDS
PARTNER

Michigan Court Again Holds It Was Unconstitutional to Include Gain from Sale of a Business in Tax Base but Not Sales Factor

By Craig B. Fields

The Michigan Court of Appeals recently reaffirmed its earlier decision that an alternative method of apportionment was necessary to avoid unconstitutional distortion from including a large gain from the sale of a corporation's business in its tax base while excluding it from the sales factor. *Vectren Infrastructure Servs. Corp. v. Dep't of Treasury,* 2021 Mich App LEXIS 5693* (2021). While the resulting level of distortion to support a constitutional challenge will depend upon the facts, this decision should assist taxpayers facing a similar statutory framework.

Facts: A corporation engaged in constructing, maintaining, and repairing pipelines, as well as providing HAZMAT responses, was headquartered in Minnesota and did business in several states including, occasionally, in Michigan. On March 31, 2011, its business was sold and it elected to treat the sale as an asset sale under IRC Section 338(h)(10).

The corporation had been retained in 2010 to assist in the cleanup of an oil spill in Michigan and had brought in equipment and employees for the project. The project was still ongoing at the time of the sale.

While the resulting level of distortion to support a constitutional challenge will depend upon the facts, this decision should assist taxpayers facing a similar statutory framework.

The corporation filed a Michigan business tax return for the short year January 1, 2011 through March 31, 2011 (the date of sale) and included the gain from the sale in both its tax base and the denominator of its sales factor. On audit, the Department of Treasury ("Department") left the gain in the base but removed it from the denominator of the sales factor. This increased the sales factor from 14.9860% to 69.9761% and resulted in a deficiency of almost $3 million.

The First Decision: The court of appeals did not rule on whether the gain should statutorily be included in the sales factor. Instead, it found that to apply the statutory formula as the Department had done led to a grossly distorted result and operated to unconstitutionally tax extraterritorial activity. This was because much of the activity and assets involved in the sale never had any connection to Michigan, but the sale occurred when there was an unusually large percentage of the corporation's business activity taking place there. The court concluded that "the statutory formula when applied in this case operates 'so as to reach profits which are in no just sense attributable to transactions within its jurisdiction.'" Citing *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123, 124 (1931).

The Supreme Court's Remand: The Michigan Supreme Court remanded the case back to the court of appeals to address the proper method for calculating the tax under the statutory formula.

The Recent Decision: After the court of appeals further remanded the case and the court of claims (the trial court) ruled that, under the Michigan statute, the gain should be excluded from the sales factor, the court of appeals again addressed the case. It had little difficulty reaffirming that application of the statutory formula here constituted a constitutional violation for the reasons stated in its earlier decision. The court stated that a large contributing factor to its conclusion was that in the context of the facts of the case "including the sale of the business in the tax base, but not in the sales factor, is impermissibly inconsistent." *Vectren,* 2021 Mich. App LEXIS *4.

Observation: Whenever a large amount of income is included in the tax base but is not included in the statutory apportionment factor, it is always wise to consider use of an alternative apportionment method. This case demonstrates that taxpayers can be successful when sufficient distortion can be shown to result.

EUGENE J. GIBILARO
OF COUNSEL

Case Dismissed: NY Court Throws Out Attorney General's Lawsuit Alleging Fraudulent Sales Tax Returns

By Eugene J. Gibilaro

The Supreme Court of the State of New York for New York County dismissed a lawsuit brought by the state attorney general ("AG") under the New York State False Claims Act alleging that a company made "reverse false claims" by failing to declare certain promotional payments that it received as receipts subject to sales tax on its sales tax returns. *People v. B&H Foto & Electronics Corp.,* 2021 NYLJ LEXIS 988* (N.Y. Sup. Ct. Sept. 21, 2021). The decision confirms that what is relevant in determining receipts subject to sales tax in New York is the consideration that the end-user customer pays in a retail transaction, without regard to separate payments made pursuant to agreements between the retailer and the manufacturer.

The decision confirms that what is relevant in determining receipts subject to sales tax in New York is the consideration that the end-user customer pays in a retail transaction, without regard to separate payments made pursuant to agreements between the retailer and the manufacturer.

The Facts: The company, a photography and video equipment retailer, purchased inventory from manufacturers and participated in "instant savings" programs through which manufacturers provided an incentive to the company to sell that manufacturer's goods. During the promotional period, the company would receive a promotional payment (typically a credit applied to future orders) for every item of the manufacturer's goods that the company sold. The company was permitted, but not required, to pass the promotional payment on to its end-user customers in the form of discounts. The AG argued that the promotional payments operated as de facto manufacturer's coupons which are taxable in New York and the payments should have been reported on the company's sales tax returns as receipts subject to sales tax. The company's position was that the promotional payments function as wholesale discounts calculated into its cost of goods sold.

