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by Arthur R. Rosen and Hayes R. Holderness

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Congress Should Sprinkle Some SALT on the Federal Courts

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In this edition of The Art of SALT, the authors examine whether Congress should establish stronger federal checks on state tax actions by opening the federal courts to interstate taxpayers.

Observers of the state and local tax world regularly note the seemingly irresponsible actions so often taken by state revenue agencies, by state courts, and by state legislatures[1] — a few recent examples of states acting badly are set forth below. In many ways federal law has encouraged these types of actions by placing limited checks on the states. The federal Tax Injunction Act (TIA)[2] and the common law comity doctrine keep federal courts off the states' backs. Also, the Supreme Court's *South Dakota v. Wayfair Inc.*[3] decision and its *Murphy v. National Collegiate Athletic Association*[4] decision, in which state legislatures were freed from congressional restraints regarding the enactment of state gambling statutes, will likely encourage states to push back on virtually any federal effort in the interstate tax arena. Adding fuel to this fire, most of the states are now, in *Franchise Tax Board v. Hyatt*,[5] seeking freedom from another check on their actions, by asking the Supreme Court to overturn precedent allowing state government actors to be sued in sister state courts (this is similar to Massachusetts's efforts in *Crutchfield Corp. v. Harding*[6]). State victories in these cases would surely fan the flames of unchecked state behavior into a veritable conflagration. There is, however, the glimmer of a fire extinguisher at the end of the tunnel — Congress could establish stronger federal checks on state tax actions by opening the federal courts to interstate taxpayers.

I. States Acting Badly

A. Revenue Agencies

Examples of state tax auditors and revenue agency managers acting improperly (or, perhaps more generously, "acting *ulta vires*") abound. Every state tax practitioner knows, for instance, the virtually universal use of penalties, or the threat of penalty imposition, as a way to pressure taxpayers into settling audits. As a practical matter, it seems totally relevant that the operative statutes clearly provide that the penalties are to be imposed only if the taxpayer fails to show that it had acted reasonably in completing the tax return, filing the return, or paying the tax (although

[1] *See, e.g.*, Mark W. Eidman and Arthur R. Rosen, "Non-Legislated Tax Legislation," *State Tax Notes*, Jan. 24, 2011, p. 301.

[2] 28 U.S.C. section 1341.

[3] *South Dakota v. Wayfair Inc.*, 585 U. S. __ (2018).

[4] *Murphy v. National Collegiate Athletic Association*, 543 U.S. __ (2018).

[5] *Franchise Tax Board of State of California v. Hyatt*, 407 P.3d 717 (Nev. 2017), *cert. granted*, Dkt. No. 17-1299 (U.S. June 28, 2018).

[6] *Crutchfield Corp. v. Harding*, No. CL17001145-00 (Va. Cir. Ct. 2018).

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penalty statutes are often worded in the opposite way: initial penalty imposition required, but abatement, waiving, or cancellation of the penalties on the showing of reasonable cause). The misuse of penalties by state tax auditors is so common and widespread that practitioners are fully shocked when the threat of penalties is *not* in the auditors' initial salvo.

At a more senior level, state tax administrators appear, from time to time, to turn a blind eye to inappropriate and irresponsible behavior of midlevel managers in their agencies. For example, the revenue agency in one mid-Atlantic state takes the same untenable positions — year after year — and then closes the case with the taxpayer paying a mere token percentage of the amount sought in the statutory notice. Although one of us has considered bringing Civil Rights Act section 1983 action against this agency's executives, developments in this area regarding personal liability of state government officials have dissuaded the client from pursuing that route.[7]

One of those positions from that mid-Atlantic state,[8] that market-based sourcing rather than cost-of-performance is the appropriate sourcing rule for receipts from the performance of services, is clearly wrong because (1) the state's legislature passed market-based sourcing explicitly on a prospective-only basis (for years after those in audit for several taxpayers) and (2) abundant case law in the state mandates the use of cost of performance. When protested to the first "independent" forum, the taxpayers' representatives are told — we have actually heard this in more than one case — that there is too much evidence to review so the decision will simply sustain the statutory notice!

B. State Courts

State revenue agencies are not the only state actors acting poorly; state courts have also reached tenuous conclusions in cases involving state taxes. The alternative apportionment cases of *Equifax Inc. v. Mississippi Department of Revenue*[9] and *Vodafone Americas Holdings Inc. v. Roberts*[10] offer examples.

