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Pennsylvania

Legislative / Administrative Update

Pennsylvania Budget

On Feb. 7, 2017, Gov. Wolf released his Executive 2017-2018 Budget. Enclosed is a high level summary of the budget:

Severance Tax on Natural Tax Drilling: Impose "a competitively structured" severance tax on natural gas. Effective July 1, 2017, the proposed new tax on the severance of natural gas would be at a rate of 6.5 percent of value. The amount paid in unconventional gas well impact fees would be available as a credit against the severance tax. Estimated tax impact: $293.8 million.

Corporate Net Income Tax:

- ***NOL Cap:*** Adopt NOL provisions "to respond to a recent court decision and enact a permanent, competitive resolution." The proposal is to remove the $5 million NOL cap while retaining the 30 percent of taxable income limitation, effective Jan. 1, 2018.
- ***Mandatory Combined Reporting:*** Adopt mandatory unitary combined reporting effective for tax years beginning on or after Jan. 1, 2018, while phasing in corporate tax rate reductions beginning in the 2019, ultimately reducing the rate to 6.49 percent by 2022. Estimated total tax impact for both changes: $81.2 million.

  Note: Prior to release of the Executive Budget, Pennsylvania State Sen. Christine Tartaglione (D) reintroduced legislation (S.B. 164) to require unitary combined reporting for tax years beginning after Dec. 31, 2016. The measure includes a "tax haven" description (but not a list of jurisdictions) and would phase-in a reduction of the corporate tax rate from 9.99 percent to 6.99 percent. The measure was referred to the Senate Finance Committee.
- ***Sales and Use Tax:*** "Eliminate special interest tax loopholes for specialty software and computer services, prepared food sold to airlines, aircraft maintenance and repair, and business storage that do not contribute a justifiable return in increased business investment." According to the budget summary, sales and use tax would be applied to commercial storage (excluding farm products and warehouse storage and transportation services);

computer services, custom programming, design and data processing; aircraft sales, use and repair; and airline purchases of catered food and non-alcoholic beverages served to passengers, effective July 1, 2017. Tax impact: $489.2 million.

- ***Insurance Premiums Tax:*** "Close loopholes to ensure all insurers, regardless of their method of incorporation, are taxed consistently." According to the budget summary, for tax years beginning on or after Jan. 1, 2018, the insurance premiums tax would be imposed "on most previously exempt insurance entities." Tax impact: $141.5 million.

For more information, please see: https://www.governor.pa.gov/2017-18-budget/

Sales & Use Tax Bulletin *2016-02 - DRAFT*, (11/18/2016)

The Pennsylvania Department of Revenue is changing the procedure for handling of large and complex sales and use tax refund petitions. To improve overall tax compliance and to improve the efficiency of reviewing these requests, large refund requests may be addressed through the field audit process.

There are several advantages for both taxpayers and the department in addressing refund requests through a field audit:

- Overpayments established would offset any audit liability, potentially reducing the amount of interest and penalty due if a follow-up audit were conducted after a refund was granted.
- A field audit can involve a stratified random sample of liabilities and overpayments, including overpayments to third parties, to limit the number of transactions required to be reviewed at all appellate levels.
- Through a field audit, areas of liabilities and overpayments would be specifically identified and discussed with the taxpayer, so that the taxpayer can take corrective action to improve compliance.
- A taxpayer can provide on-site evidence to the auditor, allowing an informed decision regarding the proper application of sales and use tax.
- Consolidating the liability and overpayment issues into a field audit would allow the appellate process to handle both issues simultaneously.

The board of appeals may dispose of a refund petition by issuing a decision and order under 72 P.S. § 9703(c) requiring a field audit. The taxpayer's due process rights will be fully preserved through the field audit process. The audit will encompass at least the same periods within the three-year refund window and may extend to additional periods if the taxpayer agrees to a waiver of the statute of limitations on assessments. Any refunds not granted in the audit may be raised in a refund petition within six months of the mailing date of the notice of assessment, or within three years of actual payment of the tax, whichever is later, under 72 P.S. § 10003.1(b).

The decision to conduct a field audit will be at the discretion of the department, but in general, large or complex refund petitions or recurring issues are more likely to be referred for a field audit. If the taxpayer has requested a hearing on the petition form, a hearing will be scheduled. The issue of an audit referral may be discussed at the hearing.

Volkswagen Class Action Settlement Agreement, Pennsylvania Sales and Use Tax Ruling No. SUT-16-003, (12/05/2016)

The Department issued a letter ruling on the taxability of payments made by Volkswagen pursuant to the Volkswagen Class Action Settlement Agreement. Class members who owned an eligible vehicle on Sept. 18, 2015, or who now own an eligible vehicle, have two options under the agreement: Volkswagen will 1) buy the vehicle (the buyback); or 2) fix the vehicle, when and if an emissions modification is approved (the modification). In addition to either the buyback or the modification, owners will also receive a cash payment (owner restitution payment) calculated at 20 percent of the vehicle value plus $2,986.73.

The ruling concluded that:

1. Neither the vehicle value paid under the buyback nor the owner restitution payment may be deducted from the purchase price of a new vehicle.
2. Neither the buyback nor the owner restitution payment is considered a replacement or refund under Pennsylvania's Automobile Lemon Law.

Under the buyback, Volkswagen, not the dealership, will purchase an eligible vehicle from the owner and pay the vehicle value, which the owner may or may not choose to apply to the purchase of a new vehicle. The buyback is considered a separate or independent sale rather than a trade-in. Accordingly, the purchase price of a new vehicle upon which sales tax is imposed may not be reduced by the vehicle value, even if it is immediately applied by the owner to the purchase of the vehicle.

The owner restitution payment is not considered a trade-in. The payment is unrelated to and independent from the owner's sale of an eligible vehicle to, or purchase of a new vehicle from, a dealership. Accordingly, the purchase price of a new vehicle may not be deducted by the owner restitution payment regardless of whether the purchase is made in connection with the buyback or otherwise.

The owner restitution payment is neither the vehicle's purchase price nor a replacement vehicle. Therefore, neither the buyback nor owner restitution payment is considered a vehicle replacement or refund under Pennsylvania's Automobile Lemon Law.

Pennsylvania Reciprocal Agreement with New Jersey - Pennsylvania Tax Update No. 187, (10/01/2016)

New Jersey reversed its previously announced termination of the reciprocal tax agreement between New Jersey and Pennsylvania. The continuation of the reciprocal agreement means that Pennsylvania employers of New Jersey residents will continue to withhold New Jersey personal income tax on behalf of their New Jersey resident employees and remit that tax to New Jersey. Also, New Jersey employers of Pennsylvania residents will continue to withhold Pennsylvania personal income tax on behalf of their Pennsylvania resident employees and remit that tax to Pennsylvania.

Pennsylvania Tax Amnesty Program: April 21-June 19, 2017

The department will administer a 60-day tax amnesty program from April 21, 2017 through June 19, 2017 as authorized under Act 84 of 2016 (L. 2016, H1198). During the amnesty period, all penalties and half of the interest owed will be waived for those who apply and pay delinquent taxes. Those eligible to participate in the amnesty program are individuals and businesses with unpaid (or underpaid) Pennsylvania taxes or unfiled returns, as of Dec. 31, 2015.

Ineligible to participate: participants in the 2010 Tax Amnesty Program, taxpayers under criminal investigation, criminal prosecution, or criminal restitution for allegedly violating a tax law, and taxpayers with a voluntary disclosure agreement for periods eligible for tax amnesty (taxpayers in bankruptcy must be granted permission from bankruptcy court).

More than 30 state taxes administered by the department are eligible for amnesty, including personal income tax, corporate net income tax, sales and use tax, and inheritance tax. Participants must file an application, file missing returns and pay any taxes due, along with half of the interest owed, by the end of tax amnesty on June 19, 2017. Individuals and businesses with tax liabilities eligible for tax amnesty that do not participate in the program will be assessed a five percent penalty.

The voluntary disclosure program will remain active during tax amnesty.

