2018: An Income Tax Year in Review

By Breen M. Schiller

Breen M. Schiller provides a review of significant income tax developments and court cases in 2018.

Everyone loves a sequel, right? What's old is new these days with remakes taking the box office by storm as well as dominating people's DVRs. The same can be said for the state tax world. A large number of my picks for this year's noteworthy income tax decisions are appeals from previous years' decisions. The following cases are ones that I believe hold particular importance either due to their potential to shape future tax policy of state revenue departments or their ability to provide valuable guidance to taxpayers as to how to approach an issue. Either way, without further ado and in no particular order of significance, here are my picks.

Addback

In *Kohl's Department Stores, Inc. v. Virginia Department of Revenue*,[1] the Virginia Supreme Court held with respect to the addback of intangible expenses the "subject to tax" exception applies if the intangible income is included in the apportionable tax base. In reaching this holding, the Court rejected Kohl's argument that because the royalty payments made to a related member were included in pre-apportioned income reported on other states' returns "the subject to tax exception" had been met. The main issue on rehearing centered around the inherent ambiguities in the "subject to tax" exception and whether it will only apply to payments actually taxed by another state and whether Kohl's had to be the entity to pay the tax.

The question to be addressed was whether the inclusion of the royalties in pre-apportioned income met the "subject to tax exemption" regardless of whether the income was actually taxed. The court in analyzing the issue found the statutory language to be ambiguous as to whether a taxpayer should receive a full exemption or a *pro-rata* exemption and concluded the *pro-rata* exemption was consistent with the statute's purpose and intent *e.g.* only applies on a post-apportionment basis. The statute was designed to permit the deduction of royalty to related parties and under a pre-apportionment approach a taxpayer could avoid this intent.

The court however, allowed the subject to tax exemption to be applied to those states in which Kohl's added the royalty expense back to income *e.g.* did not deduct the expense. The court found that statute required the item of income

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received by the related member to be taxed by another state. However, the court went on to find that the statute does not require that the related member be the entity that pays the tax on the income. Similarly, if the royalties were actually taxed by the combined return state the subject to tax exception was met. The court remanded the matter back to the Circuit Court to determine what portion of the royalties were actually taxed.

The part of this decision I find most compelling is the dissent which limited its review to what was contained on the face of the statute opposed to reading into the statute context that the Department created. Specifically, the dissent argued that nowhere in the language of the statute is there pre or post-apportionment language; and in fact, that was created by the Department in a ruling. If the application of the "subject to tax" exception was going to turn on whether it was done a pre or post-apportionment basis, then it was up to the legislature to include that language. All the exception stated was that the income was "subject to tax," which here it was. The dissent highlighted the inequity that the ambiguity was created by the Department and then ultimately resolved in favor of the Department.

The Virginia Supreme Court on rehearing affirmed the Circuit Court holding that only the portion of the royalties that were actually taxed by another state fell within the subject-to-tax exception *e.g.* the exception applies on a post-apportionment basis. The Court once again affirmed that Kohl's Illinois need not be the entity that pays the tax for the exception to apply. The Court did however revise its original opinion with respect to the difference giving to the Department's interpretation of statutes.

Transfer Pricing

In *Utah State Tax Commission v. See's Candies, Inc.*,[2] the Utah Supreme Court affirmed the District Court allowing See's to deduct royalty expense paid for the use of intellectual property. In affirming the District Court, the court agreed that the Utah statute should be interpreted using Section 482 of Internal Revenue Code ("IRC") and the regulation interpreting that section.

See's and Columbia Insurance Company are subsidiaries of Berkshire Hathaway. See's sold its intellectual property to Columbia Insurance in exchange for Columbia stock. Columbia licensed the intellectual property back to See's at arms'-length loyalty rate. Pursuant to the terms of the license agreement, Columbia would protect and develop the intellectual property. See's deducted the royalty payments and on audit the Tax Commission denied the deduction.

The decision turns on the interpretation of §59-7-113 which grants the Tax Commission discretion to redistribute deductions if necessary, to clearly reflect income. Specifically, pursuant to §59-7-113 does the Commission have broad authority to allocate income? The court concluded that the term "necessary" should be anchored in an objective standard rather than when the Tax Commission concluded allocation is necessary. In determining that objective standard the court traced both the history of the Utah statute, and Code Sec. 482 and concluded that the Utah statute was based on Code Sec. 482. In fact, the Utah statute is nearly identical to Code Sec. 482, but for the fact that Code Sec. 482 has accompanying regulations. Ultimately, the Court relied on legislative intent to incorporate the federal provisions[3] and found that Code Sec. 482 and its regulations should be used as guidance in determining when an adjustment is necessary.

