MARCH 2024

THE BR STATE + LOCAL TAX SPOTLIGHT

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STATE + LOCAL TAX TEAM:

Craig B. Fields | craig.fields@blankrome.com
Nicole L. Johnson | nicole.johnson@blankrome.com
Mitchell A. Newmark | mitchell.newmark@blankrome.com
Irwin M. Slomka | irwin.slomka@blankrome.com
Eugene J. Gibilaro | eugene.gibilaro@blankrome.com
Kara M. Kraman | kara.kraman@blankrome.com
Joshua A. Sivin | joshua.sivin@blankrome.com
Philip M. Tatarowicz | phil.tatarowicz@blankrome.com
Melanie L. Lee | melanie.lee@blankrome.com

Note from the Editors

By Joshua M. Sivin and Melanie L. Lee

Welcome to the March 2024 edition of *The BR State + Local Tax Spotlight.* We know the importance of remaining up-to-date on State + Local Tax developments, which appear often and across numerous jurisdictions. Staying informed on significant legislative developments and judicial decisions helps tax departments function more efficiently, along with improving strategy as well as planning. That is where *The BR State + Local Tax Spotlight* can help. In each edition, we will highlight important State + Local Tax developments that could impact your business. In this issue, we will be covering:

- New York ALJ Rejects Division of Taxation's Attempt to Change Its Theory of Liability after the Hearing
- Alabama Loses Interest Addback Attack, Yet Again
- Microsoft Prevails in California Dispute on Inclusion of Gross Foreign Dividends in Apportionment Formula
- Ruling Outside the Lines

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.

Co-Editors, *The BR State + Local Tax Spotlight*

JOSHUA M. SIVIN
Of Counsel
212.885.5025
joshua.sivin@blankrome.com

MELANIE L. LEE
Associate
212.885.5371
melanie.lee@blankrome.com

KARA M. KRAMAN
OF COUNSEL

New York ALJ Rejects Division of Taxation's Attempt to Change Its Theory of Liability after the Hearing

By Kara M. Kraman

A New York State Administrative Law Judge ("ALJ") recently rejected an attempt by the Division of Taxation ("Division") to change its theory of liability after the record was closed, raising its new theory of liability for the first time in its post-hearing brief. *Matter of Super PC Systems, Inc.,* DTA No. 830355 (N.Y.S. Div. Tax. App., Feb. 22, 2024).

Super PC Systems ("Petitioner") sold point-of-sale equipment such as cash registers and bar code scanners. It did not pay sales tax on the purchase of the equipment because the equipment was purchased for resale. One of the ways Petitioner sold the equipment was through a penny sale contract under which the purchaser would agree to a payment plan of one penny for 48 months and would also agree to use certain credit card processing vendors that would pay Petitioner certain amounts for the sales it processed in connection with that point-of-sale equipment.

The Division audited Petitioner and asserted use tax was due on the equipment sold through penny contracts on the basis that the penny contract sales were not real sales. The Division calculated the amount of use tax due on the purchase price paid by Petitioner for the products under a cost-of-goods-sold method ("COGS").

In its post-hearing brief, the Division changed course completely and conceded that the penny contract sales were sales, but nevertheless asserted use tax was due under the COGS method.

In determining whether the assessment should be upheld, the ALJ noted that the Division's original assessment was based on a COGS calculation under one theory of liability, but it was now attempting to apply that same COGS calculation to a very different theory of liability. The ALJ further found that the Division had been aware of the residual income from the penny contract sales on Petitioner's records throughout the audit but made no effort to determine what portion of that income related to the penny sale contracts. The Division also did not pursue its newfound theory for the liability at the hearing or attempt to gather information about the residuals from the penny contracts, despite having access to Petitioner's witnesses who could have offered insight and information on the issue.

The ALJ deemed the assessment unreasonable because the record did not establish a "compelling connection" between the use tax liability calculated based upon the COGS method and the relevant residual payments and penny contracts at issue. Additionally, the ALJ pointed out that Petitioner was not able to effectively address the Division's new liability theory since the issue was not raised until after the record was closed, potentially raising due process concerns.

> **As the ALJ noted, the hallmarks of due process are notice and an opportunity to be heard. Where, as here, the Division did not reveal the theory for the tax liability until after the hearing on the matter was over and the record was closed, the Petitioner was not provided with either.**

MITCHELL A. NEWMARK
PARTNER

Alabama Loses Interest Addback Attack, Yet Again

By Mitchell A. Newmark

Alabama's Department of Revenue ("DOR") struck out again when it attacked related party interest transactions. In *Huhtamaki, Inc. v. Alabama DOR,* Docket Nos. BIT 19-890-JP, BIT 19-1091-JP (Ala. Tax Tribunal 2024), the Alabama Tax Tribunal analyzed the Alabama interest addback statute and reasoned that the exception for payments to related parties in treaty countries contemplated payments that were directly or indirectly paid. Against the DOR's arguments to the contrary, the Tribunal held that the Taxpayer was entitled to the addback exception when the Taxpayer paid interest to its ultimate parent, and its parent paid interest to a related party that was in a treaty country.

