Wayne State University
Law School

Winter Term, 1995
Prof. Michael J. McIntyre

STATE and LOCAL TAXATION

Maximum Time: 3 hours

Maximum Points: 100

Monday, May 1, 1995

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 (or other personal information) 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, the *Jefferson Lines* case, the property tax materials prepared by Prof. Shoettle 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 five (5) questions and an extra credit question. Answer questions I, II, and III, and either question IV,A or IV,B. You may answer question VI for extra credit if you wish. Write neatly in your bluebook, observing the space limits. A substantial and proportionate penalty will be imposed for exceeding the space limits. (In practice, no penalty will be imposed if your answer exceeds the limit by no more than two lines.)

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 in your bluebook questions I, II, and III and your choice of either question IV,A or IV,B (plus the bonus question if you choose to answer it)
. 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. *Jefferson Lines* Question

(Maximum Points: 40)
(Maximum Length: 3 bluebook pages, double spaced)

Criticize any part(s) of the *Jefferson Lines* decision that you wish. Your criticism should include, wherever possible, normative principles of sales taxation, principles of constitutional analysis, and administrative considerations. You should feel free to criticize the majority or the dissent or both. You might want to offer your own defense of either the majority or the dissent's opinion, based on grounds that do not appear in the opinion.

II. Apportionment

(Maximum Points: 25)
(Maximum Length: 1 bluebook page, double spaced)

Corporation X is incorporated in and has its commercial domicile in Delaware. Corporation X has two divisions: A and B. Corporation X also has a wholly-owned subsidiary, Corporation Y. Corporation Y is incorporated in Delaware and has its commercial domicile in New York. Division A and Division B of Corporation X and Corporation Y all have operations in State S. This question deals with the taxation of the companies by State S.

Under the applicable laws of State S, Division A has $100 of pre-apportioned taxable income, Division B has a pre-apportioned $50 loss, and Corporation Y has $75 of pre-apportioned taxable income.

Corporation Y pays a $30 dividend to Corporation X.

For simplicity, assume that the formula that Corporation X uses for apportioning its income tax among the states consists of one factor: property. (You should assume there is no constitutional objection to that formula.)

The following chart summarizes the property factor for Division A (of X), Division B (of X), and Corporation Y:

	Property Within S	Property Without S
Division A	10	40
Division B	40	10
Corporation Y	50	50

Assume that State S does not use a combined reporting system and that Division A and Division B are not considered to be parts of the same unitary business under State S law. Assume further that State S considers the dividends received by X from Y to be non-business income, having adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) definition of business and non-business income.

UDITPA defines business income as:

> income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

The UDITPA definition of non-business income is "all income other than business income."

Under these facts, how much taxable income would be apportioned to State S? Explain.

III. Sales Tax

(Maximum Points: 10)
(Maximum Length: 10 lines of bluebook page)

Should a state, in its tax statute, grant taxpayers a "sale for resale" exemption on the purchase of goods within the state when the goods will be sold in another state? Explain. Please ignore constitutional law issues.

IV. Pick One

(Maximum Points: 25)
(Maximum Length: 1 bluebook page, double spaced)

Instructions. Answer **either** question IV,A **or** IV,B. The choice is yours.

A. Single-Business Tax

The State of Michigan imposes a Single Business Tax (SBT) on the value-added of corporations, partnerships, sole proprietors, and other business enterprises that conduct business in Michigan. The value added generally is computed under the following formula:

Value added = Cost of Labor + Depreciation + Interest + Profit

Michigan applies a three-factor apportionment formula (payroll, property, and sales) to the total value added of an enterprise to determine the portion that it will tax. Assume that Michigan, under its new MEGA tax incentive program, offers taxpayers operating a business in Michigan a tax credit against the SBT otherwise due equal to 10 percent of that tax for companies that promise to add at least 150 new jobs in Michigan and that are selected by the governor's staff for the tax incentive.

A tax reform group has recently challenged the constitutionality of the tax credit. They argue that the credit forecloses tax neutral decisions and discriminates against firms that produce jobs outside the state.

You are clerking for the Michigan Supreme Court. Your judge has asked you to prepare a very brief memo upholding the constitutionality of the proposed tax credit. Prepare that memo.

