Principled Subnational Tax Practice

Guidelines for Representing
Multistate Taxpayers Without All the Fireworks

David Uri Ben Carmel
349 East Multistate Tax Planning, LLC

<u>Principled Subnational Tax Practice</u>

Guidelines for Representing
Multistate Taxpayers Without All the Fireworks

By

David Uri Ben Carmel
349 East Multistate Tax Planning, LLC
daviduribencarmel@349east.com

Table of Contents

Section I

Introduction

As one of several tax lawyers addressing in-house professionals, I heard another lawyer declare over and over again that she "wants to litigate (whatever happened to be the topic of the moment)". Her enthusiasm for litigation was evident. But, I thought, who is going to pay for all of this fighting? And, if I was a company tax director, is this the attitude I would want from my representative? More pointedly, I would wonder whether all of this shoot 'em up litigation in my best interests or hers?

That experience was a catalyst for my Bureau of National Affairs article "Nonlitigated Resolutions of Multistate Tax Disputes", included here as Section VI. Another all-too-common experience involves experts in federal taxation taking responsibility for issue-spotting subnational tax issues. Those experiences were a catalyst for my Tax Notes Federal article "Unkown Unknowns", included here as Section IV.

This booklet is based on three-decades of professional experience. But this is not a technical volume. Rather, substantive issues of state tax practice are developed only to the extent necessary to demonstrate principles of client-first representation. Anyone desiring in-depth analyses of tax presence, income taxation, sales/use taxation, advising foreign businesses, etc. is invited to review the many pieces available at www.349east.com.

Section II

taxnotes® state

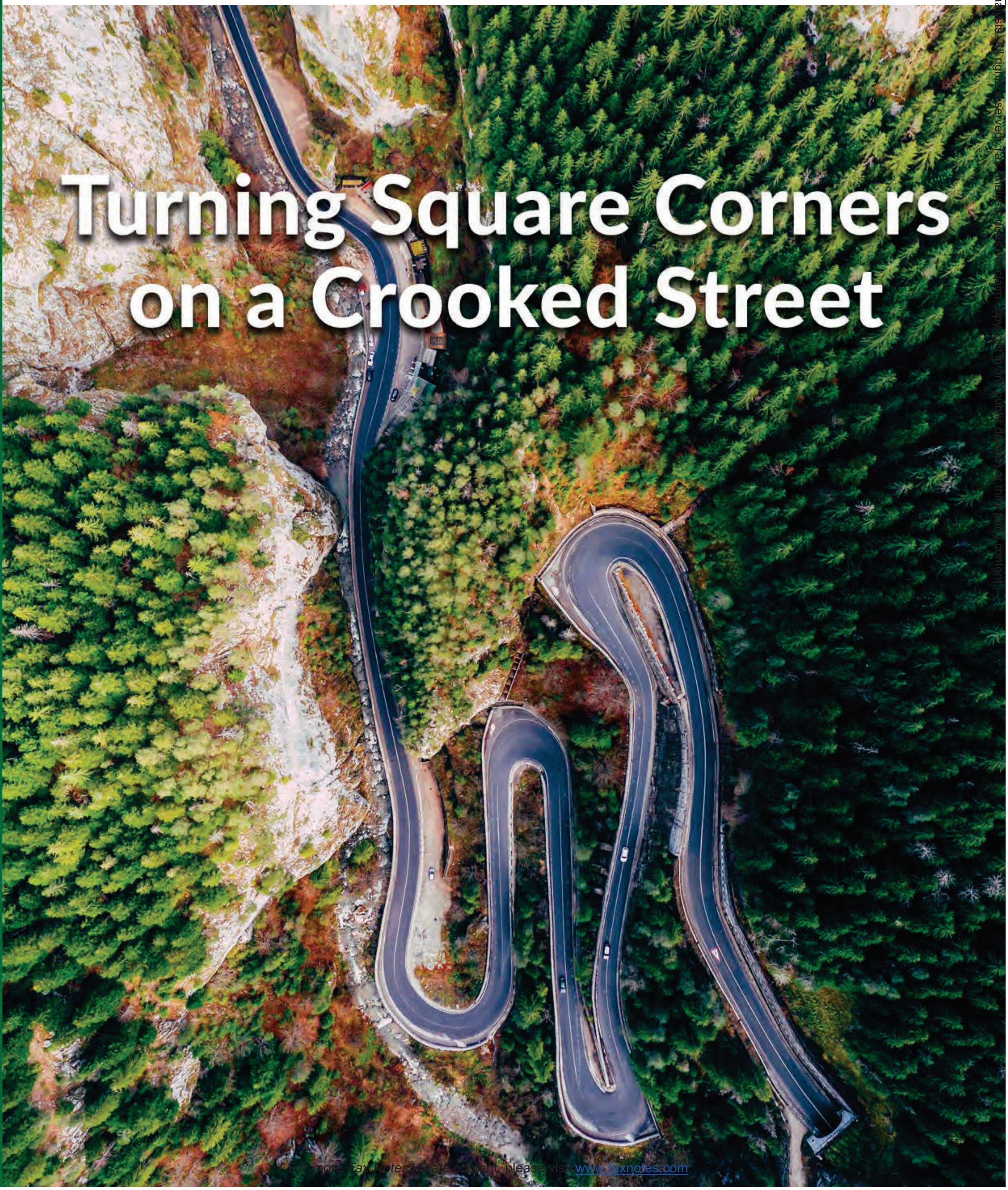
Volume 111, Number 8 ■ February 19, 2024

Turning Square Corners on a Crooked Street

by David Uri Ben Carmel

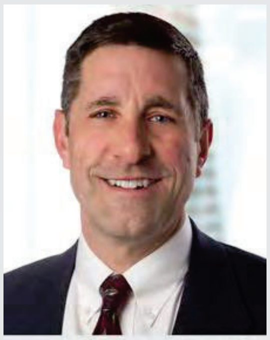
Reprinted from *Tax Notes State*, February 19, 2024, p. 547

taxnotes®
state
Volume 111, Number 8 ■ February 19, 2024



Turning Square Corners on a Crooked Street

by David Uri Ben Carmel



David Uri Ben Carmel

David Uri Ben Carmel is the principal of 349 East Multistate Tax Planning LLC (www.349east.com). Previously, he was the partner in charge of state and local taxation at two international law firms and was the chair of the American Bar Association State Tax Committee's Income and Franchise Taxes Subcommittee.

In this article, Ben Carmel continues the theme of seeking non-litigated resolutions to tax disputes, a subject that he has addressed in two previously published pieces.

"Men must turn square corners when they deal with the Government."

—Justice Oliver Wendell Holmes Jr.[1]

Some years ago, I assisted a client's accountants in the preparation of a state tax filing. The problem: a "gotcha" question on a required form. Analysis demonstrated that the question had no basis in the jurisdiction's law nor was it justified under the administrative body's enabling authority. But there it was.

This was neither the first nor the last time that I have encountered such an issue. Other examples (among quite a few) include department of revenue bulletins (or unpublished internal guidance) purporting to describe a binding interpretation of the law or prescribe an administrative policy without complying with the jurisdiction's Administrative Procedures Act; errant form instructions that are unsupported by or actually conflict with state law; and flawed audit notices naming another business even as the jurisdiction's representatives pressured my client demanding a "response" before a statute of limitations closes.

This listing of occurrences is not exhaustive. Nevertheless, a common thread is what to advise a law-abiding taxpayer confronting a tax compliance or tax planning issue created by an administrative action that does not follow the jurisdiction's laws. The ubiquity and power of the administrative state means that this issue extends far beyond subnational taxation to the many areas of life administered by agencies of the federal and subnational governments.

Court Chastised Administrative Agency

For multistate tax practitioners, consideration of relevant U.S. Supreme Court decisions is an appropriate starting point for understanding how to respond to governmental overreach. Fortunately, one need not look far, as in 2021 the Court clearly expressed its view of that government conduct.[2]

Niz-Chavez involved the federal government's notice practices relating to the removal of nonpermanent resident aliens from the United States. Under federal law, a nonpermanent resident alien may be eligible for relief from removal upon demonstrating continuous presence in the United States for at least 10 years. However, the period of continuous presence is "deemed to end . . . when the alien is served a

[1] *Rock Island, Arkansas & Louisiana R.R. Co. v. United States*, 254 U.S. 141, 143 (1920).

[2] *Niz-Chavez v. Garland*, 593 U.S. 155 (preliminary print), 141 S. Ct. 1474 (2021).

notice to appear" in a removal proceeding.[3] Federal law specifies the information that must be included in the notice. At issue was whether the requirement of *a* notice is satisfied when the government issues multiple notices, each of which contains a component of the information required by the notice law.

In a 6-3 decision cutting across ideological lines,[4] the Court rejected the government's position that multiple incomplete notices satisfy a statutory requirement that it provide *a* notice. Moreover, the Court expressed no sympathy for the government and, at times, seemed to mock its position. Here, for example, is the opinion's opening paragraph:

> Anyone who has applied for a passport, filed for Social Security benefits, or sought a license understands the government's affinity for forms. Make a mistake or skip a page? Go back and try again, sometimes with a penalty for the trouble. But it turns out the federal government finds some of its forms frustrating too. The Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (IIRIRA), 110 Stat. 3009-546, requires the government to serve "a notice to appear" on individuals it wishes to remove from this country. At first blush, a notice to appear might seem to be just that — a single document containing all the information an individual needs to know about his removal hearing. But, the government says, supplying so much information in a single form is too taxing. It needs more flexibility, allowing its officials to provide information in separate mailings (as many as they wish) over time (as long as they find convenient). The question for us is whether the law Congress adopted tolerates the government's preferred practice.[5]

Life never got better for the government. In the balance of the opinion, the Court launched the following broadsides:

- "To trigger the stop-time rule, the government must serve 'a' notice containing all the information Congress has specified. To an ordinary reader — both in 1996 and today — 'a' notice would seem to suggest just that: 'a' single document containing the required information, not a mishmash of pieces with some assembly required."[6]
- "Someone who agrees to buy 'a car' would hardly expect to receive the chassis today, wheels next week, and an engine to follow."[7]
- "Ultimately, the government is forced to abandon any pretense of interpreting the statute's terms and retreat to policy arguments and pleas for deference. The government admits that producing compliant notices has proved taxing over time."[8]
- "Beyond all that, the government stresses, its own (current) regulations authorize its practice. The dissent expands on all these points at length. But as this Court has long made plain, pleas of administrative inconvenience and self-serving regulations never 'justify departing from the statute's clear text.'"[9]
- "Besides, even viewed in isolation the government's policy arguments are hardly unassailable. If the government finds filling out forms a chore, it has good company. The world is awash in forms, and rarely do agencies afford individuals the same latitude in completing them that the government seeks for itself today."[10]

[3] 8 U.S.C. section 1229b(d)(1).

[4] Justice Neil M. Gorsuch delivered the Court's opinion, which was joined by Justices Clarence Thomas, Stephen G. Breyer, Sonia Sotomayer, Elena Kagan, and Amy Coney Barrett.

