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2023's Most Interesting State Tax Developments

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In this installment of A Pinch of SALT, the authors look back on 2023 and discuss significant and interesting state tax developments.

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In a world that is increasingly unpredictable, we are eager to share with you our predictable, yet interesting, annual end-of-year tradition, summarizing litigation highlights from the past year.

This was an eventful year, and our Most Interesting State Tax (MIST) developments contain a broad mix of cases covering income tax, sales tax, and procedural issues. In the income tax arena, apportionment cases took center stage, including the highly anticipated *Synthes* decision from Pennsylvania and several closely watched alternative apportionment cases. In a development worth following, two cases — one from Pennsylvania and one from Oregon — ruled for taxpayers on state constitutional uniformity clause grounds. Uniformity challenges are often discounted or overlooked, but in recent years, they have shown unexpected potency.

Finally, the Maryland Supreme Court decided a highly anticipated case challenging the validity of the state's digital advertising tax (ugh!). A lower court declared the tax unconstitutional. Unfortunately (ugh!), the supreme court dismissed the case on jurisdictional grounds and did not reach the merits, holding that taxpayers could not fast-track their constitutional challenge using Maryland's declaratory judgment statute. Final resolution of the tax thus awaits further litigation, which several taxpayers have initiated in Maryland Tax Court.

With numerous states grappling with the same or similar issues that grabbed our attention in 2023, what MIST developments can we expect in 2024 and beyond? The anticipation is killing us.

Income Tax — Apportionment

Income tax apportionment cases have been a fixture of the state tax scene for more than a century. Despite that long legacy, apportionment questions continue to produce a stream of

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controversy. This year was no different, with a bevy of important and noteworthy decisions.

Costs of Performance — *Synthes* and *Billmatrix*

In February the Pennsylvania Supreme Court issued its long-awaited decision in *Synthes*.[1] One month later, a Florida court issued a significant decision in *Billmatrix*.[2] Both cases involved the same question under the costs of performance method of sourcing service receipts. Does that method require in-state sales to be determined based on where the taxpayer performs its activities (a performance-based rule) or where the taxpayer's customers are situated (a market-based rule)? Most courts have concluded the performance-based rule is correct. But this year's Florida and Pennsylvania decisions were split: Florida ruled in favor of the performance-based standard while Pennsylvania adopted a market-based rule.

Billmatrix was a trial-level determination decided by the Circuit Court for Leon County. The court held that Florida's costs of performance rule requires taxpayers' sales to be sourced to the location where the taxpayer conducts its activities (the taxpayer's position), rather than the location of its customers (the Department of Revenue's position). The court based its decision on what it described as the plain language of Florida's costs of performance rule, which sources sales to the location of the taxpayer's "income producing activity," defined as the "transactions and activity directly engaged in by the taxpayer."[3] This language required the DOR to "look at the transactions and activity the *taxpayer* directly engages in . . . rather than looking at the actions or location of the customer."[4] Thus, "the Department's focus on the 'location,' 'destination,' or 'actions' of customers contradicts the plain language of the rule and must be rejected."[5]

The Pennsylvania Supreme Court reached the opposite result in *Synthes*, concluding that Pennsylvania's costs of performance rule "locates the sale of services to where the service is fulfilled and the income finally produced, *which is at the customers location*."[6] The decision in *Synthes* is remarkable in multiple respects — perhaps none more so than the fact that the attorney general and the DOR appeared separately in the case and took opposing positions. The attorney general argued that the court should adopt a performance-based rule consistent with the majority rule applied by other states, whereas the department argued — alongside the taxpayer — for a market-based rule. This divergence of state agency views created a situation in which it was unclear which agency spoke for the commonwealth, but the court concluded that both agencies were authorized to appear and argue their respective positions.

Another remarkable feature of the decision was the court's rationale on the merits. The court acknowledged the case law from other states establishing a performance-based test but concluded it was of limited relevance because Pennsylvania's costs of performance regime was unlike most other states. In particular, the court emphasized that Pennsylvania had not adopted the Multistate Tax Commission's model regulation defining "income producing activity" and "costs of performance." The court noted that those "definitions [are] phrased in terms of the taxpayer's production activity rather than the consumer's market-based activity," and thus tended to support a performance-based rule rather than a market-based one.[7] (Indeed, it was these definitions that the Florida court relied on in *Billmatrix* to reject a market-based rule.) The

[1] *Synthes USA HQ Inc. v. Commonwealth*, 289 A.3d 846, 878 (Pa. 2023).

[2] *Billmatrix Corp. v. Florida Department of Revenue*, No. 2020-CA-000435, 15 (Fla. 2d Cir. Ct. Mar. 1, 2023).

[3] *Id.* (quoting Fla. Admin. Code r. 12C-1.10155(2)(1)).