For more information please visit:

- Department's Amnesty website: http://www.revenue.pa.gov/taxamnesty/Pages/default.aspx#.WH7EU1UrJEY
- Amnesty Q&A: http://www.revenue.pa.gov/taxamnesty/Documents/tax_amnesty_qa.pdf
- Amnesty guidelines: http://www.revenue.pa.gov/taxamnesty/Documents/2017_tax_amnesty_program_guidelines.pdf

Pennsylvania sets interest rates for underpayments and overpayments for 2017 - Interest Rate Notice, Pa. Dept. of Rev., PA. Bull. Doc. No 16-2268, Pa. Bull. Vol. 46, No. 52, (12/24/2016)

The department has formally announced that the rate of interest on underpayments of Pennsylvania taxes for the year commencing Jan. 1, 2017 is 4 percent per annum. The rate of interest on overpayments of tax for the year commencing Jan. 1, 2017 is 2 percent (except personal income tax overpayments, which accrue interest at the same rate as for underpayments). These rates will remain in effect through Dec. 31, 2017.

Pennsylvania sets annual inflation adjustment for distribution of tax revenue from the State Gaming Fund - Annual Inflation Adjustment; Pennsylvania Gaming Cash Flow Management, Pa. Bull. Doc. 17-208, Pa. Bull. Vol. 47, No. 5, (02/04/2017)

The department has announced that the annual inflation adjustment required under 4 P.S. § 1403(d) for the year commencing Jan. 1, 2017 is 1.7 percent. The statute requires that the amount of net slot machine tax revenue distributed to municipalities from the State Gaming Fund be adjusted for inflation annually, using the most recent Consumer Price Index as officially reported by the U.S. Department of Labor, Bureau of Labor Statistics immediately prior to the date the adjustment is due to take effect. The most recent figures were published by the U.S. Department of Labor, Bureau of Labor Statistics on Jan. 18, 2017.

Computer Data Ctr. Equip. Incentive Program - Pa. Dep't of Revenue, (12/01/2016)

The Department published program guidelines for the Computer Data Center Equipment Incentive Program. The program is designed to attract new investments from businesses that own or operate within a computer data center. The program is available to owners and operators of computer data centers that obtain certification for eligibility in the program. Beginning July 1, 2017, an owner, operator or qualified tenant of a certified computer data center may apply annually for a tax refund for sales and use tax paid on qualified computer data center equipment used within the facility. The guidelines provide information on program certification and eligibility, tax incentive and qualification periods, qualified tenant list, refund approval, program monitoring and recapture, limitation and definitions. It also provides an application for certification.

Pennsylvania General Assembly Enacts Law to Provide for Applicability of Realty Transfer Tax Exclusion - L. 2016, H2370 (Act 175) - H.B. 2370, (enacted 11/21/2016)

The Pennsylvania General Assembly enacted H.B. 2370 to amend the Tax Reform Code of 1971, providing for the applicability of the realty transfer tax exclusion provisions enacted as part of Act 84 of 2016. Act 84 of 2016 applies to certain transactions involving conservancies, veterans' organizations and transfers to or by a land bank that are exempt from the realty transfer tax. The bill amends the provision by making certain exempt transactions involving conservancies and transfers to or by a land bank retroactive to Jan. 1, 2013. Furthermore, the bill provides that, when the statute of limitations has expired for certain transactions involving conservancies and transfers to or by a land bank, a taxpayer may still file a petition for refund with the Department of Revenue, if the petition for refund is filed within six months of the effective date of this section. This bill shall apply retroactively to July 13, 2016.

Supreme Court Updates

In re: Amendment to the Pennsylvania Race Horse Development and Gaming Act, 8 MM 2017, (01/20/2017)

On Jan. 20, 2017, the Pennsylvania Supreme Court granted the Pennsylvania Senators' application for extraordinary, or King's Bench, relief and extended the stay of the Court's decision in *Mount Airy #1, LLC v. Department of Revenue*, Pa. S. Ct., Dkt. No. 34 EM 2015, (09/28/2016), until May 26, 2017.

In this case, the court held that 4 Pa. Cons. Stat. § 1403(c)(2) and (c)(3) were unconstitutional and ordered severance. Local share assessments usually consist of a county share and municipal share. A casino located outside of Philadelphia must pay both. The General Assembly essentially created a variable-rate tax, fashioning one rate for non-Philadelphia casinos with gross terminal revenue below $500 million, and another for non-Philadelphia casinos with gross terminal revenue above $500 million. The court found that the municipal and county local share assessments were two parts of a single tax. The court stated that Pa. Const. art. XIII, § 1 prohibited such a non-uniform tax.

Nextel Communications of the Mid-Atlantic, Inc., v. Commw., Pa Commw. Ct., Dkt. No. 6 EAP 2016, (docketed date 02/02/2016)

Oral hearings are scheduled for March 7, 2017.

Commonwealth Court / Superior Court Cases

Corporate Tax Cases

None

Sales and Use Tax Cases

DS Waters of America, Inc. v. Commw., Pa. Commw. Ct., Dkt. No. 370 F.R. 2013, (11/30/2016)

The Commonwealth Court affirmed the Board of Finance and Revenue (BF&R) and held that the water company's process of converting municipal water to purified water and then to distilled water did not constitute manufacturing. Thus, the water company was not entitled to the manufacturing exemption to sales and use tax. Relying on prior cases, the court held that the company's process did not apply skill and labor to materials that resulted in a new, different and useful product, or did the process substantially transform the ingredients in form, quality and use. The court dismissed the argument that there might have been a specialized market for distilled water.

The taxpayer also argued that because BF&R and the Board of Appeals (BOA) determined that its predecessor entity qualified for the manufacturing exclusion in 1990-1993, the department is collaterally estopped from assessing use tax on tangible personal property that the taxpayer purchased and used to perform water processing activities at its facilities. The court rejected the taxpayer's claim noting that an administrative body has no authority to estop the state in the exercise of its taxing power, that the prior decision was issued to a different entity during a separate tax year, and that the court reviewed this decision of BF&R de novo.

Strongstown B&K Enterprises, Inc. v. Commw., Pa. Commw. Ct., Dkt. No. 400 F.R. 2013, (12/21/2016)

The Commonwealth Court denied exceptions to an earlier opinion in which the court held that a construction contractor, who purchased fabricated aluminum road signs, posts and accompanying miscellaneous hardware (road signs) and installed them along roads, and the Pennsylvania Turnpike, pursuant to contracts with PennDOT and various Pennsylvania municipalities, is not entitled to an exemption from use tax.

In the exceptions, the taxpayer asserted that the Commonwealth Court erred because "exclusions from tax" should be strictly construed against the Commonwealth, the road signs constitute a traffic control system, the road signs constitute "building machinery and equipment" (BME), and the court ignored the public policy implications of imposing sales or use tax on construction contractors installing road signs under contracts with the commonwealth and its municipalities.

Level 3 Commc'ns v. Commw., Pa. Commw. Ct., Dkt. No. 166 F.R. 2007, (12/08/2016)

The Commonwealth Court has denied exceptions filed by the Commonwealth, in which the court reversed BF&R's order and held that the taxpayer's sale of its 3ConnectModem (3CM) dial-up services to AOL constituted internet access exempt from Pennsylvania sales and use tax and the federal Internet Tax Freedom Act.

The Commonwealth argued that the 3CM service is not materially different from the port modem management (PMM) services, which were found to be taxable in *Am. Online, Inc. v. Com.*, 932 A.2d 332 (Pa. Commw. Ct. 2007), aff'd, 963 A.2d 903 (2008). The court held that there are material fundamental technological differences between Sprint's PMM services and the taxpayer's 3CM dial-up services, and that the services Sprint sold to AOL did not provide internet access, but the services the taxpayer sold to AOL did. The court disagreed with the Commonwealth's assertion that the taxpayer did not provide internet access because "AOL end-users are not on the internet" when they arrive at AOL's data center because the end-users are already on the internet, having entered through the petitioner's point of presence (POP) and having been directed to the AOL website. The court dismissed the Commonwealth's assertion that the end-users must be directed to what it refers to as the "public internet" in order for the tax exemption to apply and that www.aol.com is not the public internet.

The court noted that the Commonwealth's reliance on the Federal Communication Commission's Tariff Investigation Order was misplaced because it was based on the factual premise that 3CM does not deliver end-users to the internet, which was previously rejected. The court also noted that the Commonwealth's reliance on a statement in *Com. v. A. J. Wood Research Co. of Pennsylvania*, 431 A.2d 367 (1981) that "[t]he law's concepts have sufficient vital capacity for growth to accommodate technological evolution" was misplaced because in comparing this case to the *AOL/Sprint* decision, the Commonwealth only considered "*how* the services were provided," rather than considering the key difference being "*what* services were provided."

