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Current Developments in State and Local Tax

Income Tax Cases, Alternative Apportionment, and Deference to Administrative Agencies

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Income & Franchise Taxes—Deductions

Massachusetts—Appeals Court Allows Deduction for Utility Taxes Paid to Indiana

The Massachusetts Appeals Court reversed a decision of the Appellate Tax Board and allowed Bay State Gas Company ("Bay State") to deduct Indiana Utility Receipts Tax ("URT") from its Massachusetts net income for corporate excise tax purposes.[1]

Bay State is an energy company that operated in Massachusetts and, through two affiliates, in Indiana. Its affiliates were subject to and paid URT to Indiana. The URT is denominated as an "income tax" by Indiana statutes and imposes a tax on gross receipts received as consideration for the retail sale of utility services for consumption in Indiana.[2]

Bay State claimed a deduction for the amounts paid to Indiana pursuant to Mass. Gen. Laws ch. 63, §30(4), which allows corporations to deduct from Massachusetts net income "deductions … allowable under the provisions of the Federal Internal Revenue Code." The Commissioner disallowed the deduction, claiming that under Mass. Gen. Laws ch. 63, §30(4)(iii), no deduction is allowed for "taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by any [S]tate." Although the Commissioner initially argued that the URT was an income tax, he later abandoned that argument and claimed on appeal that the URT is a "franchise tax for the privilege of doing business," and therefore not deductible under Mass. Gen. Laws ch. 63, §30(4)(iii).

The Commissioner supported his position by relying on a "longstanding Department of Revenue position" that the key feature of all taxes which are not

allowed as deductions "is that they are imposed on the corporation's business as a whole, rather than on discrete events, or parts of the corporation's activities, or ownership, within a State." The Appeals Court reversed the Appellate Tax Board and found that Bay State had established that the URT is not a franchise tax on the entity as a whole, but rather is a tax on utilities' retail sales.

The Appeals Court also rejected the Commissioner's argument that the URT was not a sales tax because the URT is not separately collected from purchasers. In rejecting that argument, the court reasoned that "with or without separate collection, as a matter of economics, a rational economic actor can always be expected to attempt to pass increased costs from taxes on to the consumer." Case law from Indiana substantiated that Indiana utility vendors had increased costs after enactment of the URT to minimize the impact of the tax on their profit margins. In addition, the court took note of the fact that Indiana had adopted a compensating URT use tax on gross receipts from utility services after Indiana customers began using out-of-state companies for utility services after the URT was initially adopted, which further supported the characterization of the URT as a sales tax.

Income & Franchise Taxes—Tax Caps and Deference to Administrative Agencies

New York—Tax Appeals Tribunal Sides with Taxpayer in "Qualified Manufacturer" Dispute

The New York State Tax Appeals Tribunal ("TAT") reversed the determination of an Administrative Law Judge and held that TransCanada Facility USA, Inc. ("TransCanada") was a "qualified New York manufacturer" for New York State corporate franchise tax purposes, and therefore was subject to a $350,000 cap in computing its tax liability under the capital base of the franchise tax.[3]

TransCanada is a wholesale energy provider that conducted business through various affiliates, one of which operated a generating facility in Long Island City, NY (the "Ravenswood Facility"). The parties stipulated that the Ravenswood Facility is a power plant that generated electricity and that the property at the Ravenswood Facility was depreciable under Code Sec. 167 and had an adjusted basis at the close of the years at the issue of at least $1 million.

During the years at issue, the franchise tax was calculated and paid upon the highest of four alternative tax bases. The parties stipulated that TransCanada's capital base tax was the highest of the four alternative bases. The capital base tax was capped at $350,000 for taxpayers classified as "qualified New York manufacturers." To qualify for the tax cap, the taxpayer must: (1) be a manufacturer; (2) have a property in New York that is described in Tax law former §210(12)(b)(i)(A) (the Investment Tax Credit ["ITC"] statute); and (3) either (i) the adjusted basis of that property is at least $1 million at the close of the taxable year or (ii) all of its real and personal property must be located in New York.[4] A "manufacturer" is any taxpayer that "is principally engaged in the production of goods by manufacturing, processing, assembling …"[5] A taxpayer is "principally engaged" in an activity if more than 50% of the gross receipts of the taxpayer or combined group are derived from the sale of goods produced by such activity.[6] Because the parties stipulated that the Ravenswood Facility is located in New York and had an adjusted basis of at least $1 million and that more than 50% of TransCanada's receipts were derived from the sale of electricity that it generated at the Ravenswood Facility, the issue before the TAT was whether the sale of electricity is an activity that qualifies as "the production of goods by manufacturing [or] processing."

In answering that question, the parties first disagreed as to whether the statute at issue was an exemption or exclusion from tax, in which case it would be construed against the taxpayer, or an imposition of the tax, in which case it would be construed against the government. Significantly, the TAT agreed with TransCanada and held that the tax cap is not an exemption, deduction, credit, or exclusion, but instead "merely defines the applicable tax that is imposed." Therefore, the TAT concluded that the statutes at issue should be "construed most strongly against the government and in favor of the citizen."

