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In this installment of Pennsylvania's SALT Shaker, Karpchuk reviews major state and local tax rulings from the past year in Texas, Pennsylvania, Massachusetts, and California.

There is always something new, different, or crazy happening in the SALT world and this year has been no exception. As 2022 draws to a close, it's time to review some of the SALT highs and lows of the past year.

A Taxpayer Win? Are You *Sirius*?

The first case in our roundup comes out of Texas. In *Sirius XM*,[1] the taxpayer won a reversal of the appellate court's decision on a sourcing issue. As many vehicle owners are aware, Sirius is a provider of subscription-based satellite radio programming. Under Texas law, receipts from performing a service are apportioned to where the service is performed. If services are performed both inside and outside the state, then the receipts are attributed to Texas in proportion to the fair value of the services rendered there. The taxpayer and the comptroller ultimately disagreed about where the service was being performed.

During the tax years in question, Sirius XM's headquarters, transmission equipment, and 70 percent of the radio programming were located exclusively outside Texas. Therefore, Sirius believed that its satellite programming services were being performed almost entirely outside Texas. Conversely, in the comptroller's view, the taxpayer was providing the service of "unscrambling a radio signal," not the production of satellite programming, and this service occurred "at the radio receiver" (that is, the customer's location).

After a three-day bench trial, the trial court found that Sirius's services were performed "almost exclusively" outside Texas — and that the fair value of services it performed in Texas was less than 1 percent of its total receipts. The trial court ordered the comptroller to refund the taxes. The comptroller appealed to the Texas Court of Appeals, which reversed. The appellate court claimed there was no guidance on how to determine where a service is performed and, as a result, it adopted a "receipt-producing, end-product act" test and found that the receipt-producing, end-product act was not the radio programs or satellite services Sirius performed, but merely activating satellite car radios in Texas — which the court said was performed at the customer's radio, and therefore receipts should be sourced based on the customer's location. This decision was notably at odds with a 2013 ruling in *Westcott*, in which the same court held that satellite training programs should be taxed where they are created rather than where they are received.

Ultimately, the Texas Supreme Court set things right in 2022 and reversed the appellate court. The supreme court relied on a plain reading of the statute, supported by long-standing

[1] *Sirius XM Radio Inc. v. Hegar*, No. 20-0462 (Tex. 2022).

precedent. The court rejected the receipt-producing, end-product act test and adopted an origin-based test — finding that a taxpayer's gross receipts from the sale of services should be sourced to where its employees or equipment performed the labor related to service.

The issue raised in *Sirius* has been cropping up in various cost-of-performance states, in which a revenue agency attempts to read into the law a market-based sourcing result. A similar cost-of-performance case is also pending at the Pennsylvania Supreme Court.[2] Taxpayers should review how they have been filing in cost-of-performance states and ensure that they are reporting the tax as required under a plain reading of the statute.

Time to Party: Third-Party Seller Victory

Meanwhile, in Pennsylvania, third-party sellers secured a victory against the Department of Revenue (DOR), which had sought to collect taxes on an estimated 11,000 out-of-state sellers storing inventory in the commonwealth.

Amazon enters into third-party agreements called Fulfilled by Amazon (FBA) sales, in which a vendor ships its inventory to an Amazon warehouse, where it is stored until purchased by a customer — at which time Amazon ships the merchandise to the customer directly. The FBA saga began in 2012 (pre-*Wayfair*), when Amazon reached an agreement with the Pennsylvania DOR to voluntarily collect and remit sales tax on its internet sales. However, that agreement did not extend to FBA sales. In a second agreement it reached with the department in 2018, Amazon agreed to begin collecting and remitting sales tax on the FBA sales from 2018 forward; FBA sellers remained liable for any pre-2018 FBA sales.

Members of the Online Merchants Guild (Guild) began receiving business activity questionnaire requests from the DOR indicating that they "may have" a physical presence in Pennsylvania and therefore an obligation to collect and remit sales tax and pay personal income tax. The physical presence was based upon the FBA seller's inventory being stored in an Amazon warehouse within the commonwealth.

Finally, the questionnaire noted that "additional enforcement actions" would be taken if there was a failure to provide the requested information.

During 2021 the Guild filed a petition for review with the commonwealth court, and both parties filed cross-applications for summary relief.[3] Relying on the due process clause, the court found that the U.S. Constitution's provision prohibited the DOR's attempted taxation of the FBA sellers. Due process requires "some definitive link, some minimal connection, between the state and the person, property[,] or transaction it seeks to tax." The existence of minimum contacts requires "some act" by which an entity "purposefully avails itself of the privilege of conducting activities within the forum [s]tate, thus invoking the benefits and protections of its laws." Given the facts of the FBA sellers' relationship with Amazon and their lack of knowledge of — or involvement in — where their inventory was stored, the court proclaimed: "We are hard pressed to envision how, in these circumstances, an FBA Merchant has placed its merchandise in the stream of commerce with the expectation that it would be purchased by a customer located in the Commonwealth, or has availed itself of the Commonwealth's protections, opportunities, and services."

In a double whammy to the DOR, the court also questioned its authority in issuing the questionnaires:

> Critically, Revenue's investigative powers under Section 272 apply to the records of *taxpayers*, not individuals or entities Revenue *suspects* may be taxpayers. Furthermore, Section 272 does not grant Revenue the unfettered authority to seek business information from any person or entity it desires for the purpose of determining its status as a taxpayer. [Emphasis in original.]