[5] *Niz-Chavez*, 593 U.S. at 157-158.

[6] *Id.* at 161.

[7] *Id.* at 162.

[8] *Id.* at 165.

[9] *Id.* at 169 (internal citations omitted).

[10] *Id.* at 169.

The Court concluded with a paragraph that subnational tax administrators should take to heart:

> At one level, today's dispute may seem semantic, focused on a single word, a small one at that. *But words are how the law constrains power.* In this case, the law's terms ensure that, when the federal government seeks a procedural advantage against an individual, it will at least supply him with a single and reasonably comprehensive statement of the nature of the proceedings against him. *If men must turn square corners when they deal with the government, it cannot be too much to expect the government to turn square corners when it deals with them.*[11]

Surprisingly, in the two and a half years after *Niz-Chavez* was decided, it appears to have been cited in only two subnational tax cases or administrative decisions. Also, in items reported by *Tax Notes State*, *Niz-Chavez* was cited in only one petition to a court and has not been discussed in any articles. While other factors might be at work, the lack of citations raises the possibility that *Niz-Chavez* is being under-used by state tax practitioners.

One cannot know how often the case was cited in briefs or communications with state departments of revenue. Nevertheless, the near-invisibility of *Niz-Chavez* in the state and local tax world contrasts with the numerous citations to *Kisor*.[12] *Kisor*, like *Niz-Chavez*, was a nontax case involving federal agency powers. (*Kisor* involved deference to agency interpretations.) In the two and a half years after the Court decided *Kisor*, it was cited in no fewer than five subnational tax cases and administrative decisions. It was also cited in no fewer than seven briefs or petitions reported in these pages and in four *Tax Notes State* articles.[13]

Decisions Demonstrate 'Square Corners' Challenges

Minnesota and California rulings provide excellent platforms for demonstrating the type of challenges addressed here. The first decision was issued by the Minnesota Supreme Court.[14] *Cities Management* is an income tax case involving an S corporation, a nonresident shareholder, an election to treat the sale of stock as an asset sale under IRC section 338(h)(10), and Minnesota law relating to such federal elections. Substantively, multistate tax planning involving sales of passthrough entities by shareholders one or more levels removed from the sold entity may be complex, as are the multistate income tax consequences of IRC section 338(h)(10) elections. When a proposed sale involves both areas of state income taxation, taxpayers and practitioners are well-advised to carefully examine — and reexamine — the relevant jurisdiction's statutes, regulations, case law, and published guidance to identify a proper treatment of the sale.

In *Cities Management*, the parties disputed the treatment of the gain of a 2015 sale of an S corporation's goodwill.[15] Understandably, the tax advisers in *Cities Management* relied on a 2006 Minnesota Tax Court decision involving Minnesota income taxation of goodwill when sold in a transaction qualifying for IRC section 338(h)(10).[16] In *Nadler*, the tax court determined that a sale of goodwill constituted nonbusiness income. The Department of Revenue did not appeal *Nadler*.

In *Cities Management*, the Minnesota Supreme Court succinctly described the *Nadler*-related occurrences in the case before it:

> Based on *Nadler*, the public accounting firm advised [the S corporation and one of its shareholders] that gain on the portion of sale proceeds considered [the S corporation's] goodwill would be taxed under Minn. Stat. section 290.17, subd.

[11] *Id.* at 172 (emphasis added).

[12] *Kisor v. Wilkie*, No. 18-15, 588 U.S. ___, 139 S. Ct. 2400 (2019).

[13] An aside: A version of the deference issue is again before the U.S. Supreme Court in *Loper Bright Enterprises v. Raimondo,* No. 22-451 (2023), and *Relentless Inc. v. Department of Commerce*, No. 22-1219, which were argued in tandem on January 17. The eventual decision in those cases is certain to generate much discussion among state tax practitioners.

[14] *Cities Management Inc. v. Commissioner of Revenue*, A23-0222 (Minn. Nov. 22, 2023).

[15] The remainder of the S corporation was also sold, but only the treatment of the goodwill was at issue before the Minnesota Supreme Court.

[16] *Nadler v. Commissioner of Revenue*, No. 7736R (Minn. T.C. Apr. 21, 2006).

> 2(c). This provision directs that gain on the sale of goodwill "that is connected with a business operating all or partially in Minnesota is allocated to this state to the extent that the income from the business in the year preceding the year of sale was assignable to Minnesota under subdivision 3."
>
> [The S corporation's shareholders] agreed to make a federal section 338(h)(10) election as part of the sale. . . . In preparing [the S corporation's] 2015 Minnesota tax return, [its] accountants again followed and relied on *Nadler*, characterizing the gain on the sale of [the S corporation's] goodwill as income "not derived from the conduct of a trade or business," Minn. Stat. section 290.17, subd. 2, and assigned the income from the sale of [the] goodwill to Minnesota in accordance with subdivision 2(c).
>
> Unbeknownst to [the S corporation, the shareholder, or their accountants], the (Minnesota) Department of Revenue had internally taken the position that it "[did] not acquiesce" to the tax court's decision in *Nadler*. Minn. Dep't of Revenue, Technical Advice Memorandum (May 4, 2007). As early as 2007, the Department was circulating non-public *internal* technical advice memoranda and other documents in which it informed auditors that the Department would not follow the tax court's reasoning in *Nadler*. The Commissioner did not make the Department's disagreement with the tax court's decision public until July 2017, when [Minn. Dep't of Revenue Notice No. 17-02 (July 3, 2017)] was issued.[17]

The DOR audited the S corporation and its shareholders. Based on the department's rejection of *Nadler*, it assessed taxes, interest, and penalties.

This article will not critique the substantive merits of the DOR's interpretation, nor will it address whether the tax court's decision in *Nadler* should have been treated as binding on the department. Rather, the starting point for the analysis here is the state supreme court's statement that:

> We are troubled by the Commissioner's conduct that this case has brought to light. Rather than appealing the tax court's interpretation of tax law with which the Department disagreed, the Commissioner decided internally — apparently without notice to the public — that the Department would "not acquiesce" to the tax court's interpretation of the law. We fear that such actions do little to inspire the trust and confidence of taxpayers in Minnesota's tax system. *See Mauer v. Comm'r of Revenue*, 829 N.W.2d 59, 76 n.2 (Minn. 2013) ("For taxpayers to have trust and confidence that Minnesota's tax system is fairly and equitably applied to all, it is vitally important that taxpayers be able to understand the Department's [position]. . . . Such an understanding is important so that taxpayers can adjust their expectations, intentions, and actions accordingly.").[18]

That statement notwithstanding, the state supreme court decided in favor of the commissioner.

Nevertheless, the court included a footnote acknowledging what it characterized as the dissent's "frustration" with the commissioner's conduct. Actually, the dissent was beyond frustrated — classifying the conduct as "outrageous" and wanting to saddle the commissioner with the consequences. The dissent wrote that:

> The actions of the Commissioner of Revenue here — namely, the decision to disregard the tax court's interpretation of a

[17] *Cities Management*, A23-0222 at 4-5 (emphasis in original).

[18] *Id.* at 9-10. The Minnesota Supreme Court could have included a reference to the U.S. Supreme Court's 2012 decision in *FCC v. Fox Television Station Inc.*, 567 U.S. 239, 253 (2012), stating that: "A fundamental principle of our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required." The Minnesota court might then have adopted or distinguished the reasoning of the case, as occurred in the January 24, 2024, decision of the South Carolina Court of Appeals in *Amazon Services LLC v. South Carolina Department of Revenue*, No. 2019-001706, Op. 6047, at 18 (S.C. Ct. App. 2020) (distinguishing the case and its due process analysis from the circumstances presented by Amazon). The dissent cited two Minnesota cases addressing fairness and due process, but not *Fox Television*.

> statute and adopt the Commissioner's own interpretation without notice to the public — raise serious concerns about the fundamental fairness of the underlying audit that led to this appeal. . . .
>
> At no point during any of these events were [the shareholder] and her tax advisors aware that the Commissioner had rejected the tax court's interpretation of section 290.17 in the *Nadler* opinion. As the record produced during discovery demonstrates, the Commissioner decided within a year of the tax court's issuance of *Nadler* that the Department of Revenue would not accept the tax court's interpretation of section 290.17. For instance, a technical advice memorandum dated May 4, 2007, noted that "the Department of Revenue decided not to appeal the Tax Court decision in *Nadler v. Comm'r of Revenue* . . . but does not acquiesce to that decision regarding the treatment of goodwill under Minn. Stat. section 290.17 in that case." Other documents lay out the Department's instructions to its employees to apply the Commissioner's own interpretation of section 290.17 rather than the *Nadler* interpretation of the statute.[19]

At this point, the dissent minced no words in attacking the commissioner's conduct:

> But what is perhaps most troubling about this conduct is the Commissioner's lack of transparency. For more than 10 years after the *Nadler* opinion was issued, the Commissioner did not make public the Department of Revenue's position on the interpretation of section 290.17. Public notice of the Commissioner's disagreement was not provided until July 2017 when the Department issued Revenue Notice 17-02. In this revenue notice, the Commissioner publicly advised taxpayers for the first time that "the department does not administer the income allocation provisions in [section 290.17] using the Minnesota Tax Court's reasoning in *Nadler v. Commissioner*." Minn. Dep't of Revenue Notice No. 17-02 (July 3, 2017).
>
> This [2017] revenue notice was, of course, no use to [the S corporation]; the business was sold and the 2015 tax return was filed relying on *Nadler* before the Commissioner issued the revenue notice. The Department itself acknowledged the basic unfairness of this situation when [the S corporation] administratively appealed the audit. In removing the substantial understatement penalty initially assessed against [the S corporation], the Department noted that [the S corporation] "reasonably relied on *Nadler* and the Department had issued no written guidance until 2017 (Revenue Notice 17-02) disputing the *Nadler* decision" . . .
>
> Given the outrageous conduct of the Commissioner, I would instead announce an equitable rule that the Commissioner is bound by tax court decisions that are not appealed unless the Department of Revenue provides public notice of its disagreement with the tax court opinion.[20]

The commissioner's concealment of its non-acquiescence to *Nadler* was an egregious error. And punishing taxpayers who *the commissioner admits acted reasonably* in following *Nadler* was, as the dissent observed, outrageous.

Obviously, no one should receive the treatment meted out to the taxpayers in *Cities Management*. "No one" includes the commissioner and DOR employees who, as much as the rest of us, are unavoidably exposed to that treatment by the innumerable agencies at all levels of government with which they and we interact. Fortunately, this type of conduct is atypical of departments of revenue.[21]

[19] *Cities Management*, A23-0222 at D-1 and D-2.

[20] *Cities Management*, A23-0222 at D-2 and D-3.

[21] In my years of practice, I can recall only two circumstances rivaling what transpired in Minnesota. In the first, a long-time employee of a state revenue department lost track of his role of honestly and fairly administering the state's income tax and was called to account by a court. In the second, bureaucratic barriers, an incredible amount of turnover among revenue department employees, and a federal investigation of the agency made concluding a matter impossible. With those exceptions, I have found that the departments will cooperate in a sincere effort to avoid a patently unjust result.

