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5 Key Takeaways | State Tax Litigation

NOVEMBER 5, 2024 Written by Jordan M. Goodman

Kilpatrick partner Jordan Goodman recently participated in a presentation on state tax litigation at the 31st Annual Paul J. Hartman State and Local Tax Forum in Nashville, Tennessee.

Jordan provides the following five takeaways from the discussion:

1. Public Law 86-272 was passed by Congress and signed by the President in 1959 as a temporary measure to protect a business' income from be subject to a net income tax if its only activity in the state was limited to the solicitation of sales of tangible personal property; where the orders were sent outside the state for acceptance or rejections; and if accepted was filled by shipment or delivery from inventory located outside the state. While this type of protection may be outdated in today's electronic society where revenue from the delivery of services far outweighs revenue from sales of tangible personal property, it is still on the federal books. The Multistate Tax Commission's recent bulletin outlining activities that go beyond the protections of PL 86-272 is the wrong way to bring about change. The MTC's position paper has and will lead to multiple state cases where uniformity in interpreting the federal law is not guaranteed. Ultimately, it may require the US Supreme Court to bring clarity and that decision, if it ever happens, is years away. Better to try to "fix" the federal statute and make the changes prospective to allow for certainty in the industry.

2. There is a debate nationally on the application of the matching principal. In my mind, income that is subject to tax should be represented in the apportionment factor. Many states do not support this proposition. They believe that in certain instances the income is treated as taxable business income, but the receipts that generate the income should be excluded as distortive. We have seen states argue this successfully in situations that dealt with treasury function, hedging and significant liquidation of assets or businesses. The states are then inconsistent in several cases around the country where the states want to exclude receipts associated with income that is not included in the base. What is good for the goose is good for the gander…but the states don't like it.

3. Ohio has been a hotbed for litigation on the "ultimate destination" rule. Most taxpayers are losing the battle as any inventory shipped to an Ohio warehouse without specific proof that it will be shipped to a location outside of Ohio will be treated as an Ohio receipt for Ohio CAT purposes. Testimony, post-sale shipping records and other post sale records have been rejected by the courts. The only evidence that seems to be acceptable is pre-sale, pre-addressed items that are marked ahead of time for a "final destination" outside of Ohio.

4. The battle of how to apportion sales of services continues on a national basis. As originally contemplated, sales of services would be apportioned on a "cost of performance" basis. This is an expense side review where the income producing activity of the performer/seller of the services was the key to situsing the receipt. This methodology allowed remote sellers of service to use a state as a marketplace without receipts being used to measure activity in the buyer's state. The cost of performance methodology also put the tax burden on business that were located in that state. In light of these facts, many states have shifted to a "marketplace" approach where the sale of service is

sitused to the location of the customer. Two major issues are being litigated across the country. First, who is the customer. Second, where is the customer located.

5. The external consistency prong of the fair apportionment requirement found by the United States Supreme Court is being resurrected in use tax cases. This is a situation where a buyer brings tangible personal property into a state for use and subjects the value of the tangible personal property to a use tax. Many states will tax this type of use but offer credits for properly paid tax elsewhere. This type of system then requires the user to ultimately pay the highest applicable state rate where the property is used. This has led to the argument that external consistency requires an apportionment of the cost price of the tangible personal property based on where the property is used. It is being argued that credits for taxes paid in other states to prevent double taxation is an outward looking focus. And that the external consistency test requires an inward-looking focus as in is the tax being applied fairly represent my usage of the property in the state.

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