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In this edition of From the SALT Minds, the authors discuss recent aggressive positions taken by localities regarding their gross receipts taxes. The authors note that although these positions often do not survive a court challenge, taxpayers and practitioners should prepare for similar enforcement actions in their jurisdictions.

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As we often hear, many cities and counties across the country continue to experience revenue shortfalls. Sales tax collections remain below historical averages while online shopping continues to flourish with fewer and fewer sales tax dollars generated by bricks-and-mortar retailers. One way local governments are combating revenue losses and concomitant budget issues while maintaining services at existing levels is to pursue increasingly aggressive nexus interpretations in imposing their business license or privilege taxes on out-of-state vendors.

A recent example is *Elbow River Marketing LP v. City of Birmingham, Alabama*,[1] which involved Birmingham's attempt to impose its gross-receipts-based business license tax against Elbow River, a Canadian-based fuel broker with no physical presence in the city. During the periods at issue, Elbow River arranged for the sale of ethanol and naphtha to its two Alabama-based customers via third-party rail and trucking common carriers. Elbow River did not have any employees, agents, or direct personal business operations in Birmingham. Elbow River had, however, retained title to some of the fuel while it was still in possession of the common carriers.

Because Elbow River maintained title to some of the fuel during its transportation, or acquired title in "flash title" transactions at the point of delivery, Birmingham claimed that Elbow River was doing business in the city so that sufficient nexus existed. As such, these transactions allegedly subjected the foreign seller to the city's business license tax. Birmingham also contended that Elbow River

[1] *Elbow River Marketing LP v. City of Birmingham, Alabama*, CV-2014-000624, (Ala. Cir. Ct. of Jefferson Cty., Mar. 17, 2017), *aff'd*, Case No. 1160678 (Ala. Dec. 8, 2017).

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was conducting business through agents in the city. Specifically, the city argued that the independently owned and operated transload facility in downtown Birmingham, where some of the fuel in question was offloaded from railroad tank cars to tanker trucks, had acted as an agent or representative of the company.

Elbow River, as a fuel broker, operates in an industry that's well known for its razor-thin profit margins. Because the assessment would have essentially eliminated any profit Elbow River had earned on the sales, it challenged the tax. The company's primary argument was that it wasn't engaged in business in the city of Birmingham. In support of that position, Elbow River relied, in part, on Alabama Code section 11-51-194(b), which shields remote sellers from municipal business license tax in Alabama when their sole connection with a municipality is the delivery of their products by common carrier.[2] Elbow River also argued that imposing a business license tax in these circumstances violated constitutional nexus standards.

After a three-day trial,[3] the Circuit Court of Jefferson County agreed with Elbow River, rejected the city's multiple nexus arguments, and voided the assessment. Deciding the case solely under state law, the court held that Elbow River was not doing business in the city as required by the statutes governing municipal business license taxes, and that the language in the so-called delivery license statute precluded the imposition of a business license tax on a remote seller shipping goods into the city by common carrier.

The court explained that although Elbow River "did have title to the products at points in the delivery process," the foreign seller "did not have possession of or control over the products in the City."[4] Therefore, the court concluded that Elbow River was not engaged in business in Birmingham, and thus the statutory prerequisite to the imposition of a business license tax was absent.[5]

To the chagrin of the authors and their client, Birmingham appointed outside counsel and appealed the ruling. However, on December 8, 2017, after reviewing the lengthy trial court ruling and multiple briefs, the Alabama Supreme Court affirmed the trial court's decision without issuing a separate opinion. In effect the court agreed that under Alabama law, a foreign seller cannot be subjected to a city's business license tax if it does nothing more than deliver its product into the city by common carrier, even if title is held by the seller during some part of the transportation process. The court did not address the constitutional arguments.

While *Elbow River* dealt with foreign sales *into* a municipality, local governments are aggressively pursuing assessments on *outbound* sales as well. Another recent Alabama case is a good (or bad) example. In *P.J. Lumber Co. Inc. v. City of Prichard, Alabama*,[6] the city of Prichard included gross revenue from international export sales of lumber in calculating the taxpayer's municipal business license tax liability. Arguing that applying the tax to exported goods violated the import-export clause of the U.S. Constitution,[7] the taxpayer — a seller of lumber both domestically and internationally — paid the license tax and then petitioned for a refund of the portion of the tax imposed on sales of its lumber exported internationally.

The Alabama Court of Civil Appeals disagreed with the taxpayer and upheld the city's inclusion of foreign export sales in the business license tax base, finding that the use of gross receipts from exported goods to calculate a municipal business license tax does not violate the import-export clause. According to the court, the cases relied on by the taxpayer were inapposite

[2] Ala. Code section 11-51-194(b) provides that "mere delivery of the taxpayer's merchandise by common carrier shall not allow the taxing jurisdiction to assess a business license tax against the taxpayer."

[3] The authors' law firm, Bradley Arant Boult Cummings LLP, represented the taxpayer in this case.

[4] *Elbow River*, CV-2014-000624 at *7.

[5] *Id.* at *9 ("a product seller that does nothing more than having its merchandise delivered into a municipality by means of a common carrier cannot be subjected to [municipal] business license tax.").

