State & Local Tax, Winter 1999
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Notes on the Answers

1a. Probably no. Ling has purposefully availed itself of the Ohio market and has a physical presence in the state by sending T into the state on a regular basis. Its best defense to imposition of a corporate income tax is P.L. 86-272, which provides, in general, that a state may not impose its corporate income tax on a non-domiciliary corporation it the only activity of the corporation is mere solicitation. T solicits and also measures for the bookcases. The measuring, however, probably would be considered an ancillary activity under Wrigley, so Ling would not lose the protection of P.L. 86-272.

1b. Yes. Ohio has Due Process nexus over Ling because Ling has purposefully availed itself of the Ohio market. It has Commerce Clause nexus over Ling because Ling has a physical presence in the state through the activities of T. See Scripto. See also Tyler Pipe.

1c. Probably yes. The literal holding of *Dilworth* indicates the answer should be no, in that the title to the bookshelves passed outside the state and the contract was consummated outside the state. Still, with T in the state measuring for the bookshelves, there seems to be enough activity in the state to justify the imposition of the sales tax. No other jurisdiction can reasonably impose a sales tax under these facts.

2. Yes. The question under the statute is whether the Ohio customers are buying a service, which would not be taxable, or tangible personal property, which would be taxable. If T had come and installed custom bookcases, he would be selling a service. One might argue that he is installing bookcases, with some of the work done off site. The better argument, however, is that T is selling what amounts to a bookcase kit, in that the actual installation is done by the customer. In that event, what is being sold is tangible personal property. See *Columbia Pictures*.

> *Note: The question asks for an interpretation of the Ohio sales and use tax statute, not for a discussion of constitutional law issues.*

3a. Michigan exempts purchases for resale through its definition of "retail sale." See MI General Sales Tax, section 205.51.1(1)(b), defining "sale at retail" to include the transfer of tangible personal property "for any purpose *other than for resale*." (Emphasis added.)

3b. Michigan explicitly includes sales of "computer software offered for general sale to the public" in its definition of "sale at retail" in MI General Sales Tax, section 205.51.1(1)(f).

4a. Michigan is generally required to value property by reference to fair market value when sufficient information is available to determine market value. The actual purchase price, however, does not establish necessarily fair market value for assessment purposes. The assessor is required to look at the price that comparable property was selling for at the time of the assessment. We do not have information on any other sales. The $18 million will be useful evidence of the market value.

4b. Because of Proposition A, the assessor is not allowed to use the full increase in value of the property in determining the tax due. The increase in value is limited to the lower of 5 percent or the inflation rate. The question does not give the inflation rate for this period. The amount multiplied by 5 percent will be $18 million, indexed for inflation, divided by two.

5. I do not think that ACo has any strong grounds for challenging the State A statute. The problem illustrated by the question is that double taxation can result if one state treats an item of income as business income, subject to apportionment, and another state treats that item of income as allocable to the state of domicile. *Mobile* hints that there may be some protection against double taxation in fact, but it offers no explanation of how the Constitution would provide that protection. State A's taxing scheme seems to satisfy all of the prongs of *Complete Auto*. Note that the problem, if there is one, would be under the fairly apportioned prong. But the State A tax scheme is internally consistent because it taxes all dividends on a domiciliary basis and excludes dividends from apportionable income. Although State A, by going counter to the general practices of the states, is behaving as a bad neighbor, the current constitutional doctrines limiting state taxing power do not seem to be applicable. ACo's best hope is that the Court will impose some form of "fairly apportioned" standard on domiciliary taxation and hold that the State A tax fails to meet some external consistency standard.

6a. The Federal government taxes foreign corporations on a source basis rather than on an apportionment basis. U.S. source royalties paid to a foreign corporation are subject to a withholding tax of 30 percent. Under Federal source rules, royalties are sourced in the country that the intangible property generating the royalty is used. Thus the 30 percent withholding tax would apply on a royalty paid by XCo to HCo if HCo is located in a foreign tax haven. This tax exceeds any likely state tax that XCo and HCo would avoid. Thus the failure of State A to use worldwide combined reporting is not likely to be very important.

If there is a real loophole, the State A might respond by denying XCo (and similar companies) a deduction for payments made to foreign corporations. See Question 6b, below. This response, however, might raise problems under the Foreign Commerce Clause. See *Kraft*. To avoid an argument that the denial of the deduction is discriminatory, State A might state that the deduction is not allowed if a purpose of the royalty arrangement is tax avoidance.

6b. The easy solution to the double tax problem would be to allow the deduction if the payee is domiciled in State A. This solution, however, raises a fatal problem under the nondiscrimination prong of *Complete Auto*. A possible solution would be to give the payee company (XCo) a credit for taxes paid on the royalty by the recipient (HCo). This solution is nondiscriminatory, at least on its face, but it is very difficulty to administer, due to the difficulty of determining the amount of tax paid by the recipient corporation on the royalty. A better solution would be to deny the deduction only in the case of tax avoidance. The rule would have to be written so that the burden was on the taxpayer to show that the payment to a related company did not have the effect of avoiding State A tax.