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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.

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"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.

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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

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[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.

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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.

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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.").

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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.

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