[4] *Id.* at 15-16.

[5] *Id. Billmatrix* was decided by the same court that decided *Target Enterprise Inc. v. Florida Department of Revenue*, No. 2021-CA-002158 (Fla. 2d Cir. Ct. Nov. 28, 2022). In that case, the court likewise determined that the costs of performance rule creates a performance-based standard rather than a market-based one.

[6] *Synthes USA*, 289 A.3d at 878 (emphasis added).

[7] *Id.* at 876.

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absence of similar definitions in Pennsylvania's regime led the court to a different result.[8]

Synthes is a significant Pennsylvania case if for no other reason than it puts to rest the costs of performance debate applicable to receipts from services. This had been a long-running debate in Pennsylvania. But because of the peculiar aspects of Pennsylvania's statutory and regulatory regime, the decision's influence in other jurisdictions may be limited.

Alternative Apportionment — *Vectren*, *Tractor Supply*, and *1887 Holdings*

Decisions from courts in Michigan, South Carolina, and Virginia are MIST-worthy because each decided important alternative apportionment cases.[9] The standard applied in alternative apportionment cases is notoriously subjective and fact-specific. Under the Uniform Division of Tax Purposes Act, alternative apportionment applies when the standard apportionment formula does not "fairly represent" the taxpayer's business activity in the state.[10] This subjectivity often yields surprising and unpredictable results. The cases decided this year are no exception.

Michigan — Sales of Assets and Factor Distortion: *Vectren Infrastructure*

In *Vectren*, the Michigan Supreme Court held that the taxpayer was not entitled to use an alternative method to apportion the gain from the sale of substantially all of its assets.[11] The court was closely divided and broke along party lines, with four Democratic justices in the majority and three Republican justices in dissent.

The facts of the case presented an unusually compelling case for alternative apportionment. The taxpayer was an oil services company founded in Minnesota, with employees and operations concentrated in Minnesota. In the years leading up to the sale of its business, the company had rather modest sales in Michigan, with its Michigan sales factor averaging 7 percent. In 2011, however, the company was hired by a customer to assist in an emergency cleanup of an oil spill in Kalamazoo, Michigan, which caused its sales factor in the state to temporarily spike tenfold to 70 percent. The company was acquired later in the same tax year in a transaction structured as an asset sale. Under Michigan's statutory formula, the gain on the asset sale was included in the taxpayer's apportionable income, *but* the sales receipts from the asset sale were excluded from the taxpayer's sales factor because Michigan's sales factor limits sales to sales of the taxpayer's "stock in trade." The tax base/apportionment formula dichotomy resulted in a mismatch: This Minnesota-headquartered taxpayer was sold to a non-Michigan buyer, but Michigan taxed 70 percent of the transaction. Making matters worse, the sale involved out-of-state negotiations, and the sale relied on out-of-state intermediaries. Ouch.

The taxpayer filed a short-form return for 2011 (the year of the acquisition), claiming that the statutory formula produced a constitutionally unfair distortion for two principal reasons — the unusual and temporary spike in its sales factor in 2011 and the fact that the asset sale was not included in the sales factor. The Michigan Court of Appeals had held that those factors warranted alternative apportionment,[12] but the Michigan Supreme Court rejected both claims, unpersuaded by the taxpayer's comparisons showing that the statutory formula produced a

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[8] A dissenting opinion written by Justice Kevin Dougherty — citing decisions from Indiana, Massachusetts, Oregon, Tennessee, and Virginia — forcefully contended that the court should have followed the performance-based interpretation adopted by other states, noting that Pennsylvania's costs of performance rule was derived from the same uniform law, UDITPA. *See id.* at 883 (Dougherty, J., dissenting). Justice Dougherty criticized the majority for relying on the absence of comparable regulations in Pennsylvania, noting that it was "axiomatic" that the words of the statute "trump" an administrative agency's regulations and that "the numerous courts construing laws uniform with [Pennsylvania's statute] to provide for the costs of performance approach would not have done so unless they interpreted the words of the statute themselves to support this methodology, irrespective of the language of implementing regulations." *Id.* at 885.

[9] *Vectren Infrastructure Services Corp. v. Department of Treasury*, Dkt. No. 163742, 2023 Mich. LEXIS 1150 (Mich. 2023); *Tractor Supply Co. v. South Carolina Department of Revenue*, No. 19-ALJ-17-0416-CC, 2023 WL 5216952 (S.C. Admin. Law Ct. Aug. 8, 2023); *Virginia Department of Taxation v. 1887 Holdings Inc.*, 887 S.E.2d 176 (Va. Ct. App. 2023).

[10] *See* UDITPA, section 18 (providing for alternative apportionment if the standard "allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in the State").

[11] *Vectren*, 2023 Mich. LEXIS 1150.

