A Swing and a Miss: Maryland Court Defines “Final” for Purposes of Statute of Limitations Following Baseball Team Owner’s Federal Audit


The taxpayer, who is the ex-wife of author Tom Clancy, owned a limited partnership interest in the Baltimore Orioles baseball team. A federal income tax audit of the partnership resulted in the IRS adjusting certain partnership items using Form 870-PT, *Agreement for Partnership Items and Partnership Level Determinations*. The partnership adjustments flowed through to the taxpayer’s personal income tax return and permitted her to utilize additional losses, thereby reducing her federal taxable income. The IRS reported the impact of the partnership’s flow through adjustments to the taxpayer on Form 4549A, after which the taxpayer had a minimum of six months to challenge the IRS’s adjustments.

Maryland law provides that the statute of limitations on refund claims is reopened for a period of “one year from the date of: (i) a final adjustment report of the [IRS]; or (ii) a final decision of the highest court of the United States to which an appeal of a final determination of the [IRS] is taken.” Md. Code Ann. Tax-Gen. § 13-1104(c) (emphasis added). The taxpayer filed her Maryland refund claim more than one year after the IRS issued Form 4549A, but within one year of the time when her federal appeal rights expired. Following the state’s denial of her refund claim, she argued that the federal adjustments did not become “final” until her appeal rights expired, or alternatively, until the IRS actually applied the adjustments to her federal tax account. The court rejected her arguments and instead held that under the plain language of the statute, the Form 4549A was the IRS’s “final adjustment report,” and the date when the taxpayer could no longer challenge the Form 4549A did not matter. The court reasoned that the legislature intended to address taxpayer appeals under the second provision of the statute, and since the taxpayer did not actually appeal the federal adjustments, she did not fall within that provision.

This case illustrates the challenges and uncertainties taxpayers face when deciding how and when to report federal audit changes to the states. Particularly where the federal changes result in a refund, it is critically important to comply with state filing deadlines, some of which may be as short as 30 days instead of Maryland’s one year period. Even states with the same statutory time period and similar statutory language may interpret the starting point for the time period differently, such that a taxpayer’s refund claim could expire at different times.
"intangible property income" was not synonymous with the term "royalties" as defined by the Michigan Supreme Court in Mobil Oil Corp. v. Dep't of Treas., 373 N.W.2d 730, 736 (1985): “payment received by the transferor in patent . . . transactions[.]” The Department claimed that the definition of “royalties” in Mobil is narrower than the term “intangible property income,” as used in IRC § 936(h)(3)(B), and thus items that may be included in “intangible property income” may not necessarily be considered “royalties” for SBT purposes.

However, the court dismissed the Department’s theoretical arguments because Pfizer met its burden of proof through uncontroverted affidavits that all of the relevant income related to the subsidiary’s use of Pfizer’s patents. The court placed great weight on the Department’s failure to produce any evidence that Pfizer’s royalty payments were for anything other than the use of its patents.

The Department disallowed the royalty deduction, claiming that “intangible property income” was not synonymous with the term “royalties” as defined by the Michigan Supreme Court in Mobil Oil Corp. v. Dep’t of Treas., Docket No. 301632 (Mich. Ct. App. Feb. 14, 2012).

To calculate the SBT tax base (now two tax regimes ago), “royalties” were subtracted from federal taxable income. Pfizer calculated its royalty income based on the “profit split methodology” under Internal Revenue Code § 482 regulations, which treat 50% of a subsidiary’s profits as “intangible property income” to the parent. Pfizer subtracted these “royalty” amounts to compute its SBT tax base.

The court placed great weight on the Department’s affidavits that all of the relevant income related to the subsidiary’s use of Pfizer’s patents. The court found that the costs that the city would incur to maintain rights-of-way even if utilities were not located there could not be included in the franchise fees. The court also held that unexpected, acute costs arising from unforeseen environmental events like ice and snow storms could not be included in the franchise fees. To the extent these costs were included in the franchise fees, the Iowa Supreme Court held that the franchise fees on gas and electric services constituted an illegal tax.

The Iowa Supreme Court reviewed the individual components of the franchise fees in an effort to determine the reasonable costs of regulating each utility. The court found that the costs of the city were reasonable and that the fees had to be “reasonably related to the reasonable costs of inspecting, licensing, supervising, or otherwise regulating the activity that is being franchised.” Kragnes v. City of Des Moines, 714 N.W.2d 632, 642-43 (Iowa 2006). In 2004, Kragnes filed a class action claiming that at least part of the fees on gas and electric services was, in fact, an illegal tax because the amount of the fees far exceeded what the city was entitled to recover through cost-based franchise fees.