[6] *P.J. Lumber Co. Inc. v. City of Prichard, Alabama*, ___ So. 3d ___, Case No. 2160627 (Ala. Civ. App. Sept. 22, 2017).

[7] U.S. Const. Art. I, section 10, cl. 2 ("No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States.").

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because they were decided before the landmark 1976 U.S. Supreme Court case, *Michelin Tire Corp. v. Wages*,[8] in which the Court "initiated a different approach to Import-Export Clause cases" and began closely examining the nature of the tax being imposed to determine whether it truly qualified as an "impost" or a "duty."

Applying the policy-based standards, the court of civil appeals noted that the municipal business license tax is a nondiscriminatory tax imposed on all businesses located in the city, and in no way impedes the regulation of foreign trade, nor does it affect the harmony between the states. Also, the tax is imposed on the privilege of doing business in the city and taking advantage of city services. Quoting *Michelin Tire*, the court noted "there is no reason why local taxpayers should subsidize the services used by the [exporter]."[9] Curiously, however, it doesn't appear that the circuit court or the appeals court considered whether the commerce clause or Alabama business license tax cases invoking the commerce clause, such as *M & Associates*[10] and *Mobile Marine Radio*,[11] could have prohibited the city from taxing these out-of-state receipts. Unfortunately, the taxpayer did not petition for certiorari to the Alabama Supreme Court.

While *P.J. Lumber* ultimately found that the city's inclusion of gross revenue from export sales in the tax base passed constitutional muster, at least under the import-export clause, not all courts seem to agree with that proposition.

In *Dulles Duty Free LLC v. County of Loudoun, Virginia*,[12] the Virginia Supreme Court addressed the constitutionality of a tax similar to that in *P.J. Lumber* along with an identical defense. The court found that a county's imposition of a business, professional, and occupational license (BPOL) tax on the gross receipts of an airport duty-free store violated the import-export clause. Given that the taxpayer — a retailer of duty-free merchandise at Washington Dulles International Airport — generated more than 90 percent of its sales to international customers, it's clear why the local government took an aggressive stance and argued to include the taxpayer's export sales in its calculation.

In reaching its decision, however, the Virginia court first noted that while the Supreme Court in *Michelin Tire* indeed took a new policy-based approach in determining whether a tax violates the import-export clause, some cases decided before *Michelin Tire* also retained "precedential value."

Specifically, the *Dulles Duty Free* court stated "when it comes to assessing the constitutionality of taxes that fall on export goods in transit," the U.S. Supreme Court's bright-line test as established in *Richfield Oil Corp. v. State Board of Equalization*,[13] rather than the policy-based *Michelin Tire* test, supplies the rule of the decision.[14] Under *Richfield Oil*, a tax that falls directly on export goods in transit violates the import-export clause, regardless of the characterization of the tax under state law.

Also, the *Dulles Duty Free* court noted that despite *Michelin Tire*, the U.S. Supreme Court has never retreated from its method of assessing the constitutionality of a state tax based on its operation and effect. According to the court, by imposing the BPOL tax on a percentage of gross sales, which included export sales in transit, the BPOL tax is in its "operation and effect" a direct tax on export goods in transit, regardless of its imposition on the gross receipts of the business. Therefore, in contrast to the Alabama appeals court ruling in *P.J. Lumber*, the Virginia Supreme Court ruled that "the BPOL tax as applied to Duty Free's export goods in transit constitutes an impermissible impost upon an export in violation of the Import-Export Clause."[15] This story may not be over. The county has petitioned the U.S. Supreme Court for certiorari.[16]

Good outcomes or bad, this trend of increasingly aggressive tax levies by local

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[8] *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976).

[9] *P.J. Lumber, at ______, quoting Michelin Tire*, 423 U.S. at 289.

[10] *M & Associates v. City of Irondale*, 723 So. 2d 592 (Ala. 1998).

[11] *Mobile Marine Radio v. City of Mobile*, 719 So. 2d 213 (Ala. Civ. App. 1997).

[12] *Dulles Duty Free LLC v. County of Loudoun, Virginia*, 803 S.E.2d 54 (Va. 2017).

[13] *Richfield Oil Corp. v. State Board of Equalization*, 329 U.S. 69 (1946).

[14] *Id.* at 60.

[15] *Id.* at 62.

[16] *Loudoun County, Virginia v. Dulles Duty Free LLC*, U.S. Sup. Ct. Dkt. No 17-904 (cert. requested Dec. 19, 2017).

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governments doesn't appear to be unique to Alabama and Virginia. Numerous similar cases involving local business license and gross receipts taxes have been turning up all over the country.

For instance, in *Apex Laboratories International Inc. v. City of Detroit*,[17] the city of Detroit argued that a passive holding company with no physical presence in the city had the requisite nexus for purposes of the city of Detroit income tax (CDIT). However, the Michigan Tax Tribunal found that the evidence supported the taxpayer's position that it lacked sufficient nexus with the city and was, therefore, not responsible for any CDIT.