In 2013 the Mississippi Supreme Court overturned the Mississippi Court of Appeals and upheld an assessment and penalties against Equifax. Equifax's error? It used the cost-of-performance apportionment method for services mandated by regulations promulgated under Mississippi law. Because Equifax performed its services in Georgia, not Mississippi, its income was apportioned to Georgia and was thus not subject to Mississippi tax. On audit, the Mississippi Department of Revenue applied an alternative method of apportionment (using market-based sourcing) to determine Equifax's income subject to tax, without providing any justification for its selection of the alternative apportionment method. Unsurprisingly, this action resulted in substantial additional tax for Equifax, as well as penalties.

Even worse, in upholding the assessment and penalties, Equifax suffered numerous procedural abuses. While its protest was before the department, Equifax had no right of discovery or investigation to determine the basis for the assessment. Then, at the trial court level, Equifax was deprived of a right of *de novo* review by the trier of fact, despite the relevant statute calling for *de novo* review. Even under an arbitrary and capricious standard of review, the trial court affirmed the penalty assessment even though the department stipulated that Equifax had prepared its returns in accordance with the mandated apportionment method. The trial court also did not require the department to demonstrate any justification for prescribing an alternative apportionment formula for Equifax, but instead placed the burden on Equifax to prove that the choice of an alternative apportionment formula was in error. The Mississippi Supreme Court affirmed the trial court's rulings. Equifax was effectively penalized and taxed for following the

[7] *See, e.g.*, *Pearson v. Callahan*, 555 U.S. 223, 231 (2009) ("The doctrine of qualified immunity protects government officials 'from liability for civil damages insofar as their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would have known.'").

[8] Don't get us started on another common and repeated mischaracterization of the law by some state revenue authorities — that cloud computing services are the sale of tangible personal property. *See, e.g.*, Rosen and Hayes R. Holderness, "Cloud Computing: 1.5 Steps Forward, 2 Steps Back," *State Tax Notes*, June 26, 2017, p. 1257.

[9] *Equifax Inc. v. Mississippi Department of Revenue*, 125 So. 3d 36 (Miss. 2013), *cert. denied*, 134 S. Ct. 2872 (2014).

[10] *Vodafone Americas Holdings Inc. v. Roberts*, 486 S.W.3d 496 (Tenn. 2016).

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statute and failing to predict that the department would use an alternative apportionment method. Even if Equifax could have predicted the department's actions, the Mississippi Supreme Court still would have placed the burden on Equifax to show that the use of alternative apportionment was not warranted. One would have expected that following the statute would be the default, and that the department would have to prove the necessity of an alternative method. The Mississippi Legislature shared that expectation, rewriting the law after *Equifax* to clearly place the burden on the department in future situations like this one.[11]

The story in *Vodafone* is similar. In that case, the Tennessee Supreme Court upheld the Tennessee Department of Revenue's use of alternative apportionment — also to impose market-based sourcing on a service provider — to override the statutory cost-of-performance method that the taxpayer, Vodafone, attempted to use. Other than to claim that the statutory method resulted in less revenue for Tennessee than the alternative method (which, according to the commissioner, was "straightforward and conceptually satisfying," in contrast to the "not so straightforward" statutory method), the department failed to show that the statutory formula did not reflect the taxpayer's in-state activities. Instead of requiring the department to make its case more fully (and perhaps blinded by sympathies for state revenue), the court left Vodafone to prove that the department's action was unreasonable and an abuse of discretion. Even more troubling, the *Vodafone* court justified its conclusion by relying on a 2009 Tennessee Court of Appeals case, *BellSouth Advertising & Publishing Corp. v. Chumley*,[12] that also failed to require the department to justify its imposition of alternative apportionment beyond merely claiming that alternative apportionment raised more money for the state.[13]

Those decisions lead one to suspect a form of "judicial drift" occurs, causing state judges to be heavily biased toward supporting the position of the state revenue agencies.[14] An "us versus them" attitude, which seems to develop because state court judges are part of their states' government environment and culture, is not conducive to reaching decisions in tax cases that faithfully apply the law. Sometimes taxpayers get it wrong, but sometimes state revenue agencies also get it wrong. At a minimum, one would expect that "more revenue" would not suffice as a basis for statutory interpretation and application.

C. State Legislatures

Two recent state legislative actions demonstrate that those bodies are feeling increasingly less constrained by some basic legal principles and concepts of fairness.

