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**State and Local Taxation:  
Headline News and Trends**  
(January 10, 2014)

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**CATEGORIES TO BE COVERED**

- Megatrends and Developments
- Transaction Taxes
- Business Activity Taxes

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## MEGATRENDS AND DEVELOPMENTS



**Tax Presence**  
*Overall theme: Borders matter less than ever...  
But there are some taxpayer wins*

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PRACTICE

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## MEGATRENDS AND DEVELOPMENTS



**KEY DECISIONS**

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## MEGATRENDS AND DEVELOPMENTS



### Marketplace Fairness Legislation

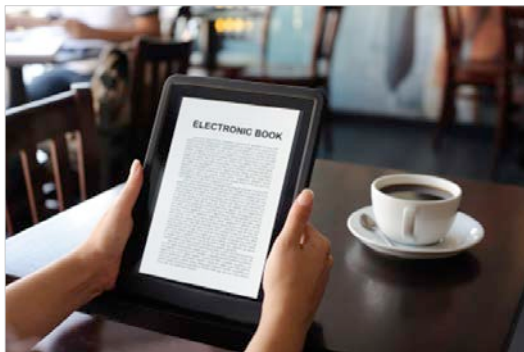
## MEGATRENDS AND DEVELOPMENTS

However, due process still matters.



*Tennessee v. NV Sumatra  
Tobacco Trading Co.,  
Tennessee Supreme Court,  
No. 01955-SC-R11-CV,  
March 28, 2013*

## TRANSACTION TAXES



### Digital Goods and Services Tax Fairness Act (S. 1354)

A federal bill addressing state and local taxation of "digital goods" and "digital services."

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## MEGATRENDS AND DEVELOPMENTS



### Challenges In Federal Court

Under two decisions issued in August, 2013, state tax challenges in Federal court became much less likely.

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## MEGATRENDS AND DEVELOPMENTS

### PRIVATE LAWSUITS. CHOOSE YOUR POISON?

#### - Vendor Undercollection

Suit by private lawyers under state False Claims Acts (“qui tam actions”) seeking reward of 15% to 30% of the state’s recovery

#### - Vendor Overcollection

Suit by private lawyers in class action refund claims



Vendors and the states hate this use of the False Claims Acts and class actions. Proposed legislation would fix the problem in Illinois (HB 74). In December, 2013 representatives of state revenue departments, assistant attorneys general and private practitioners met to fix this -- likely, the first of many such meetings.

## MEGATRENDS AND DEVELOPMENTS

### Forbes Magazine (January 2, 2014) “Five Tax Trends to Watch in 2014”



### 3 of the 5 Trends Involve State Taxes

- ▶ Tax Avoidance by Multinationals
- ▶ Internet Sales Taxes
- ▶ State Tax Reform

## TRANSACTION TAXES

EXPANSION OF SALES TAX BASE TO INCLUDE SERVICES



**MASSACHUSETTS**  
Computer Services Tax.

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## TRANSACTION TAXES





### REPEALED

Massachusetts repealed the Computer Services Tax, retroactive to the July 31, 2013 date of its adoption. St. 2013, c. 95 (“*An Act Repealing the Computer and Software Services Tax*”).

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## TRANSACTION TAXES



*Verizon Business Network Solutions Inc. v. Combs,*  
Texas Court of Appeals 7<sup>th</sup>  
District, No. 07-11-0025-CV,  
April 3, 2013

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## TRANSACTION TAXES

RECENT TAXPAYER LOSSES

### Hotel Occupancy Taxes

Endless litigation across the country.



- Texas
- Hawaii
- City of Chicago
- Baltimore
- Arkansas
- Georgia
- New York City

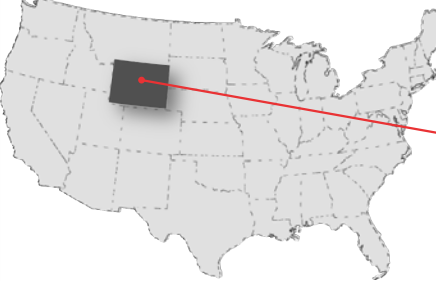
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## TRANSACTION TAXES

### Hotel Occupancy Taxes

Endless litigation across the country.