[12] We covered the appeals court's ruling in our end-of-year article from 2021. Jeffrey A. Friedman, Daniel H. Schlueter, and Fahad H. Mithavayani, "2021's Most Interesting Litigation Developments," *Tax Notes State*, Dec. 20, 2021, p. 1291.

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dramatically higher apportionment factor than its historic sales factor (a 900 percent increase) or, if the underlying asset sale was included in the sales factor (a 350 percent increase).[13] The court noted that neither comparison was authorized by statute. Separate dissenting opinions criticized the majority for ignoring the taxpayer's evidence and failing to offer any reasonable benchmark for measuring distortion for purposes of the constitutionally required comparison.

While highly fact-specific and unlikely to recur — both the majority and dissenting opinions pointed out that the adverse tax result could have been avoided if the taxpayer had structured its acquisition as a sale of stock rather than a sale of assets — the case nevertheless is an instructive example of the difficulties involved in alternative apportionment claims, particularly the absence of definitive benchmarks for establishing distortion. Unfortunately, the U.S. Supreme Court denied the taxpayer's petition for certiorari.[14]

South Carolina — Combined Reporting as Alternative Apportionment: *Tractor Supply Co.*

In contrast to the Michigan decision in *Vectren*, the South Carolina Administrative Law Court (ALC) in *Tractor Supply* upheld a finding of distortion in a case involving intercompany payments, and required the DOR's proposed alternative apportionment method — combined reporting.[15]

The ALC based its determination of distortion on the fact that the taxpayer had entered an inventory procurement agreement with related affiliates, which provided inventory procurement services at cost plus a 9.7 percent markup. The markup was supported by a transfer pricing study, but the ALC stated that both parties' experts testified that the transfer pricing study was unreliable and did not support the 9.7 percent markup.[16] Rather than present its own assessment of a reasonable markup and transfer price, as authorized by statute, the DOR argued that the appropriate remedy was to require the taxpayer to report its income using a combined report that included the related companies and resulted in the elimination of the intercompany transactions.The ALC agreed with the DOR, relying on the South Carolina Supreme Court's decision in *Media General*,[17] in which the court upheld the use of combined reporting as an alternative apportionment method. *Media General*, however, involved a stipulated finding of distortion — both parties agreed that separate reporting produced a distortive result. In post-*Media General* cases in which distortion is contested, the DOR has been unsuccessful in imposing alternative apportionment. For instance, in *CarMax*[18] and *Rent-A-Center*,[19] South Carolina's appellate courts rejected the DOR's attempt to impose alternative apportionment in cases in which it claimed intercompany payments were being used to impermissibly shift income. Will the third time be the charm for the department in *Tractor Supply*? An appeal to the South Carolina Court of Appeals (and potentially the state supreme court) will likely be needed to produce an answer. And the ALC will be deciding other cases in which the department is alleging distortion and proposing combination as the cure.

Virginia — Claiming Alternative Apportionment on an Amended Return: *1887 Holdings*

Finally, in May the Virginia Court of Appeals decided *1887 Holdings*, in which it held that a taxpayer was authorized to claim a refund by filing amended tax returns electing a special apportionment formula applicable to manufacturers.[20] Virginia requires a four-factor

[13] The taxpayer's post-2000 Michigan sales factor average was approximately 7 percent. Inclusion of the underlying asset sale yielded a sales factor of approximately 15 percent. *Vectren*, 2023 Mich. LEXIS 1150 at *13, *58.

[14] *See Vectren Infrastructure Services Corp. v. Department of Treasury*, No. 23-443 (U.S. 2023).

[15] *Tractor Supply Co.*, 2023 WL 5216952.

[16] *See id.* at *37.

[17] *Media General Communications Inc. v. South Carolina Department of Revenue*, 694 S.E.2d 525 (S.C. 2010).

[18] *CarMax Auto Superstores West Coast Inc. v. South Carolina Department of Revenue*, 767 S.E.2d 195 (S.C. 2014).

[19] *Rent-A-Center West Inc. v. South Carolina Department of Revenue*, 792 S.E.2d 260 (S.C. Ct. App. 2016).

[20] *1887 Holdings Inc.*, 887 S.E.2d 176.

