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Top State & Local Tax Cases Of 2019

By **Daniel Tay**

Law360 (December 20, 2019, 11:31 AM EST) -- From the U.S. Supreme Court finding that a trust lacked sufficient contacts to be taxed by North Carolina, to a California appellate court upholding the state's combined reporting regime, 2019 was a busy year for state and local tax cases.

Here, Law360 looks at the most influential state and local tax cases from 2019 and their impact going into the new year.

North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust

The U.S. Supreme Court's June decision that North Carolina violated the due process clause by taxing the out-of-state Kaestner trust showed states that Wayfair's less stringent nexus standard for imposing sales tax collection obligations on out-of-state sellers does not apply in every area of tax.

The court **held that** the trust beneficiary's residence in North Carolina, without any receipt of or entitlement to distributions during the years the state sought to tax the trust, did not provide the minimum contacts necessary for taxation.

North Carolina had asked the Supreme Court to apply Wayfair , arguing that just as the court removed the physical-presence standard for out-of-state businesses to collect sales and use taxes it should also hold that a trust need not be located in a state for it to be subject to that state's taxation. But Justice Sonia Sotomayor, writing for the court with a concurrence from Justice Samuel Alito, instead applied the court's due process standard in its 1992 decision in Quill Corp. v. North Dakota.

The decision itself was not surprising and fairly consistent with estate planners' understanding of North Carolina's statutes and their interactions with trust law, Stuart Kohn, head of Levenfeld Pearlstein LLC's trusts and estates group, told Law360. However, the ruling was a reminder that planners "really need to be hypersensitive" to variables such as the residency of the beneficiary or trustee, the laws governing the trust's administration or the location of trust assets, he said.

"Because our clients are moving around a lot ... we've got to continuously look at it. Because somebody moves and now all of a sudden where it wasn't taxed in a certain jurisdiction before, now somebody moves and maybe that now causes that potential for taxation," Kohn told Law360.

The increased attention brought to estate planning by the court's ruling could also kindle increased litigation at the state level. Karen Steinert, shareholder with Frederikson & Byron PA, told Law360 that between Kaestner and a separate Minnesota trust taxation case that the U.S. Supreme Court had declined to review, she had been receiving many calls from clients regarding the cases' implications, which she said was not usually the case.

If or when those cases are brought, Steinert said Kaestner would influence how they play out because it provides guidelines for analyzing the constitutional issues in a state context. That guidance is more broadly applicable than the specific ruling itself, which the court had repeatedly emphasized was narrow and dependent on the unusual facts of the case.

"It doesn't necessarily tell you the outcome in a particular case, but it is helpful with the method of analysis," Steinert said.

The case is North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, case number 18-457, in the U.S. Supreme Court.

Vazquez et al. v. Jan-Pro Franchising International

The Ninth Circuit's ruling that the California Supreme Court's Dynamex decision on worker classification **applies to franchises** is just the latest development in an increasingly contentious nationwide dispute, with potentially far-reaching tax nexus implications for franchises.

The federal appeals court in May had ruled against cleaning franchisor Jan-Pro in a case brought against it in 2008

by three California workers, who asserted they had been misclassified as independent contractors when they were employees. The Ninth Circuit initially held in May that the California Supreme Court's decision in Dynamex Operations West v. Superior Court applied retroactively and remanded the case to the lower court, but it reversed course and withdrew the opinion in July after Jan-Pro asked for a redo on the ruling.

In September, the Ninth Circuit **certified the** retroactivity question to the California Supreme Court and reinstated the rest of its earlier opinion, which held that the version of the worker classification test, or ABC test, adopted in Dynamex applied to the franchisor-franchisee relationship and can apply retroactively consistent with federal due process.

Regardless of whether Dynamex applies retroactively, the issue of whether the ABC test applies to the franchisor-franchisee relationship going forward is one that the franchising community will be concerned about. Assuming the Ninth Circuit's holding on the applicability of the ABC test stands, it could affect how franchises enter long-term commercial relationships with franchisees both in California and nationwide, Benjamin Blair, tax partner with Faegre Baker Daniels, told Law360.

Should the Ninth Circuit's holding be adopted by other states, a franchisor would be deemed to have employees in those states, which would greatly increase a company's exposure to income or sales tax nexus, Blair said.

"At least in some cases, simply licensing a trademark into a state is not sufficient to give rise to nexus. Having an employee in a state is almost uniformly going to," Blair said.

The full implications of Vazquez are still somewhat up in the air. Blair said it was possible that in answering the retroactivity question the California Supreme Court would confirm it did not intend for Dynamex to overrule its 2014 holding in Patterson v. Domino's Pizza LLC. In the Patterson case, the state high court had held the franchisor-franchisee relationship is different than other employer-worker relationships. What the Ninth Circuit would do if the state high court confirms that Dynamex does not overrule Patterson is unclear, Blair said.

The case is Vazquez et al. v. Jan-Pro Franchising International, case number 17-16096, in the U.S. Court of Appeals for the Ninth Circuit.

Abercrombie & Fitch Co. v. California Franchise Tax Board

A California state appeals court rejected Abercrombie & Fitch's claims that the state's combined reporting requirement for interstate unitary businesses violates the U.S. Constitution's commerce clause, with the decision setting a high bar for taxpayers to prove the discriminatory treatment causes them harm.