Much more common is a revenue agency failing to follow the jurisdiction's APA. Throughout the country, state APAs protect constituents by requiring administrative agencies to comply with processes before adopting or revising regulations. These processes increase transparency and, if outside comments are received, can improve the regulations ultimately adopted.

Departments of revenue sometimes make legal interpretations of broad applicability without complying with requirements of the jurisdiction's APA. They do so at their peril and at the expense of all who have no choice but to rely on their administrative probity. A California superior court's December 2023 decision in *American Catalog* provides an example.[22]

American Catalog involved the Franchise Tax Board's published interpretations of how federal Public Law 86-272 (15 U.S.C. sections 381-384) applies to "the current economy due to technological advancement."[23] The FTB asserted that posting the guidance on its website provided taxpayers with transparency and "access to information that taxpayers may find helpful in determining whether and how to file a California tax return."[24]

The FTB's assertion was relevant only if the guidance is not a regulation within the meaning of the state's APA (Cal. Gov't Code sections 11340-11361). However, if the guidance is a regulation within the meaning of California's APA, the FTB's mere posting of the effective versions of the guidance on its website would fail to satisfy the APA requirements.

California's APA defines regulation as "every rule, regulation, order, or standard of general application . . . adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure."[25] The court further observed that "absent an express exception, the APA applies to all generally applicable interpretations of a statute. . . . Indeed, a regulation subject to the APA may exist even if the agency never promulgates a written policy setting forth the rule at all."[26]

The court concluded that the "TAM and Publication 1050 [that is, the guidance] was a regulation within the meaning of the APA. As the FTB concedes, neither was enacted in compliance with the APA's requirements. As a result, the TAM and Publication are void."[27]

Resolving Square-Corners Issues Without Litigating

Each of the above examples involves litigation, and for good reason: There is no place to look for issues that were quietly resolved without involving a tax authority. However, these silent resolutions are the truly successful responses to square-corners issues.[28] Therefore, bearing in mind that litigation is always an option, it is the quiet internal resolutions that are the primary subject of the remainder of this article.

In seeking a quiet resolution, the following points are essential:

1. **Never lie or evade.** In a perfect world, this would always be obvious to all taxpayers and practitioners. However, the combination of an improper requirement, a belief that one will not get caught, rationalization, and general temptation can make these appear to be plausible options. They are not.[29]
2. **Avoid a conflict with the government to the extent possible.** Maintaining taxpayer

[22] *American Catalog Mailers Association v. Franchise Tax Board*, No. CGC-22-601363 (Cal. Super. Ct. Dec. 13, 2023).

[23] FTB TAM 2022-01 (Feb. 14, 2022) and FTB Publication 1050 ("Application and Interpretation of P.L. 86-272" (rev. May 2022)) (jointly referred to as the "guidance").

[24] *American Catalog*, No. CGC-22-601373 at 8.

[25] Cal. Gov't Code section 11342.600.

[26] *American Catalog*, No. CGC-22-601373 at 9 (citations omitted).

[27] *Id.* at 11.

[28] A contrary conclusion — viz, that the repeated citations to case law demonstrate that litigation is necessary to resolve these issues — is an example of survivorship bias. Brittanica.com defines survivorship bias as "a logical error in which attention is paid only to those entities that have passed through (or 'survived') a selective filter, which often leads to incorrect conclusions." Here, litigated matters are the survivors that provide us with useful examples, while every quiet resolution is unknown except to the few involved. Every taxpayer would prefer to resolve its square-corners problem quietly.

[29] As a junior associate I was part of a team of lawyers participating in a trial-level proceeding. During a break, an adult son was hinting to his father to lie on the witness stand. Both were tall men, and the image burned into my brain is of lead counsel — a much shorter man — jumping up and down between them waving his arms and stating very assertively, "No! No! No!"

anonymity for as long as possible is essential to avoiding such a conflict.

3. **Hope is not a strategy.** Therefore, place little confidence in making full disclosure and thereby receiving the goodwill and, for lack of a better word, mercy of government officials. Solving problems requires understanding the law and circumstances, then measuring the taxpayer's facts against that understanding. Whether to communicate the understanding to the relevant department of revenue is a late-stage consideration. On a related note, connections and local desks might ease access to government officials (which is usually available anyway), but access does not solve problems.
4. **Experience proves that compliance with an off-kilter administrative "requirement" may be accomplished without making harmful disclosures or concessions.** Accomplishing this requires an understanding of the jurisdiction's laws, legislative history, regulations, relevant publications, and the circumstances surrounding the asserted requirement. Further, it is often necessary to analyze this information as it existed in periods preceding the one at issue. Of particular interest is whether the jurisdiction made a relevant change to its laws before a new administrative interpretation or requirement was issued. If the law remained unchanged, there is an increased probability that the administrative revision is unauthorized. This step can involve a lot of work, but this is where outside tax practitioners add the greatest value. Success here requires tenacity, creativity, careful reading, and researching source materials that might be decades-old. Obviously, the amount at issue will guide how much digging is appropriate.
5. **If a satisfactory quiet resolution is identified, the supporting analysis should be documented in a privileged communication and retained by the taxpayer.**
6. **If, after working through the steps above, no quiet resolution has been identified, the taxpayer should consider again whether compliance with the new interpretation or requirement reaches an unacceptable result.** If the result is reconfirmed to be unacceptable, the company tax director can confidently report to senior management the efforts made to resolve the issue and advise that a direct challenge should be considered.

Concluding Thoughts

Tax minimization is a proper objective for every taxpayer and typically involves entity-structuring, transaction-planning, and other proactive measures. These can be accomplished with a degree of attention to right-angles that would do Justice Holmes proud.

However, when a tax authority paves a winding path, taxpayers must respond accordingly. The best results in these circumstances are achieved when a taxpayer quietly reconciles the new interpretation or requirement with what the law requires. Even if that "best" result is not possible, the effort might still yield a good quiet result. If that too is not possible, the tax director can report the efforts made to management. Management — with input from an outside expert — can then decide whether to pursue a more open, more confrontational stance. ■

Section III

taxnotes® state

Volume 105, Number 6 ■ August 8, 2022

Tax Planning Catastrophes

by David Uri Ben Carmel

Reprinted from *Tax Notes State*, August 8, 2022, p. 601

Tax Planning Catastrophes

by David Uri Ben Carmel

David Uri Ben Carmel

David Uri Ben Carmel is the principal of 349 East Multistate Tax Planning LLC (www.349east.com). Previously, he was the partner in charge of state and local taxation at two international law firms and was a special deputy attorney general to Hawaii.

In this article, Ben Carmel explores two recent state decisions — one from Alabama and one from Washington — in which tax planning did not go well.

"Happy families are all alike; each unhappy family is unhappy in its own way."

— Leo Tolstoy, *Anna Karenina*

Tax planning has much in common with Tolstoy's observation, albeit not quite so extreme in its possibilities. That is, there is more than one way to plan a structure or transaction well. And there are some problems that regularly occur when planning does not go well. Two recent decisions provide insights into some ways that planning does not go well.

In *Greenetrack*,[1] tax planning blew up spectacularly: The court held that taxpayer owed $76 million in use taxes, uncollected sales taxes, and interest for 2004-2008 — with any assessments for 2009 and later periods not a part of this dispute. Apparently, penalties were not assessed for 2004-2008 even though the planning caused the state supreme court to describe the taxpayer as making a "willful attempt to circumvent the law," having an "adherence to a legal position that was always dubious,"[2] making "a transparent attempt to evade" restrictions in the law, and using a "contrived fee structure."[3]

In *Greenetrack*, a 1975 state law (racing act) permitted a county racing commission to license pari-mutuel betting within the county on live and simulcast dog and horse races. Since 1995, the taxpayer has been the sole licensee in its county. Under its license, the taxpayer was subject to fees and a 4 percent tax on a pari-mutuel betting base amount. Those fees and tax were "in lieu of all otherwise applicable license, excise, and occupation taxes to the state of Alabama, or any county, city, or other political subdivision thereof."[4] The most important of these otherwise applicable taxes were sales taxes on its admission fees and use taxes on its purchases.

Separately, a 2003 state law — the Nonprofit Bingo Act — permitted nonprofit organizations in the county to operate bingo games. The taxpayer was ineligible to operate legal bingo games because it was not a nonprofit organization. The taxpayer was undeterred and made arrangements with schools, school clubs (for example, math teams, band booster clubs, Future Homemakers of America), and other organizations under which the school or club would "operate" a day of bingo at the taxpayer's

[1] *Alabama Department of Revenue v. Greenetrack Inc.*, No. 1200841, slip op. (Ala. Sup. Ct. June 30, 2022).

[2] *Id.* at 32.

[3] *Id.* at 43.

[4] Ala. Code section 45-32-150.15.

facility in exchange for a license fee of approximately $5,000. The taxpayer actually operated the games and "leased" its facility, employees, and equipment to the organization for the entirety of the gross receipts remaining after the approximately $5,000 payment. The taxpayer struck gold: In 2007 alone, it netted nearly $69 million on electronic bingo, while paying the nonprofit organizations some $1.77 million.

The taxpayer maintained that the racing act exempted its purchases of bingo equipment from use tax, and that because the bingo games were operated by the nonprofit organizations, the state's sales tax on amusements did not apply. The state supreme court's answers to those contentions were: (i) no, and (ii) no.

Regarding the use tax exemption argument, the court concluded that the exemption was limited to taxable items needed to operate the racing pari-mutuel gambling function. The court rejected the taxpayer's argument that the racing act's "in lieu of" exemption applied to the taxpayer as an entity, so that no use tax would be due on any of its activities. The court stated: "When we view section 45-32-150.15 in light of the rest of the act of which it is a part, the untenability of Greenetrack's reading becomes clear. From beginning to end, the racing act is concerned with one thing: pari-mutuel wagering on dog racing in Greene County."[5]

The court further stated that:

> Greenetrack's understanding of the exemption would lead to an absurd and unjust result. Under Greenetrack's theory, *any* business that secured a racing license from the Commission — a grocery store, a car dealership, a Walmart store — would be exempt from any and all license, excise, and occupational taxes except a modest license fee, a 4 percent tax on the handle, and a small tax on admissions to its racetrack.[6]

Thereafter, the taxpayer argued that the court's use tax holding should have effect prospectively only. The court applied a three-factor test[7] and used sharp language in rejecting the taxpayer's request, writing: "Greenetrack's bingo operations clearly evince a willful attempt to circumvent the law. The inequity of rewarding Greenetrack for its adherence to a legal position that was always dubious at best would far exceed any unfairness in requiring it to pay taxes the Department rightly assessed."[8]

The court then moved from the use tax issue to the question whether Greenetrack's gross receipts from its bingo operations were subject to sales tax. Unfortunately for the taxpayer, in the proceedings below it made a blanket denial that the taxes were owed but did not introduce any evidence supporting its position. Instead, the taxpayer asserted that it could wait to present that evidence. The court rejected this position: "Put simply, Greenetrack's view that it could wait to make an argument addressing [the Nonprofit Bingo Act exemption] is mistaken."[9]

This sealed Greenetrack's fate. The court stated that:

> As a for-profit corporation, Greenetrack had no way to operate legal bingo games under [the Nonprofit Bingo Act]. The "lease" system between it and the nonprofit organizations was a transparent attempt to evade that restraint. For the low cost of $4,850 a day, Greenetrack was able to use the nonprofit organizations' licenses as a fig

---

[5] *Greenetrack*, slip op. at 23.

