

STATE and LOCAL TAXATION

Maximum Time: 3 hours

Maximum Points: 100

**Tuesday, May 4, 1993**

## Instructions

1. Write your **Exam Number**, the name of your instructor (McIntyre), and the name of this course (State & Local Tax) on the cover of your Bluebook. Please do this now. If you are typing your exam, you must put your Exam Number on the top right of every page and the name of the instructor and the name of the course on the first page.
2. Thank you for putting your **EXAM NUMBER** on the cover of your bluebook. (If you have not done so, please stop reading and do so now.) Please do NOT put your own name on your bluebook.
3. This is an **open book** examination. You are expected to have with you a copy of the Pomp & Oldman Draft Casebook and the other handouts from the course. You are permitted to have any books, notes or other materials you have used during the course. You may use a pocket calculator.
4. This examination has six (6) questions. Answer all of the questions in your bluebook, observing the space limits. A substantial and proportionate penalty will be imposed for exceeding the space limits.
5. In writing in your bluebook, do not use the back side of the pages and please double space (that is, write on every other line). If you are typing, please leave big margins and double space.
6. **Note To Proctor:** Students may keep their copy of the Examination.

## Questions

*General Instructions.* Answer the following six (6) questions in your bluebook. Write in ink and do not write in the margins. The space limitations for questions in each part are stated below. Please be concise. Number your answers clearly!

Note to typists: 1 line of a bluebook is equivalent to 1 line of a typed page (8½" x 11") with 1½ inch margins (pica) or 2 inch margins (elite). This notice is typed with a pica font and has 1½ inch margins.

### I. Advice to Client (maximum points: 30)

Your client, Mr. G, sells perfumes. G imports bulk perfume stock from flower growers in Colombia. He adds certain coloring to the stock, bottles it, and affixes fancy labels to the bottles. The bottling and labeling takes place within State M. G sells the bottled perfume to customers in State M. He also sells perfume mail order to out-of-state customers, including customers in Canada. He solicits those customers by running advertisements on late night cable T.V. G also gives away free samples of his perfume to residents of nursing homes in State M, partly out of charitable impulse and partly to generate good will in the community.

G comes to you for sales tax advice. He want you to let him know whether he can buy the bulk perfume stock, the fancy bottles, the labels, and the coloring ingredients free of State M sales tax. He also wants to know whether he must pay sales tax on the purchase of his labeling machine, the purchase of his bottle-washing machine, and the purchase of his bottling machine.

The State M sales tax is typical of the sales taxes of many states. The following excerpts from the State M Sales Tax Law may or may not be relevant to this fact pattern:

**§ 120.1.** “Sale.” The term “sale” means the transfer of either the title or possession for a valuable consideration of tangible personal property, regardless of the manner, method, instrumentality, or device by which such transfer is accomplished.

**§ 120.4.** “Retail sale” or a “sale at retail” means a sale to any person for any purpose other than for resale in the form of tangible personal property or taxable services and shall

include any such transaction as the Tax Commissioner upon investigation finds to be in lieu of a sale.

§ 121.1 “*Sale for Resale.*” No sales tax is due with respect to purchases made for resale.

§ 121.12. “*Sale for resale*” means a sale of tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of reselling it in the United States of America or a possession or territory of the United States of America in the normal course of business in the form or condition in which it is acquired or as an attachment to or integral part of other tangible personal property or taxable service.

§ 122.1 “*Ingredient or Component Exemption.*” An exemption from the sales tax is provided for industrial materials for future processing, manufacturing, refining, or conversion into articles of tangible personal property for resale where such industrial materials become a component part of the finished product.

§ 122.2 “*Exemption for Machinery.*” Machinery that is used directly and exclusively in the manufacturing or processing production is exempt from the sales and use tax. The term “processing production” shall include: the processing and packaging of raw materials, in-process materials, and finished products; the processing and packaging of farm and dairy products for sale; and the extraction of minerals, ores, coal, clay, stone and natural gas.

