STATE+LOCAL TAX INSIGHTS

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WORDS MATTER: COMPLYING WITH STATE TAX LAWS

By Mitchell A. Newmark, Nicole L. Johnson, and Eugene J. Gibilaro

Statutes mean what they say. As the late Justice Scalia once quipped, the proper role of the courts "is to apply the text, not to improve upon it."[1] However, revenue departments will oftentimes take positions contrary to the clear and unambiguous meaning of tax statutes that "begin to look like efforts at text avoidance."[2] This "text avoidance" employed by many revenue departments is contrary to law and is bad tax policy. Taxpayers should take note and not allow themselves to be intimidated by revenue departments that ignore the clear and unambiguous language of a statute.

Revenue departments have argued that courts should not apply the plain language of a tax statute because application of the statute's unambiguous words in a particular case results in lower taxes due. Therefore, the States argue, the statute's language purportedly contravenes the intent or the overall purpose of the law. However, when a taxpayer follows the clear and unambiguous words of the law, *i.e.*, does what the statute says to do, the ending result should not be avoided. Furthermore, there is no rightful place for penalties in such circumstances.

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Upcoming Speaking Engagements

September 19

Wisconsin State and Local Tax Club
Milwaukee, Wisconsin

- "Significant Developments in State and Local Taxation"
  Craig B. Fields and Nicole L. Johnson

September 28

New Jersey Institute for Continuing Legal Education, Tax Law 101 – What Every Lawyer Needs to Know About Taxes
New Brunswick, New Jersey

- "New Jersey Sales Tax Basics"
  Michael J. Hilkin

October 18

Vanderbilt University Law School, 25th Annual Paul J. Hartman State and Local Tax Forum
Nashville, Tennessee

- "Market-Based Sourcing – This Is Not a Test"
  Craig B. Fields
- "Look (and Think) Before You Leap – State Tax Issues in Mergers and Acquisitions"
  Mitchell A. Newmark
- "Top Ten Income Tax Cases"
  Holly L. Hyans

October 24 – 26

Council on State Taxation, 49th Annual Meeting
Phoenix, Arizona

- "After Wayfair – Modernizing State Sales Tax Systems?"
  Mitchell A. Newmark
- "Market Sourcing: The Audits Are Coming"
  William H. Gorrod
- "Happy 10 Year Anniversary, *MeadWestvaco*!"
  Nicole L. Johnson
- "The Great 'Discussion'"
  Craig B. Fields

October 29

Tax Executives Institute, Annual Conference
San Diego, California

- "After Wayfair: Clarity, Confusion & Consequences"
  Craig B. Fields

November 8 – 9

California Tax Policy Conference
San Jose, California

- "California Residency: Should I Stay or Should I Go?"
  William H. Gorrod
- "Judicial Review – Recent SALT Cases of Interest"
  Nicole L. Johnson

November 12

Interstate Tax Corporation, Advanced Interstate Tax Conference
Stamford, Connecticut

- "The Unitary Concept"
  Michael J. Hilkin and Matthew F. Cammarata

December 6

Bar Association of San Francisco Tax Section Meeting
San Francisco, California

- "State and Local Tax – 2018 Year in Review"
  William H. Gorrod

December 17

New York University, 37th Institute on State and Local Taxation
New York, New York

- "Due Process – Significant Current Issues"
  Craig B. Fields
- "Apportionment Issues: Recent Developments"
  Holly L. Hyans

State courts have confirmed that they will not override a statute's clear and unambiguous meaning, even when revenue departments urge them to do so based on the purported legislative intent or overall purpose of the statute.[3] Taxpayers should not be afraid to file their returns following the language of the applicable statute because, should the matter proceed to litigation, taxpayers can find protection in the words of the tax statute.

The following cases provide examples of the different ways that revenue departments may seek to interpret the tax law in order to reach results that are not in keeping with the plain meaning of the words in the relevant statute. Taxpayers should take note when filing their returns or responding to audit requests that the methods employed by the revenue departments in each of these cases were rejected by the courts and the taxpayers were victorious.

