taxnotes® state

Volume 114, Number 12 ■ December 23, 2024

# 2024’s Most Interesting State Tax Developments

by Jeffrey A. Friedman, Daniel H. Schlueter, Madison Ball, and Periklis Fokaidis

Reprinted from *Tax Notes State*, December 23, 2024, p. 769

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

# 2024's Most Interesting State Tax Developments

**by Jeffrey A. Friedman, Daniel H. Schlueter, Madison Ball, and Periklis Fokaidis**

Jeffrey A. Friedman

Daniel H. Schlueter

Madison Ball

Periklis Fokaidis

Jeffrey A. Friedman and Daniel H. Schlueter are partners in the Washington, D.C., office of Eversheds Sutherland's (US) LLP state and local tax practice, and Madison Ball and Periklis Fokaidis are associates in the firm's New York office.

In this installment of A Pinch of SALT, the authors look back on 2024's most interesting state tax developments.

Copyright 2024 Jeffrey A. Friedman, Daniel H. Schlueter, Madison Ball, and Periklis Fokaidis.
All rights reserved.

The Most Interesting State Tax (MIST) developments of 2024 include some carryover themes from prior years, like income tax apportionment and conformity to the Internal Revenue Code. State taxation of non-U.S. income was a prevalent issue. This year's noteworthy developments also include important sales and use tax cases involving the taxation of payments made by an instrumentality of the federal government and a claim of unfair apportionment of a tax on moveable property. We hope you enjoy our take on 2024's MIST developments.

## IRC Section 965 Repatriated Income

When Congress enacted the Tax Cuts and Jobs Act of 2017, many predicted that an avalanche of state controversy and litigation would follow as states responded — or in some cases, failed to respond — to the many changes brought about by the federal law.

Those predictions panned out big time in 2024. At the state level, there were two significant decisions concerning one TCJA provision in particular: the one-time tax on post-1986 foreign earnings under IRC section 965. Congress enacted section 965 as a transition measure to bridge the international tax regime as it existed before the TCJA with the new regime enacted by the act. The provision requires U.S. taxpayers to include the post-1986, pre-TCJA earnings of their foreign subsidiaries in income on a one-time basis, typically in tax year 2017 or 2018.

Many states decoupled from section 965, but for those that did not, substantial questions arose — including whether the section 965 amount qualifies for a dividends received deduction and how the amount should be apportioned. In Nebraska, the state's supreme court grappled with the dividends received question. In Oregon, the state's tax court addressed apportionment.



For more *Tax Notes® State* content, please visit www.taxnotes.com.

## Nebraska — *Precision Castparts*

In *Precision Castparts*, the Nebraska Supreme Court held that taxpayers are not entitled to a dividends received deduction for section 965 repatriated income.[1]

Like many states, Nebraska allows corporate taxpayers to deduct dividends and deemed dividends paid by related corporations or by corporations not subject to federal income tax — a category that includes most foreign corporations.[2] The taxpayer, Precision Castparts, claimed a deduction under this provision for the amounts it was required to recognize under section 965. Nebraska's tax commissioner rejected the claim, arguing that the section 965 amount "does not meet the definition of dividend nor is it deemed a dividend" but was instead properly classified as an "inclusion."[3]

In a decision issued in August, the Nebraska Supreme Court agreed with the commissioner, saying, "We see nothing in the language of Section 965 that explicitly states the inclusion is to be considered or treated as dividends."[4] In support, the court relied heavily upon the U.S. Supreme Court's then-recent decision in *Moore*,[5] which had rejected a federal constitutional challenge to section 965. In *Moore*, the taxpayers argued that the section 965 tax failed to qualify as a direct tax on "income" within the meaning of the 16th Amendment to the U.S. Constitution because the shareholders being taxed had not realized any income. In rejecting that argument, the U.S. Supreme Court analogized section 965 to other forms of passthrough taxation, whereby income realized by an entity is treated as if it is earned by its owners.[6]

That characterization was sufficient for the Nebraska Supreme Court to determine that the section 965 earnings were not "dividends" or "deemed dividends" for purposes of Nebraska law. "The U.S. Supreme Court's characterization of Section 965 indicates that the statute does not operate by deeming shareholders to have received a distribution of retained earnings from" controlled foreign corporations.[7] "Instead," the Nebraska court determined, "section 965 employs pass-through treatment, which does not require a distribution of earnings to shareholders and instead attributes earnings realized by CFCs to the shareholders without regard to whether those earnings are distributed to the shareholders."[8]

While final for Nebraska purposes, it remains to be seen whether *Precision Castparts* will have much influence outside the Cornhusker State. In the wake of the TCJA, several states amended their statutes or issued explicit guidance making clear that the section 965 inclusion qualifies for that state's dividends received deduction. However, in those states without explicit guidance, the decision may be influential, particularly where the state's dividends received deduction mirrors Nebraska's.