The Fifth Appellate District of the California Court of Appeal **ruled in** August that state law bars the clothing giant and its 14 subsidiaries from filing tax returns under the separate reporting method. California extends the filing election to intrastate unitary groups but not multistate unitary businesses. The court said Abercrombie & Fitch's proposal would erect a favorable tax structure for multistate businesses by excluding income that is currently subject to state tax.

The decision was notable because it required Abercrombie to prove that it had suffered a detriment as a result of the discriminatory treatment of not being allowed to choose to file under the separate accounting method, Mike Shaikh, tax partner with Baker Mckenzie, told Law360.

"It's interesting here that the court took an approach of ... assuming that there is discrimination and went straight to the remedy," Shaikh said.

The appeals court had held the refund claimed by Abercrombie would have resulted from using separate accounting to gain an advantage over in-state businesses by excluding unitary business income attributable to in-state business activity. Such exclusion would not be available to in-state businesses, meaning Abercrombie's proposal did not address disparate treatment caused by separate reporting being available only to in-state businesses.

"The remedy is really putting them on equal footing with the purely in-state taxpayers," Shaikh said, adding that it was significant that the court had held Abercrombie's version of separate accounting "went too far."

Shaikh said if an interstate unitary group could prove it suffered a detriment under the court's version of separate accounting, it could get some relief, but he noted that this decision had put a high burden on taxpayers and others might hesitate to challenge the law.

The case is Abercrombie & Fitch Co. et al. v. California Franchise Tax Board, case number F074873, in the California Court of Appeal, Fifth Appellate District.

General Motors Corp. v. Commonwealth of Pennsylvania

The Commonwealth Court of Pennsylvania **severed the** state's $2 million cap on net loss carryovers in a case brought by General Motors over its 2001 tax year assessment, with the decision potentially providing guidance to

other states on uniformity in tax structuring.

The cap violated the state constitution's uniformity clause, the commonwealth court ruled, because it created two classes of taxpayers: those with more than $2 million in annual income, and those with $2 million or less. The court rejected arguments by the state Department of Revenue that the entire provision, not just the cap, should be severed and that no net loss carryovers should be allowed.

The court said the due process clause required an actual equalization of GM's tax position relative to other taxpayers under the cap, which would only be satisfied if the cap was severed and a retroactive remedy applied, instead of having the whole provision severed.

The court's analysis of due process and equal protection under the 14th Amendment, while not precedential for other states, still could be useful in considering when retroactivity applies in tax cases, Jennifer Weidler Karpchuk of Chamberlain Hrdlicka White Williams & Aughtry told Law360.

"To the extent that a state has a uniformity clause that is similar to Pennsylvania's, they need to be careful about how they're structuring their taxes," Karpchuk said.

When states apply any type of cap in their tax statute, they need to look at whether it would violate the uniformity clause within their statute, she said. Litigation might increase in other states as taxpayers look at the GM decision and see whether they can challenge similar statutes in their state, she added.

Karpchuk said uniformity cases have been significant in Pennsylvania in recent years and this decision would impact cases still being decided in the state. She noted that several commercial property reassessment cases in Philadelphia pose questions over whether the uniformity clause had been violated and what the appropriate remedy should be in those cases.

"General Motors would suggest that the answer here would be that the appropriate remedy is refunds for all those people," Karpchuk said.

The case is General Motors Corp. v. Commonwealth of Pennsylvania, case number 869 F.R. 2012 in the Commonwealth Court of Pennsylvania.

Deere & Company v. Wisconsin Department of Revenue

Wisconsin's Tax Appeals Commission handed Deere & Co. a win **by determining in** August that the company is entitled to a dividends-received deduction from a Luxembourg affiliate that elected to be treated as a corporation for federal tax purposes.

The Wisconsin Revenue Department had determined franchise tax was due as a result of the distributions because, among other arguments, the department said the Luxembourg company wasn't a corporation, meaning the dividends-received deduction did not apply to its distributions. The Tax Appeals Commission, however, noted the Wisconsin definition of a corporation includes entities treated as a corporation for tax purposes under federal law.

The commission's decision is a welcome relief for Wisconsin taxpayers, Steve Wlodychak, a principal at EY, told Law360. Wlodychak said the decision provided clarity and that the commission had correctly recognized that because Wisconsin specifically conformed to the federal "check-the-box" regulations, federal entity classification should control for the state's income tax.

"You've got to read your state statutes to see how they all fit within the compendium of the federal law," Wlodychak said. "Every single state is a little different in this regard and every single state taxes different. Make sure you read the statutes and make sure that they all line up correctly."

Leighanne Scott, leader of Caplin & Drysdale Chtd.'s state and local tax practice group, said the case highlighted how states have faced challenges in enforcing rules typically drafted when the corporate form was more common, as opposed to the partnership structures more widely used now. Scott added that the department has appealed to the state's circuit court and had sent notices to other taxpayers with facts similar to Deere & Co.

"Given that the favorable ruling by the commission had larger consequences outside of Deere for the department, this was likely a contributing factor in its decision to appeal," Scott said, adding that until the circuit court's decision, expected in 2020, comes down, the long-term impact of the case is unknown.

The case is Deere & Company v. Wisconsin Department of Revenue, case number 18-I-135, in the Tax Appeals Commission for the State of Wisconsin.

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