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INDIANA

In *Kohl's Department Stores, Inc. v. Indiana Department of State Revenue*,[4] the relevant statute applicable to those years provided that a taxpayer "may petition the department . . . for permission *to file a combined income tax return for a taxable year*."[5] The taxpayer had previously petitioned for and received permission from the Department to file combined returns and then so filed combined returns. Later, the taxpayer filed returns on a separate company basis (*i.e.*, the default filing methodology in Indiana). The Department rejected the separate company filing position and argued that the relevant statute should be interpreted to mean that a taxpayer must petition for permission to file *and for permission to discontinue filing* a combined income tax return. The Tax Court rejected the Department's interpretation, finding that "[t]he language of the statute is plain and unambiguous and makes no reference to discontinuing combined filing. If the legislature had intended to impose a . . . restriction on seeking permission to discontinue, it would have stated as much."[6] Finally, the Tax Court added that "[l]egislatures make the tax statutes and courts enforce them as written, not as departments of revenue may wish they had been written."[7]

Legislatures make the tax statutes and courts enforce them as written, not as departments of revenue may wish they had been written.

NEW JERSEY

In *Crestron Electronics, Inc. v. Director, Division of Taxation*, the New Jersey Tax Court held that a taxpayer properly excluded extraterritorial income from its entire net income for New Jersey corporation business tax ("CBT") purposes.[8] The taxpayer, a software and hardware provider, excluded the extraterritorial income from its federal taxable income and sought to exclude the extraterritorial income from its New Jersey entire net income. The Director rejected the taxpayer's position and argued that the extraterritorial income was required to be included in entire net income because the first sentence of the statutory provision defining entire net income stated that it includes "total net income from all sources, whether within or without the United States."[9] The Tax Court disagreed inasmuch as the Director's interpretation ignored the very next sentence of that same definition, which stated that "entire net income shall be deemed prima facie to be equal in amount to the taxable income . . . which the taxpayer is required to report . . . for the purpose of computing its federal income tax."[10] The Tax Court concluded that it was not permitted "to ignore the unequivocal provisions of [the statute at issue] linking entire net income to federal taxable income with limited, express exceptions."[11] Therefore, as the extraterritorial income at issue was not included among the express statutory exceptions authorizing a departure from the federal income tax treatment, such income was likewise excluded from taxable income for CBT purposes. The Tax Court stated that the Director "may not extend [the CBT] to income not within the fair contemplation of the Legislature as derived from the text of the statute imposing the tax."[12]

The Tax Court concluded that it was not permitted "to ignore the unequivocal provisions of [the statute]."

OREGON

In *Department of Revenue v. Rent-A-Center, Inc.*, the Oregon Tax Court reversed the Department of Revenue's interpretation of the word "and" in the applicable statute, which the Department preferred to mean "or," and ruled for the taxpayer.[13] During the year in issue, Oregon law defined a "unitary group" to mean a "group of corporations engaged in business activities that constitute a single trade or business" and further defined "single trade or business" to mean "business enterprise[s] in which there exists . . . a sharing or exchange of value as demonstrated by: (A) Centralized management or a common executive force; (B) Centralized administrative services or functions resulting in economies of scale; *and* (C) Flow of goods, capital resources or services demonstrating functional integration."[14] The Department argued that the word "and" should be interpreted to mean "or" and the court should conclude that the presence of only one or two of the three factors is necessary for a finding that a group of corporations constitutes a single trade or business. However, the Tax Court concluded that "each and every one of the factors must exist if a single trade or business is to be found."[15] Accordingly, the Tax Court concluded that, for purposes of the statute in issue, "and" means "and."

NEBRASKA

In *Stewart v. Nebraska Department of Revenue*, the Nebraska Supreme Court held in favor of resident taxpayers who structured their sale of corporate stock within the letter of the law to qualify for a special capital gains election.[16] In Nebraska, resident taxpayers are permitted to make one election during their lifetime to exclude from their gross income the capital gains from the sale of a corporation's stock if the stock was acquired

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through the taxpayer's employment by the corporation.[17] However, in order to qualify for the election, the corporation with respect to which the stock is being sold must have at least five shareholders at the time of the sale.[18] Here, the taxpayer's corporation only had three shareholders. Prior to the sale, one of the taxpayers sold one share of stock to each of three officers of the purchasing company. The purchase agreement explicitly stated that the restructuring was intended to ensure that the taxpayers qualified for the special capital gains election. The taxpayers subsequently sold their remaining stock to the purchasing company and made the election on their Nebraska income tax return with respect to the capital gains recognized on that sale. The Department of Revenue disallowed the election, arguing that there was no business purpose or economic substance to the pre-sale restructuring. The Nebraska Supreme Court disagreed with the Department and upheld the taxpayers' election, stating that "[i]f the language of a statute is clear, the words of such statute are the end of any judicial inquiry regarding its meaning."[19] The court declined to read the additional elements of business purpose and economic substance into the statute because "[i]f the Legislature wanted to impose either of these additional requirements, it could have done so."[20]

TAXPAYER CONSIDERATIONS

The above cases illustrate that taxpayers should read the applicable tax statutes at issue closely with respect to their various filing positions. To the extent that the revenue department's guidance or proposed audit adjustments are not in accord with the plain meaning of the words in the statute at issue, taxpayers should not be afraid to take positions on their returns that are squarely within the words of the statute, though contrary to that administrative guidance, and should know that they have support to challenge the adverse audit adjustments. The principle that a statutory provision should be interpreted in accordance with its plain meaning and clear language is a basic tenet of statutory construction.[21]

Taxpayers should not be afraid to take positions on their returns that are squarely within the words of the statute.