Local Taxes & Fees

Costa v. City of Allentown, Pa. Commw. Ct., Dkt. No. 826 C.D. 2016, (01/12/2017)

In 1999, the city of Allentown passed an ordinance that required each residential unit located within the city to have a residential rental license. The purpose of the ordinance is "to protect and promote the public health, safety and welfare of its citizens, to establish rights and obligations of owners and occupants relating to residential rental units in the city and to encourage owners and occupants to maintain and improve the quality of rental housing within the community." The ordinance provides for a systematic inspection program, registration and licensing of residential rental units, and penalties. By 2014, the city charged a $75 annual license fee per residential rental unit for all residential rental registrations and residential rental licenses. There are approximately 24,000 rental units in the city.

The taxpayers initiated a lawsuit against the city, alleging that the $75 annual license fee charged by the city since 2010 constitutes an unlawful special tax that subsidizes general functions of the city, such as police services, code enforcement and boarding up vacant properties and that the private industry can provide the same services performed by the city under the rental program for a fraction of the city's cost. The Court of Common Pleas of Lehigh County issued an opinion and order in favor of the city.

On appeal, the taxpayers argued: (1) the trial court erred in determining that the $75 annual license fee could be diverted to subsidize budgetary overhead and the costs of general, unrelated governmental services; (2) the trial court erred by not declaring the $75 annual license fee an unlawful special tax collected for general tax revenue purposes, because the revenues generated by it exceed the actual and probable cost of the rental program by 200 percent; and (3) the trial court erred by not declaring the $75 annual license fee unlawful because the private industry is able to perform the services provided by the city under the rental program for only 13.7 percent of the total annual license fees collected by the city.

The Commonwealth Court affirmed the trial court's order upholding a $75 annual licensing fee imposed on all residential rental units by the City of Allentown. First, the court found that the taxpayers failed to show that the annual licenses fee levied by the City of Allentown was excessive in relation to the regulatory program expenses incurred by the city. The court noted that the trial court properly rejected the taxpayers' limited, direct cost scheme and concluded that there were also indirect costs attributable to the rental program that the taxpayers' expert witness did not take into consideration in his analysis. Second, the court concluded that the trial court did not err by declaring that the annual license fee was not an unlawful special tax because the taxpayers did not meet their initial burden with establishing the total costs of the rental program. Third, the court also held that taxpayers failed to prove that the private sector could perform the services provided by city for a lower cost.

Real Property Transfer Tax / Real Property Tax Cases

In re Petition of Tax Claim Bureau of Westmoreland Cnty., Pa. Commw. Ct., Dkt. No. 316 C.D. 2015, (12/06/2016) (opinion not reported)

The taxpayer purchased a church in 2008 and filed an exemption application in 2011. The Board of Assessment Appeals (board) granted the real estate tax exemption for tax years 2012 and thereafter, but made no determination of tax exemption for tax years 2009 through 2011. The taxpayer did not appeal the determination with regards to retroactive application of the tax exemption for tax years 2009 through 2011 and only filed a petition for judicial determination of tax-exempt status after the property was put up for tax sale.

The Commonwealth Court held that the Court of Common Pleas of Westmoreland County did not err in finding that it lacked jurisdiction to hear a petition for judicial determination of tax exempt status because the taxpayer failed to file a timely appeal of the board's decision.

Kimberton Fire Co. v. Chester County Bd. of Assessment Appeals, Pa. Commw. Ct. Dkt. Nos. 166 C.D. 2016; 167 C.D. 2016, (11/23/2016) (opinion not reported)

Kimberton Fire Company (KFC) is a non-profit corporation and a voluntary fire house company. KFC was granted an exemption from paying local real estate taxes on its principal property, a firehouse, by Chester County, a sales and use tax exemption as a charitable organization by the Commonwealth, and a tax-exempt 501(c)(3) status by the IRS. Adjacent to the firehouse, KFC owned another property that was used by ABC-123 Inc. (ABC), KFC's wholly owned non-profit subsidiary, for operating a day care center. ABC was granted a tax-exempt status for sales and use tax by the Commonwealth and a tax-exempt 501(c)(3) status by the IRS.

ABC's day care is open to the general public. All customers pay the same rate, including children of KFC and ABC employees and volunteers. Further, all day care workers are employed by ABC; none are employed by KFC. The day care center is operated and managed by ABC, and KFC is operated and managed separately. ABC contributes all of its net proceeds from the day care to KFC. ABC does not pay rent for the use/occupancy of the property. KFC does not subsidize the costs or expenses of ABC beyond the free-rent provision.

KFC filed with the Chester County Board of Assessment Appeals (board) applications for tax exemption for the property used by ABC, which was denied. The trial court affirmed the board's decision, finding that KFC is not exempt because it does not occupy the property for which the exemption is sought.

The Commonwealth Court held that property owned by a charitable organization but used and occupied by its wholly owned subsidiary does not qualify for exemption from real property tax. Specifically, the court held that KFC was not exempt from taxation under Consolidated County Assessment Law (law), 53 P.S. § 8812(a)(11), because KFC does not use or occupy the property. The court held that Section 8812(a)(11) of the law provides for exemption only if the land is "used and occupied partly by the owner or owners and partly by other institutions of purely public charity ... " The court noted that exemption does not apply when the property is solely used by the institution of purely public charity but not used by the owner at all. Because ABC, a wholly-owned subsidiary of KFC, is a separate and distinct entity from KFC, KFC cannot be presumed to occupy the property through ABC's use.

The court also held that KFC was not exempt under 53 P.S. § 8812(a)(15), which provides that the fire station is exempt along with the grounds annexed to the fire station that are necessary for the occupancy and use of the fire station, and social halls and grounds owned and occupied by the fire station are exempt if they are used on a regular basis for activities that contribute to the support of the fire station by submitting all the net receipts from those activities to the fire station. The court held that for this exemption to apply, "the property must be annexed, necessary for the use of the fire station, and necessary for the occupancy of the fire station." Because the last two conditions were not met, the court held that KFC was not exempt from taxation under Section 8812(a)(15). Mere use by a subsidiary and contributions therefrom do not qualify a property as tax exempt under Section 8812(a)(15).

Washington County Tax Claim Bureau v. Miller, Pa. Commw. Ct., Dkt. No. 1083 C.D. 2014, (11/16/2016)

A trial court ordered a taxpayers' property be sold at a judicial sale. Notice was sent to the taxpayers, individually, at their respective P.O. box addresses, but neither notice was returned with either of their signatures. The record does not demonstrate that notice was posted on the property itself or sent to the property by the sheriff through certified mail. Sheriff's certification of service did not list either of the taxpayers receiving notice of the judicial sale of the property. No bids were received at the judicial sale, and the property was in the Washington County repository until it was purchased by a third party. The taxpayers were not provided notice of this repository sale.

The tax claim bureau maintained that the taxpayers had actual notice of the sale based on the notice of the previously scheduled upset sales. However, 72 P.S. § 5860.609(g) requires that the record owners of the property must be served with notice of the judicial sale. As there was no evidence to show that notice of the judicial sale was served as required under the statute, the judicial sale was deemed void ab initio, and the case remanded for further proceedings.

Sampson v. The Tax Claim Bureau of Chester Cnty., Pa. Commw. Ct., Dkt. No. 355 C.D. 2016, (12/12/2016)

The taxpayer entered into a "continued installment agreement" with the tax claim bureau under 72 P.S. § 5860.601 (Section 601) after the property was scheduled for tax sale due to nonpayment of taxes. Under the Section 601 agreement, the taxpayer agreed to pay $4,500 at the time of the agreement, the balance of taxes due for 2011 by Dec. 31, 2013, and any remaining taxes due by June 30, 2014. The property was sold at tax sale after the taxpayer missed the installment due on Dec. 6, 2013. The taxpayer filed a petition to set aside the tax sale, which found in Tax Claim Bureau's favor.