Fees masquerading as taxes have become increasingly common. And, as illustrated by the Iowa Supreme Court’s recent decision in Kragnes v. City of Des Moines, Docket No. 09-1473 (Mar. 2, 2012), in some cases all or part of a fee may constitute an illegal exaction to the extent it is deemed to be a tax. In Kragnes, the Iowa Supreme Court affirmed the district court’s holding that municipal franchise fees imposed on gas and electric services for almost 10 years exceeded the city’s reasonable costs of regulating the gas and electric franchises and, thus, the difference between the tax collected by the city and the city’s reasonable costs constituted an illegal tax.

Prior to mid-2009, Iowa cities were authorized to impose franchise fees based on gross receipts from the sale of utility services to the public, but the fees had to be "reasonably related to the reasonable costs of inspecting, licensing, supervising, or otherwise regulating the activity that is being franchised." Kragnes v. City of Des Moines, 714 N.W.2d 632, 642-43 (Iowa 2006). In 2004, Kragnes filed a class action claiming that at least part of the fees on gas and electric services was, in fact, an illegal tax because the amount of the fees far exceeded what the city was entitled to recover through cost-based franchise fees.

Kragnes is unusual because courts traditionally have analyzed whether a fee is an illegal tax by reviewing the entire fee, not its components. To the extent that other courts are willing to entertain the notion that a part of a fee could be an illegal tax, we anticipate that a number of fees across the country may be subject to challenge.

Meet Biscuit, the seven-year-old ruby nose beagle (also known as a lemon beagle) of GenOn Energy Tax Manager Lucy Lunt. Although you might not believe it from the looks of her photos, Biscuit loves going for walks and tracking rabbits—although she would have no idea what to do with a rabbit if she ever actually caught one. A true couch potato at heart, Biscuit loves her dog treats and believes that nothing is better than lazing around with a book or magazine. However, the Internal Revenue Code is her least favorite book. She thinks there are far too many regulations in the tax world, and reading it—or being used as Lucy’s desk under the heavy weight of all those rules—makes her very grumpy!

SALT Pet of the Month: It’s Your Turn!!

In response to many requests, the Sutherland SALT practice invites you to submit your pet (or pets) as candidates for SALT Pet of the Month. Please send us a short description of why your pet is worthy of such an honor, along with a picture or two. Submissions should be directed to Katie O’Brien at katie.obrien@sutherland.com.
Michigan Court of Appeals Finds Drop-Shipped Sales Are Sourced for SBT Purposes Based on Delivery Location

The Michigan Court of Appeals recently affirmed a Court of Claims summary judgment finding that sales to a related party are sourced to the location of the related party's customers. *Uniloy Milacron USA, Inc. v. Dep't of Treasury*, No. 300749 (Mich. Ct. App. Jan. 26, 2012).

Uniloy Milacron USA, Inc. (Uniloy), a manufacturer of molds used in blow-molding machines, entered into a distributor agreement with an affiliated corporation to purchase for resale and market Uniloy's products. The affiliate did not obtain physical possession of the products. Instead, Uniloy packaged, loaded, and shipped the products directly to the affiliate's customers.

The Michigan Department of Treasury (Department) argued that all of Uniloy's sales should be sourced to Michigan for purposes of the Single Business Tax (SBT) sales apportionment factor because Uniloy's products were "delivered" to the affiliate in Michigan before ultimately being sold/shipped to the affiliate's customers.

Under Michigan's repealed SBT regime, a sale of tangible personal property is sourced to Michigan if the product is shipped or delivered to a customer within Michigan. The Court disagreed with the Department and reasoned that just because Uniloy sold its products to its affiliate does not necessarily mean that Uniloy "delivered" the products to the affiliate corporation. Rather, the products were packaged by Uniloy and shipped by Uniloy directly to the affiliate's customers, the vast majority of whom were located outside of Michigan, and there was no documentary evidence to demonstrate otherwise. The terms "shipped" and "delivered" were not defined for SBT purposes, but the Court had no trouble concluding that they referred to the location to which the products were "carried and turned over," "handed over," "surrendered," "sent away," or "transported" to a customer within Michigan.

Other state courts have taken a view contrary to that of the Michigan Court of Appeals with regard to the sourcing of "dock sales" receipts (sourcing sales of tangible personal property). For example, in *Stryker Corp. v. Director, Division of Taxation*, 168 N.J. 138 (June 14, 2001), the New Jersey Supreme Court held that a Michigan-based corporation's receipts from sales of manufactured products at its New Jersey facility, sold to its wholly owned New Jersey subsidiary at the same facility, and drop-shipped directly to the subsidiary's out-of-state customers constituted New Jersey receipts includable in the New Jersey sales factor numerator because the receipts were earned in New Jersey.

