State & Local Tax, Winter 1993

Answers to Final Exam

1. G can characterize most of his purchases of bulk perfume stock, bottles, and labels as sales for resale, exempt under the sale for resale exception of STL § 121.1 That exemption does not apply to the gifts to the nursing home residents. See STL § 120.1 (definition of "sale" would not include a gift). Nor does it apply to the Canadian sales -- the resale must take place within the United States under STL § 121.12. (*Note: I think the foreign limitation is unconstitutional under the Foreign Commerce Clause, but that issue is outside the scope of this question.*) The "ingredient or component exemption" of STL § 122.1 has no territorial limit. Thus G should contend that the bulk perfume and labels are "ingredients." He can also claim this exemption for the coloring ingredients. He will have serious problems getting State M to agree that the bottles are "ingredients." He may also have some problems getting the state to agree that the bottles qualify for the sale for resale exception. The case law on packaging is mixed.

   The purchase of the labeling machine, the bottle washing machine, and the bottling machine cannot qualify under the "sale for resale" or the "ingredient" exemptions. They probably qualify under the exemption for machinery. STL § 122.2. This exemption has no territorial limit and no requirement that the goods produced by the machines by "sold." Thus the entire amount of the purchase price of those items would be exempt. without any allocation. There is some question as to whether the bottle washing machine qualifies as machinery used for manufacturing or processing. I think it should, but there is some contrary case law.

2. A property tax applicable to all property located within the state that can be credited against the state business profits tax. *Explanation*: The tax is "fairly apportioned" because is applies uniformly to all property having a nexus with the state. It "discriminates against interstate commerce" because in-state businesses are more likely to have property located within the state than out-of-state businesses.

3. A. A use tax with no credit for the sales tax of foreign states. *Explanation*: The Due Process Clause is satisfied because there are minimal contacts when property is brought into a state. The tax is not internally consistency because double taxation would occur if all states had similar taxes. (E.g. A purchases in State X, pays sales tax, and bring property to State Y and pays unrelieved use tax.)

   B. A sales tax imposed at a rate of 5 percent and a use tax imposed at a rate of 10 percent. *Explanation*: The typical use tax and sales tax satisfy the Due Process Clause. The tax is not internally consistent because if all states did this, then interstate commerce (on which the use tax falls) would pay higher taxes than intrastate commerce.

4. A use tax on mail order sales, for reasons explained in *Quill*.

5. To avoid problems under *Williams v. Vermont*, a state cannot discriminate against nonresidents in applying its credit against the use tax for foreign sales taxes paid. One way to avoid a facially discriminatory tax would be to limit the credit to use taxes paid within the past year. That rule would serve the policy goal of Vermont (it would allow its residents to shop for automobiles outside Vermont with a tax penalty) without discriminating against foreigners. The state might argue that the time limit was intended to encourage prompt registration. Unfortunately, this argument may be disingenuous and might be rejected by a court.

   Alternatively, the state might allow a sales tax to be credited against the use tax only to the extent that the sales tax was paid with respect to the values actually subject to the use tax. In the case of property that declined in value from the time the sales tax way paid, only a fraction of the sales tax would be creditable. The numerator of that fraction would be the value of the property as the time the use tax was applied, and the denominator would be value of the property at the time the sales tax was applied. In the case of Miss Y, the fraction would be $4,000/$20,000. Thus a credit would be allowed for one fifth of the sales tax, or $80 ($400 x 0.2). She would pay a use tax of $240 ($320 – $80).

6. The taxpayer, Corporation X (not Corporation Q, as misstated at one point in the question) has not made a showing that the Foreign Commerce Clause tests are violated. There is no inevitability of double taxation from the taxation of the royalty by State Q. A foreign government may not tax the royalty in some cases, and the federal government may provide relief from national double taxation in some cases. Double taxation at the state and federal levels is the norm. No evidence is given by the taxpayer to show the likelihood of double taxation or to show that the tax by State Q prevents the federal government from speaking with one voice. After *Itel Container*, it is unlikely that the one-voice argument will have much force absent an amicus brief from the federal government.

   Kraft v. Iowa involved a state corporate tax that was not unitary. The State of Iowa was simply excluding dividends from other states out of comity and taxing dividends from foreign corporations. Here State Q is correctly determining apportionable income of Corporation X under unitary rules. There is no facial discrimination, and no discrimination at all unless Corporation X demonstrates that it is entitled to include Corporation F as part of the unitary group (contrary to State Q's water's edge rule. It is quite unlikely that the Supreme Court would extend Kraft to require unitary taxation without a water's edge rule. There are lots of good technical reasons for not including foreign affiliates in the unitary group. State Q would need to know the current income (not just the distributions) of the foreign affiliate and its factors.

On policy grounds, it is improper to require that a state include a related corporation within a unitary group simply because it has paid a royalty to a member of that group. In some respect, a royalty is just a payment for some benefit granted. In analogous situations, the Court does not require unitary treatment. For example, a related corporation would not be included in a unitary group just because it bought widgets from the taxpayer.

Mobil explicitly allowed the state to tax dividends from a foreign affiliate without including the factors of the foreign affiliate in the numerator or denominator of the three-factor formula. As indicated above, the case for taxing royalties from an affiliated corporation without including that corporation within the unitary group is even stronger.