In *Apex Laboratories*, a private equity firm identified an investment opportunity in a Canadian company and created a fund to invest in the business. The taxpayer, Apex Laboratories International Inc. (Apex), was created during the acquisition process to hold the fund's investment in the Canadian entity. Later, Detroit issued a proposed assessment against Apex specifying that it had nexus with the city and thus owed CDIT resulting from dividends and capital gains it received following the creation of the fund. The taxpayer challenged the city's CDIT assessment and, like Elbow River, argued that it was not doing business in the city and that it lacked sufficient nexus.

The Michigan Tax Tribunal granted the holding company's motion for summary disposition and held that it did not have the requisite nexus with the city. In reaching its decision, the tax tribunal first noted that under relevant law, the CDIT applies only to "the taxable net profits of a corporation doing business in the city, being levied on such part of the taxable net profits as is earned by the corporation as a result of work done, services rendered and other business activities conducted in the city."[18] The tax tribunal conceded that although the taxpayer's activities were passive in nature, it was, in fact, doing business when it was formed to hold an investment with the objective of gain or benefit.

Although concluding that the taxpayer was doing business, the tribunal explained that the more important question was whether the taxpayer was specifically doing business in Detroit and had the requisite nexus for imposition of the CDIT. Citing *Quill Corp. v. North Dakota*,[19] the tribunal ruled that the taxpayer did not. The tribunal rejected Detroit's argument that nexus was established because the taxpayer's commercial domicile was in the city. According to the tribunal, as a passive holding company, the taxpayer did "not engage in an active trade or business that requires either a physical location or express direction or management." As such, the tribunal concluded that the taxpayer was not required to pay the CDIT assessment.

Questions of nexus and doing business are not the only issues being pursued by local taxing jurisdictions these days. Indeed, in *Upper Moreland Township v. 7-Eleven Inc.*,[20] a suburban Philadelphia municipality took an aggressive position in apportioning the interstate gross receipts of a taxpayer operating in multiple states. Specifically, the municipality — which is home to a 7-Eleven regional office that supervises stores throughout Pennsylvania and New England — attempted to impose additional business privilege taxes and penalties after an audit uncovered that on its tax return, 7-Eleven had reported only its receipts from sales at the regional office, which was located in the municipality, and not any of the franchise fees collected from its stores throughout the region.

Ultimately, the Pennsylvania Commonwealth Court held that imposing these additional taxes was unconstitutional because the tax scheme was not fairly apportioned, and thus violated the second prong of the commerce clause test. The intermediate appellate court found that the local government's apportionment method failed to reflect that the activity generating the fees resulted from economic activity occurring from both in and outside the state. According to the court, it was improper for the municipality to conclude that

[17] *Apex Laboratories International Inc. v. City of Detroit*, No. 16-000724 (Mich. Tax Trib., May 2, 2017).

[18] *Id.* at *13.

[19] 504 U.S. 298 (1992).

[20] *Upper Moreland Township v. 7 Eleven Inc.*, 160 A.3d 921, 924 (Pa. Commw. Ct. 2017), petition for allowance of appeal denied 170 A.3d 984 (Pa. Aug. 9, 2017).

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fees paid by 7-Eleven franchisees in the state were exclusively the result of in-state, and not interstate, commerce. The court did, however, remand the case to the trial court to recalculate the appropriate amount of business privilege taxes due from 7-Eleven to the township, explaining that the municipality is constitutionally permitted to subject the 7-Eleven franchise fees to business privilege tax if the taxed receipts are indeed properly apportioned.

In yet another recent case, *Giles & Ransome Inc. v. Whitehall Township*,[21] the issue was whether a Pennsylvania township's business privilege tax ordinance applied to sales transactions of salespersons who had desks at a taxpayer's office in the municipality, but "where the actual sales of its product took place outside the territorial limits." The taxpayer employed three salespeople who maintained offices, including physical desks, telephones, and a mailing address, in the municipality, but the sales at issue were arranged outside the local government's taxing jurisdiction.

Some Pennsylvania municipalities are authorized to "levy, assess and collect or provide for the levying, assessment and collection of such taxes as they shall determine on persons, transactions, occupations, privileges, subjects and personal property within the limits of such political subdivisions."[22] The commonwealth court explained that based on its reading of the township's tax ordinance, the taxing authority had erred in imposing a tax on all sales made by the salespersons in question. According to the court, "by focusing on the salesmen and not the specific sales," the local municipality, "in essence, attempted to tax a person and not a transaction."[23] Thus, the court voided the tax assessment on the sales that took place outside the territorial limits of the township.

Considering these recent cases, it's clear that local governments throughout the country are looking to boost or preserve their tax revenue in ways that push statutory (if not constitutional) boundaries. And, despite frequent taxpayer victories on appeal, this is not a trend we expect to end anytime soon. In the future, taxpayers should closely monitor this evolving anti-taxpayer climate at the local level. ■

[21] *Giles & Ransome Inc. v. Whitehall Township*, 61 A.3d 386 (Pa. Commw. Ct. 2013).

[22] 53 Pa. Stat. Ann. section 6924.301.1 (LTEA).

[23] *Giles & Ransome*, 61 A.3d at 395.

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