The Commonwealth Court reversed the Court of Common Pleas of Chester County, finding that the bureau was obligated to offer the taxpayer an installment agreement pursuant to 72 P.S. § 5860.603 upon payment of more than 25 percent of their outstanding property taxes, and the failure to offer a Section 603 plan invalidated the tax sale. The court rejected the argument that a continued sale agreement under Section 601 relieves the bureau of the duty to offer a Section 603 agreement, finding that once the taxpayer tendered payment in an amount exceeding 25 percent of the amount due, the bureau was obligated to offer a Section 603 agreement and failure to do so invalidated the sale.

In the Matter of the Report and Return of Christine L. Krzysiak (Appeal of: Denis Bubna), Pa. Commw. Ct., Dkt. No. 545 C.D. 2016, (12/07/2016)

The Commonwealth Court affirmed an order of the Court of Common Pleas denying the taxpayer's petition to set aside an upset tax sale. The taxpayer argued that the Crawford County Tax Claim Bureau failed to meet its burden of proving strict compliance with all statutory notice requirements because the posted notice was not reasonably secured, and he did not have actual notice of the upset sale. Specifically, the taxpayer claimed that the notice was not "reasonably secured" as required by law, because it was not clear that the tape used to post the notice was designed for adhesion to a wood surface, and it was affixed in such a way that the posting would be vulnerable to weather conditions and because no staples were used. The taxpayer also produced witnesses who either lived near the premises or did work for the taxpayer, such that they would be likely to observe the business sign on which the notice was posted on a daily or weekly basis. They testified that they never saw the notice. An agent that handles posting tax sales notices for the county testified that the notice was posted on a business sign near the road and secured on the top and bottom with very sticky tape.

The trial judge determined that the manner of posting was reasonable since there is no requirement that staples or any specific method of posting be used so long as the method chosen is reasonable and likely to inform the taxpayer of an intended sale of the property. The trial judge also found that the witnesses were not unbiased due to their relationship to the taxpayer. Since the trial court was authorized to determine the weight to be assigned to evidence, and there was sufficient evidence in the record to support the trial court's findings, the trial court's order was affirmed.

Dickson City Auto Realty, LP v. Tax Claim Bureau of Lackawanna Cnty., Pa. Commw. Ct., Dkt. No. 326 C.D. 2016, (01/12/2017)

The Tax Claim Bureau of Lackawanna County sold the taxpayer's property in a tax upset sale to the purchaser. The taxpayer filed its petition to set aside a tax sale, wherein it asserted the property was improperly posted. In its answer, the bureau admitted the property was not properly posted and that a constable "affixed the posting notice upon a telephone pole situated upon the situs of an unrelated parcel." The purchaser filed a response to the petition, averring that the property was properly posted as evidenced by the notice of public sale.

At the hearing, counsel for the bureau confirmed that the notice was not properly posted and chose not to participate further in the hearing. The purchaser moved forward and introduced a copy of the notice of public sale and presented no other evidence. A constable responsible for posting the notice testified on behalf of the taxpayer and admitted that she improperly posted the notice. The Court of Common Pleas of Lackawanna County granted the taxpayer's petition to set aside the tax sale holding that the property was improperly posted.

The Commonwealth Court affirmed finding that the trial court's decision to set aside the tax sale was supported by sufficient evidence. The court noted that the purchaser did not produce any evidence to contradict the taxpayer's evidence. The court further noted that the taxpayer offered unchallenged testimony in support of its claim. The court noted that, because the bureau admitted that the posting was improper, it was the purchaser's responsibility to demonstrate strict compliance with the tax sale law's notice provisions. The court further noted that there was no evidence to show that the notice was posted someplace conspicuous on the property.

Board of Finance and Revenue

In re Rentokil North America, Inc., Pa. Bd. of Fin. & Rev., Dkt. No. 1607493, (09/22/2016)

The department reduced taxpayer's net operating loss (NOL) deduction and issued an assessment of tax, penalty and interest. The taxpayer protested the assessment, contending that the deduction consisted of the NOLs from the taxpayer and the corporation that merged into it. The BOA abated the penalty, but denied the request for the increased deduction. The taxpayer filed the petition with the BF&R.

The BF&R denied the taxpayer's petition because the taxpayer failed to prove its entitlement to the claimed NOL deduction. The BF&R noted that Pennsylvania followed the requirements of Internal Revenue Code § 381, which permits an acquiring corporation to succeed NOL carryovers if the transfer is connected to certain reorganizations. The transaction was not a Type A reorganization, as the taxpayer argued, because the other corporation did not cease its separate legal existence, as required by 26 C.F.R. § 1.368-2(a)(1)(A). Accordingly, BF&R denied the petition.

In re Van Etten Oil Co. Inc., Pa. Bd. of Fin. & Rev., Dkt. No. 1511969, (08/24/2016).

The taxpayer, a federal and New York S Corporation, supplied propane gas and other services. The DOR increased taxpayer's corporate net income tax by disallowing the total nonbusiness income and a portion of the depreciation deduction. The taxpayer denied owning or leasing property, soliciting business or performing services in Pennsylvania and claimed that the only income it derived in Pennsylvania was from a fuel distributor (distributor).

The BF&R granted taxpayer's request for relief, finding that taxpayer's business activities did not exceed the "solicitation plus" standard of Public Law 86-272. The BF&R found that the taxpayer was only engaged in solicitation by entering the brokerage agreement with the distributor, but was not engaged in any other business activity in Pennsylvania. Additionally, the taxpayer remained in New York and did not enter Pennsylvania for any other business activity or exceed the "solicitation plus" standard. Therefore, the BF&R granted relief and held that the other claims raised were moot.

In re Bailey Jr., Pa. Bd. of Fin. & Rev., Dkt. Nos. 1515269 et. al., (08/25/2016).

The DOR determined that the taxpayer was domiciled in Pennsylvania through a nonresident review questionnaire and issued assessment notices consisting of tax, interest and penalties for tax years 2002 through 2009. The taxpayer protested the assessment at the BOA, contending that he changed his domicile to Florida in 1999. The BOA found that the DOR's determination was proper.

On appeal, the BF&R denied the taxpayer's petitions as the taxpayer failed to prove a change in domicile. The BF&R noted that, although the taxpayer took numerous actions to change his domicile to Florida, such as obtaining a Florida driver's license and voter's registration card, the evidence was insufficient to prove a permanent change in domicile. Further, the taxpayer did not show that he spent more time in Florida than Pennsylvania, and the taxpayer continued his business operations in Pennsylvania. Also, the taxpayer's Pennsylvania home was more expensive than his out-of-state home.

Philadelphia

Legislative / Administrative

On Dec. 20, 2016, Philadelphia Mayor Jim Kenney signed Bill No. 160810 (bill), enacting substantial changes to the Philadelphia Realty Transfer Tax (RTT) by imposing the tax on the "actual consideration paid" instead of the computed value of the real estate owned by an acquired real estate company and expanding the application of the RTT on real estate companies to the extent there is a 75 percent or more change in ownership within a six-year period. Such changes are effective July 1, 2017.

- The bill provides that Philadelphia RTT will be imposed on a "real estate company" when there is a 75 percent or more change in ownership within a six-year period. This varies from the current law, where tax is imposed on a real estate company once there is a 90 percent or more change in ownership within a three-year period.
- The bill amends the definition of "real estate company" to include holders of "title to real estate," e.g., holders of long-term (30 years or longer) leases, to determine if the company will be classified as a "real estate company."
- The bill makes changes to Philadelphia RTT base by amending the definition of "value." Specifically, the bill provides that the base upon which the Philadelphia RTT is imposed "shall never be less than the readily ascertainable market value of any property." With respect to the purchase of a real estate company, where the change of ownership is part of a bona fide arm's length sale, the bill provides for a rebuttable presumption that the monetary value is the actual consideration paid for the company. However, the taxpayer may rebut the presumption by providing an alternative proof of actual value of the included real estate.
- The city of Philadelphia budget, Bill No. 160471, increases Philadelphia RTT rate from 3 percent to 3.1 percent, effective Jan. 1, 2017.

For additional information, please see: https://phila.legistar.com/LegislationDetail.aspx?ID=2843443&GUID=5132C326-D781-4385-86C4-0F4B77EAA150

Supreme Court Cases

City of Phila. v. Lerner, Pa. S. Ct., Dkt. No. 26 EAP 2015, (11/22/2016)

The Pennsylvania Supreme Court granted allocatur to a taxpayer to address whether the Commonwealth Court properly decided that it was constrained by its decision in *Krug v. City of Philadelphia*, 620 A.2d 46 (1993), to sustain a judgment for a tax assessment where the Common Pleas Court found that there was no rational basis for the amount allegedly owed by the petitioner and the Commonwealth Court stated that the city's tactics may well lack authority in law.