The Decision: The Court disagreed with the AG, finding that the promotional payments under the "instant savings" programs were distinguishable from manufacturer's coupons inasmuch as when an end-user customer makes a taxable purchase using a manufacturer's coupon for an amount that the manufacturer has agreed to reimburse the retailer, then the amount of the coupon is part of the consideration that the end-user paid and is taxable. However, the Court reasoned that here, if the company provided a discount to the end-user customer because it knew it would receive a promotional payment from the manufacturer for the sale, that amount is not part of the consideration that the end-user customer paid "[s]ince there is no privity between the manufacturer and the customer." *Id.* at *9.

Finally, the AG alleged that "disagreements among [the company's] executives as to the proper tax treatment" of the promotional payments was evidence that the company knew that it was required to remit sales tax on the payments. *Id.* at *3. While acknowledging that internal company discussions can support the existence of fraud in conjunction with a statutory violation, the Court explained that here "the absence of a statutory violation" inasmuch as the promotional payments were not subject to sales tax "means that persistent fraud or illegality was not committed even if [the company] believed that it was acting unlawfully." *Id.* at *13. □

NICOLE L. JOHNSON
PARTNER

When a Court Misses the Mark

By Nicole L. Johnson

The Washington Supreme Court recently reviewed the much-maligned additional Business & Occupation ("B&O") tax on certain financial institutions. *Washington Bankers Ass'n v. Dep't of Revenue,* No. 98760-2 (Wash. Sept. 30, 2021) ("Decision"). The Court reversed the trial court and held that the additional tax did not discriminate against interstate commerce—a finding that requires a (very large) stretch of the imagination.

Beginning in 2020, financial institutions with consolidated net income of at least one billion dollars were subject to an additional 1.2 percent B&O tax. This tax was in addition to the standard tax rate of 1.5 percent, thereby almost doubling the tax imposed on those financial institutions. The Court stated that the tax was collected from 153 taxpayers, three of which were based in Washington (or less than 2 percent). Decision, p. 4.

The Court concluded that the additional tax did not discriminate against interstate commerce because it applied equally to financial institutions located both in state and out of state. *Id.* at 10. However, despite many unfavorable statements by the legislature, the Court explained away the discriminatory intent of the law. The Court went so far as to state that the "legislature asked the wealthy few to contribute more to funding essential services and programs to the benefit of all Washingtonians." *Id.* at 26. There is no doubt that those 153 financial institutions would be surprised to learn that they were only "asked" to pay the additional tax and not mandated to do so.

While the Washington high court only examined the additional tax for discrimination, it is hard to imagine that the tax would pass muster under the remaining prongs of the *Complete Auto* test. Specifically, the fourth prong of the *Complete Auto* four-part test requires that the tax be "fairly related to the services provided by the State." *Id.* at 7, citing *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). The Court found that Washington legislature enacted "the increased tax rate on the 'wealthy few who have profited the most from the recent economic expansion' and 'can contribute to the essential services and programs all Washington families need.'" Decision, pg. 24 (citing LAWS OF 2019, ch. 420, § 1). Thus, the tax was to provide services and programs to Washington families, not to provide additional services to financial institutions or state-wide infrastructure. It is hard to imagine how the services and programs for Washington families relate to the limited number of financial institutions that the tax is being imposed upon.

> **It is hard to imagine how the services and programs for Washington families relate to the limited number of financial institutions that the tax is being imposed upon.**

This decision serves as an important reminder to taxpayers that when challenging a tax, all aspects of the tax should be disputed. This is especially true in a constitutional challenge to a tax. □

What's Shaking

Blank Rome's nationally prominent State + Local Tax attorneys are thought leaders in the community as frequent guest speakers at various local and national conferences throughout the year. Our State + Local Tax attorneys believe it is necessary to educate and inform their clients and contacts about topics that will impact their businesses. We invite you to attend, listen, and learn as our State + Local Tax attorneys interpret and discuss key legal issues companies are facing and how you can put together a plan of action to mitigate risk and advance your business in accordance with state and local tax laws.

COST 2021 SALT Basics School

- Mitchell A. Newmark will serve as a panelist at the Council on State Taxation's ("COST") 2021 SALT Basics School, which will be held December 5 through 10, 2021, in Atlanta Georgia. Mitchell's session, "Restrictions on a State's Ability to Tax," will take place on Thursday, December 9, from 10:15 a.m. to 12:00 p.m., and the panel will review the various restrictions on a state's ability to impose taxes such as constitutional restrictions, federal legislation, and judicial pronouncements. To learn more, please click here.