  
*Travelocity.com LP et al., v. Wyoming Department of Revenue (No. S-13-0078) now being briefed at the Wyoming Supreme Court.*

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## TRANSACTION TAXES

### Chicago Lease Transaction Tax

Law is unchanged but starting September 1, 2013 now imposed on perpetual licenses of software. *180 degree change.* New CTT Ruling (Regulation) 5.




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## BUSINESS ACTIVITY TAXES

Update on Multistate Tax Compact Issue. States with Cases in court



**Minnesota.**  
*Kimberley-Clark Corp. et al. v. Commissioner* (Doc. No. 08670)  
(December 12, 2013)

**Michigan.**  
*IBM v. Michigan Dept. of Treasury and Anheuser-Busch v. Michigan Dept. of Treasury* (2014 hearing)

**Oregon.**  
*Health Net Inc. and Subsidiaries v. Department of Revenue*

**Texas.**  
*Graphic Packaging Corporation v. Comptroller of Public Accounts and Medtronic, Inc. v. Comptroller of Public Accounts* and two cases involving *Kimball Office, Inc.* Oral arguments were heard on December 19, 2013.

**California.**  
*Gillette Company v. FTB* (2014 hearing)

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## BUSINESS ACTIVITY TAXES

### Retroactive Taxation

Last year a California tax incentive was declared unconstitutional because it discriminated against out of state businesses.



*Cutler v. Franchise Tax Board*, 146 Cal. Rptr. 3d 244 (Cal Ct, App. 2012).

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## BUSINESS ACTIVITY TAXES



**The Fix?**  
Extend the tax incentive to out-of-state businesses?

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## BUSINESS ACTIVITY TAXES



October 2013						
MON	TUE	WED	THU	FRI	SAT	SUN
30	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31	1	2	3

**Retroactive Repealed**  
On October 4, 2013, California adopted a law eliminating the retroactive tax. AB 1412.



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## BUSINESS ACTIVITY TAXES

We have seen this before, and not just in California.




*CDR Systems Corp v. Oklahoma Tax Comm., Okla. App. Ct. No. 109,886 (Jan. 17, 2013).*

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## BUSINESS ACTIVITY TAXES

For all taxes, the question of remedies is a confusing area and always a hot topic.




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## BUSINESS ACTIVITY TAXES

### Retroactive Taxation

On August 26, 2013, Louisiana's attorney general concluded that a town that has not enforced a tax for 13 years may decide to do so, and may do so retroactively. It may go back as far as the statute of limitations permits – three years “unless prescription has been sufficiently interrupted or suspended as provided by law.” Opinion 13-0099.




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## BUSINESS ACTIVITY TAXES

### Alternative Apportionment

UDITPA Section 18



- separate accounting;
- the exclusion of any one or more of the factors
- the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income

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## Questions????



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## NOTES

### SLIDE 4

*Direct Marketing Association v. Brohl, Executive Director, Colorado Department of Revenue*, 12-1175, (U.S. Court of Appeals, 10th Circuit, Aug. 20, 2013); *Overstock.com, Inc., v. New York State Department of Taxation and Finance, et al.*, 20 NY3d 586 (Ct. App., March 28, 2013), cert. denied December 2, 2013; *Performance Marketing Association, Inc., v. Hamer, Director of Revenue*, 2013 IL 114496 (Ill. S.Ct., Oct. 18, 2013). For more on this, see State Tax Alert, "Sales Tax 2013: Representatives, Whistleblowers, Class Actions and Federal Legislation" (November 2013, available at [Rimonlaw.com](http://Rimonlaw.com)).

### SLIDE 5

Marketplace Fairness Legislation

- Senate Passed as S. 743 on May 6, 2013
- House has assigned its version (H.R. 684) to the Judiciary Committee.
  - September 18, 2013 Judiciary Committee released its seven "Principles on Internet Sales Tax"
    - Tax Relief; Tax Neutrality; No Regulation without Representation; Simplicity; Tax Competition; States' Rights; Privacy Rights.

