

5 KEY TAKEAWAYS

Top State Corporate Income Tax Cases of 2019

On November 13th [Kilpatrick Townsend](#) State and Local Tax Partner [Jeff Reed](#) presented during a webinar hosted by Strafford entitled **Top State Corporate Income Tax Cases of 2019**. The panel discussed state corporate income tax cases decided in courts throughout the United States in 2019 and was organized by substantive tax issue.

Here are 5 key takeaways from the presentation:

1

Nexus/PL 86-272 Litigation: Several of the more significant 2019 nexus cases address whether a corporation's ownership of a small minority interest in a partnership is sufficient to create nexus. A New Jersey Tax Court decision acknowledged that not all related party licensing nexus cases are the same. A Maryland case, following a long line of earlier cases, held that a licensing company has nexus if it lacks economic substance separate and apart from its parent company. An Oregon case held that PL 86-272 protection is lost where a manufacturer refunds its wholesaler customers for product that is replaced or refunded.

Addback Statute Litigation: Litigation over the availability of addback exceptions continues to be a hot area. Over the past year, several New Jersey cases have addressed the application of New Jersey's addback statute to related party payments. One case concluded that the "unreasonableness" exception to addback is available where the recipient of the payments is a New Jersey taxpayer and the income from the payments are subject to New Jersey tax. Another case holds that payments among related companies under a tax sharing agreement are an accounting mechanism rather than a related party payment subject to addback.

2

80/20 Company Litigation: 80/20 companies (i.e., companies with over 80% of their property and payroll outside the US) are not included as group members of water's edge combined returns in most states, including in Colorado. Nevertheless, the Colorado Department of Revenue attempted to administratively include income from 80/20 companies in the combined returns of several corporate tax filers; the Colorado Supreme Court held that these adjustments were statutorily unsupported. In another taxpayer victory, the Oklahoma Supreme Court reversed a lower court decision and concluded that a combined group could fully deduct income received from 80/20 companies due to state conformity to IRC § 243. On the whole, these cases support the ongoing vitality of 80/20 company planning. But note that other states including Illinois continue to audit and challenge 80/20 companies.

3

Sales of Interests in Pass-Through Entities Litigation: When an interest in a pass-through entity is sold, a key issue is how to source the gain from the sale. Generally, under UDITPA a corporation will source income from the sale of a capital asset to its commercial domicile and a nonresident will source income from the sale of an intangible asset to his or her state of domicile/residence. Several 2019 cases address attempts by auditors to apply entity-level apportionment rules to the sale (i.e., the sold entity's in-state apportionment %), rather than seller-level apportionment (i.e., the sourcing regime that applies to the seller). This is a common audit issue and, while the better answer is that the seller's sourcing rules should apply, since the legal issue is how the seller should treat the gain from the sale, there is no guarantee that state auditors will agree, particularly where there is a material amount at issue.

4

Cost of Performance Sourcing Litigation: Most states now source services using market-based sourcing. But that has not put an end to cost of performance litigation. Rather, there continues to be a considerable amount of this litigation in "hold-out" states that have retained a cost of performance sourcing rules for services and in states that have amended their statutes to provide for market-based sourcing but still have cases from older tax years working their way through the administrative appeals process. Litigated cost of performance cases from 2019 address issues such as whether costs from specific transactions or the entire operations of the business should be taken into account in determining where costs are highest. Additionally, a Virginia Supreme Court case from 2019 shows that taxpayers have a very high bar to exceed in showing entitlement to alternative apportionment (the parties in the case stipulated that interplay between Virginia's COP statute and the market-based sourcing statutes of other states resulted in over 120% of the taxpayer's income being taxed, yet the Virginia Supreme Court still held that alternative apportionment relief was not available).

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