In *Krug*, a taxpayer alleged that he did not owe Philadelphia wage taxes because he neither worked nor lived in the city, but did not timely challenge the assessment with the tax review board. The Commonwealth Court held that a taxpayer who has not timely appealed his or her assessment to the tax review board cannot challenge that assessment in a later collection action.

In this case, the taxpayer ignored various requests for information, tax bills, failed to answer the complaint, ignored discovery requests, failed to file a response to a motion in limine that precluded the taxpayer from challenging the underlying assessment in the collection action. The taxpayer waited until judgment was rendered in favor of the city to file a post-trial motion arguing that the judgment was not supported by the evidence. The lower courts precluded the taxpayer from challenging the city's assessment due to his failure to exhaust administrative remedies.

The Pennsylvania Supreme Court upheld the tax judgment because the taxpayer failed to exhaust his administrative remedies, even though the assessment was "simply made up and had no basis in any evidence." The court noted that creating a "learner exception" would justify a party's non-compliance with virtually any substantive, procedural, or jurisdictional rule. Creating an exception to the *Krug* rule would allow litigants "to forgo, flout or leapfrog the administrative process and seek a judicial resolution of a waived challenge at their leisure," which would not "promote public confidence or maintain the integrity of the judicial process."

Commonwealth Court Cases

***Williams v. City of Phila, Phila**.* Ct. of Common Pleas, Dkt. No. 1452, (12/19/2016)

The Philadelphia Court of Common Pleas sustained the defendant's preliminary objections and dismissed an action seeking declaratory and injunctive relief against the Philadelphia sweetened beverage tax, finding that the tax is not duplicative of, or preempted by, Pennsylvania sales tax, is not preempted by state implementation of the federal Supplemental Nutrition Assistance Program (SNAP), and does not violate the Uniformity Clause of the Pennsylvania Constitution. Effective Jan. 1, 2017, the beverage tax imposes a 1.5 cent-per-ounce tax on the sale, delivery or acquisition of any sugar-sweetened beverage (SSB) to or by a dealer for purpose of the dealer holding out the taxable beverage for retail sale within the city.

Specifically, regarding the plaintiffs' argument that the beverage tax is duplicative of, or is preempted by, the Pennsylvania sales tax, the court held that the beverage tax does not tax the same privilege, transaction, subject or occupation or personal property as the sales tax. The Philadelphia beverage tax, and the Pennsylvania sales and use tax apply to two different transactions, have two different measures and are paid by different taxpayers. The subject of the beverage tax is a non-retail, distribution level on SSBs, which is triggered when SSBs are distributed to the dealer, irrespective of whether the dealer sells the product to the consumer. The beverage tax is measured by the volume of fluid ounces of the SSB and is imposed on the distributor. Comparatively, Pennsylvania's sales tax is imposed on a sale at the retail level and is measured by the purchase of the retail sale and is paid by the consumer. The court also noted that in determining whether the beverage tax is constitutional, the fact that the burden of tax may be passed to the consumers is irrelevant. Because the incidence of the Philadelphia beverage tax and Pennsylvania sales tax are not the same, the beverage tax is not preempted.

The plaintiffs also made an argument that the beverage tax is preempted by SNAP, because it causes SNAP benefits to be used to pay a sales tax. SNAP is a federally funded program whose benefits help supplement an individual's or family's income to help buy nutritious food, including low-calorie and regular soft drinks. The court held that the scope of SNAP is limited to the purchase of foods from retail food stores. Since the beverage tax is not collected upon purchases at retail made with food stamps, but only upon non-retail, distributor-level transactions, and the incidence of tax is not on the consumer, the beverage tax is not preempted by SNAP.

Lastly, the plaintiffs alleged that the beverage tax is not uniform because it falls on four different classes, soft drinks, distributors, retailers and consumers, on an unequal basis. Plaintiffs allege that the beverage tax imposes a flat tax per unit of volume regardless of the market price or wholesale price of the SSB. Further, the plaintiffs allege that the beverage tax does not operate in uniformity since a distributor that sells small quantities of high-cost beverages will owe less than a distributor who distributes large quantities of budget beverages, even if the revenues or profits of the former are higher. The court held that the beverage tax is based on volume, similar to fuels and alcohol taxes, and that the manner and measure of its calculation applies uniformly to all distributors. The court also held that the beverage tax is not a property tax that needs to be assessed on an ad valorem basis.

Case Status Update:

- On Sept. 14, 2016, the plaintiffs filed a lawsuit to invalidate Philadelphia Beverage Tax. On the same day, the plaintiffs filed an Emergency Application for Excise of the King's Bench powers in the Pennsylvania Supreme Court to hear the case.
- On Nov. 2, 2016, the Pennsylvania Supreme Court denied the Emergency Application for Excise of the King's Bench powers.
- On Dec. 19, 2016, Judge Gary S. Glazer of the Philadelphia County Court of Common Pleas dismissed the case on preliminary objections.
- On Dec. 23, 2016, the plaintiffs appealed to the Commonwealth Court.
- On Jan. 5, 2017, the city filed an application for Extraordinary Relief with the Pennsylvania Supreme Court to hear the case.
- On Feb. 6, 2017, three dozen state legislators filed an amicus brief calling for the Commonwealth Court to overturn Philadelphia's sweetened beverage tax. For additional information, please see: http://media.philly.com/documents/State+soda+tax+Amicus+Brief_final.pdf
- On Feb. 13, 2017, the Pennsylvania Supreme Court denied the city's application for Extraordinary Relief. However, the Commonwealth Court has agreed to an expedited schedule. Arguments are expected to begin the week of April 3, 2017.

City of Phila. v. Singhal, Pa. Commw. Ct., Dkt. No. 128 C.D. 2016, (02/06/2017) (opinion not reported)

The owner of a Philadelphia property moved to Maryland and failed to pay real estate taxes for tax years 2009 through 2012. The city sent required notification to the owner's last known address in Philadelphia and received no response to the tax petition. The trial court entered a decree that the property would be sold at a sheriff's sale. Before the sheriff's sale, the owner made a partial payment towards outstanding taxes. However, the property was still sold at the sheriff's sale because some real estate taxes on the property remained unpaid. The sheriff's sale purchaser, who tendered a 10 percent down payment but failed to pay the remainder within 30 days as required, filed a request to complete payment and was instructed to serve notice on all interested parties, but only served notice to the owner using the address of the tax delinquent property, which was occupied by a tenant installed there by the purchaser. The purchaser did not send notice to the owner's other Philadelphia address. Meanwhile, the owner learned of the pending sheriff's sale proceedings and paid the remaining balance of taxes.

At the hearing, which the owner did not attend, the purchaser was given 15 days to pay the balance due. The city did not object. The purchaser paid the balance. Thereafter, the deed for the property was acknowledged and recorded.

The owner filed a motion to vacate the resulting order in favor of the purchaser, claiming lack of notice, and because she had paid the outstanding taxes in full prior to the hearing and order allowing the purchaser to complete payment. The trial court denied the motion as untimely and procedurally improper. Specifically, the court noted that the owner may only attack a sheriff's sale by the file of a petition to set aside within three months of recordation of the deed, and that the owner missed the statutory deadline by filing her petition eight months late. The owner appealed.

The Commonwealth Court reversed the trial court's order, which granted additional time to the purchaser to complete payment on the property purchased at the sheriff's sale, where the purchaser took deliberate steps to guarantee that the property owner had no notice of the hearing and the trial court failed to verify whether the delinquent tax remained unpaid. The court noted that this sheriff's sale included some improvisational aspects outside the scope of the Municipal Claims and Tax Liens Act (MCTLA). The court held that the trial court restarted the sale after the purchaser failed to pay within the allotted time, which required a determination that a notice of the hearing had been properly served, and that the underlying basis of the sale (delinquent taxes that remained unpaid) was still valid. The trial court's failure to inquire whether service of the owner was adequate, or to reconfirm that taxes were still owed in light of the owner's assertion that she had paid them in full prior to the hearing, constituted an abuse of discretion, so the case was reversed and remanded for further proceedings.