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formula (based on property, payroll, and double-weighted sales) to apportion income.[21] The state, however, permits manufacturers that meet thresholds based on the number of full-time employees and average wages to use a single-sales-factor formula as an alternative apportionment method.[22] If a company uses this method, it "may not revoke the election for a period of three taxable years."[23]

The taxpayer in *1887 Holdings* did not claim the alternative manufacturer's apportionment on its original returns but attempted to do so later on amended returns. The Department of Taxation determined that the taxpayer could not make the election on amended returns, but the court of appeals disagreed. The court held that, contrary to some other elections that were expressly required to be "made on or before the due date prescribed by law (including extensions),"[24] the manufacturer's alternative apportionment statute did not impose any temporal restriction on the timing of the election.[25] Absent the plain language expressly requiring such election to occur on the original return, the court found there was no ambiguity in the statute and no prohibition against electing alternative apportionment for the first time on an amended return.[26]

This ruling provides Virginia taxpayers with the ability to take a "wait-and-see" approach by filing an original return using standard apportionment, seeing if the taxpayer meets the required thresholds within the measurement period, and then filing an amended return to elect the manufacturer's alternative apportionment.

California — Proposition 39 and The End of the *One Tech* Saga

Rounding out 2023's apportionment cases is a decision by the California Court of Appeal in *One Technologies*, rejecting a constitutional challenge to the validity of Proposition 39, enacted by California voters in 2012.[27]

Proposition 39 made a momentous change in California's apportionment law. It changed the state's apportionment method from an elective four-factor method (property, payroll, and double-weighted sales) to a single-sales-factor formula.[28] In 2021, nearly a decade after the proposition passed, a taxpayer challenged the validity of the initiative, arguing that it violated the single subject rule applicable to ballot measures. More specifically, the taxpayer challenged the validity of Proposition 39 because it allowed some qualifying companies to treat 50 percent of their in-state sales as out-of-state sales and because it added a new division to the Public Resources Code, creating the Clean Energy Job Creation Fund.[29] These additional "subjects" formed the basis of the taxpayer's legal challenge.

The California Court of Appeal, affirming the trial court's decision, rejected the challenge. The court concluded that the initiative did not violate California's single-subject rule because the Clean Energy provisions were "reasonably germane" to Proposition 39's core purpose, which was to raise taxes to fund clean energy initiatives. The fact that the initiative placed a lighter funding burden on some businesses than others (via the limited 50 percent carveout) did not introduce a separate subject.[30]

Had it been successful, One Technologies' challenge would have had immense consequences for California's taxpayers, potentially reviving the historic four-factor method. Unless review is sought and granted by the California Supreme Court, the decision puts an end to the single-subject challenge to Proposition 39.

[21] *See* Va. Code section 58.1-408.

[22] *See* Va. Code sections 58.1-422(A)(3), 58.1-422(C).

[23] Va. Code section 58.1-422(B).

[24] *See* Va. Code sections 58.1-322.04(4), 58.1-402(F).

[25] *1887 Holdings Inc.*, 887 S.E.2d at 180.

[26] *See id.* at 181.

[27] *One Technologies LLC v. Franchise Tax Board*, 314 Cal. Rptr. 3d 718 (Cal. Ct. App. 2023).

[28] *See id.* at 720.

[29] Cal. Prop. 39, section 2; Cal. Pub. Resources Code section 26205.

[30] *See One Technologies LLC*, 314 Cal. Rptr. 3d at 727-732.

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Digital Advertising

Maryland — Digital Advertising Tax: *Verizon* and *Comcast*

In May the Supreme Court of Maryland issued a much-anticipated decision in a case brought by Comcast and Verizon challenging the validity of Maryland's first-in-the-nation digital advertising tax.[31] (Note that we represented the taxpayers, and our fingers are trembling as we type this summary.) Unfortunately, the court did not reach the legal challenges to the tax. Instead, it dismissed the case on jurisdictional grounds, holding that a constitutional challenge to the tax could not be fast-tracked using the state's declaratory judgment statute. The decision thus tees up individual challenges to the tax — several of which have recently been filed in the Maryland Tax Court.

The digital advertising gross receipts tax was enacted by the Maryland legislature in 2021, over the veto of then-Gov. Larry Hogan. During legislative hearings on the tax, opponents of the measure claimed that it was unlawful for several reasons — most particularly that it violated the Internet Tax Freedom Act because it was targeted at internet-based advertising.[32]

Because the General Assembly delayed the tax's effective date until 2022, no administrative processes were immediately available to taxpayers seeking to determine the tax's constitutionality. Consequently, in April 2021, shortly after the tax was enacted, affiliates of Comcast and Verizon filed a declaratory judgment seeking a determination that the tax was facially invalid. In March 2022 the trial court held that a declaratory judgment suit was a proper procedural vehicle to challenge the new tax. And in October 2022 the trial court held that the tax was constitutionally invalid under ITFA, the commerce clause, and the First Amendment and issued a corresponding declaratory judgment stating as much.

Reviewing only the procedural question, the supreme court held that the trial court was without jurisdiction to issue the declaratory judgment. The court agreed with the comptroller that while prior decisions had authorized the declaratory judgment process, those decisions had effectively been superseded by statutory amendments to the procedures governing administrative review of tax questions. Those amendments, the court said, made administrative review "exclusive."[33] The court thus sent the taxpayers and the comptroller back to square one, requiring the comptroller to issue assessments or deny taxpayers' claim for refunds.