Massachusetts Greases the Skids for Lubricant Manufacturer to Use Single Sales Factor

The Massachusetts Department of Revenue ruled that a California lubricant and cleaning products manufacturer was a manufacturing corporation, even though 70% of its production activities were outsourced to third parties. As a result, the Department permitted the company to use a single sales factor to apportion its taxable net income to Massachusetts. Mass. Ltr. Rul. 11-8: *Qualification as a Manufacturing Corporation under G.L. c. 63, s. 38(I)* (Dec. 16, 2011).

Under Massachusetts Law, a "manufacturing corporation" that has income from business activity that is taxable both in Massachusetts and outside the state is required to apportion its net income to Massachusetts using a single sales factor. There are two requirements to be a "manufacturing corporation." First, the corporation must be engaged in manufacturing during the year, and second, the manufacturing activity must be substantial. A corporation’s manufacturing activities are substantial if the corporation meets one of the five statutorily enumerated tests. The first test is that the corporation derives 25% or more of its receipts for the taxable year from the sale of manufactured goods that it manufactures.

The taxpayer was engaged in the development, manufacture, and distribution of lubricants and cleaning products. Approximately 70% of the taxpayer’s revenue was attributable to the manufacture and sale of a specified lubricant. Although the taxpayer’s internal production did not generate 25% of its receipts, the Department concluded that the taxpayer met the statutory test.

The Department explained that when products are produced through an outsourcing arrangement, "the issue is whether the Company’s activities are essential and integral to the overall manufacturing process such that its activities constitute manufacturing." The Department determined that the taxpayer was integrally involved in the creation of the product from start to finish. The taxpayer invented the product formula, manufacturing processes, and testing procedures. The Department also found that the taxpayer controlled the overall manufacturing process. As a result, the Department ruled that the Company was engaged in manufacturing that was substantial and, therefore, was permitted to use a single sales factor to apportion its net taxable income to Massachusetts.

Companies filing in Massachusetts that are considering outsourcing their manufacturing activities, and those that have already done so, should evaluate whether their own activities are "essential and integral" to the overall manufacturing of their product such that they could be permitted or required to source their receipts using a single sales factor.
Washington B&O Tax Nexus Stinks: Attributional to Economic

The Washington Department of Revenue (Department) determined that an out-of-state mail order retailer (Taxpayer) had substantial nexus with the state based on the activities of an in-state affiliate (Affiliate), and therefore, upheld an assessment of business and occupation tax (B&O Tax) and sales tax. Determination No. 10-0057 (released Dec. 20, 2011). The Taxpayer sold tangible personal property via catalog and shipped the goods to Washington customers from out-of-state via a common carrier. Although the Taxpayer did not have a place of business in Washington, the Taxpayer’s Affiliate operated two retail stores in Washington that engaged in activities on the Taxpayer’s behalf.

The Department found that the Affiliate engaged in three activities on the Taxpayer’s behalf that established or maintained a market for the Taxpayer: (1) the Affiliate sold gift cards at its two Washington stores that customers could redeem on the Taxpayer’s website; (2) the Affiliate handed out the Taxpayer’s catalogs free to its customers at its two Washington stores; and (3) the Affiliate assisted the Taxpayer’s customers seeking to return catalog purchases by calling or emailing customer service to request a free shipping label to be sent to the customer. Therefore, the Department attributed the in-state physical presence of the Affiliates to the Taxpayer, causing the Taxpayer to be subject to the B&O Tax and the sales tax.

Recently, the Washington Legislature amended state law to provide that an economic presence created sufficient contact or nexus with the state to require Taxpayers to be subject to the B&O Tax. The economic nexus rule, enacted in 2010, requires those taxpayers organized or commercially domiciled outside of Washington to register for and remit the B&O Tax if they have: (1) more than $50,000 of property in the state; (2) more than $50,000 of payroll in the state; (3) more than $250,000 of receipts from the state; or (4) at least 25% of their total property, total payroll, or total receipts in the state. Wash. Rev. Code Ann. § 82.04.067(1) (c). While Washington modified the nexus standard for the B&O Tax, the physical presence standard remains unmodified for sales tax purposes. Finally, the new nexus law may be inconsistent with the U.S. Supreme Court’s analysis of B&O Tax nexus in *Tyler Pipe v. Washington Department of Revenue*, 438 U.S. 232 (1987).

Iowa and Kansas: Remote Access to Software is Not Taxable . . . Or Is It?

