Multistate Tax Update -- January 16, 2014

ALERT | JAN 16, 2014

MICHIGAN: DEADLINE APPROACHING FOR SMALL TAXPAYER PERSONAL PROPERTY TAX EXEMPTION

Michigan taxpayers have until Feb. 10, 2014 to apply for an exemption from their personal property taxes if they have less than $80,000 of combined true cash value of industrial or commercial personal property owned by, leased by or in their possession and/or related entities in a single local taxing jurisdiction. Taxpayers owning such eligible personal property may claim the exemption by filing an affidavit on Form 5076 each year for each jurisdiction in which the taxpayer is eligible for the exemption.

The statute defines “eligible personal property” as property that meets *all* of the following conditions:

1. Is industrial personal property or commercial personal property.
2. The combined true cash value of all industrial personal property and commercial personal property in that local tax collecting unit owned by, leased to or in the possession of the taxpayer or a related entity on Dec. 31 of the immediately preceding year is less than $80,000.00.
3. Is not leased to or used by a person that previously owned the property or a person that, directly or indirectly, controls, is controlled by or is under common control with the person that previously owned the property.

For 2014 only, if a taxpayer does not timely file the affidavit, it may seek the exemption at the local taxing jurisdiction’s Board of Review in March. However, there is no requirement that the Board of Review has to grant the exemption. Therefore, taxpayers should ensure that an affidavit on Form 5076 is received by the assessor of each local taxing jurisdiction no later than Feb. 10, 2014.

Click here for a copy of Form 5076.

CALIFORNIA: FRANCHISE TAX BOARD ADOPTS REGULATIONS TO IMPLEMENT THE *FINNIGAN* RULE

The California Franchise Tax Board has amended Section 25106.5, Title 18 of the California Code to reflect the legislature’s adoption in 2009 of the *Finnigan* rule for taxable years beginning on or after Jan. 1, 2011. As explained below, the *Finnigan* rule is one of two primary methods which states use to calculate the sales factor for income tax apportionment formula purposes.

Taxpayers that have business activities within California and other states are required to determine the amount of income properly attributable to California by applying one of California’s apportionment formulas. Such formulas include a sales factor, which is a fraction, the numerator of which is the taxpayer’s sales of tangible personal property in California during the taxable year, and the denominator of which is the taxpayer’s sales of tangible personal property everywhere during the taxable year.

The general rule is that sales of tangible personal property should be assigned to the sales factor numerator of the state of destination of such property. An exception to this rule is if the taxpayer is not taxable in the state of destination, then such sales are “thrownback” to the state from which the tangible personal property was shipped and included in the sales factor numerator of such state of shipment for purposes of the apportionment formula.

States differ in how the sales factor is calculated when the taxpayer is part of a unitary or combined reporting group for state tax purposes. In such cases, the states generally follow either the *Joyce* rule or the *Finnigan* rule. The *Joyce* and *Finnigan* rules differ in whether the term “taxpayer” refers to each separate entity in a unitary or combined reporting group (*Joyce*) or to the unitary or combined reporting group as a whole (*Finnigan*).

Since a 1999 court decision, California has applied the *Joyce* rule, which requires that receipts from sales of tangible personal property be assigned to the sales factor numerator of a state only when the selling member of a combined reporting group has nexus with that state. Under the *Joyce* rule, if the selling member is not taxable in California, then any sales made by the selling member to California purchasers would be “thrownback” to be included as part of the sales factor numerator of the state of shipment even if another member of the seller’s combined reporting group was taxable in California.

In 2009, the California legislature amended Section 25135 of the California Code to adopt the *Finnigan* rule replacing the *Joyce* rule. Beginning for taxable years on or after Jan. 1, 2011, revised Section 25135 requires that receipts from sales of tangible personal property delivered or shipped to a purchaser in California be assigned to the California sales factor numerator if the seller or any member of the seller’s combined reporting group is taxable in California. In addition, all sales receipts from sales of tangible personal property delivered to a state other than California are not thrown back to the California sales factor numerator of the seller if any member of the seller’s combined reporting group is taxable in that state.