The supreme court emphasized that its decision was procedural only — stating that its ruling "is not premised on any view of the merits of the challenges raised by the Companies."[34] Thus, the only judicial decision opining on the merits of the digital advertising gross receipts tax remains the circuit court's now-vacated decision declaring the tax unconstitutional. In the wake of the circuit court's decision, the comptroller issued an extraordinary statement, agreeing that the tax is constitutionally "questionable" and urging the legislature and governor to "revisit" it.[35] However, no legislative action was taken, and multiple taxpayers have now completed the necessary steps to challenge the tax and have filed cases in the Maryland Tax Court. We expect much more to come in 2024, as these cases progress to an eventual (and inevitable MIST) ruling on the tax's validity.

Sales and Use Tax

Litigation involving sales and use tax is a constant, and 2023 was no exception. Choosing only a few cases to discuss is difficult, but the following decisions from Massachusetts, Alabama, Florida, and Missouri stand out.

[31] *Comptroller of the Treasury of Maryland v. Comcast*, 297 A.3d 1211 (Md. 2023). Attorneys with Eversheds Sutherland (US) LLP represented Comcast and Verizon.

[32] For a review of the various arguments, see Richard Pomp, "Things Not Worth Doing Are Especially Not Worth Doing Poorly: The Maryland and Nebraska Taxes on Digital Advertising," *Tax Notes State*, Apr. 6, 2020, p. 39.

[33] *See Comcast*, 297 A.3d at 1226.

[34] *Id.* at 1215.

[35] *See* Comptroller of Maryland release on digital ad tax ruling (Oct. 20, 2022).

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Massachusetts — Computer Cookies Were Not Nexus Creating Pre-*Wayfair*: *U.S. Auto Parts*

The Massachusetts DOR got caught with its hand in the proverbial cookie jar when it sought to assert nexus over an out-of-state company even though it told the U.S. Supreme Court it would not do so.[36] In *U.S. Auto Parts*, the Massachusetts Supreme Judicial Court rejected the DOR's position that a company's digital presence in a state was sufficient to constitute physical presence for purposes of establishing sales and use tax nexus. That question had considerable significance before *Wayfair* in 2018, when physical presence was required under the commerce clause for a state to impose tax collection and remittance responsibilities on a retailer.[37] But *Wayfair* abrogated the physical presence requirement in favor of a more flexible "substantial nexus" test. Thus, the issue of physical presence, and whether digital presence qualifies, is only relevant to pre-*Wayfair* periods.

The Massachusetts case arose from the state's "cookie nexus" regulation — so named because it premised nexus on retailers' use of computer cookies and other digital attributes on users' computers. In the pre-*Wayfair* world, it was theorized that these digital attributes might constitute physical presence in a state sufficient to satisfy the then-prevailing physical presence standard.[38] Several states, including Massachusetts, adopted regulations providing as much. The Massachusetts regulation was promulgated, effective October 1, 2017, approximately nine months before *Wayfair*.[39]

The taxpayer, U.S. Auto Parts, was a retailer headquartered in California that sold after-market automobile parts and accessories. The company sold auto parts entirely online and used cookies to track customers that visited its website. Relying on its cookie nexus regulation, the DOR argued that U.S. Auto Parts was subject to Massachusetts sales and use tax for pre-*Wayfair* periods.

The department made two main arguments on appeal — first that the regulation incorporated the *Wayfair* substantial nexus rule retroactively and did not require physical presence, and second that even if it did, the placement of computer cookies on users' computers in Massachusetts was sufficient to constitute physical presence.[40]

The court rejected both arguments. As to the first, the court noted that the commissioner's position was contrary to both the language of the regulation and the position it advanced in an amicus brief filed by several states with the U.S. Supreme Court in *Wayfair*. The commissioner had assured the Court in the brief that remote sellers would not be subject to retroactive tax liability under a newly announced standard if the Court were to abrogate the physical presence standard.[41]

As a result, the Massachusetts court was required to address the department's second argument — that cookies and other digital attributes constituted physical presence under the pre-*Wayfair* standard. The Court rejected the argument, noting that *Wayfair* itself "strongly suggested" that "the use of modern technologies (such as the use of apps and cookies) . . . would not constitute the requisite physical presence in the taxing states."[42] Indeed, that was one of the reasons why the *Wayfair* Court jettisoned the physical presence requirement — because it was not attuned to modern ways of conducting commerce. But even if the question was not definitively resolved by *Wayfair,* the Massachusetts court concluded that it was of sufficient ambiguity that it was properly resolved in favor of the taxpayer under the rule that tax statutes are strictly construed, with ambiguity resolved in favor of the taxpayer.[43] Thus, the court ruled that the taxpayer lacked sales tax nexus, and the assessments were overturned.