Given the rise in transfer pricing issues that we are seeing across the states, See's can provide taxpayers valuable insight as to what support will be helpful in proving the arm's-length nature of its transactions. Specifically, See's deductions were respected because it provided expert testimony that established significant business purpose for undertaking the transaction. See's had a transfer pricing study that was previously conducted to support the value of the IP as well as the royalty payments. And last, but certainly not least the MTC had previously conducted analysis upholding the propriety of the deduction in earlier audit years.

Unitary

In *Harley Davidson Inc. v. Franchise Tax Board*,[4] the California Appellate Court affirmed the Superior Court decision holding that the state had a legitimate reason for treating in-state and out-of-state unitary businesses differently. Thus, the state's tax law did not unduly burden interstate commerce. The court went on to conclude the different treatment could not be accomplished by reasonable non-discriminating alternatives *e.g.* to accurately measure, apportion and tax all revenue acquired in California by an interstate unitary business.

Harley Davidson argued that the requirement for an interstate business to use the combined method of reporting income and apportioning tax while allowing an instate unitary business to choose to either file using a separate return or combined method was discriminatory. Specifically, the differencing treatments harmed the flow of interstate commerce. The court held that because Harley Davidson raised a facial challenge to the statute it need not establish that the company itself was burdened. However, the company was required to show the different choices of filing methods had an actual discriminatory impact on interstate commerce. A tax scheme that burdens the flow of interstate commerce must be invalidated unless it advances a legitimate purpose that cannot be achieved by a reasonable non-discriminatory alternative. The court found it was reasonable to require combined reporting to accurately measure and fairly apportion the income from functionally integrated entities and to prevent the manipulation of taxable income. Harley Davidson failed to provide evidence supporting its claim that requiring an instate unitary business to file a combined report would be reasonable nondiscriminatory alternative. This California matter has been a long road for Harley-Davidson (no pun intended) and it not quite over yet as the taxpayer has appealed this matter to California's highest court for review.[5]

Another case out of California was *Bunzl Inc. v. FTB*, a follow-up to *Swart Enterprises, Inc. v. FTB*[6] included in last year's case review, in which the California Court of Appeals agreed with the FTB that the taxpayer should have included the income of its six single-member nonresident limited liability companies in the numerator of its apportionment formula under the Uniform Division of Income for Tax Purposes Act ("UDITPA"). In reaching this conclusion, the court rejected Bunzl's assertion that the LLCs should not be included because it had already paid taxes and fees for the LLCs under Rev. & Tax Cd §18633.5. Bunzl also argued that because the owner of the LLCs does not do business in California separate and apart from the LLCs then "they had no income attributable to California that could be included in the apportionment formula." The Court found that the legislative history of §18633.5 did not support Bunzl's assertion that the legislature intended for amendments to the rule to alter the rules of apportionment for unitary businesses with single member LLCs. The court ultimately found that Bunzl and the LLCs were part of a unitary business that conducted significant business in California and could not "remove themselves from the reach of UDITPA simply by filing returns and paying taxes and fees under" alternative statutes." Unlike the facts in *Swart Enterprises*, here the member was actively involved in managing the business, which was treated as a division of its member.

In the matter of the Protest of General Electric Company & Subsidiaries,[7] the Office of Administrative Hearings ("AHO") granted General Electric's penalty abatement request but upheld the assessment resulting from the denial of a dividends received deduction for foreign dividends. At issue was whether the Department's corporate income tax assessment unconstitutionally discriminated against foreign commerce under the Commerce Clause by taxing G.E.'s dividends and Subpart F income received from foreign affiliates while treating domestic dividends more favorably by excluding them.[8]

On audit, the Department recalculated the tax base and assessed corporate income tax, due to the denial of the deduction of foreign dividends. General Electric argued that the assessment violated the U.S. Constitution's Foreign Commerce Clause by taxing dividends and Subpart F income received by its foreign affiliates. The AHO held that the method used to determine base income for General Electric's consolidated group was not unconstitutional. In fact, the foreign dividend income was subject to tax in the same manner as the domestic income because the income of the consolidated group subject to tax included the income that was distributed by domestic corporations. Further, General Electric failed to establish that the use of the Detroit formula recalculation resulted in an unfair apportionment.

Apportionment

Issues of sourcing are rarely simple and with the different rules the states have for purposes of determining where to source the sale of services or intangibles, sometimes somewhat unclear. The next two cases are illustrative of the different rules popping up in different jurisdictions.

