

## State And Local Tax Cases To Watch In 2023

By **Maria Koklanaris**

*Law360 (January 2, 2023, 12:02 PM EST)* -- From two expected U.S. Supreme Court decisions with potentially strong implications for state tax professionals to an array of litigation that could determine how states and localities may tax remote workers, 2023 offers plenty of significance to watch.

Here, Law360 presents cases that state and local tax professionals will pay attention to in the coming year.

### **Delaware v. Pennsylvania and Arkansas v. Delaware**

The U.S. Supreme Court heard oral arguments Oct. 3 in a long-standing dispute between Delaware and 30 other states, led by Pennsylvania, over who can lay claim to about \$300 million in abandoned MoneyGram checks.

The cases, which the court has consolidated, were already laden with complexities. The key to them lies in defining various financial instruments, a quandary that even the justices struggled with. If the instruments are found to be third-party bank checks, they likely fall under the jurisdiction of the common law laid out in the 1965 decision *Texas v. New Jersey*, and will escheat, or revert, to Delaware. If they are found to be money orders, or at least similar enough to money orders, they will likely fall under the jurisdiction of a 1974 federal law and escheat to the states challenging Delaware.

Recently, though, the cases have taken yet another turn. In 2021, a special master appointed by the justices to advise them found solidly for the challenging states, saying the checks are money orders, or at least "similar written instruments." But in October, Senior Judge Pierre N. Leval of the Second Circuit issued a brief order saying he had partly changed his mind, and in December the judge published another report with findings markedly different from his first. Now, the judge said, hearing oral arguments and reviewing the record again had convinced him that none of the checks are money orders. Some of them may be similar and could still escheat to the challenging states, Judge Leval said in the second report, but many are bank checks and should go to Delaware. In addition, now that the judge was not finding a clear win for Pennsylvania, he said the commonwealth's wish to revisit *Texas v. New Jersey* had validity and asked the justices to remand that issue to him.

The justices said Dec. 20 that they would accept additional briefing in the case to be filed in January, with exceptions to the special master's concerns to be filed first, and then replies.

Adam Beckerink, state and local tax leader at Duane Morris LLP, told Law360 he had already been

interested in the case to see if the justices would rule narrowly on definitions or expand more broadly into the scope of the authority of the common law. But now, he said, he is even more intrigued because of the unusual procedures at play.

"Whether the special master had the ability or the right to go in and revise his determination is interesting in itself," Beckerink said.

Beckerink said he did not think the court would overturn the rules set forth in common law even if the justices did allow the special master to revisit them. The result would be nearly unimaginable, he said.

"That would throw the whole area into chaos," said Beckerink, who like many state tax practitioners has part of his portfolio in the unclaimed property space. "You'd see a lot more suits between states."

The cases are Delaware v. Pennsylvania et al. and Arkansas et al. v. Delaware, case numbers 22O145 and 22O146, in the U.S. Supreme Court.

### **National Pork Producers Council v. Karen Ross**

One of state tax professionals' most eagerly awaited decisions of the year is actually not a state tax case.

But a pending U.S. Supreme Court decision in a challenge to a California animal welfare ballot initiative could signal how claims that state tax systems impose undue burdens on remote sellers may be viewed under the commerce clause.

The case centers on whether a 2018 voter-approved initiative that bans in-state sales of meat from pigs born to mothers confined in small spaces unconstitutionally regulates out-of-state conduct because California imports most of its pork products from other states. The case has piqued the interest of tax professionals who see parallels between arguments presented in the dispute and those raised in tax-related litigation.

At the heart of the dispute is the application of the U.S. Supreme Court's 1970 holding in *Pike v. Bruce Church*, which established that a state law is unconstitutional if it imposes a burden on interstate commerce that is "clearly excessive in relation to the putative local benefits." The weighing of those factors, called the Pike balancing test, has been raised in tax cases but has rarely served as the guiding principle in their decisions. However, that test was reinvigorated by the U.S. Supreme Court's *South Dakota v. Wayfair* decision, which allowed states to require out-of-state sellers to collect and remit sales and use taxes.

It remains to be seen whether the Pike test will be decisive here, as it has been difficult to apply, Michael Lurie, counsel at Reed Smith LLP, told Law360. Instead, he said he sees the case as an opportunity for the court to speak further on the degree to which states may reach over their own borders to regulate or influence out-of-state activity, and to what extent that imposes a burden.

"I think the court is bound to draw a line in the sand here," Lurie said. "I don't know what the line is going to be, but I hope they're going to speak in relatively strong terms and say states should not be regulating conduct outside their borders."

The case is *National Pork Producers Council et al. v. Karen Ross et al.*, case number 21-468, in the U.S. Supreme Court.

## **Josh Schaad v. Karen Alder**

Ohio's highest court is set to decide whether an Ohio law that allowed cities including Cincinnati to tax remote workers at the beginning of the pandemic violates due process protections afforded by the U.S. and Ohio constitutions.