[6] *Id.* at 27 (emphasis in original).

[7] The three-factor retroactivity test was from the Alabama Supreme Court decision in *McCullar v. Universal Underwriters Life*, 687 So. 2d 156, 165 (1996):

> First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied . . . or by deciding an issue of first impression whose resolution was not clearly foreshadowed. Second, it has been stressed that "we must weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation." Finally, we have weighed the inequity imposed by retroactive application, for "where a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the 'injustice or hardship' by a holding of nonretroactivity." [Quoting *Chevron Oil Co.* v. Huson, 404 U.S. 97, 106-107 (1971) (internal citations omitted).].

[8] *Id.* at 32.

[9] *Id.* at 38.

leaf for its own illegal — but extremely profitable — bingo activities.[10]

Finally, the court concluded that winnings that were not converted into cash by bingo players but simply retained as credits and used for continued playing were fully includable in the taxpayer's taxable receipts.[11]

Case observations:

1. The decision highlights the differing risks attendant to specific taxes. Here, the taxpayer sought to extend a use tax exemption from one activity to all its activities. The rejection of that attempt seems merely to have delayed the imposition of use taxes that otherwise would have been due. Apart from interest charges, there appears to have been no financial downside to the attempt. In contrast, in attempting to qualify under the Nonprofit Bingo Act, the taxpayer apparently could find no justification for collecting from its customers Alabama's 4 percent sales tax on amusements. As demonstrated here, sales tax planning can carry a great risk; namely, the possibility that the business will be required to pay taxes that it could have but did not collect from its customers. Interest charges on an assessment (almost always non-waivable) add insult to that injury, and in circumstances involving a large shortfall in remittances, penalties generally will be imposed.

2. As bad as this decision is for the taxpayer, matters could have been worse. First, it is not clear why penalties were not imposed. While this is not the place for a detailed analysis of Alabama's array of sales and use tax penalties (which can be as high as 50 percent of the unpaid tax), it is an opportune time to caution advisers and businesses that state departments of revenue regularly impose penalties in far less egregious circumstances (see below). Second, it is possible that the taxpayer's ultimate objective was simply to generate revenue from bingo rather than attempting to plan for taxes. One suspects that the Alabama attorney general's office must have already considered whether to seek disgorgement of the taxpayer's entire receipts (net of justifiable expenses) from the illegal bingo operation. If not, the supreme court's strong language might suggest this consideration to the attorney general's office.

An entirely different scenario is presented in *Jenson Online*,[12] a Washington Board of Tax Appeals decision that involved four businesses participating in Fulfillment by Amazon and Merchants@Amazon programs. These programs are used by small vendors seeking to access remote markets nationwide through Amazon's platform.

At issue for the businesses were sales, use, and business and occupation taxes from periods within 2010 through 2018 — during which the *Quill*[13] physical presence test was effective. As such, a vendor without a physical presence in a state could not be required to collect the state's use taxes.[14]

Each of the businesses provided inventory to Amazon, and it appears that inventory belonging to each was at some point stored by Amazon in its Washington warehouses. For each taxpayer there is a line in the decision to the effect that "The Department obtained copies of (the business's) Amazon Inventory Event Detail Reports."[15] The decision does not disclose the source of any of these reports. Nor does it disclose the volume, value of, duration, or frequency with which the businesses' inventory was in Washington, information essential to understanding the extent

[10] *Id.* at 43.

[11] A contrary Alabama DOR ruling, issued three years after the last of the periods at issue, was not binding on the court, and the court expressly disagreed with its analysis. *Id.* at 50.

[12] *Jenson Online Inc., S&F Corp., Blue Bargain Inc., Orthotic Shop Inc v. State of Washington Department of Revenue*, Wash. Board of Tax Appeals, Dkt. Nos. 19-033, 19-063, 19-066, and 20-136 (Mar. 30, 2022).

[13] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[14] The physical presence requirement was changed by *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018). *Wayfair*'s retroactive application has been widely discussed but was not at issue in the Washington cases.

[15] *See* Findings of Fact 11, 14, 18, and 24.

of each business's presence.[16] The decision also does not indicate whether these businesses could choose where to store inventory or where inventory must not be stored.[17]

The businesses raised many objections to their alleged tax liability, including that Amazon and its affiliates had structured their operations to isolate members of its group from tax exposure on the businesses' sales and that the state was favoring Amazon and affiliates by not treating any of them as jointly liable (with the four businesses) for the uncollected use taxes. The board briefly addressed and dismissed those arguments.

For these smaller businesses, having to pay six figures in uncollected taxes (that is, taxes that they need not pay out of their own resources) and 30 to 35 percent in interest and penalties had to be exceptionally painful. Further, the businesses' apparent misapprehension regarding the consequences of having in-state inventory — which just a few years earlier might not have provoked a tax assessment — might result in painful consequences in other states as well.

Case observations:

1. Orthotic Shop Inc. and S&F Corporation jointly appealed the decision of the Board of Tax Appeals.[18]

2. The department might have been overconfident in arguing that the businesses' due process claims were "[30] years out of date" (that is, because *Quill* rejected arguably comparable claims in 1992 in analyzing tax presence under the U.S. Constitution's due process clause (14th Amendment, section 1)). *Jenson Online* at 17. In fact, seven months *before* oral argument in these cases, Justice Elena Kagan (writing for the majority), Justice Samuel Alito (concurring), and Justices Neil M. Gorsuch and Clarence Thomas (concurring separately) all indicated concern that World War II era personal jurisdiction principles might not apply to e-commerce. Thus, contrary to the department's assertion, these businesses' (or other similarly situated businesses') due process arguments might not be 30 years late but precisely on time for a challenge to their alleged personal jurisdiction in the state of Washington.[19]

3. The substance-over-form concept that is so familiar in an income tax context tends to be much less important in sales and use tax contexts. Still, there are sales and use tax cases nationwide in which entity lines have been crossed with the result that an entity has been treated as acting as an agent or surrogate for its affiliates. These circumstances tend to involve tax presence and the establishment of a market within a state, but in concept they also might be significant in addressing the consequences of separating a business's operations into separate but interdependent entities. Notably, there are instances in which variants of the unitary business principle have been applied to non-income taxes.[20]

4. Notwithstanding the observations above, it seems that the four businesses in the board's decision were lulled into thinking that sales and use tax presence —

---

[16]For *Blue Bargain Inc.* and *S&F Corp.*, the board made the vague statement that the companies had "a stock of goods in warehouses in Washington throughout the audit period" (Findings of Fact 15 and 19). For the other two businesses, the board could not make even those vague representations.

[17]In *Geoffrey Inc. v. South Carolina Tax Commission,* 313 S.C. 15 (1993), the state supreme court held as significant in finding income tax presence a trademark owner's unexercised ability to limit the states in which the trademarks were used (in that case, by an affiliate). This treatment is controversial, and in a much more recent case involving nonaffiliates, the unexercised ability to limit this use did not cause a remote entity to be treated as having personal jurisdiction (or tax presence) in Louisiana. *Robinson v. Jeopardy Productions Inc.,* 2019 CA 1095 (La. Ct. App. 1st Cir. 2020), *writ denied*, 308 So. 3d 1166 (2021). Applying these concepts to the Washington cases, if these four businesses could not control where and when Amazon moved their merchandise, it is difficult to accept as correct a tax presence decision that places weight on where the merchandise is located apart from the jurisdiction to which the goods were originally shipped.

[18]*Orthotic Shop Inc. and S&F Corp. vs. Washington Department of Revenue*, Pet. For Jud. Review Sup. Ct. Thurston County (Apr. 28, 2022).

[19]For more on this, see Ben Carmel, "After *Ford*: Personal Jurisdiction for E-Commerce Vendors," *Tax Notes State*, Apr. 26, 2021, p. 397.

[20]*See, e.g., DTCT Inc. v. City of Chicago Department of Revenue*, 407 Ill. App. 3d 945 (Ill. App. Ct. 2011) (involving Chicago's employers expense tax (aka, the head tax)) and *Reynolds Metals Company LLC v. Michigan Department of Treasury*, Dkt. No. 30001 (Mich. Ct. App. Mar. 20, 2012) (unpublished) (involving Michigan's single business tax and stating that: "While the unitary business principle is frequently applied to test the constitutionality of the apportionment of income-based taxes, no case has held that the unitary business principle is only applicable to income-based taxes; nor would such a holding reasonably follow from the line of cases applying the unitary business principle.").

and a responsibility to collect taxes — is limited to "where we are based and maintain a physical presence."[21] This has never been correct.[22] Also, it appears from testimony at the hearing that the businesses' executives did not believe that the presence of inventory in a warehouse could create tax presence. A belief in a general rule of this sort, if that belief existed, was incorrect. And it seems unlikely that a state tax expert would have provided that general guidance. In the end, even if the businesses succeed on appeal, acting based on those mistaken beliefs will have proved costly.

Conclusion

All five of the businesses in these decisions learned lessons that often are relearned when tax planning fails. First, when businesses do not collect taxes from customers, they risk creating exposures that are both large and unnecessary. Therefore, a decision not to collect a transaction tax must be carefully considered and reconsidered, and an experienced state tax adviser often can recommend adjustments to activities, descriptions, or other circumstances to reduce the risk to the vendor. Second, reliance on industry practices or lay understandings can result in large liabilities going back many years and, potentially, in many states.

If a business believes that it might have under-collected or under-remitted taxes, a state tax professional should be able to suggest approaches to reducing the consequences of the mistake. These might include client-anonymous negotiations with state tax officials, voluntary disclosure agreements, tax amnesties, or other methods of resolving the problem. ■

[21] *See Jenson Online*, Findings of Fact 13, 16, 22, and 26.

[22] Certainly, it would be possible to string cite cases finding tax presence from contacts far less substantial than "where we are based and maintain a physical presence," but doing so would serve no purpose. Rather, for present purposes it should suffice to cite *Scripto Inc. v. Carson*, 362 U.S. 207 (1960), in which Florida tax presence was found from the in-state presence of independent contractors attempting to generate sales for Scripto — a company based in Georgia.