To determine whether TransCanada was a "manufacturer" for purposes of the tax cap, the TAT rejected the Division of Taxation's argument that the legislature used the same language from the ITC statute, which expressly excluded "electricity" from the term "goods" for determining whether a taxpayer is a manufacturer. The TAT reasoned that because the tax cap statute at issue did not incorporate the electricity exclusion from the ITC statute, such an exclusion was not intended by the legislature in defining manufacturers for purposes of the tax cap. The TAT noted that the ITC definition of the manufacturer did not originally include an exclusion for electricity, which was only added after the TAT had held in other cases that electricity *did* qualify as a "good" for ITC purposes. Because the legislature later added a definition of "manufacturer" for the tax cap that did *not* include an

exclusion for electricity, the TAT held that "the legislature chose to use language that the Tribunal had interpreted to include the generation of electricity, without including an exclusion or exception for the generation of electricity."

The TAT further found that TransCanada was a "qualified New York manufacturer" because it "has property in New York that is described in" the ITC statute. The TAT found that deference to the tax agency's interpretation was not warranted and rejected all of the Division of Taxation's arguments, which the TAT held would impermissibly extend the meaning of the statute beyond legislative intent.

Income & Franchise Taxes—Inclusion of Income in the Tax Base

Minnesota Supreme Court Finds Sale of Business Subject to Minnesota Corporate Income Tax

The Minnesota Supreme Court held that the gain realized by YAM Special Holdings, Inc. ("YAM") from its sale of a majority interest in its Go Daddy business was subject to Minnesota tax under the U.S. Constitution and Minnesota statutes.[7]

YAM is an Arizona S corporation with its principal place of business and commercial domicile in Arizona. Through various disregarded entities, YAM operated Go Daddy, an Internet business that provides internet domain names and website hosting among other services. YAM owned no property in Minnesota and did not have any employees based in Minnesota.

Approximately 1% of YAM's revenue was derived from Minnesota customers. YAM sold a majority interest in Go Daddy and realized a long-term capital gain of approximately $1.35 billion and a long-term capital loss of $1.66 million. For Minnesota corporate income tax purposes, YAM treated the gain from the sale of the Go Daddy interest as income that was not apportionable to Minnesota. The Commissioner determined that the gain was apportionable business income and assessed additional tax.

YAM argued on appeal that the income was not subject to tax in Minnesota under the Due Process Clause of the U.S. Constitution because Minnesota did "not have a sufficient connection with the income it seeks to tax." However, YAM conceded that it and the subsidiaries that operated Go Daddy were a unitary business at the time of sale. The court, therefore, rejected YAM's arguments, holding that taxing an apportioned share of a unitary business's income was consistent with Due Process principles. The court noted that the unitary business received significant revenue from Minnesota customers, which evidenced that YAM and its subsidiaries had a sufficient connection to Minnesota to satisfy the Due Process Clause. The court also rejected YAM's argument that the unitary business principle applies only when one of the entities in the unitary business is physically located in the taxing state.

YAM also argued that under Minnesota statutes, the income from the sale of the Go Daddy interest is not apportionable to Minnesota because the income was "derived from a capital transaction that solely serves an investment function."[8] The court rejected that argument, holding instead that the Minnesota statute merely codified the standard adopted by the U.S. Supreme Court in *Allied-Signal, Inc. v. Director* to determine when income from a capital transaction satisfies constitutional standards.[9] Under the *Allied-Signal* standard, which was clarified in *MeadWestvaco Corp. v. Illinois Department of Revenue* a state may include income from a capital transaction if the income forms part of the working capital of the company's unitary business.[10] Under that test, the income from the Go Daddy transaction was apportionable because YAM conceded that it was engaged in a unitary business with the subsidiaries that it sold.

Income & Franchise Taxes—Alternative Apportionment

Maine Supreme Judicial Court Rejects Taxpayer's Use of Alternative Apportionment

The Maine Supreme Judicial Court held that the gain realized by Kraft Foods Group, Inc., and affiliates ("Kraft") was apportionable to Maine, and rejected the company's request for alternative apportionment.[11]

Kraft operates a diversified food and beverage products business in Maine and throughout the United States. Kraft Pizza Company ("Kraft Pizza") operated a frozen pizza business under various recognizable brand names, such as DiGiorno and California Pizza Kitchen. In 2010, Kraft sold its frozen pizza business to Nestle USA, Inc. for approximately $3.7 billion. Kraft filed a Maine corporate income tax return including Kraft Pizza as part of its unitary business and reported that the majority of the gain realized from the sale of Kraft Pizza—approximately $3 billion—(the "Kraft Pizza Gain") was not subject to tax in Maine under either the U.S. or Maine Constitutions.