## Oregon — *Microsoft*

In Oregon, unlike Nebraska, it is clear that section 965 income qualifies for the state's dividend received deduction.[9] The Oregon deduction, however, is an 80 percent deduction, meaning 20 percent of a taxpayer's section 965 inclusion is includable in income.[10] That naturally leads to questions about how the amounts should be treated for apportionment purposes. What amount should be included in the sales factor — the sales giving rise to the section 965 earnings, the section 965 earnings themselves, or some other amount?

[1] *Precision Castparts Corp. v. Nebraska Department of Revenue*, 317 Neb. 481 (Neb. 2024).

[2] *See* Neb. Rev. Stat. section 77-2716(5) (allowing deduction for "dividends received or deemed to be received from corporations which are not subject to the Internal Revenue Code.").

[3] *Precision Castparts*, 317 Neb. at 484-485. In support, the commissioner relied on Treas. reg. section 1.902-1(a)(11), stating that federal tax law makes a distinction between "deemed dividends" and "deemed inclusions" and that the term "dividend" includes "deemed dividends" but does not include "deemed inclusions."

[4] *Precision Castparts*, 317 Neb. at 489.

[5] *Moore v. United States*, 144 S. Ct. 1680 (2024).

[6] *Id.* at 1685.

[7] *Precision Castparts*, 317 Neb. at 491.

[8] *Id.* at 491-492.

[9] Or. Rev. Bulletin 2018-01 (Nov. 9, 2018) (stating, regarding IRC section 965 amounts, "Under OAR 150-317-0330, the deemed repatriation is treated as a dividend and is eligible for the dividend received subtraction in ORS 317.267(2).").

[10] Or. Rev. Stat. section 317.267(2)(b).



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes*® *State* content, please visit www.taxnotes.com.

The Oregon Tax Court addressed these issues in *Microsoft*.[11] To apportion income to the state, Oregon uses a single-sales-factor formula, under which income is apportioned to Oregon in the same proportion that the taxpayer's in-state sales bear to its sales everywhere. In administrative guidance issued after the TCJA was enacted, Oregon determined that no amount attributable to the section 965 inclusion should be included in the taxpayer's sales factor.[12] The taxpayer in *Microsoft* argued that this would be distortive. It would mean that a substantial amount of income would be included in the tax base without any recognition of the business activities giving rise to that income in the apportionment factor. To alleviate that distortion, Microsoft argued that the foreign sales that generated the repatriated section 965 earnings should be included in the sales factor. Because the sales were all foreign, they would necessarily go in the denominator only.

In a decision issued in August, the Oregon Tax Court disagreed with both parties. The court disagreed with the Department of Revenue that no amount should be included in the apportionment factor. Instead, it held that Oregon's statutes required 20 percent of the repatriated 965 amount — that is, the same amount Microsoft was required to recognize in income — to be included in the factor.[13] The court based that conclusion on an earlier decision, *Oracle II*, in which it had interpreted the same apportionment statute in the context of subpart F income.[14] The court held in *Oracle II* that subpart F income is includable in the sales factor if the taxpayer and the CFC are engaged in a unitary business and "the CFC's earnings and profits constituting the subpart F amounts are from a single 'primary business activity' shared by the CFC and the taxpayer."[15] The court concluded that Microsoft satisfied this standard, as repatriated amounts were derived from its primary business activity of selling software.[16]

At the same time, the court disagreed with Microsoft that the amount to be included in the sales factor should be the gross receipts from the foreign sales, rather than the net earnings from the sales. The court analyzed that question under Oregon's alternative apportionment statute and the standard for constitutional distortion under the U.S. Constitution. It found no distortion based on a calculation the state had submitted, which purported to be based on an application of the "Augusta formula" upheld by the Maine Supreme Court in *E.I. DuPont de Nemours & Co.*[17] That formula asks whether the statutory method apportions more income to a state than would a method of worldwide reporting. If it does, the statutory formula is presumptively unconstitutional. The state's calculation showed that if the section 965 earnings were spread back over a 20-year period, the statutory method apportioned less income than would a worldwide method.

Microsoft subsequently moved for reconsideration, noting that the state's application of the Augusta formula was incorrect and inconsistent with section 965, because section 965 requires earnings to be recognized in a single year, not backward over a 20-year period. In Microsoft's case, if the formula had been applied to the single year in which the earnings were *actually* required to be recognized, the results would have been flipped: substantially *less* income would be apportioned to Oregon under the worldwide method than under the statutory method. Microsoft therefore argued that the Augusta formula supported a finding of distortion, rather than the opposite. The court has since directed the parties to submit further briefing on the motion for reconsideration, so our final report on the decision will have to wait until next year.

[11] *Microsoft Corp. v. Department of Revenue*, No. TC 5413 (Or. T.C. Aug. 29, 2024).

