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This Year in SALT

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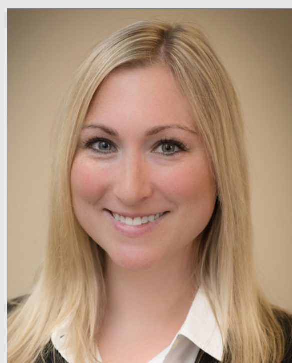

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In this installment of Pennsylvania's SALT Shaker, Karpchuk reviews some of the top cases of 2021 — including litigation on Public Law 86-272, sales tax apportionment, use taxes for advertising materials, sales tax class actions, and billboard taxes in Baltimore and Cincinnati.

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From old issues involving Public Law 86-272 to new issues involving billboard taxes, 2021 was certainly not dull — yielding a number of important state and local tax decisions from courts throughout the country. Many of the year's top cases offer something to watch for or consider in 2022.

Public Law 86-272: Alive and Well . . . For Now

P.L. 86-272, enacted more than 60 years ago, still offers an enormous protection to companies that meet its guidelines: no income tax. Thus, taxpayers seek to interpret it as broadly as possible, while tax authorities seek the opposite — which is the case with *Procacci Brothers Sales Corp.*[1]

Procacci Brothers is a wholesale distributor of fresh fruits and vegetables headquartered in Pennsylvania. During the years at issue in the case, the company did not have an office or inventory in New Jersey: Any orders were received and processed in Pennsylvania and were fulfilled and shipped from its Philadelphia warehouse. For most of the years at issue, the company occasionally picked up rejected produce in New Jersey with its own trucks upon delivery, but before acceptance of the product. The taxpayer claimed the protections of P.L. 86-272, and the New Jersey Division of Taxation disagreed.

The Tax Court found that to the extent that the product was returned before acceptance, the act of returning rejected produce was ancillary to the sale of the product and protected by P.L. 86-272. The court also reasoned that the facts showed that that activity was de minimis because it involved less than 1 percent of products shipped in New Jersey. However, for one of the years under audit the court upheld the assessment because the distributor sent trucks into New Jersey to obtain tomatoes from a related entity on a regular and systematic basis and delivered that produce to the taxpayer's Pennsylvania warehouse. The court found that those actions — combined with sending trucks into New Jersey to pick up the rejected produce after it was delivered — gave the company sufficient contact with New Jersey to subject it to tax.

The division also raised an argument that the taxpayer had property in the state by virtue of pallets upon which its produce was delivered to customers. However, the evidence showed that those pallets were owned by an unrelated third party and that for each pallet that was delivered, a similar pallet was exchanged. Thus, the arrangement resulted in no pallet remaining in New Jersey belonging to Procacci Brothers. Neither party appealed the Tax Court's decisions.

[1] *Procacci Brothers Sales Corp. v. Division of Taxation*, Dkt. No. 015626-2014 (N.J. Tax Ct., May 25, 2021) (not for publication).

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Procacci Brothers highlights the intensive factual inquiry necessary with P.L. 86-272 cases, as well as how quickly a taxpayer can lose its protections.With our shift to a service-based economy, P.L. 86-272 does not apply to as many companies as it did when it was enacted more than 60 years ago. However, many businesses continue to assert its protections.

This year also brought the Multistate Tax Commission's updated P.L. 86-272 guidance, which is the culmination of a two-year effort — spurred by *Wayfair* — to identify internet activities that are not covered by the federal law. According to the MTC's guidance, determining whether someone selling tangible personal property via the internet is shielded by P.L. 86-272 involves the same analysis as that for a person selling property by other means. The MTC's guidance provides that when a business interacts with customers via its website or app, it is engaging in activity within the customer's state. The presence of static text or photos on a company's website, however, does not constitute business activity in a given state. The guidance lists specific activities that it views as protected or not protected.

States have not yet officially adopted the MTC's guidance — but they wouldn't necessarily need to. Instead, states could assert the MTC's positions on audit. And if states adopt the MTC's guidance either directly or on audit, we will undoubtedly see more P.L. 86-272 litigation in the coming years.