Alabama — Constitutionality of Selective Retroactive Application: *Cellular Express Inc.*

In *Cellular Express*, the Alabama Court of Civil Appeals ruled that the retroactive application of a

[36] *U.S. Auto Parts Network Inc. v. Commissioner of Revenue*, 199 N.E.3d 840 (Mass. 2022).

[37] *See South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080, 2099 (2018).

[38] *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[39] *See U.S. Auto Parts*, 199 N.E.3d at 850-851; 830 Code Mass. Regs section 64H.1.7

[40] *See U.S. Auto Parts*, 199 N.E.3d at 852-856.

[41] *See id.* at 852-854.

[42] *Id.* at 854-855.

[43] *Id.* at 856.

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sales tax amendment was unconstitutional when the retroactivity extended only to those taxpayers that were under audit.[44] The taxpayer, Cellular Express Inc. (Cellular), was an authorized dealer for Boost Mobile (Boost). It sold Boost prepaid wireless service plans to customers. Before 2014 Alabama imposed sales tax on "prepaid telephone calling cards," but only if the sale involved a physical calling card or authorization number.[45] Because it did not issue physical calling cards or an authorization number, Cellular took the position that its sales were not taxable. The Alabama Department of Revenue disagreed and issued an assessment for unpaid sales tax.

While Cellular was in the process of appealing the assessment, the legislature revised the Tax Code via Act No. 2014-336 (the 2014 Act) to amend the definition of prepaid telephone calling card to include "prepaid wireless service," which did not require any physical calling card or authorization number.[46] Section 6 of the 2014 Act said that it would not apply retroactively to any transactions in which the consumer did not receive from the retailer either an authorization number or a physical card if the DOR had not collected sales tax as a result of those transactions. However, it excluded from this limitation on retroactive application taxpayers as to whom the DOR had begun sales tax audits or had entered sales tax assessments before the effective date of the 2014 Act. Thus, some taxpayers were excluded from retroactive application of the 2014 Act while others, including Cellular, were subject to its retroactive application.

The Alabama Court of Civil Appeals held that this selective application of retroactivity was unconstitutional under the due process clause. The court applied the two-part test articulated by the U.S. Supreme Court in *United States v. Carlton*,[47] which requires: (1) that retroactive tax legislation be "supported by a legislative purpose furthered by rational means" and (2) that the period of retroactivity be "modest."[48] The court agreed with the trial court that the retroactive features of the 2014 Act failed the first part of the test, requiring a legislative purpose furthered by rational means. The DOR argued that the 2014 Act's legislative purpose was to clarify existing law, but the court noted that this purpose was not served by making the legislation retroactive to a "small number of taxpayers" and nonretroactive to everyone else. Because the retroactive features of the 2014 Act failed the *Carlton* test and violated due process, the court refused to enforce them.[49]

Florida — Sales of Electronically Delivered Software Not Taxable: *T-Mobile Resources*

In *T-Mobile*, a Florida trial court held that electronically delivered software was an intangible not subject to Florida sales tax.[50] Florida law imposes tax on sales of tangible personal property and enumerated services sold at retail in Florida.[51] In contrast, Florida does not consider the sale of electronically delivered software to be a sale of tangible personal property or a taxable service; therefore, it is not subject to sales tax.[52]

Notwithstanding this statutory scheme, the DOR has sometimes sought to impose sales tax on sales of electronically delivered software on the theory that the software is a taxable "service" delivered with tangible personal property. That was the DOR position in *T-Mobile*. The court, however, rejected the department's argument on two grounds — first, the software was an intangible, not a service, but even if it could be regarded as a service, the software was not sold with tangible personal property. None of the software at issue was purchased with or at the same time as hardware, and all the software was uploaded onto preexisting equipment.

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[44] *Alabama Department of Revenue v. Cellular Express Inc.*, Ala. Civ. App. No. CL-2022-0701, 2023 WL 3400306 (Ala. Civ. App. May 12, 2023).

[45] Ala. Code section 40-23-1(a)(13) (2012).

[46] Ala. Code section 40-23-1(a)(13), (14) (2014).

[47] *United States v. Carlton*, 512 U.S. 26 (1994).

[48] *Cellular Express Inc.*, 2023 WL 3400306 at *6-7.

[49] *Id.*

[50] *T-Mobile Resources LLC v. Florida Department of Revenue*, No. 2021-CA-000206 (Fla. Cir. Ct. Sept. 27, 2023). Attorneys with Eversheds Sutherland represented T-Mobile Resources LLC.

[51] Fla. Stat. section 212.05(1)(a)(1).