Section IV

taxnotes federal

Volume 175, Number 2 ■ April 11, 2022

Unknown Unknowns: State Tax Hazards In Transaction Planning

by David Uri Ben Carmel

Reprinted from *Tax Notes Federal*, April 11, 2022, p. 227

Unknown Unknowns: State Tax Hazards In Transaction Planning

by David Uri Ben Carmel


David Uri Ben Carmel

David Uri Ben Carmel is the principal of 349 East Multistate Tax Planning LLC (www.349east.com). Previously, he was the partner in charge of state and local taxation at two international law firms and was a special deputy attorney general to Hawaii.

In this article, Ben Carmel explores some of the problems entities might run into when not planning for state and local tax issues and how expert analysis in federal tax matters may be insufficient to plan for and reduce state and local liabilities.

"There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns — the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult one."

— U.S. Secretary of Defense Donald Rumsfeld[1]

Experience reveals that transactions may be well into their structuring before an adviser is asked to carefully analyze tax considerations. Notably, this careful analysis often is limited to federal tax issues, with advisers explicitly or implicitly accepting responsibility for identifying state tax issues. Thus, one too often hears a comment from a federal adviser that he will contact a state tax expert "if he spots any state tax issues."

Respectfully, that refrain has no place in tax planning, as state taxes are not merely federal taxes writ small. As is shown below, state and local landmines can be hidden in unexpected places.[2] Serious missteps can occur because of the omission of expert state tax issue spotting and follow-up analyses — missteps that cannot be justified with state tax expertise so widely available.

A Classic Income Tax Scenario

Fact pattern. A business has been operating in a jurisdiction for many years. The business sells its operating assets, resulting in significant gain. Payment will be received over several years, and the business's federal tax advisers and management accepted (did not elect out of) installment sale treatment under IRC section 453, allowing for the spreading of income taxes over those years. For state income tax purposes, these same advisers and decision-makers conclude that because the business is no longer actively conducting affairs in a jurisdiction, it should file a final tax return with that jurisdiction.

Expected result. By filing a final return in a state, the business's installment gains reported federally in later periods will not be subject to income tax in that state.

---

[1] Defense Department news briefing, Feb. 12, 2002 (accessed Mar. 1, 2022).

[2] The transactions and tax reporting discussed in this article resulted in adverse, apparently unexpected, state and local tax consequences and demonstrate the need to obtain expert state tax guidance when planning a transaction. However, the cited decisions do not describe the tax planning conducted by the parties. Thus, it is beyond the scope of this article to critique the planning that occurred in any instance, and no critique is intended or implied.

Actual result. By filing a final income tax return, the business accelerates the required reporting to the state of its installment income, causing it to owe income taxes in the state ahead of its federal reporting and, indeed, even before it receives the taxed payments.

The following are two recent instances of this scenario.

A. Gain on a Deemed Sale of Assets Under Section 338

In *Amarr*,[3] an S corporation operated throughout the United States. In November 2013 the S corporation and its shareholders entered into an agreement to sell all the S corporation's stock and to elect to treat the stock sale as an asset sale under section 338(h)(10). Payment was to occur in four annual installments, with the first installment being a fixed amount and the three subsequent installments being tied to growth in earnings before interest and taxes averaging at least 38.4 percent in the three years following the sale.

Under federal law, the 2013 stock sale and section 338(h)(10) election ended the S corporation's tax year. For that short period, the S corporation filed a California tax return that it marked as its final return. The California Franchise Tax Board audited the return and concluded that, because it was a final return, all the gain must be accelerated into that short period. The taxpayers paid the assessed tax and filed refund claims, which the FTB denied.

The California Office of Tax Appeals (OTA) sustained the FTB's denial of the refund claims. First, regarding the installment payment acceleration, the OTA cited Cal. Rev. and Tax Code section 24672(a), which state:

> Where a taxpayer reports income arising from the sale or other disposition of property as provided in this article, and the entire income therefrom has not been reported prior to the year that the taxpayer ceases to be subject to [California corporation franchise tax] or [California corporation income tax], the unreported income shall be included in the measure of the tax for the last year in which the taxpayer is subject to the [corporation franchise tax or corporation income tax].

The OTA rejected the taxpayers' claim that, although S corporation status was lost, the entity continued to exist as a C corporation. In doing so, the OTA cited Treasury reg. section 1.338(h)(10)-1(d)(4)(i) and stated that "when an IRC section 338(h)(10) election is made, the corporation is treated as if it sold its assets, liquidated, and ceased to exist." The OTA continued by referencing the well-known precept that "while a taxpayer is free to organize its affairs as it chooses, nevertheless, once having done so, it must accept the tax consequences of its choice, whether contemplated or not, and may not enjoy the benefit of some other route it might have chosen to follow but did not."[4] The OTA therefore agreed with the FTB that the entirety of the installment sale income had to be reported in the year that the S corporation ceased being subject to California's income and franchise taxes.[5]

B. Gain From Sale of Real Estate

1018 Morris Park[6] involved a taxpayer's liability for New York City's general corporation tax (GCT). The taxpayer was formed in 1993 and on that day purchased two parcels of real property in New York City. On November 17, 2009, it sold both of those parcels in an installment sale.[7] Two months later, on January 27, 2010, the taxpayer filed a GCT return for the period ending November 30, 2009, which it marked as its final return.

[3] *Matter of Amarr Co. and Amarr Co. (C SGNF)*, 2022-OTA-041P (Cal. OTA Dec. 9, 2021, *nonprecedential*).

[4] Notably, the company operated nationwide with more than 90 percent of its sales outside of California. Therefore, it might have income acceleration issues in other jurisdictions as well.

[5] This led to a disagreement between the parties over the proper measure of the taxpayers' income. While this aspect of the decision is beyond the scope of this article, it involved the proper valuation of the installment sale in the year that the S corporation ceased to be subject to California taxes because the amounts of the three later payments were contingent on future results.

[6] *Matter of 1018 Morris Park Realty Inc.*, TAT(E) 14-4 (GC) (N.Y.C. Tax App. Trib. Aug. 7, 2017).

[7] While the number of years over which the installments were to be paid is not disclosed in either *1018 Morris Park* or in the administrative law judge determination from which it was appealed, the decisions note that installment payments were still being received in 2015. *Matter of 1018 Morris Park Realty Inc.*, TAT(H) 14-4(GC) (Dec. 5, 2016).

The GCT return that was marked final reported the installment payment received in November 2009. This payment was 3 percent of the total installment payments to be received. The remaining 97 percent of the installment payments were to be made after the taxpayer terminated its New York City contacts and were not reported in later years as being subject to the GCT.

In November 2012 the New York City Department of Finance (DOF) assessed GCT against the taxpayer by taxing in tax year 2009 the other 97 percent of the installment gain. In 2013 the taxpayer filed an amended 2009 GCT return removing the "final" designation. In 2014 and 2015 the taxpayer had monthly deposits in an account in a bank located in the Bronx, but there is no indication that after 2009 it owned or leased property in New York City or maintained an office there. Moreover, despite the 2009 amended return and 2014 and 2015 bank activity, the taxpayer did not file GCT returns for 2010, 2011, or any later periods.

Administrative Code section 11-602.8(d) allows the commissioner of finance to disregard the taxpayer's method of accounting if that method results in an understatement of income subject to GCT. Moreover, state regulations applicable to the comparable state tax contain an example relating to a foreign corporation's gain on an installment sale and provides that, if the taxpayer concludes its New York activity in the year of an installment sale, all unreported gains on the sale must be accelerated into the year of the sale.[8] Further, the tribunal — citing letter rulings and other DOF guidance from the 1990s, 1980s, and 1970s — observed that "longstanding published statements of [DOF] policy also provide that the installment method of accounting should be disregarded when a corporation files a final return and ceases to do business in the City after selling its assets in an installment sale."

Finally, the taxpayer's assertion that its monthly bank deposits in 2014 and 2015 demonstrated that it was conducting business in the city in the years after the installment sale ran headlong into a DOF regulation stating precisely the opposite. That is, the regulation states that maintenance of cash balances with banks in New York City shall not cause a corporation to be deemed to be doing business there.[9] Therefore, without more, the deposits were insufficient to support the taxpayer's claim that it was conducting business in New York City. In sum, the taxpayer was left with the undesirable consequence of a final GCT return: All of its gain was accelerated into 2009.

Sales and Use Tax Scenarios

The possibilities for stepping on sales and use tax landmines are all but ubiquitous. Fundamentally, retailers must identify the most likely characterization of the goods or services they sell. Further, if what is being sold are services or digital goods, one must look deeper at the laws of the jurisdictions in which the services or digital goods are sold or used to determine taxability. Again, these are tasks requiring multistate expertise.

Secondarily, businesses selling their operating assets potentially generate significant sales tax liabilities, unless the sale qualifies for an occasional sale or other exemption. Unfortunately, the laws here vary greatly among the states, and it is easy to misread the controlling language in laws and regulations. Also, the actual application of potentially relevant exemptions can be generous or cramped depending on the interpretations of tax administrators.

The District of Columbia and Texas demonstrate the range of potential occasional sale treatments. District law provides an exemption for an occasional sale of operating assets by "a vendor who is not regularly engaged in the business of making sales at retail."[10] Thus, the exemption does not apply to "a sale of the entire operating assets of a business or of a separate division, branch, or identifiable segment of a business where the sale is by a vendor who is regularly engaged in the business of making sales at retail."[11]

[8] 20 NYCRR section 3-2.8, example 2.

[9] 19 RCNY section 11-04(c)(1).

[10] D.C. Code Ann. section 47-2005(7)(A).

[11] D.C. Muni. regs. 402.1(d).

In contrast, Texas law generally exempts "the sale of the entire operating assets of a business or of a separate division, branch, or identifiable segment of a business."[12]

Other states allow nontaxable occasional treatments at a variety of intermediate points, which makes expert planning assistance necessary to qualify for these exemptions. For this, there might be no better example than the 2019 Wyoming Supreme Court decision in *Delcon Partners*.[13]

Wyoming law allows for nontaxable treatment of some retail sales of a business's assets as follows:

> "Sale" means any transfer of title or possession in this state for a consideration . . . but excluding an exchange or transfer of tangible personal property upon which the seller or lessor has directly or indirectly paid sales or use tax incidental to: . . .
>
> (N) The sale of a business entity when sold to a purchaser of all or not less than eighty percent (80 percent) of the value of all of the assets which are located in this state of the business entity when the purchaser continues to use the tangible personal property in the operation of an ongoing business entity in this state.[14]

Delcon purchased 100 percent of the target business's tangible assets located in Wyoming[15] and more than 80 percent of all its tangible assets.[16] Delcon, however, did not purchase the seller's cash or checking accounts (which were sitused to Wyoming), nor did it purchase the seller's accounts receivable (which were also apparently sitused to Wyoming).

Wyoming sales tax is not imposed on the sale of any of these intangibles, and all cash and cash equivalents would be expected to sell at 100 percent of their face amount (except for accounts receivable that presumably would be discounted because of the need to wait for payment and possibility of nonpayment). Therefore, it might have been presumed that purchasing cash and cash equivalents would be irrelevant to determining whether a purchase of tangible personal property was nontaxable under Wyoming law.