[12] *See id.* at *13 (citing Or. Rev. Bulletin 2018-01).

[13] *Id.* at *58; Or. Rev. Stat. section 314.665(6)(a) (since amended by the Oregon Legislature, striking *former* subsection 6 altogether).

[14] *Microsoft*, No. TC 5413 at *4; *Oracle Corp. and Subsidiaries II v. Department of Revenue*, 24 Or. Tax 359, 360 (2021).

[15] *Microsoft*, No. TC 5413 at *4.

[16] *Id.* at *23.

[17] *Id.* at *43-44; *E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996).



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes*® *State* content, please visit www.taxnotes.com.

### California — *Appeal of Microsoft Corp. and Subsidiaries*

Unlike Nebraska and Oregon, California did not conform to section 965, meaning taxpayers' post-1986 foreign earnings were not required to be included in the California tax base as they were in other states.[18] The section 965 regime nevertheless had important practical consequences in California because many taxpayers repatriated their foreign earnings via actual dividends after paying the one-time federal tax. Because those earnings were not previously subject to California tax, they became subject to tax as actual dividends when the dividends were paid.

Microsoft was one of those taxpayers, and its actual dividend payment gave rise to a series of significant apportionment decisions by the California Office of Tax Appeals (OTA). Like Oregon, California allows a deduction for dividends received — although the exclusion in California is 75 percent of the dividend rather than 80 percent. In two separate decisions, one issued in July 2023 and another denying the Franchise Tax Board's request for reconsideration in February 2024, the OTA determined that the statute required Microsoft to include 100 percent of the dividend in the denominator of the sales factor, even though only 25 percent of the dividend was required to be included in income.[19]

The FTB argued that only 25 percent of the dividends should have been included in the factor denominator. It made three supporting arguments, each of which was rejected by the OTA. First, the OTA rejected the FTB's assertion that a "matching principle" required only 25 percent to be included in the factor, noting that such "principle" could not contradict the express language of the statute, which required 100 percent of the dividend to be included. Second, the OTA rejected the FTB's assertion that Microsoft's receipts from qualifying dividends should be excluded as occasional sales. Finally, the OTA determined that the FTB failed to meet its burden of showing that alternative apportionment was warranted, as it did not provide sufficient evidence indicating that the standard apportionment formula did not fairly represent Microsoft's activity in California.[20]

Following the OTA's decision on reconsideration, the FTB launched an extraordinary campaign in the Legislature to overturn the tribunal's decision. That process ultimately bore fruit with Cal. Rev. & Tax. Code section 25128.9, which purports to "clarify" the applicable statute by adopting the FTB's litigation position in *Microsoft* — that is, it requires dividends to be included in the sales factor in the same proportion as they are included in income. Because the statute is styled as a clarification, the FTB claims it has unlimited retroactive effect. That aspect of the statute has already been challenged by taxpayer groups, including the California Taxpayers Association, which has claimed that the statute is contrary to the California and U.S. Constitutions.[21] Whether these cases are ultimately successful in restoring the OTA's interpretation will have to await next year's report.

## Conformity to the Internal Revenue Code

As every practitioner knows, state conformity to the federal tax base is a defining feature of state income tax law. That conformity produces obvious and well-appreciated efficiencies, as federal law provides the starting point for the state income tax calculation. If each state had its own definition of taxable income, the number of state tax controversies would multiply a thousandfold.

But even though conformity to the federal tax base is fundamental, the precise contours of that conformity depend on the specific language adopted in each state's law — and that language can produce controversy. This year was no exception, with two notable decisions from New York City and Florida. The New York case involves the perennial issue of whether a state or locality has

[18] This is a product of California's fixed-date approach to conformity, which conforms to the IRC only as of a certain date. During the 2017 and 2018 tax years, California conformed to the IRC as of January 1, 2015, meaning the state did not conform to the version of section 965 enacted with the TCJA in 2017.

[19] *In re Appeal of Microsoft Corporation & Subsidiaries*, OTA Case No. 21037336 (Cal. Off. Tax App. July 27, 2023).

[20] *Id.* at 27.

[21] Verified Complaint for Declaratory Relief, *California Taxpayers Association v. California Franchise Tax Board*, No. 24CECG03564 (Cal. Super. Ct. Aug. 15, 2024) (Eversheds Sutherland represents the taxpayer's association in this case).



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

adopted additional requirements for deductibility not present in federal law. The Florida case involves a more nuanced question, involving the interaction of conformity with apportionment and how federal limitations apply to post-apportioned items, like net operating losses.

### New York City — *A&E Television Networks*

In *A&E Television Networks*, the Administrative Law Judge Division of the New York City Tax Appeals Tribunal held that the determination of whether an item is deductible under New York City's unincorporated business tax (UBT) is governed by the applicable federal standard.[22] There are no additional city-specific requirements.