Iowa and Kansas recently issued rulings regarding the taxability of cloud-based software applications and online training services. While the conclusions reached by both states—that the services are not taxable—are generally the same, the reasoning relied upon by each department of revenue illustrates the ongoing uncertainty of applying state sales and use tax laws to cloud computing services.

The Iowa Department of Revenue (IDOR) looked to the state’s statutory authority and acknowledged that the taxability of “cloud computing has not been expressly addressed by the Iowa Code.” Nonetheless, the IDOR determined that the sale of hosted software is not taxable because the Iowa Code provides that a “taxable ‘sale’ of tangible personal property does not occur if the substance of the transaction is delivered to the purchaser digitally, electronically, or by utilizing cable, radio waves, microwaves, satellites, or fiber optics.” I.C. § 423.3(67). Likewise, the IDOR considered web-based training to be nontaxable because “software training” is not an enumerated service under the Iowa Code.

The Kansas Department of Revenue (KDOR) made a distinction between the treatment of such an arrangement depending on the specific contractual terms agreed upon, for purposes of determining the proper sales and use tax treatment. While the KDOR maintains that the charges for using “someone else’s software” on a remote computer are not subject to tax (commonly referred to as Software as a Service), it has advised that when an in-state or out-of-state business leases space on a remote server located in Kansas and buys prewritten software that is installed on that server, both the software purchase and the charge for leasing space on the Kansas server (commonly referred to as Infrastructure as a Service) are subject to Kansas tax.

The KDOR described a “hosted software” transaction as one that “obligates a service subscriber to pay a fee to gain Internet access to, and the use of, the service provider’s software and servers and to the data the subscriber inputs and stores on those servers.” The ruling further provides that charges for hosted software services are not taxable “because the software that is installed on a remote server isn’t delivered to subscribers or installed on their computers” and “[t]he service provider has title and possession of the software.” But the KDOR further qualifies this position by stating that “[s]uch software is not taxable as a sale of prewritten software so long as the software is not billed to subscriber as a separate line item charge.”

Also important to note is the sourcing implication of this guidance: Kansas considers the location of the server, rather than the customer/user, to be the proper taxing jurisdiction for hosted software applications. Since the majority of states that tax cloud-based software services source the sale to the end user location, the KDOR effort to tax at the server location could lead to multiple taxation.
When Do Independent Contractors’ Activities Deprive a Taxpayer of Public Law 86-272’s Immunity? Ann Sacks and Its Implications

Public Law 86-272 provides that a state does not acquire jurisdiction to impose an income tax on an otherwise tax-immune person “merely by reason of sales in such State . . . or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.”

That statement remains as true today as it was 25 years ago.

To be sure, one could argue that if an “independent contractor” conducts activities in the state on behalf of its out-of-state principal that are more extensive than those activities specifically enumerated in Public Law 86-272, the plain language of the statute indicates that the out-of-state principal no longer retains its immunity from income taxation under the statute. But we know that this simply cannot be. It would mean that every time an out-of-state principal contracted with a lawyer or an accountant (whose in-state activities on behalf of their clients clearly go beyond “solely of making sales, or soliciting orders for sales, of tangible personal property”), the principal would lose its Public Law 86-272 immunity. Not even the most aggressive state tax administrator would take such a position. Indeed, the Ohio Department of Taxation, in issuing nexus guidelines for its corporate franchise tax, explicitly provided that “[l]awyers, accountants, investment bankers, and other similar professionals that are not employees of the out-of-state corporation or its related members and who in their professional capacity perform their customary services in this state for an out-of-state corporation do not create nexus for out-of-state corporation.”

Moreover, Public Law 86-272 must be read against the background of state law that generally does not attribute the activities of an independent contractor to the principals for whom it is acting. As the California SBE observed:

It has been settled law in California for many years that for tax jurisdictional purposes and for purposes of determining the source of income, the business activities of an independent contractor will not be equated with the business activities of his principal. In pre-UDITPA[4] decisions, this board has concluded that sales solicited outside California by independent contractors acting on behalf of a California vendor cannot be treated as out-of-state sales in computing

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1 Pub. L. No. 86-272, § 101(c).
5 The reference to UDITPA is to the Uniform Division of Income for Tax Purposes Act, described in State Taxation, ¶¶ 9.01 et seq.
the sales factor of the apportionment formula. The tax policy behind these decisions is that a sale of goods by an independent contractor constitutes a part of the independent contractor’s own business, rather than the business of the individual or corporation whose products he sells. The state in which the sale is made has jurisdiction to tax the independent contractor’s profits from the sales, and that state is therefore being paid for the protection it affords the only activity occurring within its borders. The same reasoning serves as a basis for the policy set out in Public Law 86-272, which permits the out-of-state seller to have the independent contractor do more than it allows the seller’s employees to do without incurring tax liability. (See Beaman, [Paying Taxes to Other States (The Ronald Press, 1963), p. 6.21].)