The Schaad case in the Ohio Supreme Court is just one of several cases pending in Ohio over the remote work taxation law, but the situation is in no way limited to that state. Around the country, states and businesses have struggled with the way that states should tax employers and employees when the employee is working somewhere other than the location of the employer. Not a temporary trend, remote work clearly has staying power, and the tax issues surrounding it continue to be vexing, Lisa Hansen, tax partner at Lathrop GPM, told Law360. She said it is one of the top concerns she deals with in her practice.

"You would think that with everything that is out there, people would understand it more," but they are still surprised, Hansen said. "What do you mean I have to file an income tax return in another state?"

The Schaad case, in which plaintiff Josh Schaad is an Ohio resident, is somewhat distinct from another Ohio remote work case, involving a Pennsylvania resident. In the latter case, an Ohio appeals court ordered a hold of an appeal challenging a decision that said Cleveland couldn't impose its income tax on Pennsylvania resident Manal Morsy, who was working remotely. The appeal is on hold pending the Ohio Supreme Court outcome in Schaad.

If the Ohio Supreme Court decides, for example, that the Ohio remote work law is OK for residents but not for nonresidents, the ruling may be more narrowly tailored to Ohio, said Jamie Yesnowitz, state and local tax leader at Grant Thornton's Washington national tax office. But if the Ohio justices say the remote tax law does not work for anyone, Yesnowitz said, that could strongly implicate some other states with similar rules, often referred to as convenience-of-the-employer laws.

"I think this Ohio litigation could go a long way toward determining whether the convenience-of-the-employer rule is really viable," he said.

The case is Josh Schaad v. Karen Alder et al., case number 2022-0316, in the Ohio Supreme Court.

## **Quinn v. Washington**

Washington state's tax on capital gains, the only such tax in a state without an income tax, will be upheld or permanently struck in 2023, depending on the judgment of the Washington Supreme Court.

There have been many developments since the tax was signed into law by Democratic Gov. Jay Inslee in May 2021. S.B. 5096 enacted the tax, which imposes a 7% levy on individuals' long-term capital gains exceeding \$250,000. A group of individuals sued to strike it before it was even signed, contending that it is unconstitutional in Washington. On March 1, Superior Court Judge Brian Huber ruled in the group's favor, holding that the tax violates the uniformity clause of the state constitution because it does not tax gains below \$250,000. It also violates the constitution because its 7% rate exceeds the 1% aggregate maximum for all taxes levied on real and personal property, which under Washington case law includes income, he said.

However, the state asked the Washington justices to stay Judge Huber's strike of the tax pending their final decision. They agreed, and the stay clears the way for the Washington Department of Revenue to collect the tax for the 2022 tax year.

The way that Washington defines property and the potential violation of the uniformity clause will be a top matter for the Washington justices to deal with during their scheduled oral arguments Jan. 26, noted Carl Erdmann, tax counsel at Skadden Arps Slate Meagher & Flom LLP. That issue is particularly complex because Washington's definition of property is so unusual, he said, but another aspect to the case is more fundamental. Washington's constitution does not allow a state income tax.

"They think the Legislature attempted to save this by calling it an excise tax," Erdmann said. "But this is significantly different. This is a tax on capital gains. It's an income tax in substance."

The case is *Chris Quinn et al. v. State of Washington et al.*, case number 100769-8, in the Supreme Court of Washington.

### **American Catalog Mailers v. Franchise Tax Board**

A complaint against California's guidance disqualifying many internet activities from protections of P.L. 86-272, the federal law also called the Interstate Income Act, is going forward in 2023 in a California trial court.

A state court judge said the case, which is notable as the first lawsuit challenging updated guidance on P.L. 86-272 for the internet age, can proceed despite an objection from the state Franchise Tax Board.

A trial date has not yet been set in the case, in which the FTB had sought a demurrer, or a challenge to the legal sufficiency of the complaint brought by the American Catalog Mailers Association. The association, an interstate trade group, is seeking to strike a technical advice memorandum published Feb. 14 by the FTB, which administers the income tax in California.

The memorandum being challenged by the catalog mailers' association essentially conforms to an updated statement from the Multistate Tax Commission on how to employ P.L. 86-272 for the internet age. The federal law, established in 1959, insulates businesses from tax on net income when soliciting tangible personal property orders is their only connection to a state.

The law is old but still important at a time when states are extending economic nexus to the income tax, John Biek, co-chair of the tax practice group at Neal Gerber & Eisenberg LLP, told Law360. He said he is watching the California litigation closely because P.L. 86-272 "really should, and I think, will matter" as a guardrail against economic nexus.

Like the MTC statement, which the MTC agreed upon in August 2021, California said soliciting orders for tangible personal property is the same whether done over the internet or done by another method.

However, like the MTC guidance, California added various internet activities in which the seller would not be protected by P.L. 86-272. Many practitioners have criticized the guidance as overreach, including Jeffrey Friedman, tax leader at Eversheds Sutherland.

"I think the ridiculous — and I don't use the word lightly — positions contained in the MTC's updated interpretation of 86-272 are going to be tested," Friedman said. "We're seeing the first one, and

California is probably the first of many."

The case is American Catalog Mailers Association v. Franchise Tax Board, case number CCG-22-601363, in the California Superior Court, San Francisco County.

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