In *Honnigman Miller Schwartz & Cohn LLP v. City of Detroit*,[9] the Appellate Court held that for purposes of sourcing the income from legal services one must look to where the service is delivered not where the service is performed. Honnigman is a law firm with offices in Detroit and other locations both within and outside Michigan. In determining the firm's income sourced to Detroit a three-factor formula consisting of property, payroll and sales is used. The sales factor is gross revenue derived from sales made and services rendered in Detroit. The issue relates to whether "services rendered" is where the clients receive the service or where the work is performed. Honnigman in filing its return took the position the receipts would be sourced to where the service was received. The court analyzed the statutory language and concluded the term "service rendered" to mean where the service was received. If the services were as received in Detroit the receipts were properly sourced to Detroit. In other words, the sales factor adopts a destination approach for sourcing sales of services.

Whereas in *Sirius XM Radio, Inc. v. Hegar*,[10] the District Court granted Sirius's claim for refund concluding that the receipts from its subscription services should be apportioned to Texas based on the fair value of the services performed in Texas. In reaching its conclusion the court rejected the Comptroller's argument that the receipts should be apportioned based on the location of where the satellite transmissions were received by the subscribers. The court concluded that Texas uses an origin-based method for sourcing service receipts and the state was seeking to apply a market-based method to apportion the receipts.

Alternative Apportionment

What kind of income tax review article would this be without some discussion of alternative apportionment? Not many decisions are as egregious to me as the Tennessee Supreme Court 2016 *Vodafone*[11] decision; however, *Associated Bank* in Minnesota is a close second. Minds differ as to whether this decision was correctly decided[12] in terms of fair apportionment, but what I find most unsettling about this case wasn't the Minnesota Supreme Court's about face change in reversing the lower court's decision,[13] or even the Court's finding that the Director properly invoked her Section 18 authority, instead I was disappointed with the Court's lack of discussion as to what will qualify as distortion for purposes of financial institutions sourcing revenue to the states.

In *Associated Bank*,[14] the Minnesota Supreme Court overturned a lower tax court ruling in holding that the tax commissioner properly invoked her alternative apportionment authority when calculating the bank's corporate franchise tax liability.[15] The court rejected the bank's argument that the commissioner was prohibited from using alternative apportionment under *HFM Financial v. Comm'r. of Rev*.[16] The court distinguished the cases on the grounds that here, the Commissioner sought to "rebut the presumption that the method used by the bank produced fair and correct results."

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The Minnesota Supreme Court held that the state's standard apportionment method did not fairly reflect the taxpayer's net income allocable to the state, reversing the Tax Court's ruling. The Commissioner argued that the partnerships' application of the statutory apportionment method failed to account for the taxpayer's Minnesota business activities and thus, distorted the taxpayer's state income by excluding interest income paid by Minnesota borrowers. The Commissioner proposed an alternative apportionment method requiring the partnerships to follow the rules for financial institutions and include interest income in their receipts factor. The court agreed with the Commissioner, concluding that the statutory apportionment formula failed to recognize any of the taxpayer's income from its Minnesota business activities. The court noted that the taxpayer's transfer of its loan portfolios to the partnerships did not change the management of the loans, and Minnesota borrowers continued to make their loan payments directly to the taxpayer as a collection agent for the partnerships. The statutory method therefore distorted the taxpayer's in-state income.

What this decision does not do is address what will qualify as distortive for purposes of a Minnesota Section 18 analysis of financial institution apportionment. While Associated Bank's use of partnerships to minimize its Minnesota income tax was characterized by the Department as aggressive and purely motivated by tax savings, the structure itself complied with Minnesota law. Further, Associated Bank's fact pattern seems to fall on one end of the apportionment spectrum with a wide breadth of planning opportunities still viable for most taxpayers. What happens to the financial institution that is structured according to this provision, but not necessarily to the extent of Associated Bank? Ideally, distortion should be a factual question, does the taxpayer's apportionment reflect its business activities in the state or how income is earned in the state? The concern now, and is left to be seen, is whether *Associated Bank* will lay the groundwork for the Department to audit and ultimately disregard any structure that a financial institution has set-up under the guise of a Section 18 analysis.