Sales Tax Apportionment and Statutory Construction

Oracle USA Inc.[2] involves sales tax apportionment, yet ultimately this Massachusetts case is focused more on statutory construction and the commissioner's authority.

Hologic Inc. purchased or licensed software from Oracle and Microsoft. The company timely installed the vendors' software onto its computers, and the vendors collected sales tax on the total value of the transaction and remitted the tax to Massachusetts. After remittance, Hologic informed the vendors that only a small percentage of its employees were actually using the software in Massachusetts. Thereafter, the vendors submitted an application for abatement and refunds for the tax remitted on software transferred for use outside Massachusetts.

In 2005 the Massachusetts legislature amended the statute at issue to provide that "the commissioner may, by regulation, provide rules for apportioning tax in those instances in which software is transferred for use in more than one state." Thus, effective October 20, 2006, the commissioner promulgated regulations regarding sales tax apportionment for the multistate use of software.

The regulation contains two important provisions. First, paragraph 15(a) requires that if a purchaser "knows at the time of its purchase of prewritten computer software that the software will be concurrently available for use in more than one jurisdiction," it may provide a Form ST-12 to the vendor "no later than the time the transaction is reported for sales or use tax purposes."[3] Second, paragraph 15(b) provides that those sellers who know that the prewritten software will be used in more than one jurisdiction but have not provided an exempt use certificate to the purchaser "may work with the purchaser to produce the correct apportionment," which the purchaser must certify.[4] Importantly, paragraph 15(b) does not explicitly state when the seller and purchaser must complete the apportionment calculation and certification.

The commissioner denied the vendors' applications for abatement regarding the Hologic purchases, reasoning that the vendors had not complied with paragraph 15(a) of the regulations because Hologic did not submit a certificate to the vendors at the time of purchase or within the time the transaction was reported for sales tax purposes. The vendors appealed the decision, claiming that they had the right to apportion under the statute, and that the requirement for certificates was only relevant in determining whether there was a duty to collect and remit and did not prohibit a taxpayer from later seeking an

[2] *Oracle USA Inc. et al v. Commissioner of Revenue*, Dkt. No. SJC-13013 (Mass. 2021).

[3] 830 Mass. Code Regs. 64H.1.3(15)(a) (20-day window following the end of a seller's sales tax reporting period).

[4] 830 Mass. Code Regs. 64H.1.3(15)(b).

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abatement for the tax remitted that was attributable to out-of-state sales.

The court focused on the statute and legislative intent and ultimately sided with the vendors. The court reasoned that the legislature had intended to allow taxpayers to apportion sales tax on software in situations in which the software was transferred for use in more than one state. If a taxpayer wants to avail itself of the benefits of paying only the apportioned tax when the tax is due, then the procedures set forth in the Department of Revenue's regulations must be followed. Otherwise, the presumption that the full amount is taxable applies, and the seller must pay tax on the entirety of the sale at the time of purchase. Thereafter, allowing a vendor to seek an abatement for the apportioned amount comports with legislative intent. This case was less about tax and more about statutory construction, which is not uncommon in SALT cases in which courts are all too frequently tasked with determining legislative intent.

Where's the Use?

During routine sales tax audits, many taxpayers are surprised when a tax authority asserts a use tax liability. *Bed Bath & Beyond*[5] involved the question whether the company owed use tax to Michigan on advertising materials and coupons that were mailed to state residents. Bed Bath & Beyond is a New Jersey company that sells household products. As many likely know from personal experience, the company produces 800 million to 900 million advertising materials annually, which are delivered to customers throughout the country — including Michigan residents. These materials are addressed directly to customers and delivered via the U.S. Postal Service.

Bed Bath & Beyond designed the advertising materials in-house, then purchased the requisite paper product and sent it to a printer — all outside Michigan. After the advertising materials were printed, Bed Bath & Beyond directed the printer to send the materials to Harte Hanks Mailing House — a mail vendor under contract with the company to process and prepare the materials for mailing to Bed Bath & Beyond customers.