B. Property Tax

G owns a restaurant, the *Purple Plum*, located on L Street in City A. City A is a vibrant town that has grown substantially over the past 50 years. Average property values went up rapidly in the 1960s and 1970s. Growth in property values slowed in the 1980s. There has been some overall growth in property values in the 1990s, although some parts of the city have shown modest declines in value. The *Purple Plum* is located in a transition neighborhood — some buildings have been going up in value slightly and some have declined slightly.

The *Purple Plum* is widely considered to be the best restaurant in City A, due in large part to G's skill as a master chief and businesswoman. The restaurant building has 6,000 square feet and is situated on a 12,000 square-foot lot. Over the past three years, the *Purple Plum* has grossed $1,800,000 in annual sales, with annual profits of $700,000. The modest one-story building is constructed of brick and is rectangularly shaped. It was purchased in 1950 by G's grandfather for $20,000. G has spend over $300,000 in modernizing the building and improving its appearance. G has fully depreciated the building, so it is carried on G's books at zero. A year ago G looked into the possibility of tearing down the building and erecting a larger one. She found that for a one-story brick building, she would need to pay about $100 a square foot for construction. Partly because of the estimated cost and partly because she liked the look of the old building, she decided to keep what she had.

There are several office buildings on L Street, and about a block away, on M Street, are some high-rise apartment buildings. Three blocks away, on P Street, are some expensive residential homes situated on half-acre lots. P Street runs along the S River. Across the street from the *Purple Plum* is a railway station. L Street and M street are zoned commercial, and P Street is zoned for single-family residences. Based on recent sales of vacant lots in the area, the land on L and M Streets, not including improvements, is valued at $5 per square foot.

The railway station serves commuters coming to work in the office buildings. It originally was constructed for intercity transport during the early 1920s. With the decline in such rail service after World War II, the station fell into disuse and disrepair. Last year, the station was purchased for $600,000. The new owners invested an additional $500,000 to fix it up to serve as a commuter station. The station is a well-known landmark in City B and is widely thought to be its most beautiful building. Under a tax abatement deal, the railroad station is carried on the City A assessment roll at $100,000. The lot size on which the station is located is 44,000 sq. ft (about one acre).

None of the office buildings has been sold in recent years. The offices in those buildings are leased under long-term lease contracts. The price for office space under the contracts range from annual rent of $8 per square foot to $15 per square foot. The most recent contracts have gone for $11 or $12 per square foot — the difference depending primarily on whether the office has a good view of the river. The office buildings are assessed at 9 times annual rents. For uniformity, the tax office uses an annual rent of $13 per sq. ft. for all river-view offices and $11 per sq. ft. for all other offices.

About two years ago, a high-rise apartment building was constructed for $14 million, with $12 million of that price financed by a nonrecourse mortgage. The lot size of that building is 30,000 sq. ft., and the building has 200,000 sq. ft. of floor space. The building contains 100 apartment units, 91 of which have been rented (at an annual rate of $7 per sq. ft.). The apartment building is assessed at $150,000 for the land and $12 million for the improvements.

There were three recent sales of residential real property overlooking the S River. The average sales price was $500,000 per house. The houses are assessed based on a market survey conducted three years ago, with an upward adjustment of 3 percent per year.

There are two other restaurants in City A that are roughly comparable in size to the *Purple Plum*. None of them has been sold in recent years. From conversations with assessors in other cities, the City A tax office is aware of a sale of a restaurant in City Z that is similar in size to the *Purple Plum*. The sales price was $1 million. City Z is located 4,000 miles away from City A. City A does not know anything about the income earned by the restaurant in City Z and has no easy way to obtain such information.

City A's property tax statute states in relevant part that property should be assessed “at its full value.” The courts have interpreted that phrase as requiring that the property be valued at its fair market value. There are no regulations and no assessing manual to guide the assessors. The informal practice of the assessors has been to use what they consider to be the best method of assessment under the facts and circumstances of the particular case.

What assessment method should the City A tax assessors use to value the *Purple Plum* and the land on which it is located for purposes of the City A property tax? What result would be achieved under that method in this case? Is there important information needed for the assessment under your proposed method that is missing and that you feel the tax office could obtain without great difficulty? Explain.

VI. Extra Credit

(maximum points: 5)

Look at the sentence in parenthesis in numbered paragraph 4 on the first page of this examination (**Instructions**). Discuss the similarity of that penalty relief provision to a common practice in the taxation of residential real property.

End of Exam