The case includes a succinct review of the due process clause and its application to FBA sellers, which may be applicable in other cases across the country in which states have raised a similar issue. Further, it questions a taxing authority's

[2] *Synthes USA HQ v. Commonwealth*; No. 11 MAP 2021 (Pa.).

[3] *Online Merchants Guild v. Hassell*, 179 M.D. 2021 (Pa. Commw. Ct. Sept. 9, 2022).

ability to target and impose burdens on out-of-state taxpayers. An out-of-state taxpayer will likely consider this decision in determining its obligation to respond to future questionnaires.

An Investee Apportionment Taxpayer Triumph — Sort Of

Our next case out of Massachusetts was a taxpayer win, but not necessarily on the grounds that taxpayer hoped for. In *VAS Holdings*,[4] VAS Holdings & Investments LLC (VASHI), a Florida limited liability company taxed as an S corporation based in Illinois, owned a 50 percent membership interest in Cloud5 LLC, a Massachusetts LLC taxed as a partnership. VASHI did not conduct any business in Massachusetts and had no Massachusetts resident shareholders, and its only material assets were bank accounts and its membership interest in Cloud5. VASHI and its shareholders paid Massachusetts income tax on their distributive shares of Cloud5's operating income. However, during 2013 VASHI sold its 50 percent interest in Cloud5 and excluded the resulting capital gain from both its own Massachusetts income tax base and that of its shareholders.

On audit, the Massachusetts commissioner of revenue disagreed with VASHI's position and instead assessed corporate excise tax and nonresident composite tax on 100 percent of VASHI's capital gain. The commissioner's position was based on a Massachusetts regulation that taxes a non-domiciliary owner on all capital gains from the sale of a partnership interest if the dollar amounts of the partnership's property and payroll factors are greater in Massachusetts than in any other state.

On appeal, VASHI raised due process clause and commerce clause issues and claimed that the U.S. Supreme Court's ruling in *MeadWestvaco* established that nonresident gains could only be taxed by Massachusetts if the company and Cloud5 were part of a unitary business. The commissioner stipulated to the fact that there was no unitary business; however, according to the commissioner, a unitary business relationship was not required to impose the tax. Without thoroughly addressing the Supreme Court precedent to the contrary, the Massachusetts high court disagreed with VASHI's arguments that applying the unitary business principle was the only constitutional manner in which the state could tax gains from nonresidents. Thus, on a constitutional basis, the court upheld the commissioner's position. However, the taxpayer ultimately won when the court examined the Massachusetts statute and its taxing authority, which itself applied the unitary business principle. Because no unitary relationship existed, the court held that the state law — as currently written — did not permit the tax.

VASHI is likely not the end of the story. There is a current trend nationwide of cases dealing with whether states are permitted to look to the presence of the in-state entity being sold as a sufficient basis to tax capital gains from its nonresident investors.

You Win Some, You Lose Some

To wrap up our 2022 SALT highlights, we turn to California. In *Metropoulos Family Trust*,[5] Pabst Corporate Holdings Inc., an S corporation, held assets related to the brewing of beer. In 2014 Pabst sold a subsidiary in a transaction that was treated as an asset sale for federal purposes. The sale resulted in capital gain, almost all of which was attributable to intangible assets, such as goodwill. In the originally filed California return, the gain was apportioned between the jurisdictions, and tax was paid to California based on the income attributable to the state. In 2016 the taxpayers filed amended returns and claimed a refund, asserting that none of the gain should be sourced to California because the taxpayers were not California residents at the time of the sale.

The refund was ultimately denied and the case made its way to the Court of Appeals. The crux of the debate between the parties came down to a mismatch between the statute and the regulations. The taxpayer pointed to the statute, which sourced a nonresident's gain on the sale of intangibles to the state of domicile unless the

[4] *VAS Holdings & Investments LLC v. Commissioner of Revenue*, SJC-13139 (Mass. 2022).

[5] *The 2009 Metropoulos Family Trust v. California Franchise Tax Board*, D078790 (Cal. Ct. App. May 27, 2022).

property had acquired a business situs in California. Meanwhile, the Franchise Tax Board argued that the S corporation's sale of goodwill passing through to the trusts should be apportioned under California's Uniform Division of Income for Tax Purposes Act provisions, as incorporated into its regulations.

In siding with the FTB, the court held that the goodwill was inseparable from Pabst's business operations: "The goodwill was used as an integral part of Pabst's California business and related to its California business activities, at least for purposes of Pabst's taxation." The court reasoned that because the gain from the asset sale of goodwill is undisputedly business income to Pabst, it remains business income for purposes of sourcing the trusts' pro rata share of that income.

Apart from the ultimate holding, there is some concern in one of the court's statements in its opinion. It claims that the regulations should be "accorded the same dignity as a statute" — which is at odds with the true hierarchy in lawmaking. A key difference between statutes and regulations is their creation. Statutes are laws that are written and approved by state legislatures. On the other hand, regulations are rules written by agencies (such as the DOR) to supplement laws passed by the legislature. Regulations and statutes should not be given the same weight, particularly when they conflict.

Finally, the decision serves as a reminder to consider SALT when contemplating a transaction, since a stock sale and asset sale can have very different SALT implications for the owners.

Expect more highs and lows in SALT in 2023. ■