[52] Florida DOR, TAA 07A-022 (2007) ("A sale that solely involves software, canned or customized, that is electronically downloaded by the customer, [is exempt] as there is no conveyance of tangible personal property.").

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Missouri — Sale for Resale Exemption: *Walmart Starco*

In *Walmart*, the Missouri Supreme Court found that computer equipment purchased solely for resale to a taxpayer's affiliates was exempt from use tax.[53] The fact that the taxpayer installed software, tested, and repackaged the computer equipment before its sale to ensure it was usable in the affiliate's business did not change that result.

Missouri's sale for resale exemption provides that personal property is exempt from use tax when it is "held by processors, retailers, importers, manufacturers, wholesalers, or jobbers solely for resale in the regular course of business."[54] The taxpayer, Walmart Starco LLC (Starco), purchased equipment, consisting of electronic price scanners, credit card readers, computers, and servers, for resale to other Walmart subsidiaries to facilitate store operations. Starco loaded software or hardware on the equipment as needed, tested it, and repackaged it for resale. The DOR contended that Starco's installation, testing, and repackaging caused the equipment to no longer be held "solely" for resale and that Starco therefore owed use tax on the equipment.

The Supreme Court of Missouri disagreed, holding that Starco's sole purpose was to resell the equipment to its affiliate stores. The court noted the purpose of the resale exemption, which was to avoid multiple taxation of the same property as it passes through the chain of commerce. Because the Walmart stores accrued and remitted use tax to the jurisdictions where the equipment was delivered and used (including Missouri), the court found that any other outcome would result in the double taxation the exemption was designed to avoid.

[53] *Walmart Starco LLC v. Director of Revenue*, No. SC99998, 2023 Mo. LEXIS 367 (Mo. 2023). Attorneys with Eversheds Sutherland represented Walmart Starco LLC.

[54] Mo. Rev. Stat. section 144.615(6).

Uniformity Claims — Pennsylvania and Oregon

Finally, we conclude with two decisions involving different tax types (income tax and property tax) and different courts on opposite sides of the country (Pennsylvania and Oregon). The common feature of the two decisions is that they involved claims under the uniformity clause of their respective state constitutions, and the courts granted relief in both cases. As we noted at the outset, uniformity claims are often underappreciated because the legal standard is typically weighted in favor of the state. But that does not mean the state always prevails. In recent years, these types of claims have seen noteworthy successes, as courts have demonstrated an increased willingness to enforce norms of equal treatment guaranteed by state constitutions.

Pennsylvania — *Alcatel-Lucent*

The Pennsylvania case, *Alcatel-Lucent*, involved the latest chapter in Pennsylvania's litigation over its cap on the income tax deductibility of net operating losses.[55] For many years, Pennsylvania used some version of a flat dollar limitation capping the amount of losses carried forward from prior years that a taxpayer could deduct in determining its current year income. In 2015, for example, the flat dollar cap was $4 million. Because taxpayers with income less than that amount could claim an unlimited deduction, the cap necessarily affected only a subset of taxpayers, i.e., those with taxable incomes greater than $4 million. During 2015, for example, there were 13,566 large corporate taxpayers with deductible losses. Only 347 of those taxpayers had income above the $4 million cap. All other taxpayers could deduct the entire amount of their carryforward losses.[56]

In *Nextel Communications*,[57] the Pennsylvania Supreme Court declared the flat dollar cap to be a violation of the uniformity clause of the Pennsylvania Constitution, which provides that

[55] *Alcatel-Lucent USA Inc. v. Commonwealth*, 290 A.3d 1285, 2022 WL 17971289 (Pa. Commw. Ct. 2022). The commonwealth court's decision was released on December 28, 2022. We include it in our 2023 year in review because it was not available when our 2022 review went to print.

[56] *See id.* at *2.

[57] *Nextel Communications of the Mid-Atlantic Inc. v. Commonwealth*, 171 A.3d 682 (Pa. 2017).

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"all taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under general laws."[58]

The question before the commonwealth court in *Alcatel-Lucent* concerned the appropriate remedy. Under the federal due process clause and applying the U.S. Supreme Court's seminal decision in *McKesson Corp.*, the court held that a uniformity clause violation could be remedied either (1) by refunding the difference between the tax paid and the tax that would have been assessed had the law been uniform or (2) by assessing and collecting back taxes from those that benefited from the nonuniform provision.[59] After the supreme court issued its decision in *Nextel*, the DOR announced that it would apply the decision on a prospective basis only and would not seek to collect back taxes from those that benefited from the flat dollar cap. Many of those taxpayers would not have been open to assessment under the applicable statute of limitations in any event.