That question arose in the context of certain deductions for an interest expense claimed by the taxpayer, A&E Television Networks. The interest expense at issue was incurred by A&E in connection with a redemption transaction involving one of its owners' interests. The city agreed that the interest was deductible for federal purposes, but it denied the deduction for purposes of the city's UBT, arguing that the city code imposed additional requirements for deductibility that were not satisfied in the case of the A&E interest.

Subject to enumerated modifications, the applicable provision of the city code allows taxpayers to deduct "the items of loss and deduction directly connected with or incurred in the conduct of the business, which are allowable for federal income tax purposes for the taxable year."[23] The city argued that the phrase "directly connected with or incurred in the conduct of the business" should be read without reference to the subsequent phrase "which is allowable for federal income tax purposes." In other words, it argued that even if an expense was deductible for federal purposes, the regulation imposed an additional requirement for deductibility — that the expense be "directly connected with or incorrect in the conduct of the business."[24]

Noting that the "applicable federal income tax standard" already imposes a requirement that the expense be "directly connected with" the taxpayer's trade or business, the ALJ rejected the city's argument that the city administrative code imposed a different and additional standard.[25] The ALJ supported that conclusion by reference to the history of the city UBT and the state UBT on which the city UBT was patterned. That history showed that the "federally allowable" language was added to the state UBT in 1960 to "conform . . . to the applicable standard for federal income tax purposes."[26] Making matters clearer, the New York State Tax Appeals Tribunal had already concluded that the same "directly connected with" language in the state UBT did not create a separate state-specific requirement in addition to the federal standard. Whether an expense was "directly connected with" the business was thus determined by federal law alone. Accordingly, it was dispositive that the interest qualified for deduction under the federal standard.[27]

### Florida — *Verizon Communications*

The conformity issue in *Verizon Communications* was different.[28] It concerned IRC section 382, which limits the amount of NOLs a taxpayer can use from acquired corporations. The limitation is determined by reference to a complicated formula, which is based on the loss corporation's value before its acquisition, multiplied by the federal long-term, tax-exempt interest rate.[29]

The taxpayer in the Florida case was Verizon, which had acquired two companies with substantial accumulated losses — MCI Inc. and Terremark Worldwide Inc.[30] MCI had over $15 billion in NOLs when it was acquired by Verizon in 2006, and Terremark had over $308 million in

[22] *In re Matter of the Petition of A&E Television Networks LLC*, TAT(H)20-32(UB) (N.Y.C. Tax App. Trib. July 2, 2024) (Eversheds Sutherland represented the taxpayer in the case).

[23] *Id.* at 10 (quoting N.Y.C. Admin. Code section 11-507).

[24] *Id.* at 7.

[25] *Id.* at 10 (citing Treas. reg. section 1.162-1(a)).

[26] *Id.* at 15.

[27] *Id.*

[28] *Florida Department of Revenue v. Verizon Communications Inc.*, 380 So. 3d 541 (Fla. 1st Dist. Ct. App. 2024).

[29] *See* IRC section 382(b)(1). The purpose of the limitation is to discourage trafficking in loss companies by limiting the amount of losses an acquiror can use. The limitation seeks to approximate the amount of losses the loss corporation itself would have been able to use on a stand-alone basis had it not been acquired.

[30] *Verizon Communications*, 380 So. 3d at 543.



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

NOLs when it was acquired in 2011. The federal section 382 limitation for the MCI NOLs was approximately $241 million, meaning it would take over 60 years ($15 billion/$241 million) for Verizon to deduct the full amount of the NOLs on its federal returns. That would exceed, by a substantial amount, the 20-year carryover period allowable under federal law.[31]

Like many states, Florida requires taxpayers to determine state-level NOLs on an apportioned basis. Those losses are then used against apportioned income. In Verizon's case, the Florida NOLs acquired from MCI were approximately $267 million, and the Florida NOLs acquired from Terremark were approximately $238 million.[32] The question before the Court was how the section 382 limitation should be determined for those Florida NOLs.

Verizon argued that the same dollar limitation applicable to its federal NOLs should apply ($241 million for the MCI NOLs and $128 million for the Terremark NOLs), while the DOR argued for a greatly reduced amount computed under a "proportional calculation methodology." Under that method, the limit would be calculated by multiplying the federal limit by the ratio of Florida NOLs to federal NOLs.[33]

The court agreed with Verizon, finding that its argument relied upon a "straight-forward reading of the statute," which allowed a deduction for NOLs "in the same manner, to the same extent, and for the same time periods" as is "allowable for federal income tax purposes."[34] In addition to the statute, the court relied on the DOR's regulation, which provided that "in computing the Florida corporate income tax, a deduction for the NOL carryover will be allowed to the extent of the amount allowed for federal purposes, provided that the deduction does not exceed the total amount of the Florida NOL carryover available in such taxable year."[35]

Thus, under the court's decision, the same section 382 dollar limitation applies to both federal NOLs and Florida NOLs. This could be of substantial benefit to taxpayers. In Verizon's case, it meant that Verizon was able to deduct the full amount of its Florida NOLs in two years rather than the 60 years required for federal purposes.