The Maine Revenue Services recharacterized the Kraft Pizza Gain as income apportionable to Maine. On appeal, the Board of Tax Appeals applied two apportionment factors to calculate Kraft's Maine taxable income. One apportionment factor calculated Kraft Pizza's income from the sale by dividing Kraft Pizza's sales in Maine by Kraft Pizza's sales everywhere. The second apportionment factor calculated Kraft's income by dividing Kraft's Maine sales by Kraft's sales everywhere. Kraft argued before the Supreme Judicial Court that it should be entitled to use this alternative apportionment method.

The court rejected the arguments in support of alternative apportionment. Alternative apportionment is only available under Maine law to the extent that the standard apportionment formula does "not fairly represent" the taxpayer's business in Maine.[12] The court first noted that Kraft's apportionment did not actually change substantially in the year of sale. Instead, only its income changed and was much larger as a result of the Kraft Pizza Gain. According to the court, the increase in income did not indicate that the scope of Kraft's business in Maine had changed, and its consistent apportionment factor supported that conclusion.

The court also rejected Kraft's argument that alternative apportionment should be used because the frozen pizza was not a substantial portion of Kraft's business in Maine as compared to other food and beverage products. The court reasoned that Kraft's argument was "inconsistent with one of the core principles justifying the use of a sales factor formula to apportion the income of a unitary business for tax purposes," because Kraft's unitary business earns income that results from functional integration, centralization of management, and economies of scale of the entire business operation.

The court sustained substantial understatement penalties, holding that there was not substantial authority for the position taken on the original return.

Gross Receipts Taxes—Apportionment

Ohio Supreme Court Sides with Taxpayer in Apportionment Dispute

The Ohio Supreme Court reversed the Ohio Board of Tax Appeals and the Court of Appeals and concluded that receipts earned by Defender Security Co. ("Defender") were not apportionable to Ohio.[13]

Defender is an Indianapolis-based company that serves as an authorized dealer for ADT Security Services, Inc. ADT provides security services to residential and commercial property owners, including remote monitoring services. Defender and ADT entered into an agreement pursuant to which Defender generates leads for new ADT customers, installs equipment at Ohio properties on behalf of ADT (for which it collects a fee), and signs contracts with Ohio customers pursuant to which ADT provides security-monitoring services for Ohio customers. Defender has Ohio branch locations, but its executive and administrative work is performed in Indianapolis. ADT operates outside of Ohio.

When Defender enters into contracts with Ohio customers for security services, it collects the contracts at its Indianapolis headquarters and forwards them to ADT's offices in Colorado, where ADT decides whether to take the assignment of the contracts. If ADT assumes the contract, it makes a payment to Defender.

Defender earns three types of revenue from its business: (1) payments from Ohio customers for installation of security equipment; (2) payments from Ohio customers under security services contracts that are not assumed by ADT; and (3) payments from ADT as consideration for ADT's purchase of security contracts with Ohio customers. Defender conceded that the first two types of receipts were apportionable to Ohio under the Commercial Activity Tax ("CAT") law, but claimed that the third type of receipts was not apportionable to Ohio.

The parties agreed that the relevant CAT provisions required receipts to be apportioned to Ohio according to "the proportion that the purchaser's benefit in [Ohio] with respect to what was purchased bears to the purchaser's benefit everywhere with respect to what was purchased."[14] To determine that ratio, "[t]he physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere."[15]

Reversing the lower tribunals, the court agreed with Defender that ADT received the benefit of its purchase of intangible contract rights at physical locations outside of Ohio, where ADT actually used and received the benefit of the contractual rights. The court held that the Commissioner, the Board of Tax Appeals, and the appeals court "all failed to properly distinguish between the benefit Ohio consumers received from ADT and the benefit ADT received by purchasing consumer contracts from Defender."

ENDNOTES

[1] *Bay State Gas Co. & Affiliates*, 98 Mass. App. Ct. 582 (2020).
[2] Ind. Code §6-2.3-1-4.
[3] *Matter of TransCanada Facility USA, Inc.*, DTA No. 827332 (N.Y.S. Tax App. Trib., May 1, 2020). It is noted that attorneys at Blank Rome LLP represented TransCanada.
[4] N.Y. Tax Law former §210(1)(b)(2).
[5] *Id*.
[6] *Id*.
[7] *YAM Special Holdings, Inc.*, 947 N.W. 2d 438 (Minn. 2020).
[8] Minn. Stat. §290.17, subd. 6.
[9] *Allied-Signal, Inc. v. Director*, SCt, 90-615 USTC ¶400-172, 504 US 768, 112 SCt 2251.
[10] *MeadWestvaco Corp. v. Illinois Department of Revenue*, SCt, 06-1413 USTC ¶401-877, 553 US 16, SCt 1498.
[11] *State Tax Assessor v. Kraft Foods Grp., Inc.*, 2020 ME 81, 235 A.3d 837.
[12] Me. Rev. Stat. Ann. tit. 36, §5211(17).
[13] *Defender Sec. Co. v. McClain*, No. 2019-0531, 2020 Ohio LEXIS 2138 (Sept. 29, 2020).
[14] Ohio Rev. Code Ann. §5751.033(I).
[15] *Id*.