1. What advice do you give Mr. G? Give him specific advice about the statutory exemptions you feel he is entitled to claim, with an explanation of the grounds for your opinion. Include appropriate references to cases included in the Pomp & Oldman materials that may apply to State M by analogy. Do not address possible constitutional issues.

**Space Limits.** You may not exceed three bluebook pages, double spaced (45 lines).

## II. Example City

(maximum points: 20)

*Instructions.* The following three (3) questions ask you to provide examples of state taxes that either would satisfy or would violate certain constitutional doctrines. You may use taxes discussed in the course as your examples or you may offer your own examples of hypothetical or actual taxes. After each example you provide, give a brief explanation of how it satisfies the stated criteria. If you conclude that there are no examples that meet the criteria, explain why you hold this view. (*Hint: I think that there are examples available.*)

**Space Limits:** You will only need a few lines to explain each answer. In any event, you are limited to ten lines of your bluebook per example.

2. Provide **one** example of a state property tax that discriminates against interstate commerce and yet is fairly apportioned.
3. Provide **two** examples of state taxes that satisfy the Due Process Clause but do not satisfy the internal consistency test. (*Note: Please label your answers "3A" and "3B".*)
4. Provide **one** example of a state tax that satisfies the Due Process Clause and fails the first prong of the Commerce Clause tests set forth in *Complete Auto*.

### III. Tax Policy

(maximum points: 20)

State A has a sales and use tax applicable to automobile sales made within the state. The rate is 8 percent of the sales price. State B, a neighboring state, has a use tax and a sales tax with rates of 2 percent. State A provides a credit against its use tax for sales taxes paid to State B (and other states), but only for persons who are resident of State A at the time they purchased their automobile.

The State A statute is now under challenge by Miss Y, an individual who recently moved from State B to State A. Miss Y had purchased an automobile in year 1, while a resident of State B, for \$20,000 and paid a sales tax to State B of \$400 (2% of \$20,000). In year 8, she moved to State A. When she registered her automobile with the State A authorities, she was assessed a use tax of \$320, computed by multiplying the fair market value of the automobile in year 8 (\$4,000) by the statutory use tax rate (8%). No credit was allowed for the sales taxes Miss Y paid to State B in year 1.

5. Having read the U.S. Supreme Court's decision in *Williams v. Vermont*, the tax officials in State A understand that they have some problems with their use tax rules as applied to Miss Y. They ask you, as an authority on state and local tax policy, to suggest for them a revised statutory rule that would satisfy constitutional objections to the current tax and would produce an appropriate result for Miss Y and analogous cases. State your proposed solution and explain its rationale.

**Space Limits.** Do not exceed two (2) pages, double spaced (30 lines).

**IV. Tax Practice**  
(Maximum points: 30)

The income tax act of State Q provides that corporations engaged in business in the state must compute their “apportionable income” and pay tax on the amount of that income allocated to State Q under the familiar three-factor formula – sales, payroll, and property. Each of those factors is given equal weight in the formula. State Q uses what is sometimes called a “water's edge” unitary system. If a taxpayer is engaged in business in the state, it includes in the taxpayer's apportionable income the income of its domestic affiliates engaged in the same unitary business but it does not include the undistributed income of foreign corporations in apportionable income. That is, State Q does not employ the worldwide unitary system used, for example, by California.

Federal taxable income of a taxpayer is the starting point in computing its apportionable income. In accordance with the federal computation of taxable income, State Q requires taxpayers to include dividends, interest, and royalties received from foreign affiliated companies in apportionable income whenever the foreign affiliate is engaged in the unitary business of the taxpayer. The sales, payroll, and property of the foreign affiliates are excluded, however, from both the numerator and denominator of the three-factor formula. The corporate tax rate in State Q is a flat rate of 10 percent.