### Income Tax — Apportionment

Consistent with prior years, apportionment continued to be a significant source of controversy in 2024. Notwithstanding claims by proponents of market-based sourcing, widespread adoption of that method has not been the magical elixir that was promised. Controversies have not been eliminated or substantially reduced. In fact, the opposite has been true. The sourcing of service revenues continues to bedevil taxpayers and revenue departments alike, as parties struggle to define the relevant "market."

One of the most contentious areas is "look-through" sourcing. When, if ever, is it appropriate to source receipts by looking through the taxpayer's direct customer to the customer's customer? What standards will be applied in making that determination? While several recent decisions have rejected look-through sourcing in various circumstances,[36] one decision this year arguably took a different tack.

### Look-Through Sourcing

#### South Carolina Income Tax — *Mastercard*

The South Carolina Administrative Law Court (ALC) reached a "look through" result in *Mastercard*,[37] finding that receipts from Mastercard's services should be sourced to the locations where individual cardmembers and merchants consummated credit card transactions using Mastercard-branded credit cards, rather

[31] *See id.* at 545 n.2. The disparity between the section 382 limitation and NOLs acquired was much smaller in the case of Terremark. There, the section 382 limitation was approximately $128 million and the NOLs acquired were $308 million, meaning it would take approximately three years to fully deduct those losses ($308 million/$128 million). *See id.* at 543.

[32] *Verizon Communications*, 380 So. 3d at 543.

[33] *Id.*

[34] *Id.* at 544 (quoting Fl. Stat. section 220.13(b)(1)).

[35] *Id.* (quoting Fla. Admin. Code Ann. section 12C-1.013(15)(j)).

[36] *See, e.g.*, *Wisconsin Department of Revenue v. Microsoft Corp.*, 936 N.W.2d 160 (Wis. Ct. App. 2019); *LendingTree LLC v. Department of Revenue*, 460 P.3d 640 (Wash. Ct. App. 2020); *Defender Security Co. v. McClain*, 165 N.E.3d 1236 (Ohio 2019); *Walter Dorwin Teague Associates Inc. v. Department of Revenue*, 500 P.3d 190 (Wash. Ct. App. 2021).

[37] *Mastercard International Inc. v. Department of Revenue*, No. 20-ALJ-17-0008-CC (S.C. Admin. Ct. June 3, 2024).



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

than the locations of the banks that were Mastercard's direct customers.

South Carolina requires receipts from services to be sourced to the location where the taxpayer performs its "income-producing activity."[38] Based on the evidence introduced at trial, the ALC found that Mastercard's income-producing activity consisted of "providing Network access to Cardholders, Merchants, and banks," and that activity occurred in South Carolina when the cardholder and merchant concluded transactions in the state.[39]

Mastercard argued that its income-producing activity occurred solely at the data center locations used to communicate with its direct customers, that is, the issuing and acquiring banks that issue credit cards to cardmembers and contract with individual merchants. All those locations were outside South Carolina.[40] It argued that sourcing receipts based on the activities of merchants and cardholders would be akin to look-through sourcing, for which there was no South Carolina precedent.[41]

The ALC disagreed with Mastercard, although it did not directly dispute Mastercard's legal premise that look-through sourcing would be inappropriate. Instead, it disputed Mastercard's factual premise that Mastercard's "only customers" were the banks that issued credit cards to cardmembers and contracted with individual merchants.[42] The ALC determined that "the evidence demonstrate[d] that Merchants and Cardholders are also Mastercard's customers."[43] In support, the ALC pointed to evidence that "Mastercard promotes its cards and services to both Cardholders and Merchants, has designed specific benefits for each, and generates income based on their activities."[44] It further determined that cardholders and merchants were "beneficiaries of Mastercard's services" because they are "able to consummate cashless transactions . . . because of the Mastercard Network."[45] Accordingly, the ALC determined that it was appropriate to source Mastercard's receipts to the South Carolina locations where cardmembers and merchants consummated their transactions.

## Services Versus Intangible Property

### South Carolina Bank Tax — *U.S. Bank*

Three weeks after it issued its decision in *Mastercard*, the South Carolina ALC issued a second significant apportionment decision — again ruling against the taxpayer. In *U.S. Bank*,[46] the ALC upheld a bank tax assessment based on adjustments the DOR made to the taxpayer's sales factor and tax base.