SCOTUS Update

Petitions for Cert. Filed or Pending

American Bus. USA Corp., v. Fla. Dep't of Rev., petition for cert. filed, U.S. S. Ct., Dkt. No. 16-567, (10/24/2016)

The U.S. Supreme Court has been asked to review a decision of the Florida Supreme Court which held that Florida's tax on flower sales by in-state florists that are delivered to out-of-state customers did not violate the dormant Commerce Clause of the U.S. Constitution.

The taxpayer, American Business USA, now challenges the Florida Supreme Court's ruling and asks the U.S. Supreme Court to consider whether "a State [can] collect sales tax on out-of-state property ordered over the internet for out-of-state delivery, by relying on this Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and the State's connection to the corporation that accepts the order and arranges the sale, or does such a tax violate both the Due Process Clause and dormant Commerce Clause of the U.S. Constitution by imposing a sales tax on the out-of-state transfer of tangible personal property?"

Status of the case
Distributed for Feb. 17, 2017 conference.

Dot Foods, Inc. v. Wash. Dep't of Rev., petition for cert. filed, U.S. S. Ct., Dkt. No. 16-308, (09/09/2016)

The U.S. Supreme Court has been asked to review a decision of the Washington Supreme Court, which upheld the retroactive elimination of a tax exemption for out-of-state businesses. The period of retroactivity at issue is 27 years. The question presented is whether, or under what circumstances, imposing additional tax beyond the year preceding the legislative session in which the law was enacted violates due process.

Status of the case
The court indicated on the docket for *Dot Foods Inc. v. Dep't of Revenue of the State of Washington* that it had been moved from the Jan. 19 conference, but did not set a new date.

Michigan's Retroactive Repeal of MTC Election

On Nov. 21, 2016, several petitions for certiorari filed with the U.S. Supreme Court involved Michigan's retroactive repeal of its statute enacting the Multistate Tax Compact and its three-factor apportionment election:

- Docket No. 16-699: *Goodyear Tire Rubber Co. v. Michigan Dep't of Revenue*
- Docket No. 16-697: *Gillette Commercial Operations N. Am. v. Michigan Dep't of Revenue*
- Docket No. 16-687: *Sonoco Products Co. et. al. v. Dep't of Treasury*
- Docket No. 16-698: *International Business Machines Co. v. Michigan Dep't of Revenue*
- Docket No. 16-688: *Skadden, Arps, Slate, Meagher & Flom LLP v. Michigan Dep't of Treasury*

Status of the case
The Court has extended through March 13 the deadline for Michigan to respond to petitions in the Michigan cases.

Petitions for Cert. Denied

Kimberly-Clark Corp. v. Minn. Comm'r of Rev., petition for cert. denied, U.S. S. Ct., Dkt. No. 16-565, (10/20/2016)

On Dec. 12, 2016, the U.S. Supreme Court denied a petition for a writ of certiorari to review a Supreme Court of Minnesota decision which held that Minnesota was not contractually prohibited from repealing the Multistate Tax Compact's three-factor apportionment election from the state's tax laws without also entirely withdrawing from the Compact. The Supreme Court of Minnesota upheld the state's refusal to allow Kimberly-Clark to use the Compact's equally weighted, three-factor apportionment formula during the tax years at issue.

Kimberly-Clark is the second case involving the MTC's elective apportionment formula that the U.S. Supreme Court has declined to take this session. In October, the Court denied cert in *Gillette v. California Franchise Tax Board* (Dkt. No. 15-1442).

Direct Mktg. Ass'n v. Brohl, petition for cert. denied, U.S. S. Ct., Dkt. Nos. 16-267, 16-458, (08/29/2016).

On Dec. 12, 2016, the U.S. Supreme Court denied a petition for a writ of certiorari regarding a case in which the U.S. Court of Appeals for the Tenth Circuit held that Colorado's statutory scheme imposing notice and reporting requirements on out-of-state retailers is not in violation of the dormant Commerce Clause because it does not discriminate against or unduly burden interstate commerce. The court held that *Quill* applies narrowly and has not been extended beyond tax collection. Because Colorado notice and reporting requirement law is not a tax, the Complete Auto test does not apply.

In 2010, Colorado passed a law that imposed the following obligations on retailers that did not collect sales taxes: (1) to send a "transactional notice" to purchasers informing them that they may be subject to Colorado's use tax; (2) to send Colorado purchasers who buy goods from the retailer totaling more than $500 an "annual purchase summary" with the dates, categories and amounts of purchases, reminding them of their obligation to pay use taxes on those purchases; and (3) to send the department an annual "customer information report" listing their customers' names, addresses and total amounts spent.

Status of the case

- The Tenth Circuit decision is now binding on states within the Tenth Circuit: Colorado, Kansas, New Mexico, Oklahoma, Wyoming and Utah.
- Colorado's notice and reporting law has been subject to injunction and not enforced since January 2011. Colorado will need to ask a state court to dissolve the current injunction. Initially, the law was enjoined by the U.S. District Court for the District of Colorado. That federal court injunction was dissolved in February 2014. However, a state court — the district court for the city and county of Denver — issued another preliminary injunction, again preventing Colorado from enforcing the law. That state court preliminary injunction remains in place at this time, because the court in July 2014 stayed its case pending the conclusion of the proceedings in federal court.
- While the commerce clause issues in DMA are resolved, the state does not yet know whether DMA will pursue other claims (First Amendment, the right of privacy of Colorado consumers, and the takings clause) which were stayed in earlier proceedings.

Self-Insurance Inst. of Am. v. Snyder, petition for cert. denied, U.S. S. Ct., Dkt. No. 16-593, (01/09/2017).

On Jan. 9, 2017, the U.S. Supreme Court denied a petition for a writ of certiorari of the Sixth Circuit decision that held that the Michigan Health Insurance Claims Assessment Act is not prohibited by the preemption provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The Michigan Act imposes a one percent tax, along with various reporting and record-keeping requirements, on all paid claims by carriers and third-party administrators to healthcare providers for services rendered in Michigan for Michigan residents. The following questions were presented for review: (1) Whether the Sixth Circuit's determination that the Michigan tax, including its reporting and recordkeeping obligations, does not relate to employee benefit plans and is not preempted by ERISA § 514(a) conflicts with Gobielle and other decisions of this court; and (2) Whether the Sixth Circuit's constricted reading of Gobielle and the increasing tendency of states to impose onerous new financial and administrative requirements on ERISA plans requires this court to further elaborate

Gobeille's teaching.

This is the second review of the Self-Insurance Institute's challenge to the Michigan Act. Previously, the Sixth Circuit issued a similar ruling in *Self-Insurance Inst. of America v. Snyder*, 761 F.3d 631 (6th Cir. 2014), cert. granted, judgement vacated, 136 S. Ct. 1355 (2016) (mem). On March 7, 2016, the U.S. Supreme Court vacated the Sixth Circuit's original decision and remanded the case back to the lower court for further consideration in light of *Gobeille v. Liberty Mut. Ins. Co.*, 136 S. Ct. 936, (2016).

Multistate Update

Corporate Income Tax Cases

Crutchfield Corp. v. Testa, Ohio Supreme Ct., Dkt. No. 2015-0386, (11/17/2016)

The taxpayer, based outside of Ohio, shipped goods from outside of the state to its consumers in Ohio using common-carrier delivery services. The taxpayer did not have employees or facilities in Ohio. Ohio imposes its Commercial Activity Tax (CAT) on the privilege of doing business in Ohio, measured by gross receipts from business activities in Ohio. An out-of-state person is required to register and pay the CAT if that person has bright-line presence in Ohio, which exists if any of the following apply at any time during the calendar year:

- Property or payroll in Ohio is at least $50,000; or
- Taxable gross receipts sitused to Ohio are at least $500,000; or
- 25 percent of total property or total payroll or total gross receipts is within Ohio; or
- The person is domiciled in Ohio.

The taxpayer contested a CAT assessment, arguing that Ohio may not impose a tax on the gross receipts associated with its sales to Ohio consumers because the taxpayer lacks a "substantial nexus" with Ohio. The taxpayer argued that a substantial nexus within a state is a necessary prerequisite to imposing the tax under the federal dormant Commerce Clause. The taxpayer also argued that its nexus to Ohio is not sufficiently substantial because it lacks a "physical presence" in Ohio – i.e., property in the state or agents or employees acting in the state in connection with its sales.