Public Law 86-272 was enacted in 1959 in an effort to limit the power of the various states to tax income derived from interstate commerce. Although Congress thereby carved out a specific area of immunity from state taxation, we find nothing in that law’s legislative history to indicate any congressional intent to change prior state law regarding the tax effect of a corporation’s utilization of independent contractors to consummate its sales in other states, provided such independent contractors otherwise come within the definition contained in Public Law 86-272. (See generally S. Rep. No. 658, 86th Cong. 1st Sess., reprinted in (1959) U.S. Code Cong. & Ad. News 2548–2561.) In fact, we believe it would be inconsistent with the whole restrictive purpose of that federal law to construe it in a manner which would make the selling corporation more vulnerable to state taxation after the enactment of Public Law 86-272 than it was under pre-existing law.6

Although the foregoing discussion indicates that the law is anything but settled in this area, perhaps one could state the operating principles as follows:

1. If an out-of-state vendor itself conducts no activities in a state other than “solicitation of orders” (or activities “ancillary” to solicitation of orders), the vendor does not lose its Public Law 86-272 immunity from taxation merely because (a) an “independent contractor” makes sales of tangible personal property in the state on the vendor’s behalf or (b) an “independent contractor” maintains an office in the state, if its sole activity in the state on behalf of the out-of-state vendor is making or soliciting orders for sales of tangible personal property.

2. If the “independent contractor’s” activities on the out-of-state vendor’s behalf in the state exceed making or soliciting orders for sales of tangible personal property, then Public Law 86-272 no longer immunizes the out-of-state vendor from income taxation in the state.

3. Even though an out-of-state vendor loses its federal statutory immunity from income taxation when its “independent contractor’s” in-state activities on its behalf exceed those protected by Public Law 86-272, the state’s common law will continue in many cases to immunize the out-of-state vendor from taxation, because the acts of an “independent contractor” are not ordinarily attributed to the out-of-state principal.

One might criticize this summary of the operating principles on the ground that it essentially renders Public Law 86-272’s “independent contractor” language mere surplusage. After all, if a state’s common law would not subject an out-of-state vendor to income tax in a state merely because an independent contractor operated on its behalf in a state, Public Law 86-272’s declaration to that effect (albeit in the limited context of “making sales” or “maintenance of an office”) was unnecessary.

There is a two-fold response to this critique. First, Congress might well have wanted to remove any possible doubt that an independent contractor’s sales or its maintenance of an office did not compromise the protection that Congress was affording to out-of-state vendors under Public Law 86-272, at least when the independent contractor’s activities on the out-of-state vendor’s behalf amounted to no more than “making sales, or soliciting orders for sales, of tangible personal property.” In so doing, Congress was not undermining the general rule that an independent contractor’s activities are not attributable to the principal.

Second, as we know from subsequent Supreme Court decisions, there is considerable uncertainty from a constitutional standpoint over the extent to which an independent contractor’s activities in a state expose an out-of-state principal either to taxation or to tax collection responsibilities.7 Indeed, the Court has said that determining whether an out-of-state vendor’s in-state representatives are characterized as “employees” or “independent contractors” is “a fine distinction without constitutional significance,”8 and that “the crucial factor governing nexus is whether the activities performed in the state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in the state for sales.”9

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7 See State Taxation, ¶ 6.09 and ¶ 19.02[2].
Accordingly, it is clear (although with the benefit of hindsight) that Public Law 86-272’s “independent contractor” language performs an important function in providing statutory protection from state income taxation to out-of-state vendors who might lack constitutional protection from such taxation.

This still leaves the question of whether an “independent contractor’s” in-state acts on behalf of an out-of-state vendor that exceed making sales or soliciting orders for sales in the state expose the out-of-state vendor to income taxation in the state. There is no short answer to this question. The longer answer lies in an analysis of both the underlying state common law and federal constitutional principles. The former typically focuses on a fact-sensitive inquiry into whether the “independent contractor” is really carrying on its own business or that of its out-of-state principal. The latter look beyond labels (such as “independent contractor” and “employee”) and focus on the question of “whether the activities performed in the state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in the state for sales.” Neither inquiry is likely to yield bright lines.

Prior to 2011, there was, as far as we can tell, no case law addressing the question discussed above, except for the 1980 California SBE opinion in Learner, which we have quoted at some length in the preceding discussion and incorporated into our view of the law, such as it is. In 2011, however, the Oregon Tax Court broke the judicial silence with a very thoughtful opinion that considered the jurisdictional consequences of independent contractors’ activities that exceed Public Law 86-272’s safe harbor.