The taxpayer offered a range of banking and trust services, generating income by providing residential mortgages and other loans and issuing credit cards to consumers. The primary dispute concerned the characterization of the taxpayer's sales for apportionment purposes — were the taxpayer's mortgage lending and credit card receipts generated from the sale of a service or an intangible? As described above in our discussion of *Mastercard*, South Carolina sources services based on the location of the taxpayer's "income-producing activity."[47] Intangibles are sourced based on the location where the intangible is "used."[48]

The taxpayer argued that its mortgage and credit card activities constituted services, while the DOR argued they were intangibles. The ALC agreed with the DOR, finding that a mortgage is intangible property and not a service. The ALC was not persuaded by the fact that the statute listing different types of intangible property (royalties, copyrights, trademarks, and trade names) did not include mortgages because the statute stated that the list was non-exhaustive.[49]

[38] *Id.* at 17 (quoting S.C. Code Ann. section 12-6-2295(A)(5)).

[39] *Id.*

[40] *Id.* at 4-5, 13 n.27.

[41] *Id.* at 34.

[42] *Id.* at 27.

[43] *Id.* at 22.

[44] *Id.*

[45] *Id.*

[46] *U.S. Bank National Association v. South Carolina Department of Revenue*, No. 20-ALJ-17-0168-CC (S.C. Admin. Law Ct. June 25, 2024).

[47] *Id.* at 12 (citing S.C. Code Ann. section 12-6-2295(A)(5)).

[48] *Id.* (citing S.C. Code Ann. section 12-6-2295(A)(3)).

[49] *Id.* at 17.



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

Having concluded that the mortgages were intangibles, the ALC proceeded to analyze where the mortgages were "used." In making that determination, the ALC assumed, without discussion, that it was the borrower's use that mattered, not the taxpayer's. Based on that assumption, the ALC found that the mortgages were "used" at the location of the underlying real property, because the mortgages were "being used by borrowers to buy or improve residential real estate in South Carolina."[50]

The ALC reached the same conclusion regarding receipts from the taxpayer's credit card business. It determined that receipts from payments on credit cards, including interest, late fees, and annual fees, constituted receipts from intangibles because "in extending credit to cardholders as an issuing bank," the taxpayer "is creating accounts receivables that fall into the definition of intangible property."[51] It found that "use" took place in South Carolina if the cardholder was in South Carolina.[52]

Notably, the ALC also concluded in the alternative that if the taxpayer's receipts from its mortgage and credit card operations were properly classified as sales of a service (rather than an intangible), the DOR would still prevail. The ALC acknowledged that the taxpayer's mortgage and credit card operations were all located out of state — but consistent with the idiosyncratic definition of income-producing activity adopted by the South Carolina Court of Appeals in *DirecTV*.[53] It characterized these operations as "anticipatory" or "preparatory" activities, not the "income-producing activities" themselves.[54] Instead, applying *DirecTV*, the ALC viewed the "true" "income-producing activity" to be the "issuance (sale) of mortgage loans to South Carolina borrowers" (in the case of mortgages) and the "loan . . . that produces income for U.S. Bank" (in the case of credit cards).[55] Because the borrowers were in South Carolina, the "income-producing activities" were also deemed to be in South Carolina. For all intents and purposes, this is a market-based standard, not one based on the taxpayer's activities.

### Personal Income Tax

In *Wynne*,[56] the U.S. Supreme Court confirmed that a state must provide a complete credit for taxes paid to other states. Since *Wynne* was decided, there have been a spate of personal income tax cases concerning the income tax treatment of employees who live in one state and work in another.

#### Limiting Credits to Local, Not State, Taxes

Last year, the Pennsylvania Supreme Court held that Philadelphia was not required to provide a credit for income taxes paid to Delaware. In *Zilka*,[57] the court distinguished *Wynne* based on differences between the Philadelphia tax system and the Maryland tax system at issue in *Wynne*.

Diane Zilka, a resident of Philadelphia, was subject to Pennsylvania's income tax and Philadelphia's wage tax. Because she worked in Wilmington, Delaware, Zilka was also subject to Delaware's income tax and Wilmington's earned income tax. Philadelphia limited its allowable credit to Wilmington's tax (which was imposed at a lower rate than Philadelphia's tax) and did not include the Delaware income tax.

The court found that Philadelphia's limitation of its credit to only local taxes did not discriminate against interstate commerce in violation of the commerce clause. In reaching its decision, the

[50] *Id.* at 15.

[51] *Id.* at 24.

[52] *Id.* Unlike interest and fees paid by cardmembers, the ALC found that interchange fees paid by merchants constituted fees paid for the provision of a service, rather than an intangible. But it determined that interchange fees should likewise be sourced to South Carolina, because the income-producing activity occurred in South Carolina. *Id.* at 25.