The tax commissioner argued that the Commerce Clause case law does not impose a physical-presence requirement and that as a result, the $500,000 sales-receipts threshold set forth in the Ohio CAT statute satisfies the Commerce Clause requirement of a substantial nexus. In the alternative, the tax commissioner argued that even if the Commerce Clause does impose a physical-presence requirement, the taxpayer had "internet nexus" with Ohio, meaning that mobile phone applications and the data that retailers store on customers' computers (such as cookies) constitute a physical presence sufficient to satisfy *Quill*.

The Ohio Supreme Court held that although a physical presence in the state may furnish a sufficient basis for finding a substantial nexus, *Quill*'s holding that physical presence is a necessary condition for imposing the tax obligation does not apply to a business-privilege tax such as the CAT, as long as the privilege tax is imposed with an adequate quantitative standard, such as the $500,000 here, that ensures that the taxpayer's nexus with the state is substantial. The court held that the case law indicates that the physical-presence requirement recognized and preserved by the U.S. Supreme Court for purposes of use-tax collection does not extend to business-privilege taxes such as the CAT. The Ohio Supreme Court never had to decide on the physical presence / internet nexus claims, finding instead that the physical presence standard articulated in *Quill* "does not extend to business-privilege taxes such as the CAT." The court rejected the taxpayer's claim that the burdens placed on interstate commerce were excessive.

In a dissent, Justice Kennedy said the court was bound by *Quill* physical presence test and rejected the majority's assertion that *Quill* was limited to sales and use tax.

Swart Enter., Inc. v. Cal. Franchise Tax Bd., California Court of Appeal, Fifth District, Dkt. No. 13CECG02171, (01/12/2017)

The California Court of Appeals held that a corporate taxpayer was not "doing business" in California based on its passive 0.2 percent interest in the LLC that leased and disposed of interests in California capital equipment. The LLC was a manager-managed LLC, which provided that only the manager had full, exclusive and complete authority in the management and control of the LLC's business. The taxpayer was not the LLC's manager and had no connection to California aside from its LLC interest.

Both the California appellate and lower trial court rejected the Franchise Tax Board's narrow interpretation that the "doing business" exception related to limited partnership interests and did not extend to an interest in an LLC, and further held that there was "no legal authority" for such an interpretation.

The appellate court affirmed the lower trial court's holding that the "doing business" exception is dependent on a limited partner's lack of right to manage or control the decision making process of the entity. The court further reasoned that if an LLC's tax election renders the LLC and its members as "partners" for all taxation purposes, then there would be no meaningful distinction between limited partnership interests and LLC interests. Under the taxpayer's circumstances, the court concluded that the taxpayer's LLC interest was akin to that of a limited partner, and that the taxpayer was not "doing business" in California based solely on its minority membership interest in the LLC.

ComCon Prod. Serv. I, Inc. v. Cal. Franchise Tax Bd., Dkt. No. B259619, (12/14/2016).

ComCon Production Services I, Inc., one of approximately 200 subsidiaries of Comcast Corporation, filed an action for the refund of additional corporate franchise taxes assessed by the California Franchise Tax Board (board) against Comcast Corporation and its subsidiaries (collectively Comcast) for their 1998 and 1999 tax years. The complaint alleged Comcast was entitled to a refund on two separate grounds: (1) the income and apportionment factors of its then majority-owned subsidiary QVC Inc., should not have been included in the combined report used to calculate Comcast's California tax liability because Comcast was not engaged in a unitary business with QVC during the years at issue; and (2) the $1.5 billion termination fee Comcast received as a result of the failed merger of Comcast and MediaOne Group Inc., in 1999 was nonbusiness income that was not subject to any California tax.

The California Court of Appeal, Second District, affirmed that Comcast Corp. was entitled to the California franchise tax refund because it was not engaged in a unitary business with one of its subsidiaries. The court held that Comcast and QVC were not integrated with each other and neither company was dependent upon or contributed to the other within the meaning of the legal standards for determining a unitary business.

Additionally, the court held that a $1.5 billion termination fee was taxable business income. The court found that entering into cable acquisition agreements was a regular part of Comcast's business, even if receipt of a termination fee was not.

See's Candies, Inc. v. Auditing Div. of the Utah State Tax Comm'n, Fourth Judicial District Court, Utah County, Dkt. No. 140401556, (10/06/2016)

Utah's Fourth Judicial District Court found that the Utah State Tax Commission's discretion to adjust income or deductions between or among related corporations is limited by IRC § 482 and its accompanying regulations. In this case, a taxpayer was allowed to deduct royalty payments to an affiliated company because the transactions resulting in the royalty payments were conducted at arm's length following the principles of IRC § 482 and its regulations. The court said the tax commission abused its discretion when it denied the taxpayer's deduction for royalties paid to a related company for intellectual property by classifying the transactions as per se outside arm's length instead of analyzing the transactions under federal standards. The court, however, disallowed 10 percent of the deductions to reflect the lowest royalty rate provided in the taxpayer's transfer pricing support. The commission has appealed the decision to the Utah Court of Appeals.

Midrex Technologies, Inc. v. N.C. Dep't. of Rev., N.C. S. Ct., Dkt. No. 5A16, (12/21/2016)

The taxpayer was not entitled to utilize the single-factor apportionment methodology for excluded corporations to determine its North Carolina corporate income and franchise tax liability during the period at issue because the taxpayer was not engaged in business as a building or construction contractor. The taxpayer was formed to exploit the market potential of the Midrex Direct Reduction Process, which converts iron ore into direct reduced iron, a premium iron used as an alternative feed for steel, and is utilized in a facility or module known as a Midrex Plant.

Although the taxpayer engages in three primary business activities: (1) engineering services and procurement services; (2) Midrex Plant sales; and (3) aftermarket sales; the ultimate focus of its business is the sale of Midrex Plants. Neither the taxpayer's engineering services and procurement services nor the taxpayer's aftermarket sales involved construction.

As for the taxpayer's Midrex Plant sales, under the terms of the contracts for the taxpayer's design and sale of a Midrex Plant, the taxpayer must provide engineering, equipment procurement, and advisory and field services needed in connection with the construction of the plant. However, while the taxpayer's employees may perform a limited amount of hands-on construction activity, the client retains ultimate responsibility for directly supervising and obtaining the performance of all on-site construction work in accordance with the relevant plans and specifications.

Since the taxpayer has only limited involvement in the actual physical construction of a Midrex Plant, the North Carolina Supreme Court found that the taxpayer was not a "building or construction contractor." In support of this conclusion, the court noted that the taxpayer classified itself as an engineering company rather than a building or construction company for purposes of the NAICS system.

Therefore, the taxpayer was not an "excluded corporation" engaged in business as a building or construction contractor, and was not entitled to use the single-factor formula apportionment applicable to "excluded corporations" authorized by N.C. Gen. Stat. § 150-130.4(r).

Bank of America Consumer Card Holdings v. N.J. Div. of Taxation, N.J. Tax Ct., Dkt. Nos. 012945-2011, 012947-2011, 012942-2011, 000386-2012, 000387-2012, (10/06/2016).

The taxpayers earned credit card service fees from cardholders located nationwide, including in New Jersey. The taxpayers filed amended returns seeking refunds of approximately $42 million. The division rejected their refund requests. The taxpayers filed suit, challenging how receipts from service fees should be apportioned under the CBT.

New Jersey sources fees from services to the location where the services are performed. New Jersey also has a catch-all provision for "other business receipts" which it sources to the location where such receipts are earned. The taxpayers argued that the service fees should be sourced outside New Jersey because their operations that rendered these services were located outside the state, specifically North Carolina and Delaware. The division argued that receipts from service fees charged to New Jersey cardholders should be allocated to New Jersey, regardless of where the taxpayers' operations were located.

The New Jersey Tax Court has ruled that receipts received by credit card issuers from interest and interchange fees derived from New Jersey cardholders should be treated as New Jersey receipts for purposes of computing New Jersey Corporate Business Tax based on New Jersey's catch all provision contained in N.J. Rev. Stat. Sec. 54:10A-6(B)(6). The court held that the credit card service fees are sourced to New Jersey to the extent the fees were earned there.