In Ann Sacks Tile and Stone Inc. v. Department of Revenue, Kohler, a manufacturer of plumbing products, engines, and power generators, sent its employees into Oregon to conduct sales activities that were protected by Public Law 86-272. In addition, however, Kohler hired independent contractors to perform warranty and related services on its behalf with respect to its plumbing, engine, and generator products. These services admittedly exceeded the scope of activities in which independent contractors are permitted to engage on behalf of out-of-state vendors without jeopardizing the vendors’ Public Law 86-272 immunity, because those activities are limited to the making of sales in the state or maintaining an office in the state for the purpose of making sales or soliciting orders.

The court had little difficulty concluding that Kohler was “doing business” and thus subject to tax under state law, because the “legislature is considered …to have extended the reach of the excise tax to the limit defined by the federal constitution.” The activities carried on in Oregon by and on behalf of Kohler easily satisfied constitutional nexus standards (apart from those demanded by the Supremacy Clause in light of Public Law 86-272). The more difficult question was whether Kohler was subject to tax, even though its employees’ sales activities were protected by Public Law 86-272, as a result of the activities of the independent contractors acting on its behalf in Oregon.

The court alluded to the foregoing analysis in the treatise suggesting that it simply “cannot be the law” that a taxpayer loses its Public Law 86-272 immunity every time its independent contractors exceed the literal limits of Public Law 86-272, because it would deprive a taxpayer of Public Law 86-272’s protection merely because “it contracted with a law firm, accounting firm or advertising firm in the state for the performance of … services.” Nevertheless, the court declared that “what some say cannot be the law is, in fact, the law – at least for now,” and, we would add, at least in Oregon.

In arriving at this conclusion, Judge Breithaupt first demanded to know, “what constitutional or statutory or case law authority says” it “is not the law” that a taxpayer loses its statutory immunity if an independent contractor engages in any activity on the taxpayer’s behalf that exceeds Public Law 86-272’s literal scope? “Absent such authority,” he continued, “the court cannot reach a conclusion simply because the proposition seems extreme.” Judge Breithaupt went on to observe that

[n]o Oregon constitutional or statutory provision says that activity of an independent contractor acting pursuant to a contract with an out-of-state seller of goods is insufficient to expose the out-of-state seller to Oregon’s tax jurisdiction or the reach of the tax statutes that have been enacted. Nor … does any Oregon case justify such a conclusion. To the contrary, [Oregon case law] case stands for the proposition that

...continued on page 8
purposefully availing oneself of the economic milieu of the state of Oregon provides adequate federal constitutional basis for taxation in such an instance.\(^\text{19}\)

Nor was there any federal constitutional authority or "case authority interpreting Pub L No 86-272 as affording relief to taxpayers on the facts of this case."\(^\text{20}\)

Accordingly, the court was "left only with Pub L No 86-272,"\(^\text{21}\) and the court further inquired:

Does it say that if a taxpayer enters into a contract with an independent contractor, that choice comes without potentially adverse consequences if the activities of the contractor in a state exceed what is allowed under Pub L No 86–272? No. In fact, by specifying certain activities that will not cause loss of immunity, the statute clearly implies that some independent contractor activities will result in loss of immunity. Importantly, as to the task of a court in applying the statute, nor does Pub L No 86–272 provide any principles, tools, tests or guidelines to be used to define some category of "permissible" activities, beyond those stated expressly in the statute, in which independent contractors may engage. Given both what Pub L No 86–272 says about independent contractors and what it does not say, the court is of the opinion that the statute cannot protect Kohler in this case, for the reason that the activities of the [independent contractors] extend beyond activities allowed by the statute.\(^\text{22}\)

Despite Judge Breithaupt’s rejection of our position, as a matter of principle, that it "simply cannot be" the law that any activities of independent contractors beyond those specifically enumerated in Public Law 86-272 deprive a taxpayer of tax immunity under Public Law 86-272, we suspect that there may be less than meets the eye as to the differences between our respective views.

First, as our earlier summary of the law reveals, we are actually in complete agreement with Judge Breithaupt that Public Law 86-272 itself ceases to protect a taxpayer if the activities of its independent contractors exceed the protected activities enumerated in the statute.