For example, if a tax statute states that a taxpayer must file its return a certain way if five specific requirements are met and the taxpayer does not meet all five, then the taxpayer should not yield if the revenue department were then to issue audit workpapers making adverse adjustments as if all five were met.

Taxpayers should not shy away from following the plain meaning of a tax statute solely because following the plain meaning would result in a favorable tax result. Recently, a federal appeals court noted that the tax law is "intricate and complicated" and "[t]he last thing the federal courts should be doing is . . . closing gaps in taxation whenever that complexity creates them."[22] State courts across the country agree. While revenue departments may not like the result that ensues from a taxpayer following the words of the statute, it is ultimately the will of the legislature expressed through the words of the statute that controls. Revenue departments only have the authority to interpret and implement the law. They do not have the authority to change the law when they do not like the outcome that the law yields. Courts across the United States, both state and federal, have repeatedly affirmed this basic principle.

Taxpayers – take note, words mean what they say.

1 *Pavelic & LeFlore v. Marvel Entm't Grp.*, 493 U.S. 120, 126 (1989).

2 *Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779, 787 (6th Cir. 2017).

3 *See, e.g., Kohl's Dep't Stores, Inc. v. Ind. Dep't of State Revenue*, 822 N.E.2d 297 (Ind. T.C. 2005); *Stewart v. Neb. Dep't of Revenue*, 885 N.W.2d 723 (Neb. 2016); *Crestron Elecs., Inc. v. Dir., Div. of Taxation*, 26 N.J. Tax 102 (Tax Ct. 2011); *Dep't of Revenue v. Rent-A-Center, Inc.*, 22 Or. Tax 28 (T.C. 2015).

4 822 N.E.2d 297. Morrison & Foerster LLP represented Kohl's Department Stores, Inc. before the Tax Court.

5 Ind. Code § 6-3-2-2(q) (emphasis added). Effective January 1, 2007, Section 6-3-2-2(q) was amended to state that "[a] taxpayer filing a combined income tax return must petition the department within thirty (30) days after the end of the taxpayer's taxable year to discontinue filing a combined income tax return." 2006 Ind. Acts 162, § 25.

6 *Kohl's Dep't Stores, Inc.*, 822 N.E.2d at 301.

7 *Id.* at 301-02 (quoting *Ind. Dep't of State Revenue v. Endress & Hauser, Inc.*, 404 N.E.2d 1173, 1178 (Ind. Ct. App. 1980)).

8 26 N.J.Tax 102. Morrison & Foerster LLP represented Crestron Electronics, Inc. before the Tax Court.

9 N.J. Stat. Ann. § 54:10A-4(k).

10 *Id.*

11 *Crestron Elecs., Inc.*, 26 N.J. Tax at 112.

12 *Id.* at 116.

13 22 Or. Tax 28. Morrison & Foerster LLP represented Rent-A-Center, Inc. before the Tax Court.

14 Or. Rev. Stat. § 317.705(2), (3) (2003) (emphasis added). Effective January 1, 2007, Section 317.705(3)(a) was amended to replace the word "and" with the word "or" when listing the three ways in which "a sharing or exchange of value" can be demonstrated. 2007 Ore. Laws 323, § 1.

15 *Rent-A-Center, Inc.*, 22 Or. Tax at 32.

16 885 N.W.2d 723.

17 Neb. Rev. Stat. § 77-2715.09(1), (2)(a).

18 *Id.* § 77-2715.08(c).

19 *Stewart*, 885 N.W.2d at 729.

20 *Id.* at 730.

21 *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 202-03 (1819) ("But if, in any case, the plain meaning of a provision . . . is to be disregarded . . . it must be one in which the absurdity and injustice of applying the provision to the case, would be so monstrous, that all mankind would, without hesitation, unite in rejecting the application.").

22 *Summa Holdings, Inc.*, 848 F.3d at 790.

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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.

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