Conclusion

This was an exciting year for state and local tax for reasons none of which were discussed in this article! This was a *Wayfair* and federal reform discussion free safe zone. Nevertheless, putting those two issues aside we still had many significant and exciting developments handed down through caselaw. Our climate is constantly changing and is somewhat of a moving target. However, I am going to double down on my predictions from last year and say that we see more bright-line factor presence standard tests being rolled out by the states for income tax purposes (challenged or not); challenges to market-based sourcing regimes specifically including the constitutionality and due process concerns of customer look-through rules. Lastly, a new prediction for 2020 being potential challenges to single sales factor sourcing.[17]

ENDNOTES

[1] *Kohl's Department Stores, Inc. v. Virginia Department of Revenue*, VA SCt No. 160681 (Mar. 22, 2018). Kohl's operates retail stores throughout the United States. The company's affiliate Kohl's Illinois operated retail stores in certain select states and held the intellectual property for the group. Kohl's paid Kohl's Illinois royalties for the use of the intellectual property and deducted the payments as an expense. Kohl's Illinois included the royalties in taxable income. Kohl's Illinois did not pay state income tax on the substantial portion of the royalty income as the returns only reflected apportionable income.

Kohl's was included in my "2017: Income Tax Year in Review" article published in last year's Spring Edition.

[2] *Utah State Tax Commission v. See's Candies, Inc.*, Utah SCt No. 2018 UT 57 (Oct. 5, 2018).

[3] This finding was supported by the court on four bases: (1) prior Utah cases finding that §59-1-113 did not operate in isolation; (2) the absence of state specific guidance and the need to look to the federal provisions; (3) Utah's entire income and franchise tax system relies heavily on the federal system; and (4) reliance on other state's arm's-length pricing in tax regimes.

[4] *Harley Davidson Inc. v. Franchise Tax Board*, California Appeals Court Docket D071669 (Aug. 22, 2018).

[5] BNA Daily Tax Report, *Harley-Davidson Will Appeal Tax Loss to California High Court* (Sept. 17, 2018).

[6] Dckt. No. F070923 (Jan. 12, 2018).

[7] *In the matter of the Protest of General Electric Company & Subsidiaries,* New Mexico Administrative Hearings Office, D&O No.18-12 (April 6, 2018).

[8] G.E. had 419 foreign subsidiaries which it received dividends from, most of which were more than 50% owned by G.E. or another G.E. subsidiary. Most of G.E.'s foreign subsidiaries conducted no business in the United States or New Mexico. G.E. elected to file as a consolidated group. G.E. included the income from all of its domestic subsidiaries doing business in the United States, but excluded the income of its foreign subsidiaries going business exclusively outside the United States.

[9] *Honnigman Miller Schwartz & Cohn LLP v. City of Detroit*, Michigan Court of Appeals, No. 336175 (Jan. 18, 2018).

[10] *Sirius XM Radio, Inc. v. Hegar*, Travis County Dist. Ct. No. D-1-GN-16-000739 (Aug. 3, 2018) (Appeal pending).

[11] *Vodafone Americas Holdings, Inc. et al v. Comm'r. of Rev.*, M2013-00947-SC-R11-CV (Tenn. 3/23/16).

[12] I frequently debate a colleague as to whether or not this decision was properly decided. My colleague's position is that ultimately Associated Bank's apportionment did accurately reflect its business in the state. My position being, Associated Bank followed the law as it is written. How can there be a "loophole" if that was the legislature's intent? And if there is such a thing as a "loophole," then it is up to the legislature to fix it, not the courts. A taxpayer should not be penalized for following the letter of the law, regardless of whether they benefit from it or not.

[13] See, B. Schiller, *2017: Income Tax Year in Review* (JST Spring 2018).

[14] *Associated Bank NA and Affiliates v. Comm'r. of Rev.,* No. A17-0923 (Minn. 2018)

[15] In *Associated Bank,* the taxpayer, a national financial institution, transferred its loan portfolios to two newly formed partnerships. For apportionment purposes, Minnesota requires financial institutions to include loan interest in their sales factor numerators but does not require other entities to do so. Unlike the taxpayer, the partnerships were not financial institutions. The partnerships thus excluded loan interest and reported their receipts factors as zero. The taxpayer's distributive share of the partnerships' apportioned income, in turn, contributed no receipts to its own receipts factor.

[16] In *HFM Financial v. Comm'r. of Rev.,* 782 N.W.2d 558 (Minn. 2010), the Minnesota Supreme Court examined the provision authorizing the Commissioner to use an alternative apportionment method. The Supreme Court held that Minn. Stat. §290.20's plain meaning presumes "that a taxpayer has fairly and correctly determined its Minnesota taxable income if that taxpayer used the reporting methods outlined in §290.191."

[17] My last prediction is more of a "wish" than a prediction. Alas, a state and local tax practitioner can dream!