The addback statute, AL Code § 40-18-35(b)(1), clearly provides that:

> a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs **directly or indirectly paid,** accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows…that the corresponding item of income was in the same taxable year:… b. subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States, if the recipient was a 'resident' (as defined in the income tax treaty) of the foreign nation. For purposes of this section, subject to a tax based on or measured by the related member's net income means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.… That portion of an item of income which is attributed to a taxing jurisdiction having a tax on net income shall be considered subject to a tax even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise.

(Emphasis added.)

The case was not the first case to deal with the interest addback. In *Pfizer, Inc. v. Alabama DOR,* Docket No. BIT 18-236-JP (Ala. Tax Tribunal 2022), the Tribunal previously held that a direct payment to a related party in a treaty country ended the inquiry regarding eligibility for the exception to the addback. The *Pfizer* Tribunal concluded that the DOR was not entitled to look through that treaty country return to determine whether interest was paid out by the treaty-country-located interest recipient to another entity. It so concluded because: (1) the statute asks only whether the Taxpayer made a qualifying payment; and (2) the statute states that the exception applies even if no tax is ultimately paid in the treaty country.

The DOR asked the *Huhtamaki* Tribunal to reconsider its decision in *Pfizer.* The same Judge hearing the *Huhtamaki* case ruled in *Pfizer.* It was no surprise to us that the *Huhtamaki* Tribunal declined to reconsider *Pfizer.*

The *Huhtamaki* Tribunal cited the clear language used several times in the interest addback statute that expressly allowed for direct or indirect payments to the recipient in the treaty country.

> **In its discussion, the Tribunal noted that the record demonstrated, and the DOR did not dispute, that the interest payments were indirectly made to related recipients in treaty countries (a Luxembourg affiliate and a Hungary affiliate). Therefore, the Tribunal allowed the interest addback exception.**

Courts will apply the plain meaning of statutes. Words matter!

IRWIN M. SLOMKA
SENIOR COUNSEL

Microsoft Prevails in California Dispute on Inclusion of Gross Foreign Dividends in Apportionment Formula

By Irwin M. Slomka

In a decision that may have significant repercussions regarding apportionment for California corporate tax purposes, the California Office of Tax Appeals ("OTA") has denied the Franchise Tax Board's ("FTB") petition for a rehearing and in doing so let stand its holding that Microsoft was entitled to include 100 percent of its foreign dividends in its sales factor denominator, including the portion that qualified for a 75 percent deduction from income under California law. *Appeal of Microsoft Corporation and Subsidiaries,* Opinion on Petition for Rehearing, Case No.: 21037336 (Calif. Office of Tax Appeals, Feb. 14, 2024).

Facts: For the fiscal year ended June 30, 2018, Microsoft filed on the basis of a California water's-edge unitary combined return. Microsoft received repatriated dividends distributed by certain unitary controlled foreign corporations ("CFCs") totaling approximately $109 billion. On its original California return, Microsoft excluded 75 percent of those dividends from income pursuant to the California corporation tax law (R&TC § 24411(a)), resulting in only 25 percent of the dividends being included in business income.

Also on its original California return, Microsoft included only the 25 percent of the dividends in its sales factor denominator, commensurate with the net amount included in business income. On its amended return, however, Microsoft included 100 percent of the dividends ($109 billion)—that is, before the 75 percent deduction—in the sales factor denominator and claimed a refund of nearly $94 million. The FTB denied the refund claim and this litigation followed.

Prior Opinion: In July 2023, the OTA ruled that Microsoft properly included 100 percent of the dividends in its sales factor denominator and rejected the FTB's alternative arguments that the amounts should be excluded as a "substantial and occasional sale" or under alternative apportionment to avoid distortion. The FTB filed a motion for rehearing, principally on the alleged grounds that the Opinion was "contrary to law."

Opinion on Petition for Rehearing: On February 14, 2024, the OTA issued its Opinion in which it rejected the FTB's arguments and declined to grant it a rehearing. It declined to apply the FTB's "matching principle" set out in Legal Ruling 2006-01, under which only income included in the apportionable tax base could be included in the sales factor. The OTA found the plain language of the tax law, which required the inclusion of the taxpayer's "gross receipts" in the sales factor, to require that the *gross* amount of dividends be included *before the 75 percent qualifying dividends deduction,* making the "matching principle" unpersuasive.