COST 2021 Intermediate/Advanced State Income Tax School

- Nicole L. Johnson will serve as a panelist at the Council on State Taxation's ("COST") 2021 Intermediate/Advanced State Income Tax School, which will be held December 5 through 9, 2021, in Atlanta, Georgia. Nicole's session, "Advanced State Taxation Related to Foreign Income," will take place on Tuesday, December 7, 2021, from 11:00 a.m. to 12:00 p.m., and the panel will explore state adjustments with a focus on adjustments related to foreign operations and transactions. To learn more, please click here.

University of Wisconsin at Milwaukee | 2021 SALT Lecture Series

- Craig B. Fields will serve as a speaker for the University of Wisconsin-Milwaukee's Lubar School of Business State and Local Taxation ("SALT") Webinar Series, being held in October and November 2021 to provide in-depth analysis and discussion on a wide variety of critical SALT-related topics. Craig and co-presenter Richard Pomp, Professor of Law at University of Connecticut School of Law, will present "Significant Nationwide Developments in State and Local Taxation" on Thursday, November 4, 2021, from 11:00 a.m. to 1:00 p.m. CDT, covering recent developments in SALT across the country and their implications for tax filing and planning. To learn more, please click here.

2021 California Tax Policy Conference

- Nicole L. Johnson will serve as a panelist for two sessions at the California Lawyers Association's ("CLA") 2021 California Tax Policy Conference, which will be held November 3 through 5, 2021, at the Hyatt Regency Mission Bay Spa and Marina in San Diego, California. Blank Rome is pleased to be a platinum sponsor of the conference. Nicole's first panel, "California's R&D Credit," is scheduled for Thursday, November 4, 2021, from 8:30 to 9:30 a.m., and will discuss a credit that was initially designed to increase R&D efforts within California and provide insight on the trends they are seeing, including increased scrutiny, in the R&D credit landscape. Her second panel, "State and International Digital Service Taxes," will be Friday, November 5, 2021 from 2:10 to 3:10 p.m., and will discuss the latest state and international trends surrounding the taxation of digital services. To learn more, please click here.

MICPA Michigan Tax Conference

- Nicole L. Johnson will serve as a panelist at the Michigan Association of Certified Public Accountants' ("MICPA") Michigan Tax Conference, presented in partnership with the Michigan Department of Treasury & the State Bar of Michigan Taxation Section on November 3 and 4, 2021. Nicole's session, "Gig Economy: Contractor vs. Employee," takes place Wednesday, November 3, from 2:40 to 3:40 p.m. EDT, and will explore ongoing litigation stemming from the pressure being placed on the U.S. Department of Labor to act on the gig economy debate over whether Uber, Grubhub, and other contractors should be treated as W2 employees and the proper classification for employees and contractors, generally. To learn more, please click here.

28th Annual Paul J. Hartman State and Local Tax Forum

- Hollis L. Hyans and Craig B. Fields will speak at Vanderbilt University Law School's 28th Annual Paul J. Hartman State and Local Tax Forum, being held October 27 through 29, 2021, in Nashville, Tennessee. There will also be a virtual option available for all program sessions. Blank Rome is pleased to be a Gold Level sponsor of the forum. Holly, who is also a member of the forum advisory board, will speak on the "Top Ten Income Tax Cases" panel, taking place Thursday, October 28, from 9:00 to 10:00 a.m. Panelists will discuss the top ten income tax cases that all state and local tax ("SALT") professionals should be watching and offer insights into the issues that are likely to dominate in the coming year. Craig's session, "A Constitutional Rethink," later that day from 3:30 to 4:30 p.m., will look at where the Complete Auto and Moorman rulings stand now, after having anchored much of state tax law over the last few decades, and how the changing face of the U.S. Supreme Court may impact them. To learn more, please click here.

TEI's 76th Annual Conference

- Mitchell A. Newmark will serve as a panelist at the Tax Executives Institute ("TEI") 76th Annual Conference, being held October 24 through 27, 2021, as a hybrid event. This year's conference, themed "Embracing the Certainty of Change," provides registrants the option to attend the conference in person or remotely, with access to sponsors, networking opportunities, and more via either option. Mitchell's session, "State Tax Controversy from Coast to Coast: Current Audit Issues," will take place on Monday, October 25 from 9:45 to 10:45 a.m. EDT as part of the State & Local Tax ("SALT") educational track. Blank Rome is pleased to be a sponsor of the conference. To learn more, please click here.

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