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## NOTES

### SLIDE 6

The Tennessee Supreme Court reversed the appellate court and held that Tennessee lacked personal jurisdiction over a foreign cigarette manufacturer. Because the company lacked sufficient ties for a finding of jurisdiction, the company was not required pay into the Tobacco Manufacturers' Escrow Fund.

The defendants, an Indonesian cigarette manufacturer, conducted business in the United States through a Florida business man who imported and distributed their cigarettes. To establish jurisdiction over the manufacturer, the state needed to demonstrate the manufacture could reasonably anticipate being hauled into court in Tennessee. In this case, the defendant's connections to Tennessee are extremely tenuous. Defendants never visited Tennessee, conducted no advertising or marketing in Tennessee, and possibly had never even been to the United States. The state argued that the defendant was within the jurisdiction of Tennessee courts by virtue of the quantity of cigarettes sold in the state.

The court disagreed finding that although a significant quantity of the defendants cigarettes were sold in Tennessee the defendant made no effort to serve Tennessee and merely placed their product into the stream of commerce. Under Tennessee law, more than being aware their product was being sold in Tennessee is necessary to establish jurisdiction. As a result, the court reversed the appellate court's finding of jurisdiction and reinstated the trial court's dismissal of the case.

## NOTES

### SLIDE 7

The measure proposes to regulate state and local taxation of these products in the following ways:

- Banning "multiple taxation," that is, taxation of a single purchase of a digital good or service by more than one state and more than one local government (unless the purchase occurs in overlapping local governments, such as a city and a county);
- Banning "discriminatory taxation" of digital goods and services, such as a higher tax rate on a digital book delivered online than on the purchase of a printed book;
- Setting up a series of mandatory, uniform "sourcing rules" that establish which state and locality can tax a particular transaction

## NOTES

### SLIDE 8

- See *Direct Marketing Association v. Brohl, Director of Colorado Department of Revenue* (Case No. 12-1175) (U.S. Ct. App. 10<sup>th</sup> Cir. August 19, 2013) and *Capra v. Cook County Board of Review* (Cases Nos. 11CV 04028 and 10 CV 06882) (U.S. Ct. App. 7<sup>th</sup> Cir. August 21, 2013).

### SLIDE 9

- **Huge qui tam case:** *State of New York et al. v. Sprint Nextel Corp. et al.*; Index No. 103917/2011 (\$300 million), motion to dismiss denied June 27, 2013.
- **Recent class action decision:** A Pennsylvania case involves the failed use of federal court in a class action lawsuit against Wal-Mart for allegedly overcollecting tax by 21 cents on the purchase of two cans of shaving cream in a "buy one, get one free" arrangement. *Farneth et al. v. Wal-Mart Stores, Inc.*, case No. 2:13-cv-01062-MRH (United States District Court Western District of Pennsylvania, December 30, 2013). Here, the attempt to use the federal court system was by the defendant. The case was remanded (moved) to state court.

## NOTES

### SLIDE 11

- On September 16, 2013, in TIR 13-14, DOR announced that

*"In light of public statements of support for repeal of these new tax provisions by the Governor, the Senate President, and the Speaker of the House, the Commissioner, under her authority in Chapter 62C, announces an extension of the first due date for the reporting and payment of sales and use taxes with respect to these services relating to computer system design and to modification, integration, enhancement, installation, or configuration of standardized or prewritten software. Pursuant to this extension, reporting and payment of these particular taxes that cover the period July 31, 2013 – September 30, 2013 should be reflected on the September return due on October 20, 2013."*

**SLIDE 12** For more guidance see TIR 13-17 (September 30, 2013).

### SLIDE 13

The Texas Court of Appeals for the 7<sup>th</sup> District affirmed the trial court's finding that software updates used in the state and not used solely for maintenance are considered personal property. In light of this finding, the court affirmed the denial of a refund for sales and use taxes paid on such software.