However, according to Wyoming's highest court, State Board of Equalization, and Department of Revenue, that presumption is incorrect. Read literally, the sales tax exemption can be understood as requiring consideration of sales or non-sales of intangibles sitused to Wyoming in evaluating the applicability of the exemption.

Applying section 39-15-101(a)(vii)(N), the court held that exemption from sales tax required the purchase of not less than 80 percent of "all of the assets which are located in" Wyoming — which in this case included the seller's cash and cash equivalents. The court stated that "section 39-15-101(a)(vii)(N) does not differentiate between tangible and intangible assets. We will not add that language in the guise of statutory interpretation" (citations omitted).[17]

---

[12]Texas Tax Code Ann. section 151.304(b)(2).

[13]*Delcon Partners LLC v. Wyoming Department of Revenue*, 2019 WY 106 (Oct. 21, 2019) *aff'g Matter of the Appeal of Delcon Partners LLC from a Decision of the Department of Revenue*, 2018-30 (Wy. BOE Jan. 18, 2019).

[14]WY Stat. Ann. section 39-15-101(a)(vii)(N).

[15]The State Board of Equalization decision at para. 8 states: "The assets Delcon bought from Seller included 'equipment, vehicles, furniture, fixtures, leases and contracts, inventory, intellectual property, software, post-closing accounts receivable, and goodwill.' (*Id.* at para. 8). Seller owned other Wyoming assets (*all of which were intangible*) worth $3,010,602 that it did not sell to Delcon" (emphasis added).

[16]The State Board of Equalization at para. 14 decision states: "Delcon urges us to interpret Subparagraph (N) to require a purchase of 80 percent of a seller's *tangible personal property* rather than a purchase of 80 percent of a seller's *total Wyoming assets*" (emphasis in original).

[17]This article includes a discussion of *Delcon Partners* solely to demonstrate the hazards of state tax transaction planning. However, this does not indicate agreement with the Wyoming Supreme Court's analysis, which does not appear to take seriously the idea that limitations on the availability of tax categorizations must be relevant to the categorization or another legitimate state interest. Significantly, *Delcon Partners* contains no justification for why the Legislature would have desired this result. Rather, we apparently are expected to accept that the Legislature arbitrarily mandated the purchase of cash (an otherwise meaningless occurrence for sales tax purposes) so that a purchase of tangible assets can qualify for a sales tax exemption. Respectfully, this analysis is questionable. In contrast, other courts have required states to provide meaningful justifications for alleged statutory requirements when no such justifications are apparent. For an excellent example, see the Illinois Supreme Court's decision in *Searle Pharmaceuticals Inc. v. Department of Revenue*, 117 Ill. 2d 454 (1987), in which the court analyzed the state constitution's uniformity clause and rejected as arbitrary a proffered justification for a tax treatment: "There is no real and substantial difference between the two classes of corporations that is rationally related to the stated objective of reducing the number of amended returns that must be processed. The same objective could be achieved by denying corporations the right to carry the loss back based on any number of arbitrary considerations such as corporations having their offices in certain geographical areas, or corporations whose names start with certain letters of the alphabet."

Will Federal Tax Planning Be Respected?

There appears to be a widespread misimpression that states and localities must respect a business's legitimate federal income tax planning. However, much to the contrary, subnational departments of revenue generally have a right to review income tax planning to determine whether it satisfies their jurisdiction's requirements. Here, two items bear noting.

First, because the members of a state income tax reporting group are seldom identical to the members of a federal consolidated group, states are on alert for affiliate tax planning that, in their opinion, improperly increases deductions sourced to the state or improperly decreases income sourced to the state. Separate reporting states are especially attuned to this possibility. Second, state tax reduction might be a satisfactory justification for federal income tax planning, but it generally is not a satisfactory justification for state tax planning — even if the taxpayer demonstrates that the state conducting an audit was not a target of the planning.

States and localities also may review — and might reject — federally permitted income tax reduction arrangements. For example, in a recent New York City administrative decision now on appeal, the city and taxpayer disputed the unincorporated business tax (UBT) consequences of a taxpayer's use of a federally recognized domestic international sales corporation (DISC).[18] In *Skidmore*, the taxpayer was a partnership subject to UBT. The taxpayer's partners established a DISC in conformity with federal law, and the relationships and activities involving the DISC apparently conformed to federal law.

Although the DISC had no employees, the taxpayer paid it some $17 million in commissions over two years for services the DISC was deemed by federal law to have performed. The administrative law judge said that "the parties agree that the DISC is a federally authorized fiction, in which payments are made for deemed services which are not actually performed." The DISC did not file any New York City tax returns.

The DOF disallowed deductions for almost all the taxpayer's commission payments to the DISC, asserting that under the UBT, deductions for payments to partners for services or the use of capital are capped at $10,000 per partner annually.[19]

At issue was whether the DISC should be treated as an entity distinct from its owners, each of whom was a partner in the taxpayer. If that distinction was respected, the taxpayer's payments to the DISC would not be subject to the limitation on the deductibility of payments to partners. But if payments to the DISC were treated as payments to its partners (that is, effectively ignoring the federal tax treatment of the DISC), the UBT's deductibility limitation would apply. The ALJ ruled in the DOF's favor, finding that the economic substance of payments to the DISC for deemed but not actual services was really a payment to the partners individually for their services or the use of their capital.

In language that supports this article's premise, the ALJ concluded:

> Petitioner uses [a case] to argue that "[i]n the absence of any such express modification, federal conformity requires that Petitioner be allowed the UBT deduction claimed in respect of the Commissions paid to S-DISC." (Petitioner's Surreply at p. 6.) . . . [That case] is not controlling here. Federal taxable income is the starting point for computing UBT taxable income. The issue here is whether there is a provision that requires the commissions to be added back in computing UBT. In this case, there is such a provision because, as explained above, when the economic substance is analyzed, the payments are to partners or for their benefit. [Citations omitted.]

Conclusion

State and local taxes involve issue spotting and follow-up analyses that require multistate expertise, which now is widely available. The business activity tax and transaction tax examples

---

[18] *Matter of the Petition of Skidmore, Owings & Merrill* LLP, TAT(H)17-21(UB) (July 30, 2021).

[19] NYC Admin. Code sections 11-507(3) and 11-509(a).

presented are surrogates for the unnecessary issues encountered after the fact by state tax auditors and practitioners. Other areas of complexity that require state tax expertise include:

- knowing whether tax presence might be transferred from one affiliate to another;
- knowing whether in-state contacts might be accumulated among remote affiliates to create tax presence for all the affiliates, even though tax presence would not exist separately;
- understanding how affiliates will be treated in different states for business activities tax purposes;
- suggesting factor-planning possibilities;
- knowing whether transfers between affiliates will be subject to transaction taxes;
- suggesting transaction tweaks that can reduce sales tax exposures; and
- knowing whether acceptable federal tax planning will trigger state tax challenges.

The challenges presented by subnational taxation mean that federal tax advisers can no longer declare — without fear of triggering professional liability exposure — that "if I notice a state tax issue, I will request the assistance of a state tax expert." That approach makes no more sense than having a state tax planner make the same claim about federal tax issues. These are separate areas of expertise, each of which requires expert attention. ■

Section V

Practitioner Responds to Bucks's Article on Corporate Income Shifting

POSTED ON MAR. 31, 2014

To the Editor:

In 2011 I wrote an article "Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground" (BNA Daily Tax Reports, Mar. 3, 2011). The thrust of the article is that there is too much tax litigation, and that in some cases unnecessary litigation arises from a lack of respect for the party sitting across the table. I counseled that:

> Both in-house tax professionals and outside tax advisers are paid to be advocates and are expected always to have the business's best interest in mind. But that best interest might require abandoning attempts to reach the lowest "dollars and cents" resolution on the discrete issue at hand and instead working with state personnel to find the best solution for both sides. This requires the attorney to consider the state's interest as well as his client's interest. The good news here is that many senior personnel within state revenue departments are prepared to take the same approach to building bridges.

Unfortunately, that bridge building approach is not as widely held as it should be, as demonstrated by Dan Bucks's article "Corporate Income Shifting: State Tax Evasion or Worse?" (*State Tax Notes*, Mar. 24, 2014, p. 701) in which tax planners "sputter" and corporations that structure their affairs "evade" income taxes, commit "theft" of services, stuff money "inside (their) pantyhose" (huh?), and behave immorally.

As Bucks's first paragraph makes clear, his piece targets some state tax administrators -- specifically, those officials who do not treat corporate tax planning as tax evasion. In that regard, the disrespectful tone and language in Bucks's article serves no one's purpose. Nor will anyone be benefited by the disproportionately adversarial posture Bucks recommends.

Thus, the target for my response is broader than was Bucks's. Every state government should encourage its tax administrators to avoid a war-like relationship with taxpayers. Businesses rightfully structure their affairs to reduce their state tax liabilities, and state tax administrators rightfully challenge some of those tax planning arrangements. Sometimes we disagree. But when tax administrators view tax structuring through a prism of immorality, they are certain to distort their vision and their judgment.

As Judge Learned Hand wrote almost 70 years ago: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." Dissenting in *Commissioner v. Newman*, 159 F2d 848 (1947).

David Fruchtman

Rimon PC

March 24, 2014

DOCUMENT ATTRIBUTES

JURISDICTIONS	UNITED STATES
SUBJECT AREAS / TAX TOPICS	CORPORATE TAXATION TAX HAVENS APPORTIONMENT
MAGAZINE CITATION	STATE TAX NOTES, MAR. 31, 2014, P. 800 71 STATE TAX NOTES 800 (MAR. 31, 2014)
AUTHORS	DAVID A. FRUCHTMAN
INSTITUTIONAL AUTHORS	RIMON P.C.
CROSS REFERENCES	"CORPORATE INCOME SHIFTING: STATE TAX EVASION OR WORSE?" *STATE TAX NOTES*, MAR. 24, 2014, P. 701 .
TAX ANALYSTS DOCUMENT NUMBER	DOC 2014-6976
TAX ANALYSTS ELECTRONIC CITATION	2014 STT 61-11
OTHER STATUTORY CLASSIFICATION	NEWS, COMMENTARY, AND ANALYSIS

Section VI

BNA Tax and Accounting Center™

Source: Daily Tax Report: News Archive > 2011 > March > 03/03/2011 > BNA Insights > Dispute Resolution: Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground

42 DTR J-1

Dispute Resolution

Litigating tax disputes can be expensive, and the costs are not always measured in amounts paid to outside counsel. A tax case can consume valuable internal resources as a company works with counsel to answer discovery, prepare for depositions, hearings, or trial, and, quite often, prepare or respond to an appeal. Many disputes, however, can be resolved without resorting to a lawsuit or filing an administrative protest. In this article, author David Fruchtman, of Horwood Marcus & Berk Chartered, uses three case studies to explain how taxpayers can effectively apply alternative approaches to resolving disputes.

Dispute Resolution

Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground

By David A. Fruchtman

David A. Fruchtman is of counsel with Horwood Marcus & Berk Chartered. He can be reached at dfruchtman@hmblaw.com.