[53] *DirecTV Inc. & Subsidiaries v. South Carolina Department of Revenue*, 804 S.E.2d 633 (S.C. Ct. App. 2017). We refer to the *DirecTV* standard as "idiosyncratic" because many states have adopted a version of the income-producing activity test. Unlike *DirecTV*, most judicial interpretations of the term look to the activity of the taxpayer, not the taxpayer's customer, and do not distinguish between anticipatory and non-anticipatory activities. *See, e.g.*, *University of Phoenix Inc. v. Indiana Department of State Revenue*, 88 N.E.3d 805, 810-811 (Ind. T.C. 2017); *Bellsouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350, 364 (Tenn. Ct. App. 2009); *Boston Professional Hockey Association Inc. v. Commissioner of Revenue*, 820 N.E.2d 792, 800-801 (Mass. 2005); *Billmatrix Corp. v. Florida Department of Revenue*, No. 2020-CA-000435, at 15 (Fla. 2d Cir. Ct. Mar. 1, 2023).

[54] *U.S. Bank*, No. 20-ALJ-17-0168-CC at 21.

[55] *Id.* at 21, 25.

[56] *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015).

[57] *Zilka v. City of Philadelphia, Tax Review Board*, 304 A.3d 1153 (Pa. 2023).



For more Tax Notes® State content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

court concluded that the Philadelphia wage tax was a "purely local tax . . . promulgated by Philadelphia's City Council and . . . collected . . . for the sole benefit of the City and its residents."[58] These characteristics are different from the local Maryland tax examined by the *Wynne* Court, which the Pennsylvania Supreme Court characterized as a "state tax masquerading as a local tax."[59]

On February 20, 2024, Zilka filed a petition for writ of certiorari with the U.S. Supreme Court.[60] Hopefully, the Court will address whether differences in local tax systems justify different credit treatment.

### Sales and Use Tax

State sales taxes have been the subject of litigation and of several U.S. Supreme Court cases,[61] but there are far fewer cases exploring the reach of state use taxes. *Ellingson Drainage* raised important questions regarding the reach of the use tax as applied to moveable property.

#### Constitutional Challenges

##### South Dakota — *Ellingson Drainage*

In early 2024 the South Dakota Supreme Court held that the imposition of the state's use tax on the fair market value of equipment purchased outside the state and used in the state for as little as one day did not violate the commerce or due process clauses.[62]

The taxpayer, a Minnesota-based company, engaged in approximately 30 drain tile construction projects in South Dakota between 2017 and 2020. To complete these jobs, the taxpayer used construction equipment that had been purchased in Minnesota.[63] No Minnesota sales tax was paid on the purchase of the equipment because it qualified for a Minnesota sales tax exemption. Following an audit, the South Dakota DOR assessed use tax on the value of the equipment used by the taxpayer in the state. The taxpayer asserted that the assessment of use tax on its equipment violated the commerce clause's external consistency requirement.[64]

The U.S. Supreme Court's dormant commerce clause analysis requires that state taxes meet a fair apportionment requirement. In *Container Corp.*, the Court described fair apportionment as containing both an "internal consistency" test and an "external consistency" test:

> The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency — that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed. The second and more difficult requirement is what might be called external consistency — the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.[65]

The South Dakota Supreme Court's external consistency analysis is both interesting and troublesome. In concluding that the use tax was externally consistent, the court characterized the tax as a "substituted sales tax" that can reasonably be imposed — even on property used in the state for a brief period — because no sales tax had been paid on the purchase of the equipment. While sales and use taxes are "complementary taxes," they are distinct.[66] This blending of the sales tax and use tax into essentially a single tax is unprecedented. Moreover, the "reasonableness" of imposing a full use tax based on a single day's use is questionable.

---

[58] *Id.* at 1170.

[59] *Id.* at 1167.

[60] *Zilka v. City of Philadelphia, Tax Review Board*, No. 23-914, *petition for cert. filed* Feb. 20, 2024.

[61] *See Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994); *Goldberg v. Sweet*, 488 U.S. 252 (1989); *Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175 (1995).

[62] *Ellingson Drainage Inc. v. South Dakota Department of Revenue*, 3 N.W.3d 417 (S.D. 2024).

[63] *Id.*

[64] *Id.*

[65] *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

[66] *See Fulton Corp. v. Faulkner*, 516 U.S. 325, 332 (1996).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



For more *Tax Notes® State* content, please visit www.taxnotes.com.

In May 2024 the taxpayer filed a petition for writ of certiorari with the U.S. Supreme Court; unfortunately, it was denied on October 7.[67]

## Marketplace Facilitators

### South Carolina — *Amazon Services LLC*

In recent years, many states have revamped their sales tax systems to create a new responsible tax collector: marketplace facilitators. South Carolina was no exception, as it amended its sales tax law in 2019 to make marketplace facilitators liable for sales tax collection.[68] Nevertheless, the South Dakota DOR assessed Amazon Services tax on sales made by third-party sellers on the Amazon marketplace before 2019. This sales tax assessment was upheld by the South Carolina ALC[69] and the South Carolina Court of Appeals.[70]

The South Carolina Supreme Court granted review on October 3, 2024.[71] In its opening brief, Amazon Services urged reversal on the basis that the pre-2019 law unambiguously did not apply to marketplace facilitators. It is hard to imagine a clearer case of mischaracterizing a change in law: If the South Carolina DOR is right, the 2019 law change was superfluous. Several influential amici are urging reversal; hopefully, the South Carolina Supreme Court will heed their call.