In furtherance of that objective, Harte Hanks either bundled or trayed the advertising materials, shrink-wrapped them on pallets, and tagged the pallets by destination for bulk delivery to USPS mail distribution centers. None of Harte Hanks's locations were in Michigan. For Bed Bath & Beyond's Michigan customers, Harte Hanks prepared the materials at its nearest facility, which was in Pennsylvania. Harte Hanks was responsible for determining where the advertising materials entered the USPS system. Once it determined the appropriate USPS center, Harte Hanks loaded the pallets onto its trucks for delivery to those locations.

The Michigan Department of Treasury claimed that the advertising materials were subject to use tax, arguing that tangible personal property is subject to use tax when a taxpayer exercises its rights of ownership over the property within Michigan state lines — and that Bed Bath & Beyond controlled the aspects of delivery of the materials. The department further asserted that Bed Bath & Beyond imposed requirements regarding how and when the materials could be used after delivery to Michigan residents, thereby constituting a taxable use. The company responded that the mere distribution of advertising materials — without indicia of control — did not constitute a taxable use. Moreover, Bed Bath & Beyond contended that how Michiganders used the advertising materials after delivery was irrelevant to its alleged control for use tax purposes.

The court looked to a 1996 Michigan appeals court decision that found that Sharper Image catalogs mailed from a postal service facility in Nebraska were not subject to tax. The court had concluded that the company's exercise of power over the catalogs terminated when the catalogs were delivered to the postal service and that Sharper Image did not use them in Michigan. Likewise, in *Bed Bath & Beyond*, the court found in favor of the taxpayer. The court reasoned that following production of the advertising materials, Harte Hanks had the contractual obligation to prepare and deliver the materials within

[5] *Bed Bath & Beyond Inc. v. Department of Treasury*, Dkt. nos. 352008, 352677 (Mich. Ct. App. 2021) (unpublished).

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Michigan, which it did according to its own method.

The court also addressed the department's claim that an incident of ownership included the right to manage the use of the advertising materials by customers, which it said Bed Bath & Beyond satisfied by requiring customers to present materials at its Michigan stores by a specific date set by the company. The court emphatically disagreed — finding that Bed Bath & Beyond no longer exercised a right of power over the advertising materials incident to ownership once in the hands of customers. Instead, upon receipt of the advertising materials, the customers became the owners of the materials and could do with them as they pleased. Simply because a customer might not be able to redeem a coupon after a specific date did not equate to Bed Bath & Beyond's management of the advertising materials.

Sales Tax Collection Is Not 'Trade or Commerce'

There have been a number of class actions popping up over the past year concerning the alleged improper collection of sales tax on various items. Most of the cases seek relief under a state's unfair trade practices law. The plaintiffs essentially claim that a retailer incorrectly charged sales tax on an item — and therefore the class is entitled to relief above and beyond the tax itself.

Four of those suits in Pennsylvania were thrown out by the U.S. District Court for the Western District of Pennsylvania in 2021.[6] The *Big Lots* case detailed why — under Pennsylvania's Unfair Trade Practices and Consumer Protection Law (UTPCPL) — collecting sales tax did not apply to the UTPCPL. The *Walmart* decision focused on the fact that collecting sales tax is not trade or commerce, which is a necessary element of a UTPCPL claim. In dismissing the case, the *Walmart* court held that when a retailer acts as a tax collector for the commonwealth, it wears a different hat than when it is marketing and selling products. In the former instance, the retailer is no different from a governmental entity carrying out its public duty. At the time of publication, most of the cases had been appealed to the Third Circuit.

Meanwhile, in state court, cases in the Allegheny County Common Pleas Court have survived preliminary objections, despite the holdings in the district court and similar high courts in other states. In August defendants in a class action over the alleged improper collection of sales tax on face masks filed a petition with the Pennsylvania Superior Court for an interlocutory appeal from the common pleas court's denial of preliminary objections. The retailers are asking the appellate court to weigh in on the "act in the conduct of trade or commerce" issue.[7] In November the superior court agreed to hear the case. Decisions should be expected from both the superior court and the Third Circuit in 2022.