The OTA also rejected the FTB's claim that the qualifying dividends constituted receipts arising from "substantial and occasional sales," which are excluded from the sales factor, noting that the FTB's regulations make clear that the exclusion is limited to receipts from the "sale of a fixed asset or other property[.]"

The OTA also held that the FTB failed to prove that use of its discretionary authority to exclude 75 percent of the dividends in order to "fairly represent" Microsoft's business activity in the state was warranted. Citing to the California Supreme Court decision in *Microsoft Corp. v. Franchise Tax Board,* 39 Cal. 4th 750 (2006), which set out criteria for deviating from the standard apportionment formula, the OTA held the FTB failed to show that Microsoft's receipt of dividends was occasional and qualitatively different from its main line of business and that the quantitative effect of their inclusion was as substantial as the inclusion of the gross amount of securities redemptions in the 2006 *Microsoft* decision.

> **The FTB cannot appeal the Opinion and it is therefore final, entitling Microsoft to nearly $94 million in tax refunds.**

As of this writing, the OTA had not yet posted the Opinion on its web site, which it may designate as either "precedential" or "non-precedential." The Opinion sheds important light on what constitutes gross receipts for California sales factor purposes, as well as on what must be shown for application of discretionary authority to justify deviation from the statutory sales factor.

NICOLE L. JOHNSON

PARTNER

Ruling Outside the Lines

By Nicole L. Johnson

The Michigan Court of Appeals recently issued its third decision in *Apex Laboratories International, Inc. v. Detroit,* No. 363984 (Jan. 4, 2024)—a case involving whether the company has the requisite nexus with the City. While the Michigan Supreme Court issued a clear directive on remand, the Court of Appeals opted to expand its review.

In round one of this case, the Michigan Tax Tribunal and the Court of Appeals both held that the company did not have the necessary nexus for Detroit to impose tax. Nevertheless, the Michigan Supreme Court remanded for consideration in light of *Wayfair. Apex,* 503 Mich. 1034 (2019).

However, the case was never an economic nexus case. Instead, the issue revolved around whether the company was doing business in the city, despite having no employees and no property—in Detroit or anywhere else. The officers and directors of the company were employees of another entity and worked in Detroit. Initially, the Court of Appeals upheld the Tribunal's finding that the company lacked a physical presence in Detroit and that the officers and directors did not act for the benefit of the company. *Apex,* 2018 Mich. App. LEXIS 2486 (2018).

Nevertheless, on review, the Court of Appeals reversed course. Reviewing the same evidence and the same legal standard, the Court of Appeals found that the officers' testimony was "self-serving" and those officers were "legally acting on behalf of" the company. *Apex,* No. 363984. Thus, in the court's view, those officers' and directors' activities in Detroit were sufficient to show nexus between the company and the City (*i.e.,* a physical presence).

> **However, the Michigan Supreme Court remanded for review in light of the eradication of the physical presence standard. A finding of nexus based on physical presence is certainly outside of the Supreme Court's directive.**

Moreover, the Court of Appeals provided little analysis as to why it reversed course and harshly criticized the testimony of the officers. Thus, taxpayers in Michigan are left with an unsettled standard as to what evidence is necessary to show that the officers did not act for the benefit of an entity. If the officers' own testimony will be brushed aside as "self-serving," then what other evidence could a company provide? Hopefully, the Michigan Supreme Court will answer that question for us.

In Michigan, the saga continues…

What's Shaking: Blank Rome's State + Local Tax Roundup

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.

The Council on State Taxation ("COST") 2024 Spring Meeting

- Blank Rome State + Local Tax partners Craig B. Fields, Nicole L. Johnson, and Mitchell A. Newmark will be speaking at the Council on State Taxation's 2024 Spring Meeting from May 1st through May 2nd in Boston, MA.

State Tax Roundtable for Utilities & Power ("STARTUP") Spring Conference

- Blank Rome State + Local Tax partners Craig B. Fields, and Nicole L. Johnson, will be speaking at the State Tax Roundtable for Utilities & Power Spring Conference on May 7th in Columbus, OH.

Tax Executives Institute ("TEI") 2024 Region 10 Conference

- Blank Rome State + Local Tax partners Craig B. Fields, and Nicole L. Johnson, will be speaking at the Tax Executives Institute's 2024 Region 10 Conference from May 22nd through May 24th in Dana Point, CA.

The Council on State Taxation ("COST") SALT Basics School

- Blank Rome State + Local Tax partner Mitchell A. Newmark will be speaking at the Council on State Taxation's SALT Basics School event on May 23rd in Atlanta, GA.

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