## Intergovernmental Tax Immunity

### Washington — *Assurance Wireless*

In *Assurance Wireless*,[72] the Washington Supreme Court overturned a sales tax assessment on payments made to the taxpayer by the Universal Service Administrative Co. (USAC) under the federal "Lifeline" program, which subsidizes wireless services for low-income consumers. The court held that USAC was an instrumentality of the federal government, exempt from state tax under the federal instrumentality doctrine.

The supremacy clause of the U.S. Constitution has long been held to bar states from taxing the federal government and entities closely connected to it. The rule dates back to the Supreme Court's decision in 1819 in *McCulloch v. Maryland*, which famously declared that "the power to tax involves the power to destroy."[73]

The rule is easy to apply when the federal government is itself the target of the tax, but difficulties arise when the target has a more attenuated connection to the federal government — so-called federal instrumentalities. That was the case here because the payments at issue were made by USAC, which is not itself part of the federal government but is instead an independent not-for-profit entity formed to administer the Lifeline and other Universal Service Fund programs. It has no federal government employees, but the federal government, through the Federal Communications Commission, is closely involved in its operations — the FCC appoints or approves all USAC board members.[74]

The Washington Supreme Court noted that the instrumentality doctrine extends to "an entity 'so closely connected to the Government that the two cannot realistically be viewed as separate entities.'"[75] Although "no simple test" applies, the court found that the standard was met in the case of the USAC.[76]

The court placed particular emphasis on the close control the FCC maintained over the USAC's operations, leadership, and finances and on the fact that USAC existed solely to carry out the FCC's mission of advancing universal service (including through the Lifeline program). It "pursue[d] no independent business objectives."[77]

[67] *Ellingson Drainage Inc. v. South Dakota Department of Revenue*, 3 N.W.3d 417, *petition for cert. denied*, Dkt. No. 23-1202 (Oct. 7, 2024) (Jeffrey A. Friedman and professor Richard Pomp served as counsel to Ellingson Drainage).

[68] *See* S.C. Code Ann. section 12-36-1340.

[69] *Amazon Services LLC v. South Carolina Department of Revenue*, No. 17-ALJ-17-0238-CC (S.C. Admin. Law Ct. Sept. 10, 2019).

[70] *Amazon Services LLC v. South Carolina Department of Revenue*, 442 S.C. 313 (S.C. Ct. App. 2024).

[71] *Amazon Services LLC v. South Carolina Department of Revenue*, No. 2024-000625, *review granted*, Oct. 3, 2024.

[72] *Assurance Wireless USA v. Department of Revenue*, 544 P.3d 471 (Wash. 2024) (Eversheds Sutherland represented the taxpayer in this case).

[73] *McCulloch v. Maryland*, 17 U.S. 316, 431 (1819).

[74] *See Assurance Wireless*, 544 P.3d at 475.

[75] *Id.* at 482 (quoting *United States v. New Mexico*, 455 U.S. 720, 735 (1982)).

[76] *Id.* at 485.

[77] *Id.*



© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

Accordingly, the payments made by the USAC to the taxpayer were determined to be exempt.

## Concluding Thoughts

If you made it this far, we think you'd agree that 2024 was chock-full of noteworthy cases. We are confident that 2025 will be just as eventful. Among other things, we expect a decision from the Maryland Tax Court in the closely watched challenge to the Maryland digital advertising tax. Plus, there will be several appeals in cases covered in this year's developments (we're looking at you, South Carolina), not to mention decisions on two pending petitions for cert. in the U.S. Supreme Court challenging New York's treatment of foreign dividends.[78] We look forward to covering those developments this time next year and wish everyone the best in the new year! ■

taxnotes®

Education | Debate | Fairness | Transparency

We're on a mission.

Creating a marketplace of ideas and an atmosphere that fosters public debate, where exchanges are open, all sides of the aisle are represented, and all ideas are welcome.

We publish world-class news and analysis, host and provide speakers for conferences on topics that matter, provide material for free on our site, and pursue the release of important public information through the Freedom of Information Act.

Find out more at taxnotes.com/free-resources.

[78] *See IBM v. Tax Appeals Tribunal*, No. 24-332, *petition for cert. filed*, Sept. 24, 2024; and *The Walt Disney Co. v. Tax Appeals Tribunal*, No. 24-333, *petition for cert. filed*, Sept. 24, 2024.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



For more *Tax Notes® State* content, please visit www.taxnotes.com.