Do Billboard Taxes Violate the First Amendment?

The answer to this question is a resounding yes and a categorical no, depending on which state high court you ask. The facts that make up billboard tax cases brought in Maryland and Ohio are virtually identical. Both Baltimore and Cincinnati impose an excise tax on licenses to install billboards; the tax falls only on billboard operations, which are free to pass the tax on to their customers; and no other types of signage are subject to tax (for example, newspapers and other media). In both cases, the taxpayers argued that the laws fall within the ambit of the First Amendment by targeting speech by taxing billboard operators providing a platform for the dissemination of speech and content — and by only applying the laws to a narrow subset of speakers.

In Maryland, the court found that the ordinance did not implicate the First Amendment and that the city had a rational basis to enact the tax as a revenue-raising measure.[8] The dissent noted that when a law implicates a fundamental right, as the ordinance in question appeared to do, it is subject to a heightened level of scrutiny and

[6] *See McLean v. Big Lots Inc.*, 2021 U.S. Dist. LEXIS 106039 (W.D. Pa. June 7, 2021); *James v. Aldi Inc.*, No. 2:21-CV-00209-MJH, 2021 WL 2896837, at *2 (W.D. Pa. July 9, 2021); *Lisowski v. Walmart Stores Inc.*, 2021 U.S. Dist. LEXIS 145568, at *2-3 (W.D. Pa. Aug. 4, 2021); *Ranalli v. Etsy*, 2021 U.S. Dist. LEXIS 214243 (W.D. Pa. Nov. 5, 2021).

[7] *American Eagle Outfitters Inc. et. al. v. Garcia*, Pa. Super 59 WDM 2021.

[8] *See Clear Channel Outdoor Inc. v. Director, Department of Finance*, Case No. 24-C-18-001778 (Md. 2021).

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the government must show a compelling or important justification for imposing it.

Turning to Ohio, Cincinnati's tax did contain one provision that Baltimore's did not: It prohibited billboard operators from advising customers of the tax.[9] However, the operator was still free to pass the tax on in the form of increased rental fees.

The two taxpayers in the case owned most billboards in Cincinnati. The court found that the tax was not on the existence of the sign but required the sign to be leased or offered for lease. Therefore, the tax was targeting advertising revenue and taxing a means of communication. The court also expressed concerns because the tax was not generally applicable and was mainly imposed on the two companies. There was also evidence that city council members had not been shy in asking the taxpayers to donate billboard space for their projects or in seeking the removal of messages with which they disagreed.

Ultimately, the Ohio court permanently enjoined enforcement of the billboard tax, holding that it did not survive strict scrutiny because the need to raise revenue did not justify the city's "selective tax on speech and the press." Noting that it found the Maryland high court's analysis of the issue unpersuasive, the court took issue with the Maryland court's determination that Baltimore's tax did not target a small group of speakers. The Ohio court also noted that the U.S. Supreme Court has held that a tax can violate the First Amendment without having a purpose to censor.

Clear Channel appealed the Maryland decision to the U.S. Supreme Court. As of this writing, the Court has not announced whether it will grant cert. While it is impossible to know what the Court will do, the split in the lower courts certainly adds a layer of consideration for the Court. If the Court does take the case, it could have implications for other cities with billboard taxes, like Philadelphia, and it may also have ramifications for states that have or are considering adopting digital advertising taxes, which arguably have their own First Amendment issues.

This year certainly had some significant SALT cases involving key issues that are applicable throughout the country. Although 2021 is ending, 2022 is sure to bring its share of riveting SALT cases. ■

[9] *See Lamar Advantage GP Co. LLC and Norton Outdoor Advertising Inc. v. City of Cincinnati*, Slip Op. 2021-Ohio-3155 (Sept. 16, 2021).

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