The court determined that because of advances in technology (i.e., the internet), services performed in connection with intangibles, in this case financial transactions, cannot be sitused to a particular location, and therefore, should be "based upon where the benefit of the service is derived or earned, not necessarily where the service is technically performed."

In determining where the fees were earned, the court concluded that for services provided to New Jersey cardholders, "the benefit of the service is being provided in New Jersey and is earned in New Jersey." Due to the Division's regulation, the Tax Court held that 50 percent, not 100 percent, of the service fees received from New Jersey cardholders should be included in the numerator.

Notes: Some tax practitioners in the Tax Notes article view that the court used the "other business receipts" sourcing rule to create a market-based sourcing regime for services that the statute specifically and explicitly sources to New Jersey only if the service is performed in the state.

Sales and Use Tax Legislation / Cases

Economic Nexus Laws: As of the end of January, at least 35 bills have been introduced in 17 states that would require out-of-state retailers to collect and remit the tax.

North Carolina Directive, No. SD-16-4 (11/15/2016)

Effective Jan. 1, 2017, the repair, maintenance and installation of digital property is subject to sales and use tax in North Carolina. Digital property is property that is delivered or accessed electronically, is not considered tangible personal property, and would be taxable if sold in a tangible medium. The term includes an audio work; an audiovisual work such as a book, magazine, newspaper, newsletter, report or another publication; and a photograph or a greeting card. Any digital property that becomes a part of or is applied to property in the performance of taxable repair, maintenance and installation services should be purchased exempt from sales and use tax. Prior to Jan. 1, 2017, repair, maintenance and installation services were taxable only to the extent they applied to tangible personal property.

Missouri adopts ban on sales tax for services – See Amendment 4, (passed 11/08/2016)

On Nov. 8, 2016, Missouri voters approved (57 percent to 43 percent) a constitutional amendment banning any new sales and use taxes on services. Amendment 4 to the Missouri Constitution prohibits state and local governments from imposing any new sales tax or use tax on services on any service or activity that was not subject to tax as of Jan. 1, 2015. The measure does not prohibit increases in the sales tax rate on services or transactions currently taxed.

Arkansas Administrative Hearing Decision, Dkt. Nos. 17-041, 17-170, (11/01/2016)

A jewelry store does not qualify as a manufacturer and is not entitled to the manufacturing exemption on equipment used to make jewelry. The taxpayer is a retail and jewelry gift store and was registered as such on its application for a sales and use tax permit. The Arkansas Department of Finance and Administration explained that construction of custom jewelry (whether for a particular customer or unique pieces designed by the owner) by a retail jewelry store is consistent with the normal operation of retail jewelry stores and not commonly understood to be manufacturing within the ordinary meaning of that word. Consequently, the taxpayer is not entitled to claim the manufacturing exemption on its purchase of the equipment.

Massachusetts Letter Ruling No. 16-3, (11/22/2016)

Sales of optional service contracts, including accidental damage contracts and extended warranties, that are purchased with taxable hardware as a "single solution for a package price," are subject to sales tax when amounts charged for these items are not separately stated from charges for computer hardware on a customer invoice or acknowledgment. Service contracts, accidental damage contracts and/or extended warranties are "services that are part of the sale" and are therefore included in the sales price of the entire "single solution... package" transaction. Service contracts, accidental damage contracts and extended warranties are generally not taxable when sold separately.

Missouri Private Letter Ruling No. LR 7767, (12/12/2016)

The Missouri Department of Revenue has determined that tuition for instructional services at a for-profit medical skills school is not subject to sales tax. Mo. Rev. Stat. § 144.020.1 imposes a sales tax on sales of tangible personal property and certain enumerated services, and instructional services provided by the school are not one of the enumerated services, so the tuition is not subject to sales tax.

Missouri Private Letter Ruling No. LR 7764, (12/12/2016)

The Missouri Department of Revenue opined that fees for classes at a fitness center are not subject to sales tax because they qualify as "instructional classes." Mo. Rev. Stat. § 144.020.1(2) imposes sales tax on taxable services rendered at retail for the amounts paid except for instructional classes. "Instructional class" is defined under Mo. Rev. Stat. § 144.010.1(5) as "any class, less, or instruction intended or used for teaching," but the department noted that "teaching" itself is not defined, so it deferred to the plain meaning. The taxpayer receives fees for classes at a gym, where its staff leads activities and shows, guides and directs, i.e., "teaches" its members how to use equipment and/or exercise. The Department determined the fees to be amounts paid for instructional classes and were thus excluded from Mo. Rev. Stat. § 144.020.1(2).

Atheer Wireless LLC v. Dep't of Rev., Ala. Ct. Civ. App., Dkt. No. 2150645, (11/10/2016)

The Department of Revenue issued an assessment for sales tax for sales of prepaid wireless services sold between Sept. 1, 2009 and Aug. 31, 2012. Under section Ala. Code § 40-23-1(a)(13), the sales tax statute at the time the assessment was issued, the sale of a prepaid calling card or authorization number was treated as a sale of tangible personal property. The taxpayer challenged the assessment administratively at the DOR, arguing that prepaid wireless services were not subject to sales tax. The appeal was transferred to the newly created tax tribunal. The case was held in abeyance until the Montgomery Circuit Court ruled in another case, *Beauty & More Inc. v. Alabama.*

On Aug. 27, 2014, the department filed an amended answer and a motion to set the case for a hearing. The department asserted that the legislature had passed Act No. 2014-336, Ala. Acts 2014 (the 2014 Act), effective July 1, 2014, amending § 40-23-1(a)(13) by clarifying that sales of prepaid wireless services are subject to sales tax. The taxpayer responded to the department's motion and argued that the 2014 law was unconstitutional.

After a hearing, the tax tribunal found that the department correctly assessed the taxpayer pursuant to § 40-23-1(a)(13), as amended by the 2014 Act, and that it did not have the jurisdiction to consider the taxpayer's constitutional challenges and that those challenges could be made in an appeal to the circuit court.

The taxpayer appealed to the circuit court, again asserting that the 2014 law was unconstitutional. After the DOR moved for summary judgment, the taxpayer filed its own motion and attached an affidavit from a former DOR employee claiming that the department did not consider prepaid cellular minutes taxable, which was denied.

On appeal, the Alabama Court of Civil Appeals affirmed the circuit court's judgment that the taxpayer's prepaid wireless services were subject to sales tax, and found that it lacked jurisdiction to determine whether the department violated rulemaking provisions under the Alabama Administrative Procedure Act to apply the tax to prepaid services because the issue was not raised before the tax tribunal. The court noted that although Ala. Code section 40-2B-2-(m)(4) provides for a trial de novo on an appeal from the tax tribunal, the statute does not authorize the court to hear issues that could have been raised at the tribunal but were not.

Citibank, N.A. v. The Ill. Dep't of Rev.; Chrysler Fin. Services Americas, LLC v. The Ill. Dep't of Rev., IL App (1st) 133650, (11/02/2016)

In Citibank, retailers doing business in Illinois provided their customers options to finance their purchases, including any applicable Retailers' Occupational Tax Act (ROTA) tax, on a credit basis. Citibank would originate or acquire consumer charge amounts and receivables from the retailers on a nonrecourse basis. Citibank would pay the full purchase price of the item, as well as the sales tax to the retailer, and the retailer would then remit the tax to the Illinois Department of Revenue. In instances when customers defaulted on their accounts, making the loans worthless, Citibank wrote off those balances as bad debt for federal income tax purposes.

Citibank sought a sales tax refund attributable to the unpaid portion of defaulted customer charge accounts and installment contracts. The department denied Citibank's claim for refund. On appeal, a circuit court reversed, finding in favor of Citibank. The department appealed to the appellate court.

The department contended that Citibank lacked standing to seek a refund of ROTA taxes because the right to a refund could not be assigned to Citibank by retailers. The department argued that the assignment of the right to a refund is prohibited under the ROTA and violates public policy.

The Illinois Appellate Court, First Judicial District, held that under the ROTA, retailers could assign the right to receive sales tax refunds attributable to uncollected debt to a third-party financing company. The court found that that the ROTA contained no language that discussed the assignment of the right to a tax refund, let alone prohibited the assignment of the right. Additionally, the court found the assignment of rights to a refund did not violate public policy, noting that refunds would not be mistakenly given out because the procedural safeguards remain in place.