Second, we would also agree with Judge Breithaupt that "on the facts of this case"\(^\text{23}\) the activities of the taxpayer’s independent contractors – warranty and related work – should deprive a taxpayer of its immunity under the statute. These are quite distinguishable from the type of independent contractor activity that we identified above, namely, hiring third-party lawyers, accountants, and similar service providers that are not performing acts that fall within one’s “core” business (an elusive term, to be sure, but one that captures the thought). Indeed, Judge Breithaupt appears to agree with this point, although he would leave to the legislature the task of making it clear that the ancillary activities of lawyers, accountants, and similar independent contractors would not subject a taxpayer to the state’s taxing jurisdiction.\(^\text{24}\)

Third, and perhaps most importantly, the state jurisdictional law in Oregon, which extends to "the limit defined by the federal constitution,"\(^\text{25}\) is not the law in many other states. Many states, like California,\(^\text{26}\) would apply common law principles that do not go as far as the federal Constitution in attributing the acts of an in-state independent contractor to an out-of-state taxpayer. Indeed, while the U.S. Supreme Court has declared that the distinction between employees and independent contractors is “a fine distinction without constitutional significance,”\(^\text{27}\) the distinction will be relevant to jurisdictional analysis in many states, even though it is not relevant in Oregon.

Finally, we believe that there are federal constitutional limitations on attributing the acts of in-state independent contractors to out-of-state taxpayers when the relationship between them is so attenuated that asserting jurisdiction over the out-of-state taxpayer on the basis of the acts of its in-state contractor would exceed even the most expansive view of “attributitional nexus.” Hiring a law firm or accounting firm may well be an example of such an overexpensive assertion of jurisdiction to tax. If it were, of course, then this would be the law in Oregon as well.

\(^\text{19}\) Id. at *5.
\(^\text{20}\) Id.
\(^\text{21}\) Id. at "6
\(^\text{22}\) Id.
\(^\text{23}\) Id. at *5 (emphasis supplied).
\(^\text{24}\) Judge Breithaupt observed:

Unless one wishes to do so, one need not read this order as opening the flood gates on the independent contractor question. The activities of these contracting parties acting in Oregon are not for limited legal, advertising, or accounting services of the type that seem to present difficulty in analysis. If this result is unacceptable to those who are constitutionally charged with making tax law, at either the state or the federal level, those legislative branches may act to change the result. Id. at *6.
\(^\text{25}\) Id. at *2.
\(^\text{26}\) State Taxation ¶ 6.15[2] (discussing Learner).

For sales factor purposes, California sources the sales of intangibles and services using costs of apportionment (COP). The sales of intangibles and services are attributable to California if a greater proportion of the income-producing activity is performed in California than in any other state, based on COP. Before 2008, taxpayers could not include payments to agents and independent contractors as part of the taxpayer’s COP analysis. But beginning in 2008, California began to require taxpayers to take into account payments made to agents and independent contractors in calculating COP. As part of the analysis, the taxpayer must determine the location of the income-producing activity, and the regulations provide a comprehensive list of cascading rules to determine the appropriate location of the income-producing activity. See Cal. Code Regs. tit. 18, § 25136.

This taxpayer was in the business of placing targeted advertisements for its customers with online publishers (i.e., website owners or operators). Customers contracted with the taxpayer, who in turn contracted with online publishers to place online ads on websites that targeted a customer’s audience. The cost to purchase ad space from online purchasers represented the taxpayer’s largest cost of performance.

Under the cascading rules for determining the location of third-party, income-producing activity, a taxpayer defaults to the commercial domicile of its corporate customer if the services were performed in more than one state and the contracts or taxpayer records do not identify in what state all or a portion of the services were performed. However, this particular taxpayer also did not have enough information to determine its customers’ commercial domiciles. The taxpayer’s records did include the customers’ billing addresses, and it therefore sought to use the billing address as a reasonable proxy for the commercial domicile information required by the regulation.

The Chief Counsel allowed the taxpayer to source its sales using its customers’ billing addresses.

As technology evolves and the location of services becomes increasingly blurred, it is becoming more difficult to identify where services are being performed, which may lead to more use of the final default rules under those regulations that use a cascading approach.

Almost a year after vetoing similar legislation, Arizona Governor Jan Brewer signed SB 1046 on February 21, 2012, which allows “multistate service providers” to elect to use a market sourcing methodology for purposes of computing the sales factor numerator. The election is limited to taxpayers that derive more than 85% of sales from services provided to customers outside of Arizona.

Last year, Governor Brewer vetoed similar market sourcing legislation because it was viewed as conflicting with the temporary voter-approved increase to Arizona’s sales tax rate. This time around, legislators cured the conflict between tax hikes and cuts by delaying the effective date of the marketing sourcing election until 2014, after the sales tax increase expires, and by adopting a unique phase-in that will delay full market sourcing for qualified taxpayers until 2017.