## NOTES

### SLIDE 13 cont.

To support their wireless network, Verizon contracts with a number of vendors to update their network's software. These third party vendors would modify old code or create new code to implement the new feature or functionality desired by Verizon. The feature enhancements contained in these software updates were initially tested by Verizon in Texas. After the updates were tested and installed in switches across the country, the original software was stored in Texas in case additional troubleshooting was required. Sales and use taxes in the amount of nearly \$20 million were imposed on Verizon for the network updates acquired between 1996 and 2000. In seeking a refund, Verizon argued that a sale or use tax on the feature enhancements was impermissible as the software fit within the maintenance exception within the Texas Tax Code. Rejecting this argument the court held that a computer program can be subject to both the sales and the use tax. Specifically, a computer program is subject to sales tax when, as in this case, it is transferred in electronic or physical form for consideration. Additionally, a computer program is subject to use tax when it is stored, used, or consumed in the state. Furthermore, while an exception for maintenance does exist; software that alters the original capacity of the system is subject to such taxes as it constitutes an improvement, not maintenance or repair. In this case the court found that the updates purchased and installed by Verizon constituted feature enhancements and improvements and not maintenance as the software brought new functionality to the wireless network.

Verizon also suggested they were entitled to a partial refund for the enhancements that were installed outside of Texas. The court rejects this argument finding no statutory provision permitting apportionment and noting that the enhancements were initially shipped to and tested in Texas before being installed across the country. As a result of these findings the sales and use tax imposed on Verizon was affirmed and their request for a refund denied.

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## NOTES

### SLIDE 14

*Hotel Occupancy Taxes.* Endless litigation across the country. 2013 was a rough year for the taxpayer litigants. Through October, 2013, they lost cases against Hawaii (\$246 million), Texas municipalities (\$55.1 million), the City of Chicago (harsh opinion) and Baltimore. Then on October 10, 2013, the Arkansas Supreme Court affirmed class action certification of municipalities against them, and on November 21, 2013, New York State's highest court upheld the constitutionality of New York City's 6 percent hotel occupancy tax on online travel companies. *Expedia, Inc. et al. v. New York City Department of Finance* (No. 180). However, the online travel companies closed 2013 with a victory in *City of Rome v. Hotels.com*, (US App. Ct, 11<sup>th</sup> Cir., December 13, 2013). New cases filed in 2013 include a federal class action brought by seven Illinois municipalities in Spring, 2013, New York City's claim against AirBNB (subpoena served on October 4, 2013) and New Hampshire's October 16, 2013 lawsuit. *New Hampshire v. Priceline.com, Incorporated et al.* (Merrimack County Superior Court).



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## NOTES

### SLIDE 19

- The fix? Extend the tax incentive to out-of-state businesses? No. FTB is going back five years to require taxpayers who took the benefit to pay the tax, interest and penalties. See WSJ editorial "Lawless Taxation" August 30, 2013.

**SLIDE 20** Specifics are discussed in the Franchise Tax Board's October 7, 2013 FAQ "Qualified Small Business Stock (QSBS) Gains".

### SLIDE 21

Holding: The capital gain deduction statute T.T. 68 §2358.D2 violates the Commerce Clause by facially discriminating against non-Oklahoma companies or companies that were not headquartered in the state. The statute allowing the capital gain deduction provided for a shorter holding period for Oklahoma- headquartered companies.

The court found the law discriminated on its fact and thus "per se" was invalid. The statute treats Oklahoma companies differently than an out-of-state company for a similar taxable event. Specifically, an out-of-state company must make a longer investment in Oklahoma to take advantage of the deductions. The court rejected the Tax Commission's argument that there was a legitimate local purpose to increase investment in Oklahoma. In fact, the court determined the statute did not encourage such investment.

## NOTES

### SLIDE 23

It may go back as far as the statute of limitations permits – three years "unless prescription has been sufficiently interrupted or suspended as provided by law." Opinion 13-0099.

### SLIDE 24

UDITPA Section 18

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- separate accounting;
- the exclusion of any one or more of the factors;
- the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income