STATE+LOCAL TAX
INSIGHTS

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SUCCESS STORIES: WINS OF 2017 AND A POTENTIALLY BRIGHT NEW YEAR

By Craig B. Fields and Eva Y. Niedbala

This past year has been remarkable in many ways, and not just for its Twitter wars. We are happy to report that our clients had many wins in 2017 (both public record victories as well as non-public victories). In addition, we expect 2018 to be just as bright—if not brighter—creating a new round of success for our clients.

In New York, in a case that received a lot of press both within and without the tax world because of the love story described in the decision, a State Administrative Law Judge ("ALJ") agreed that our client changed his domicile and, therefore, could not be taxed as a New York resident.[1] Our client, a senior corporate executive who married his high school sweetheart after being apart for more than 40 years, had moved from New York to Paris upon retiring from his executive position to be with his new wife. The ALJ concluded that based upon an analysis of the facts, even though the former executive maintained an apartment in

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Upcoming Speaking Engagements

February 8

The 2018 National Multistate Tax Symposium
Orlando, Florida

- **"Positioning for More Favorable Outcomes: Indirect Tax Controversies"** Craig B. Fields

February 28

Council on State Taxation, 2018 Sales Tax Conference & Audit Session
New Orleans, Louisiana

- **"State of the States – State Tax Overview"** Craig B. Fields
- **"Minimize Exemption Certificate Chaos"** Mitchell A. Newmark

March 28

Tax Executives Institute 68th Midyear Conference
Washington, D.C.

- **"State and Local Tax Judicial and Legislative Developments"** Craig B. Fields

May 21-22

2018 Energy Tax Association Annual Conference
San Antonio, Texas

- **"State of the States"** Craig B. Fields and Nicole L. Johnson

June 1

Georgetown University Law Center, 2018 Advanced State and Local Tax Institute
Washington, D.C.

- **"Debating the Future of Sales Tax Nexus"** Craig B. Fields
- **"The Traps and Opportunities of Nonuniform Sourcing Rules Applicable to Sales of Other Than Tangible Personal Property"** Mitchell A. Newmark

June 19

New Jersey Bar Association
New Brunswick, New Jersey

- **"State Implications of Federal Tax Reform"** Mitchell A. Newmark and Nicole L. Johnson

September 19

Wisconsin State & Local Tax Club
Milwaukee, Wisconsin

- **"Significant Developments In State And Local Taxation"** Craig B. Fields

New York City, and continued to spend considerable time in the City, much of which was for medical treatment, he no longer intended New York to be his permanent home and, therefore, was not a New York domiciliary.

This case is significant because it demonstrates that an individual can establish a change of domicile from New York even if the individual continues to maintain an apartment in the State. What is essential is that the individual provide credible and unequivocal testimony and support that testimony with documentary evidence. The Department of Taxation and Finance did not appeal, making the decision final.

In Colorado, the Court of Appeals affirmed the Denver District Court's decision and held that the Department of Revenue cannot force a parent corporation to file a combined tax return with its subsidiary, a holding company that had no property or payroll of its own and that derived its income solely from investments in foreign subsidiaries.[2] The Court of Appeals ruled that this holding company could not be included in a Colorado combined return because it did not have any property or payroll and, therefore, did not have more than 20% of its property and payroll in the United States, as required under Colorado law for combination. This conclusion was consistent with the Department's own regulation, which provided that a corporation without any property or payroll of its own cannot be included in a Colorado combined report. Further, the Court ruled that the subsidiary could not otherwise be included in the parent's combined report under: (1) the Department's authority to reallocate income and deductions among related corporations under a State statute equivalent to Internal Revenue Code Section 482; or (2) the economic substance doctrine.

This decision demonstrates that a state taxing authority must adhere to the statutory requirements and to its own rules on which taxpayers rely when filing returns with the state.

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In Virginia, in a 4-3 decision, the Virginia Supreme Court held that even though the subject-to-tax safe harbor to the State's royalty addback statute is ambiguous, it applies only to the extent that royalties are actually taxed by another state, meaning to the extent the royalties are included in a post-apportioned (rather than pre-apportioned) tax base.[3] Yet, the Court agreed with our client's alternative argument that, in addition to the safe harbor applying when the royalty recipient includes the royalties in its tax base in a state, a payor also qualifies for the safe harbor when the royalties are taxed by states where: (1) the payor adds back the payments; or (2) combined or consolidated returns are filed.

A state taxing authority must adhere to the statutory requirements and to its own rules on which taxpayers rely when filing returns with the state.

A petition for rehearing at the Virginia Supreme Court has been filed and we are awaiting the Court's decision.

In Indiana, the Tax Court agreed that our client's gain from the sale of partnership interests could not be apportioned to Indiana inasmuch as it was nonbusiness income and, also, that the company properly deducted its intercompany interest expenses.[4] With respect to the partnership gain issue, the Court concluded that the gain was nonbusiness income under both the transactional test, because the purchase and sale of businesses did not constitute our client's regular trade or business, and under the functional test, because our client did not manage the partnership as an integral part of its own trade or business. In addition, the Court held that there was no functional integration, centralization of management, or economies of scale between the company and the partnership and, therefore, the gain was nonapportionable under the U.S. Constitution as well.