In *Comptroller of the Treasury of Maryland v. Wynne*,[15] the U.S. Supreme Court concluded that a portion of the Maryland tax scheme that limited the tax credit that residents could take against their Maryland local taxes was unconstitutional; the Maryland General Assembly then, rubbing salt right into that interstate discrimination wound, enacted a statute severely limiting the interest rate taxpayers would be paid on refunds of those credit amounts. Fortunately, the Maryland Tax Court, in *Wynne v. Comptroller of Maryland*,[16] found that an interest limitation on just those refunds violated the same constitutional anti-discrimination rule that the initial tax credit statute had violated. This rare but welcome taxpayer victory in the Maryland Tax Court perhaps is due to the high profile of the case and clear injustice of the Maryland legislature's action (the tax court needed only three brief paragraphs to decide the case).

A deeper concern, however, arises when one considers the legislation enacted, or being considered, by numerous state legislatures in

[11] *See* Mississippi H.B. 799 (effective Jan. 1, 2015).

[12] *BellSouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. App. 2009).

[13] *See* Rosen and Julie M. Skelton, "Desperately Seeking State Tax Fairness: The Need for Federal Adjudication," *State Tax Notes*, Aug. 8, 2011, p. 357.

[14] *Cf.* Lee Epstein et al., "Ideological Drift among Supreme Court Justices: Who, When, and How Important," 101 *Nw. U. L. Rev*. 1483 (2007) (discussing the shift in ideology of Supreme Court justices depending on their circumstances).

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

[16] *Wynne v. Comptroller of Maryland*, Dkt. No. 16-IN-OO-0216 (Md. Tax May 23, 2018).

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attempts to offset the effects of the recent federal tax changes in the Tax Cuts and Jobs Act (P.L. 115-97). For example, several states are sponsoring "charities" to which residents can contribute and then get a federal income tax deduction for the full amount in lieu of paying assessed property taxes, which are now subject to the federal state and local tax deduction limit of $10,000.[17] This effort at circumventing the clear legislative intent of a tax law by attempting to "shoehorn" into acceptable behavior that which a legislative body has deemed undesirable from a public policy perspective is precisely what state governments have been railing against for decades; when taxpayers engage in such behavior, it is called "inappropriate tax planning" or "tax sheltering." How ironic!

II. *Murphy*, *Wayfair*, *Crutchfield*, and *Hyatt*

Recent cases lead us to believe that states may become more unchecked in the exercise of their tax powers. The recent U.S. Supreme Court decision in *Murphy v. NCAA* concludes merely that Congress cannot prohibit a state legislature from enacting some types of gambling restrictions. The case has nothing to do with a state's right, or non-right, to violate the due process and commerce clauses — either the common law (that is, due process and dormant commerce clause) aspects such as nexus rules or statutory aspects, such as the Railroad Revitalization and Regulatory Reform Act of 1976 and P.L. 86-272. Nevertheless, based on experience and a tad of recent articles,[18] we expect some states to misread the case (intentionally or unintentionally) as saying that states have almost unlimited flexibility in enacting their laws, with the U.S. Constitution being a mere quaint "backdrop."

Also, in *Wayfair*, the Court considered South Dakota's law that explicitly ran counter to the *Quill* physical presence rule for sales and use tax collection. South Dakota's win may very well embolden other states to disregard other federal restrictions that burden them (the *Wayfair* decision makes clear that some prongs of the *Complete Auto Transit* commerce clause test still need to be met).

One already-used check on states' exceeding their legal authority and their overall behavior is their being subject to suit in a sister state's court for alleged tortious activity. The long-running *Hyatt* case provides a recent example. In *Hyatt*, an inventor sued the California Franchise Tax Board for intentional torts and bad-faith conduct committed by FTB auditors during audits of the inventor. This suit was filed in California's sister state, Nevada. After years of litigation, including a trip to the U.S. Supreme Court, Hyatt was awarded substantial damages by the Nevada courts, and the FTB's argument that it could not be hailed into another state's courts failed. Stinging from this reprimand, the FTB has appealed to the U.S. Supreme Court one more time, asking it to overturn the rule from *Nevada v. Hall* that permits state actors to be sued in sister state courts. The Court granted certiorari at the end of June 2018.

As states pursue aggressive tax assessment efforts, taxpayer suits in other states continue to be relied on as a check on such behavior.[19] For example, in *Crutchfield Corp. v. Harding*, Massachusetts has found itself sued in Virginia state court over its recently promulgated "cookie nexus" regulations. The idea of cookie nexus — that the use of in-state software and cookies constitutes physical presence — is controversial, and Crutchfield, the taxpayer bringing the suit, is seeking a declaratory judgment that the regulation fails under *Quill Corp. v. North Dakota* and the Internet Tax Freedom Act. Similar to the FTB in *Hyatt*, the Massachusetts Department of Revenue is arguing that it should not be able to be hailed into Virginia courts.[20] Wins by the FTB or the Massachusetts DOR on that issue would remove a serious protection against unreasonable state tax actions.