As a result, the commonwealth court determined that taxpayers subject to the flat dollar cap were constitutionally entitled to a refund under the due process clause. "Because a retroactive reassessment of favored taxpayers' tax liability [was] foreclosed under the statute of limitations, replete with inequities, the only remedy available is to issue Taxpayer a refund to remedy the Uniformity Clause violation to equalize the tax positions between favored and nonfavored taxpayers."[60]

Oregon — *Delta Air Lines Inc.* and *PacifiCorp*

In *Delta Air Lines*, the Oregon Tax Court found that Oregon's system of property tax assessment violated the rights of airlines and other transportation companies under the Oregon uniformity clause and the federal equal protection clause.[61] The court, however, found no violation in the case of electric utilities.

Oregon uses a two-tier property tax system, in which property is either centrally assessed by the state DOR or locally assessed by county property assessors. Most taxpayers are locally assessed — only 14 types of business are subject to central assessment. These include various forms of rail and air transport; electric, heating, and gas utilities; and communication businesses.[62] The most significant substantive difference between central and local assessment is that centrally assessed taxpayers are assessed and taxed on their intangible property, whereas locally assessed taxpayers are exempted from this taxation. Delta Air Lines and PacifiCorp (an electric utility) claimed that the taxation of their intangible property violated Oregon's uniformity clause and the federal equal protection clause.[63]

Under judicial interpretations of Oregon's uniformity clause, any legislative classification taxing property differently must be based on "genuine differences" that bear "a reasonable relationship to [a] legislative purpose."[64] The state claimed that "genuine differences" existed between locally assessed businesses and centrally assessed businesses because centrally assessed businesses tended to operate a network of property over a large geographic area. But the court noted that the same was true of many types of locally assessed business, such as multistate retailers, multistate restaurant chains, consumer goods manufacturers, professional services businesses, and hospital systems. Finding no "genuine differences" justifying differential taxation of airlines and other transportation companies, the tax court determined that the taxation of their intangible property violated the

[58] Pa. Const. Art. VIII, section 1. During the years at issue in *Alcatel-Lucent* and *Nextel*, Pennsylvania used an additional cap, which was computed as a percentage of the taxpayer's income. In those years, the greater of the two caps (flat dollar or percentage-based cap) applied. The court held that the percentage-based cap was lawful because it applied equally to all taxpayers.

[59] *See Alcatel-Lucent*, 2022 WL 17971289 at *6 (citing *McKesson Corp. v. Florida Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990); and *Annenberg v. Commonwealth*, 757 A.2d 338 (Pa. 2000)).

[60] *Alcatel-Lucent*, 2022 WL 17971289 at *6.

[61] *Delta Air Lines Inc. v. Department of Revenue*, No. TC 5409, 2023 WL 5425246 (Or. T.C. Aug. 23, 2023); *PacifiCorp v. Department of Revenue*, No. TC 5411, 2023 WL 5424122 (Or. T.C. Aug. 23, 2023).

[62] *See* Or. Rev. Stat. section 308.515(1)(a)-(n).

[63] The text of Oregon's uniformity clause is virtually identical to Pennsylvania's. It provides that "all taxation shall be uniform on the same class of subjects within the territorial limits of the authority levying the tax." Or. Const. Art. I, section 32. A separate clause provides that "all taxes shall be levied and collected under general laws operating uniformly throughout the State." Or. Const. Art. IX, section 1.

[64] *Delta Air Lines*, 2023 WL 5425246 at *3 (citing *Knapp v. City of Jacksonville*, 151 P.3d 143, 148 (Or. 2007)).

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uniformity clause and the federal equal protection clause.[65]

In the case of regulated electric utilities, however, the court determined that the standard was met and that the uniformity clause was not violated because these businesses are rate regulated. According to the court, that distinguishing feature provided a basis for taxing utilities differently because the legislature could have permissibly concluded that the guarantee of a rate regulated return would produce otherwise untaxed value.[66]

Concluding Thoughts

Thank you for reading our 2023 MIST developments. There were plenty of interesting cases, and we undoubtedly *missed* some of our readers' favorites.[67] We expect our 2024 edition to include an equally — if not more robust — group of MIST developments (we are looking at you, Maryland, Pennsylvania, and South Carolina). The ever-evolving landscape of state and local tax continues to provide major developments year after year, and 2023 was no exception.

We are looking forward to the new challenges 2024 will bring and wish you all the best in the coming year! ■

[65] *Delta Air Lines*, 2023 WL 5425246 at *23-24.

[66] *Id.* at *24.

[67] We did not include the important cases from Washington regarding its adoption of a capital gains excise tax (*Quinn v. Department of Revenue*, 526 P.3d 1 (Wash. 2023)) and its special tax on large banks (*Washington Bankers Association v. Department of Revenue*, 495 P.3d 808 (Wash. 2021), *cert. denied*, 142 S. Ct. 2828 (2022)), among many other runner-up cases.

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