A taxpayer can prevail in proving that gain from the sale of a business should not be included in the apportionable tax base.

For the intercompany interest expense issue, the Court ruled that the State could not disallow the deductions because the intercompany loan arrangement had business purpose and economic substance and the interest was at arm's-length rates.

This decision is important because it shows that a taxpayer can prevail in proving that gain from the sale of a business should not be included in the apportionable tax base and that, despite many taxing agencies' positions, intercompany arrangements must be respected when supported by economic substance, business purpose and arm's-length pricing.

In addition to these public wins, we assisted our clients in securing a string of non-public victories. In a Midwestern state, we obtained 100% relief for a global manufacturer of confectionery and other food products

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when the State ultimately agreed that it could not tax the company's income from foreign dividends as the foreign dividend income had nothing to do with the state.

A Northeastern state conceded that it could not tax the gain that a financial institution realized from the sale of its ownership interests in another entity and cancelled a seven figure assessment in its entirety. We also successfully resolved a payroll withholding tax audit for a multinational medical device, pharmaceutical and manufacturing company that resulted in it paying approximately 5% of the amounts initially asserted as due by another Northeastern state.

We negotiated and finalized an agreement with a Mid-Atlantic state eliminating virtually all of the liability for unclaimed properties for a 20-year period, resulting in a payment of less than $2,000.

A Northeastern state conceded that it could not tax the gain that a financial institution realized from the sale of its ownership interests in another entity.

Lastly, a Northeastern state ultimately concluded that the former CEO of a Fortune 50 Company, who lived with his wife in another state but had an apartment in this Northeastern state, was neither a domiciliary nor a statutory resident of the Northeastern state.

In addition to these wins, we have many pending cases for which we expect to receive news in 2018.

In one Northeastern state, we have three cases awaiting decisions. The first involves the constitutionality of a partnership filing fee that is imposed on partnerships and is measured on the number of partners. Another involves whether the State's denial of deductions for the full amount of the royalties that our client paid to an affiliate is proper. The third case involves whether our client, by and through a partnership it partly owned, maintained a regular place of business outside of the state so that it can apportion its income.

In one Northeastern state, we have three cases awaiting decisions.

A court in one Mid-Atlantic state will address whether the proper calculation of the apportionment factor for a company receiving royalty and/or interest income from related members is that company's own apportionment factors or, instead, the apportionment factors of the related members. A court in a Southeastern jurisdiction will rule on whether our client satisfies the statutory requirements to qualify for tax economic development incentives.

Another Northeastern state is considering whether sales and use tax is due on telephone directories that our client had delivered into the state. Also, in a separate matter in that state, an adjudicatory body will rule on whether a generator of electricity may compute its tax under a cap that applies to certain manufacturers.

A Midwestern state will rule on the proper calculation of a deduction for federal income taxes when a corporation files a consolidated federal income tax return but a separate company state income tax return.

Finally, in a Western state, an appellate court will address the question of whether optional gratuities added to a patron's bill for parties of eight or more are subject to sales tax.

We look forward to hearing the results of these cases and are ready to continue advocating on our clients' behalf to secure more successes in 2018 and beyond.

1 *Matter of Stephen C. Patrick, et al.*, DTA Nos. 826838 & 826839 (N.Y.S. Div. of Tax App., June 15, 2017).

2 *Agilent Techs., Inc. v. Dep't of Revenue*, No. 2016CA849 (Colo. App. Nov. 2, 2017).

3 *Kohl's Dep't Stores, Inc. v. Va. Dep't of Taxation*, 803 S.E.2d 336 (Va. 2017).

4 *E.I. DuPont De Nemours & Co. v. Ind. Dep't of State Revenue*, 79 N.E.3d 1016 (Ind. T.C. 2017).

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WHAT SEPARATES US FROM THE REST?

OUR EXPERIENCE. We've been doing it longer, have more experience and published decisions, and have obtained a greater number of favorable settlements for our clients than the rest.

OUR TRACK RECORD OF PROVEN SUCCESS. We've successfully litigated matters in nearly every state, and have resolved the vast majority of matters without the necessity of trial.

OUR NATIONAL PERSPECTIVE. We approach state and local tax issues from a nationwide perspective, taking into account the similarities and differences of SALT systems throughout the United States.

OUR DEPTH. Our team is comprised of a unique blend of public and private backgrounds with experience spanning various industries. We're nationally recognized as a leading practice for tax law and tax controversy by *Chambers*, *Legal 500* and *Law360*. In fact, we've been referred to as "one of the best national firms in the area of state income taxation" by *Legal 500 US* and were rated Law Firm of the Year for Litigation – Tax by the 2016 "Best Law Firms" Edition of *U.S. News & World Report – Best Lawyers*.

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