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[17] *See, e.g.*, Lauren Loricchio, "State Enacts SALT Deduction Cap Workaround for Passthroughs," *State Tax Notes*, June 11, 2018, p. 1100; and Loricchio, "Second State Enacts SALT Cap Workaround," *State Tax Notes*, May 14, 2018, p. 746.

[18] *See, e.g.*, Daniel Hemel, "Justice Alito, State Tax Hero?" Whatever Source Derived (May 15, 2018).

[19] *See* Brief of Indiana and 44 Other States as Amici Curiae in Support of Petitioner, *Franchise Tax Board of the State of California v. Hyatt*, No. 17-1299, at *8-11 (U.S., filed Apr. 13, 2018).

[20] Massachusetts Commissioner of Revenue's Memorandum of Points and Authorities in Support of His Motion to Dismiss for Lack of Personal Jurisdiction, *Crutchfield Corp. v. Harding*, No. CL17001145-00 (Va. Cir. Ct. Feb. 15, 2018).

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III. Is There Hope?

Interstate taxpayers have, for years, been justifiably wary of having their tax disputes adjudicated by state courts in and for the very state that is seeking additional revenue (in an assessment situation) or protecting revenue (in refund situations). As states face fiscal pressures, some have resorted to "creative" solutions similar to those discussed above. Those solutions are harmful to taxpayers and often counter to legislated state policy. Also, the multistate tax world is in constant evolution. Today's businesses are becoming more fluid and multijurisdictional in operation. This mobility in commerce raises profound concerns for the multistate taxpayer, which must navigate the state tax rules in all the states in which it operates — not to mention determining whether it is even subject to tax in the state to begin with.

To preserve the free flow of commerce between the states, the need for consistency and uniformity in interstate taxation is paramount. Without it, the risk of multistate litigation of the same issue is high. In recent years taxpayers like Gillette and Newegg.com have litigated the same issue in multiple states. Coordinating and centralizing such litigation would result in obvious efficiencies by removing the need to litigate the same issue multiple times and by providing consistency and certainty in the state tax world.

Therefore, one solution to those concerns would be to bring interstate tax disputes to federal courts, which may be more capable of achieving impartial resolutions as federal judges are further removed from state revenue apparatuses. Unfortunately, the TIA and the common law comity doctrine have presented hurdles for these cases reaching federal courts. The TIA prohibits federal jurisdiction in state tax matters when a "plain, speedy, and efficient remedy may be had in the courts of the State." The case law applying the TIA has treated it as a very high bar for federal jurisdiction.[21] Likewise, the comity doctrine, which the Supreme Court described the TIA as partially codifying,[22] reflects the "federal reluctance to interfere with state taxation"[23] and generally counsels federal courts against claiming jurisdiction over state tax cases when the state may have the authority to act.

As the need for uniformity and impartiality in state tax disputes grows, Congress should address the lack of objectivity at the state court level. Not in a substantive way, as pushed for in the case of sales and use tax collections, but in a procedural one. By repealing the TIA and affirmatively granting jurisdiction to the federal courts over interstate tax disputes,[24] Congress could ease the pressure to legislate state tax solutions while ensuring that states cannot run amok, fearless of consequences in many cases. A simple repeal of the TIA would not suffice; the affirmative granting of jurisdiction in the federal courts is needed to overcome the barriers of the comity doctrine. Obviously, there would be details to work out, such as the appropriate burden of proof and persuasion in state tax matters brought to federal courts, but moving toward more uniformity and consistency in state tax has always been and will continue to be an important process for taxpayers, the national economy, and states alike. ■

[21] *See, e.g.*, *Levin v. Commerce Energy Inc.*, 560 U.S. 413 (2010).

[22] *Id.* at 424.

[23] *Id.*

[24] As Rosen and Skelton argued before in, "Desperately Seeking State Tax Fairness: The Need for Federal Adjudication," *State Tax Notes*, Aug. 8, 2011, p. 357: "Of the three federal venues available — district courts, the Court of Federal Claims, or the Tax Court — the Court of Federal Claims presents the best option to achieve the important goal of uniformity. . . . Finally, the Court of Federal Claims is a congressional court (in contrast to an Article III court), so there are few limitations as to what role Congress can give it. As a result, the Court of Federal Claims presents the best solution for uniformity, efficiency, and certainty."

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