At some point, almost every multistate business will find itself pregnant with a potential state tax dispute.

The potential dispute is often based on the business's strategic planning but it can also be the result of a simple tax reporting mistake. Other times, the dispute is based on a new or different interpretation of the law than the states' revenue departments decide to take. As businesses always prefer to conduct their affairs unimpeded by state revenue departments, many businesses will continue to rely on their unproven interpretation, implicitly or explicitly intending to defend themselves in litigation if their position is challenged. [1]

[1] In this article "litigation" refers to all contested tax matters, whether in an administrative proceeding or in a court of law. While the case studies below involve potential assessments, the advantages of avoiding litigation extend to refund claims as well.

However, when the interpretation involves a repeat transaction—for example, the taxability for sales and use tax purposes of the sale of the business's goods or services—the financial risk of an ever-rising exposure for uncollected and/or unpaid taxes can overwhelm even strongly held beliefs in nontaxability.

Further, state information-sharing arrangements can cause an isolated dispute to spread to other tax jurisdictions. This is even more likely when a legal decision is rendered, whether the case was won or lost, as a published decision in one jurisdiction can lead to audits in other jurisdictions.

In such circumstances, many businesses will desire a quicker, quieter, and more predictable resolution than is obtainable in litigation. This article describes some methods practitioners can use to resolve tax disputes without litigation.

Reasons to Avoid Litigation

> *"When will mankind be convinced and agree to settle their difficulties by arbitration?"*
>
> *Benjamin Franklin*

Litigation is expensive, sometimes very expensive. At its most obvious, tax litigation requires paying lawyers at hourly rates that reflect their expertise in two areas—litigation and the technicalities of taxation. In most circumstances, one lawyer is not proficient in both areas, meaning that the business has to pay at least two lawyers. This is especially true when litigation enters the discovery phase and at all points thereafter, which also is a time when expert witness fees might be incurred.

Litigation also creates substantial internal costs. These include the value of time spent strategizing with counsel, preparing timelines and factual backgrounds, reviewing draft documents, answering discovery, preparing for and being deposed, preparing for hearing or trial, attending the hearing or trial, and assisting on appeals (whether as the appellant or appellee).

Litigation involves nonfinancial costs as well, starting with the emotional energy it absorbs as a case winds it way through its life cycle. In addition, many businesses do not want any publicity regarding their tax situation, a position that is jeopardized when a dispute enters the courts. Furthermore, negative publicity from a loss can create unpleasant effects lasting well after the state revenue department deposits the business's check for tax, interest, and penalties. In some circumstances, this can be true even from a litigated win. [2]

---

[2] The author received a first-rate education in this when he was tax counsel in a dispute involving a large, newly constructed, industrial facility. Efforts to resolve the matter through negotiation were checked at every step by litigious counsel for the tax authority. With no alternative, the dispute entered the courthouse and led to the issuance of a temporary restraining order against the authority. This, in turn, led to an expedited discovery schedule and a successful conclusion to the matter, with the possibility of further gains. However, rather than press its advantage, the business worked again and again to reach a resolution with the tax authority and its counsel. The vice president of finances explained that the bigger picture needs of the business mandated these repeated attempts at resolution. As he explained, "We are here for the long term. I need a good relationship with the community so that my trucks will have access to the facility, for future zoning issues, and for other future business needs."

Adding the risks of adverse decisions to these external and internal costs should make any vice president of taxes hesitant to begin a formal dispute. It is therefore important that these officers are able to tell other senior management that they made their best effort at resolving a dispute before it matured into a case. This is especially true when confronting litigation in multiple jurisdictions.

Three Case Studies

Three case studies drawn from real world experiences demonstrate how these situations might arise and will be used below to demonstrate how the situations can be addressed. Each of these circumstances could have resulted in litigation:

- **Case Study No. 1.** Corporation A is a start-up business selling a new product of uncertain sales taxability. Due to internal confusion, Corporation A began collecting sales taxes even though it was not registered to do so with any state. It never remitted the collected taxes. Corporation A never believed that the money belonged to it and never took the collected funds into revenue. Rather, the company's bookkeeper continued to receive collected taxes, retaining the money in a separate bank account while debiting a contra-asset account on the company's financial records. These practices quickly became routine within Corporation A, and were not reviewed for several years.

- **Case Study No. 2.** Corporation B is a large business with a sophisticated tax department. The corporation performed one of several variations of a cutting-edge service. The service was sold across the country but did not fit cleanly into any category of service that is subject to sales tax. Corporation B and other businesses in this industry were aware that, as a general principle, services are not subject to state sales taxes. Therefore, the businesses (including Corporation B) consistently treated such sales as nontaxable. However, when several jurisdictions contended that a variant of the service is taxable, Corporation B's senior management became concerned that its service would be challenged as well. The corporation's management therefore instructed its tax department to eliminate the company's historic exposure for unpaid sales taxes and to treat the sales as taxable going forward.

- **Case Study No. 3.** Limited Liability Company C is a small Canadian business that was beginning its initial entry into the U.S. market. In making its entry, its entire focus was on increasing its sales. LLC C did not know whether its sales were taxable but, given its small size and insubstantial revenue stream, it did not engage a tax adviser to evaluate the taxability of its sales across the country. Rather, it did not collect any sales taxes on its sales and did not file income tax returns outside of the state of its U.S. headquarters. Over several years, LLC C's sales grew, as did the size of its sales tax exposures. (The company had losses for income tax purposes.)

Attitude Comes First

The first step toward reaching a nonlitigated resolution sounds obvious but in truth needs to be addressed directly: The business's tax managers and outside counsel must want to reach a nonlitigated resolution. They must become comfortable with the reality that a nonlitigated resolution will cost something.

Attitude also refers to the approaches taken with state revenue departments. There is no one correct approach, and most lawyers use different approaches depending on the situation. But central to all approaches is respect for the intellect and authority of revenue department personnel.

This by no means suggests being a supplicant. Both in-house tax professionals and outside tax advisers are paid to be advocates and are expected always to have the business's best interest in mind. But that best interest might require abandoning attempts to reach the lowest "dollars and cents" resolution on the discrete issue at hand and instead working with state personnel to find the best solution for both sides. This requires the attorney to consider the state's interest as well as his client's interest. [3]

---

[3] Of course, outside counsel can do this only to the extent that he or she knows the state's interests. Revenue departments, like business clients, might have incentives or limitations affecting the resolutions they are prepared to consider. But unlike the attorney's clients, revenue departments will not disclose these to the client's lawyer. For example, the author attempted to negotiate a resolution of an income tax dispute involving the application of a technical area of a state's law. Efforts to address this directly were made difficult by the state official's apparent inability to appreciate the "apples to oranges" approach she was requiring. The author sought a fresh perspective from one of his colleagues as to the cause of the state official's confusion, but with no better success. The author subsequently learned that other taxpayers were reaching the same obstacle with the state. The problem, therefore, was not an inability to explain the issue; nor did the problem arise from the state official's inability to appreciate the issue. Rather, the state had adopted a policy that it chose not to disclose and that no amount of reasoning from a taxpayer's advocate was going to change. In such a circumstance, the lawyer must explore other routes to a nonlitigated resolution.

Attitude also involves creativity and flexibility in exploring possible mixes of solutions. Multijurisdictional issues in particular are likely to require more than one type of solution.

The good news here is that many senior personnel within state revenue departments are prepared to take the same approach to building bridges. However, it is important to recall that the taxpayer bears the burden of designing possible solutions.

Many Paths to Reaching A Nonlitigated Resolution

State tax practitioners must be aware of the many formal and informal methods of dispute resolution. This article will describe many of these through a discussion of the case studies. (Minor factual adjustments have been made to protect client confidentiality.)

Case Study No. 1

In Case Study No. 1, Corporation A had stumbled into one of the true cardinal sins of state taxation. In states across the country, collecting but knowingly failing to remit sales or use taxes can be treated as a crime. State revenue departments publicize, for in terrorum effect, successful prosecutions of proprietors who engage in such conduct.

So, while Corporation A's failure to remit taxes was accidental, it was not expected that the states were going to accept that claim easily, nor was it expected that the states would excuse Corporation A's conduct without imposing substantial penalties.

Corporation A's first step was to stop the improper conduct. This is a direct application of the "Law of Holes," which teaches that "the first step in getting out a hole is to stop digging." Here that was a two-step process: First, Corporation A had to stop collecting taxes without making remittances. Second, Corporation A had to disgorge its improperly retained taxes. Thus, its choices were to either:

- register with states immediately and continue to collect and remit taxes while determining whether its sales are taxable; or
- stop collecting tax and work quickly to remit taxes to the states, and then to determine whether the sales are taxable.

The downside of the former approach was substantial, as the corporation would have had to identify itself and leave itself largely unprotected from the states' punishments. The downside of the latter approach was that, until Corporation A received guidance from counsel or the states, it was implicitly treating its sales as being nontaxable, and accepting upon itself a liability for state sales taxes that it otherwise could have collected from its customers.

Corporation A chose the latter approach. It therefore halted its sales tax collections while its counsel contacted the states to make remittances on a taxpayer anonymous basis.

The first step was to identify states having open or upcoming amnesty programs. Participation in these generally is an excellent solution to the problem of improperly collected taxes. The programs, however, come with at least one notable downside—namely, the information-sharing agreements the amnesty states have with other jurisdictions create a risk that the business's identity will be disclosed to those other jurisdictions.

As protection against such information-sharing agreements, taxpayers sometimes request assurances from the amnesty jurisdiction that the jurisdiction will not offer its name to other taxing bodies, an assurance that is sometimes provided. A taxpayer receiving such an assurance should have the time it needs to contact the other states before the states contact it.

This, too, highlights an important strategy for a business in Corporation A's predicament: Counsel should initiate contact with the relevant state and local jurisdictions as quickly as possible so that the business is making the first communication (i.e., a voluntary communication) about the problem.

At the same time that the amnesty states were being contacted, Corporation A needed to contact the remaining states. Because so many states were involved, counsel sought a method of streamlining the remittance process. Counsel therefore contacted the Multistate Tax Commission (MTC), and proposed an atypical application of the MTC's multistate voluntary disclosure program.

Counsel should initiate contact with the relevant state and local jurisdictions as quickly as possible so that the business is making the first communication about the problem.

The desired arrangement was atypical because, unlike a voluntary disclosure in which the taxpayer's identity is always disclosed when an agreement is reached, here the business's identity would not be disclosed. Further, there would be no signed voluntary disclosure agreement and payment of back taxes would be made by checks issued by the law firm.

The arrangement involved several telephone discussions with a representative of the MTC, followed by a letter from counsel explaining the circumstances that led to the business's collection but nonremittance of sales taxes. The letter also contained an offer to anonymously remit taxes and interest through the business's counsel. The letter, while addressed to the MTC representative, was actually intended for the MTC's participating states.