The first year of the phase-in will allow multistate service providers to include 85% of market sourced sales along with 15% of costs-of-performance sourced sales in the numerator. Similar to when states phase-in a single sales factor formula by still accounting for the property and payroll factors at a reduced weight, this phase-in requires taxpayers to source sales using both sourcing methods and to include the respective percentage of those sales in the numerator of the sales factor during the phase-in period.

Under the new market sourcing rules, receipts are included in the numerator of a taxpayer’s sales factor based on where a purchaser receives the benefit of the service. However, there is no elaboration on how to determine where the benefit of a service is received. This lack of clarity may present difficulties for taxpayers in trying to implement the new sourcing rules. However, because of the delayed effective date, the Arizona Department of Revenue will have an opportunity to issue regulations or guidance to help taxpayers interpret the provisions.
Recently Seen and Heard

**March 1, 2012**
**Stratford Webinar**
**Charlie Kearns** on Sales and Use Tax on Digital Products and Services: Managing Multi-State Compliance Challenges for Vendors and Customers

**March 2, 2012**
**TEI Atlanta Chapter Meeting**
**Home Depot, Inc.** – Atlanta, GA
**Maria Todorova** and **Carley Roberts** on National Update on Sales & Use Taxes
**Eric Tresh** and **Zachary Atkins** on Top 10 Tips for Settling State Audits; When to Waiver or Walk

**March 5-7, 2012**
**COST Sales Tax Conference and Audit Session**
**Four Seasons – Austin, TX**
**Diann Smith** on Abandoned and Unclaimed Property
**Michele Borens** on Ethics and Professional Responsibilities for Transactional Tax Professionals

**March 6, 2012**
**DC Bar Seminar**
**DC Bar Conference Center – Washington, DC**
**Jack Trachtenberg** on Reflections from New York State’s First Taxpayer Rights Advocate

**March 7, 2012**
**COST Intermediate-Advanced State Income Tax School**
**Georgia Tech Hotel and Conference Center – Atlanta, GA**
**Jeff Friedman** on Determining the Corporate Income Tax Base
**Jonathan Feldman** on Manufacturing/Construction Sales & Use Tax Issues

**March 9, 2012**
**TEI New York Chapter Meeting**
**Carley Roberts** and **Prentiss Willson** on California Legal Developments
**Marc Simonetti** on Top 10 Practical Tips for Successfully Settling State Tax Audits
**Jack Trachtenberg** on New York State Tax Issues You Must Litigate

**May 1, 2012**
**TEI Tri-Chapter Meeting**
**RIT Inn & Conference Center – Rochester, NY**
**Jack Trachtenberg** on Business Tax Reform – Beyond 9A/32 Integration

**May 2, 2012**
**TEI Nashville Chapter Spring Seminar**
**Nashville, TN**
**Marc Simonetti** on State Tax Settlement Strategies

**May 3, 2012**
**TEI Houston Chapter Tax School**
**Hyatt Regency – Houston, TX**
**Prentiss Willson** on Top 10 Cases
**Marc Simonetti** on Alternative Apportionment

**May 8, 2012**
**TEI New York Chapter Meeting**
**Carley Roberts** and **Prentiss Willson** on California Legal Developments
**Marc Simonetti** on Top 10 Practical Tips for Successfully Settling State Tax Audits
**Jack Trachtenberg** on New York State Tax Issues You Must Litigate

**May 9, 2012**
**STARTUP Conference**
Montreal, QC, Canada
**Jeff Friedman** on Document Management Retention

**May 10, 2012**
**Sutherland State and Local Tax Roundtable**
St. Regis Hotel – Houston, TX
**Sutherland SALT** on a state tax update and discussions of income tax apportionment trends and California state tax developments

**May 10, 2012**
**IPT Luncheon**
Atlanta, GA
**Zachary Atkins** and **Maria Todorova** on National Update on Transaction Taxes

**May 15-18, 2012**
**COST Spring Audit Session/Income Tax Conference**
Westin Gaslamp – San Diego, CA
**Jeff Friedman** on Top 10 Reasons for Inconsistencies: Multistate Corporate Taxpayers and Varied State Laws

**May 16-18, 2012**
**Teles strategies 2012 Communication Taxation Conference**
Peabody Orlando Hotel – Orlando, FL
**Steve Kranz** and **Eric Tresh** on Telecommunications Controversies - Why and How Communications Companies Continue to Be a Favorite Target of State and Local Tax Authorities

**May 25, 2012**
**North Carolina Bar Association 11th Annual North Carolina/South Carolina Tax Section Annual Meeting**
Kiawah Island Golf Resort – Kiawah Island, SC
**Michele Borens**, **Jeff Friedman** and **Marc Simonetti** on State Tax Litigation Update