Dividends, interest, and royalties received from domestic affiliates that are engaged in a unitary business and are part of the taxpayers control group (for purposes of filing a federal consolidated tax return) are treated differently. To avoid double taxation of the same income items, dividends are simply excluded from apportionable income. Interest and royalties are also excluded, and the deduction otherwise allowable to the affiliated company for the payment of the interest or royalty is disallowed. This treatment – disallowance of the deduction and exclusion of the income – is consistent with the federal rules for computing the consolidated income of a group of commonly controlled domestic corporations.

Corporation X is organized under the laws of State D. It manufactures and sells computers worldwide, including in State Q, as part of a unitary business. It has an office in State Q, from which it makes sales and provides technical assistance to its customers located in State Q. Under the three factor formula, one half of the income of Corporation X is allocated to State Q.

Corporation X has one subsidiary, Corporation F, organized under the laws of France. Corporation F is engaged in the unitary business of Corporation X. During the taxable year, Corporation X received a royalty from Corporation F of \$1 million. That royalty is included in Corporation X's federal taxable income. A 10-percent withholding tax (\$100,000) was paid over to the French government by Corporation F on behalf of Corporation X upon the distribution of the royalty to Corporation X. Corporation X was allowed a foreign tax credit by the federal government for that withholding tax.

*Note: The foreign tax credit reduces, dollar for dollar, the federal income tax otherwise due on the royalty. The federal government does not allow a deduction for foreign income taxes (including withholding taxes) if the taxpayer has elected to claim a foreign tax credit.*

Corporation X excluded the royalty from its apportionable income in computing its taxes due to State Q. On audit, State Q added the royalty to Corporation X's apportionable income and assessed a deficiency of \$50,000. The deficiency was computed by multiplying the amount of the royalty (\$1 million) by the apportionment fraction (0.5) and then multiplying the amount so determined by the tax rate of 10 percent ( $\$1,000,000 \times 0.5 \times 0.1$ ). In objecting to the deficiency, the taxpayer wrote the Tax Department of State Q a protest letter containing the following paragraphs:

Corporation Q contends that the Foreign Commerce Clause and Due Process Clause of the U.S. Constitution preclude the Department from including, in combined State Q apportionable income, income which is earned in and subject to taxation by foreign countries. In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the U.S. Supreme Court established a six-prong test, all parts of which must be met in order for a state tax to be permissible under the Foreign Commerce Clause. The Department's adjustment in this case violates two prongs of the test, namely, that (i) a state tax must not result in inevitable multiple international taxation and that (ii) a state tax must not prevent the federal government from "speaking with one voice" in foreign policy matters. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

In making its adjustment, the Department fails to recognize that when income is subjected to the taxing jurisdiction of a foreign country, any taxation of that same income by a state will always result in multiple taxation. Indeed, the concepts of allocation to a single situs and apportionment are theoretically incommensurate and constitutionally

impermissible under long standing constitutional principles. The Department, in making its adjustments, also fails to recognize that its tax as applied to multinational taxpayers violates well-established U.S. foreign policy in the area of foreign commerce which seeks to avoid rather than encourage multiple taxation.

In addition, the Department fails to recognize that its failure to allow a deduction for royalties from a foreign subsidiary facially discriminates against foreign commerce under the test of *Kraft v. Iowa*, – U.S. –, 112 S.Ct. 2365 (1992). The discrimination arises because royalties from a domestic subsidiary that is part of a control group are excluded from its parent company's income in computing federal taxable income.

In the alternative, State Q must modify Corporation X's apportionment formula to give recognition to the factors of the foreign subsidiary (Corporation F) which produces the income State Q seeks to tax.

Corporation X has conceded that Corporation F is engaged with it in a unitary business.

6. You have been hired as a consultant to the Tax Department of State Q. Please prepare for the Department a response to Corporation X's protest letter. (*Hint: The quoted paragraphs are adapted with only minor changes from a real case. Be sure that you do not overestimate the professional competence of Corporation X's attorney.*)

**Space Limits.** You may not exceed three bluebook pages, double spaced (45 lines).

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