Corporation A did not request anything further of the states except that they accept the money. It was aware of the risk that a state might contact it later, in which case the state would not have a record of a remittance from the corporation. However, the corporation concluded that proving remittance should be possible by demonstrating that its counsel remitted the taxes and, in all events, continued to believe that the downside of disclosing its identity was greater than the downside of remaining anonymous.

The arrangement with the MTC worked as desired. Some states required additional attention, usually a need to talk through what was being offered to become comfortable that accepting the funds would not cause the state to forfeit any rights. However, in short order Corporation A had remitted its collected taxes to the MTC states as well as to the amnesty states.

Other states had to be contacted directly. Once the taxes were remitted, Corporation A and its counsel thereafter obtained state determinations regarding the taxability of the corporation's sales (taxable in some states; nontaxable in others).

Case Study No. 2

Case Study No. 2 presents the most straightforward circumstances of the three case studies. Corporation B made an informed and defensible decision not to collect sales tax on its sales. It maintained that position in good faith for between six and 15 years, but when several states challenged a competitor's sales tax treatment of a similar service, Corporation B decided to take a new approach.

Rather than risk incurring the litigation costs described above, Corporation B sought to become compliant with the states' and local tax jurisdictions' desired treatments. To do so, it began a national voluntary disclosure process, offering through counsel to begin collecting the jurisdictions' taxes in exchange for the jurisdictions' agreement not to assess taxes for prior periods.

Local jurisdictions were generally more challenging because of difficulty identifying the parties who could agree to such arrangements.

Most of the states understood the issue and responded quickly. Several states agreed with the taxpayer that there was a good argument that its sales were nontaxable, and accepted prospective treatment. Another state agreed with the taxpayer that its sales probably were not taxable and therefore refused to enter into a prospective voluntary agreement. Instead, it referred the matter to its tax policy group, which issued a letter ruling holding that the sales were not taxable. Most other states required payment of two to three years' back taxes plus interest, with waiver of penalties.

Local jurisdictions were generally more challenging because of difficulty identifying the parties who could agree to such arrangements. Even after that person was identified, there remained the sometimes formidable task of persuading them that voluntary disclosure agreements were an accepted practice. Taxpayers needing to negotiate voluntary disclosure agreements with local tax authorities should anticipate that the process will take longer than the same negotiation would take with a state.

In the end, Corporation B's legal bills were a fraction of its contemporaries' (which continued to climb) and its sales tax payments made in resolving its multistate issue were much less than its potential exposure. And, after the conclusion of its compliance project, it no longer had an exposure for uncollected and unpaid back taxes, while its customers were continuing to purchase its service despite the imposition of sales taxes.

Case Study No. 3

LLC C presents an additional factor to the discussion above—namely, continuing uncertainty regarding the characterization of its product as being a type of manufacturing equipment. If the product was manufacturing equipment, many states would treat the sale of the product as nontaxable. But if the product was not manufacturing equipment, many states would treat the sale as taxable unless another exemption applied to the sale.

While LLC C was beyond the start-up phase of its U.S. activities, it was in no position to pay for rulings in 40, 30, or even 20 states. It therefore identified the six states where the amount of its sales were greatest and began the process of requesting rulings from those states. It received a very quick but negative response from one state. The state provided a formal appeal process but, before LLC C filed an appeal, it determined that several of its other selected states used the same definition as the first state.

LLC C thereafter determined that the relevant definition was contained in the Streamlined

Sales and Use Tax Agreement. In such a situation, where the issue involves the interpretation of a sales tax definition, the taxpayer can petition the Streamlined Sales Tax Governing Board for a ruling. If the governing board agrees to issue the ruling, its determination must be followed by all member states and all states waiting to become members of the governing board. [4] At the time that LLC C sought its ruling, there were more than 20 such states.

[4] A state that does not follow the determination can be held noncompliant and required to come into compliance or risk a variety of sanctions.

Requesting a ruling from the governing board meant—if the board exercised its discretion to consider the issue—that LLC C could obtain one ruling applicable to more than 20 states. The board agreed to consider the issue on an expedited basis. Several months later, LLC C received its desired ruling, which was binding on all member and associated states, including the state that had previously issued an adverse ruling. [5]

[5] Notably, the receipt of a requested definition does not assure that the item will be nontaxable when sold. The Streamlined Sales and Use Tax Agreement is designed to provide uniform sales tax definitions; however, participating states are able to treat the sale of any item as being taxable or nontaxable as they deem appropriate. In LLC C's circumstance, some 16 states provided exempt or other favorable tax treatments to the sale of the item that was the subject of LLC C's inquiry.

Of the remaining states, there were a handful meriting individualized attention; in the remainder, LLC C conducted its best possible analysis of taxability, erring on the side of collecting tax.

When it concluded the project, LLC C established the sales taxability of its product without unduly exposing itself to assessments for uncollected taxes and without spending any resources on contested appeals or litigation.

Income Tax Concerns

In the author's experience, multistate income tax issues that can be resolved in a consolidated effort are less common than sales tax issues.

By way of example, while issues involving tax presence, anti-passive investment company legislation (denying deductions for interest and royalty payments to affiliates), and income sourcing often affect the taxpayer in more than one state, they are fact-specific and generally must be resolved on a state-by-state basis. Fortunately, many of the same approaches described above are available for taxpayers seeking nonlitigated resolutions.

Moreover, if the taxpayer and its counsel are motivated, the complexity of these issues also presents settlement opportunities.

An important step is to determine whether the issue affects one period or several periods. Where several periods are affected, there is often an opportunity for splitting the open periods on a principled basis so that both the taxpayer and the state can claim victory.

Even at the audit level, where auditors often claim an inability to reach negotiated resolutions, experience has shown that auditors often are willing to involve senior personnel to conclude complex issues if doing so will result in an agreed audit.

When All Else Fails

"Even peace may be purchased at too high a price."

The analysis above describes the application of a variety of approaches for avoiding litigation. There are other methods as well. But by far, the

Benjamin Franklin

most important element to reaching a nonlitigated resolution is an attitude that makes working with tax jurisdictions a high priority.

The second most important is having the creativity to find a solution that is acceptable to both parties, recognizing that other elements of a settlement might be as important as dollars paid.

However, there remain circumstances where settlement is not possible. This can occur when the tax jurisdiction wants an answer to a question and uses the taxpayer's circumstance as a test case. And it can occur when a tax jurisdiction simply rejects the taxpayer's positions and refuses settlement or is willing to settle only on terms the taxpayer finds unacceptable.

Here, the only nonlitigated resolution is to accede to the tax jurisdiction's demands. For any of a number of reasons the taxpayer might decline to do so, in which case litigation is necessary. When this occurs, the tax manager, having attempted several approaches to achieving a nonlitigated resolution, should report those efforts to management.

Thus informed, management will know that the expense of litigation was unavoidable and also will be aware of the approaches to resolution already attempted. This latter consideration is important, as settlement is possible at every stage of litigation.

Conclusion

Experience has shown that state and local tax litigation is expensive and often unnecessary. Taxpayers that are willing to use a mix of available resources can often eliminate multistate tax exposures without incurring penalties and without exposing their business to unwanted publicity.

Likewise, taxpayers that are prepared to work cooperatively with state and local revenue departments will often find the departments receptive to the overtures, so that a mutually satisfactory resolution is obtainable.

Essential to all of these efforts is in-house personnel and tax counsel who are committed to reaching such nonlitigated resolutions.

ISSN 1947-3923

Section VII

About The Author

David Uri Ben Carmel, principal of 349 East Multistate Tax Planning LLC, has advised clients on complex issues in all 50 states and the District of Columbia involving tax planning, disputed audits, and tax controversies before administrative bodies and courts. He was the Partner in charge of state and local taxation at the law firms of Steptoe & Johnson LLP and Winston & Strawn LLP. He served as a Special Deputy Attorney General to the state of Hawaii.

Mr. Ben Carmel is admitted to the U.S. Supreme Court and submitted a much-discussed amicus brief in *Wayfair* warning the Supreme Court about the states' intentions to experiment by imposing sales taxes on many multistate services. The brief was the subject of an article in the National Law Journal (copies of the brief and article are included in the "Covering the Waterfront" booklet available at www.349east.com) and was cited authoritatively to the Court.

In 2023, Mr. Ben Carmel twice submitted materials to the Multistate Tax Commission cautioning the MTC that its uniformity project extending market-based sourcing of receipts was irrelevant to analyses of personal jurisdiction and tax presence. He counseled the MTC to include a warning to that effect in all draft and final versions of its regulations. For more, see the article *Personal Jurisdiction and Economic Nexus vs. Market-Based Sourcing*, available at www.349east.com.

Mr. Ben Carmel assists clients on complex issues involving virtually all subnational taxes -- whether business activity taxes (most often income taxes), transaction taxes (most often sales or use taxes), excise taxes and fees (involving activities deemed to be "privileges"), net worth taxes (typically based on the value of a franchise or item), unclaimed property (not a tax but every bit as onerous in its potential impact on a business's finances), and residency issues (for individuals).

Mr. Ben Carmel is a past chairman of the Income and Franchise Taxes Subcommittee of the American Bar Association's state tax committee, and for more than 25 years has been co-author of the ABA's Sales and Use Tax Deskbook. He lectured at NYU's Summer State and Local Tax Institute for 13 years on constitutional issues, LLC and partnership taxation, and escheat of abandoned property, and at Georgetown Law Center for six years on state taxation of foreign businesses. He is the author of more than 100 articles, two Bloomberg BNA tax portfolios on "The Definition of a Unitary Business" (1110-3rd) and "Consolidated Returns and Combined Reporting" (1130-3rd), and has delivered scores of speeches and webinars across the United States. He is a graduate of Harvard Law School.

Mr. Ben Carmel does not claim any successes as his own. Rather, he proudly included the following note of appreciation in his unitary business portfolio expressing gratitude to his mentors:

> "A Note of Appreciation: During Mr. [Ben Carmel's] career, he has been privileged to work with and learn from four of the leading state tax lawyers of his, or any, era. First among these was the late Paul Frankel, whose enthusiasm, good nature, and brilliance make him the undisputed, all-time, heavyweight champion of the state tax world. Second was Richard (Rick) Hanson, whose analytical and writing skills are unsurpassed. It was Rick's insights as taxpayer's counsel in *Quill Corporation* that lead to the untethering of Commerce Clause analysis from Due Process analysis and, in turn, resulted in a tax presence win for remote businesses that withstood unrelenting attacks for the better part of three decades. Third is Fred Marcus, whose integrity and knowledge of the law have long made him a trusted advisor to America's largest businesses, and a pleasure to work beside. And fourth is Stanley (Stan) Kaminski, whose tremendous recall, ability to simplify complex issues, and unassuming manner have made him a welcome figure in the offices of taxpayers and tax collectors alike. Therefore, using this portfolio to its greatest advantage, Mr. [Ben Carmel] extends a sincere 'Thank you' to each of them."

349 East Multistate Planning, LLC
6218 Georgia Ave. NW, Office 506
Washington D.C. 20011-5125
(847) 656-4823
daviduribencarmel@349east.com