The California Franchise Tax Board amended regulation Section 25106.5 to implement the change in the law from the *Joyce* rule to the *Finnigan* rule and to provide guidance to multistate taxpayers on when and how to assign sales receipts from sales of tangible personal property to the California sales factor under the *Finnigan* rule.

ILLINOIS: STATE APPELLATE COURT HOLDS THAT ASSESSMENT OF STATE INCOME TAX ON TRUST WAS UNCONSTITUTIONAL

In ***Linn v. Department of Revenue***, the Illinois Appellate Court decided, in a case of first impression in Illinois, whether the Department of Revenue’s (the Department) assessment of income tax against a trust violated the Due Process Clause of the U.S. Constitution.

As the court noted, “for a tax to comply with the due process clause, (1) a minimum connection must exist between the state and the person, property, or transaction it seeks to tax, and (2) ‘the income attributed to the [s]tate for tax purposes must be rationally related to values connected with the taxing [s]tate.’” Citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (internal citations omitted). As noted in *Quill*, the Supreme Court equates due process analysis with the determination of whether a state has jurisdiction over a given entity. 504 U.S. at 307-08.

In the antecedent case to *Linn*, Lew Linn, as trustee of the Autonomy 3 Trust, sought the return of an income tax payment the trust made under protest, arguing that any income tax was unconstitutional as the trust had no connection with Illinois. After the parties filed cross-motions for summary judgment at the circuit court level, the circuit court granted the Department’s motion for summary judgment and denied Linn’s motion.

Linn appealed the decision to the Appellate Court of Illinois, asserting that the circuit court erred in two ways when it granted summary judgment in favor of the Department. First, the plaintiff contended, the Illinois choice-of-law provision in the original trust agreement did not apply to the Autonomy Trust 3, which the Department assessed and collected taxes. Second, the imposition of income tax on the Autonomy Trust 3 by the Department is unconstitutional because it violates the due process and commerce clauses of the U.S. Constitution.

The facts of this case, while complex, are essential to understanding the ultimate holding of the Illinois Appellate Court.

Background

In 1961, the grantor and trustee established 20 separate irrevocable *inter vivos* trusts. At the time of the trust agreements, both the grantor and trustee were Illinois residents and the trust assets were deposited in Illinois. The “Linda Trust” was one such trust established in 1961 and the prior assets of the Linda Trust are the assets in dispute in this case. The Linda Trust’s beneficiary was Linda Pritzker, the granddaughter of the grantor. The 1961 trust agreement, with respect to each trust, allowed the trustee to distribute: (a) the whole or part of the corpus of the trust to a different trustee or trustees to hold in further trust for the exclusive benefit of the beneficiary of each of the 1961 trusts; and (b) the whole or part of the trust corpus to its beneficiary after the beneficiary reaches the age of 30. The 1961 trust agreement also provided that it “shall be construed and administered and the validity of the trusts hereby created shall be determined in accordance with the laws of the State of Illinois.”

The grantor of the Linda Trust died in 1986 as a resident of Illinois. In 2002, new trustees who were residents of Illinois succeeded the original trustee to the Linda Trust. On Jan. 2, 2002, the trustees of the Linda Trust exercised their limited rights of appointment under the 1961 trust agreement and irrevocably distributed assets from the Linda Trust to the plaintiff, Lew Linn, as trustee of the Autonomy Trust 3, for the exclusive benefit of Linda Pritzker. Additionally, the trustees of the Linda Trust and Lew Linn (as trustee) entered into a trust agreement that created the Autonomy Trust 3 (the January 2002 Trust Agreement).

At the time of the creation of the Autonomy Trust 3, the protector of such trust was a resident of Illinois. However, in December 2002, a new protector was assigned who was a resident of Connecticut. Additionally, the January 2002 Trust Agreement contained the same perpetuities savings clause (a safeguard provision designed to prevent the property interest from reverting back to the grantor or his estate) and referenced the lives of those named in the 1961 trust agreement. Finally, the Autonomy Trust 3 was to be construed and regulated under Texas law, except that the terms “income,” “principal” and “power of appointment,” and the provisions related to those items were to be interpreted under Illinois law.

In 2005, Linn (as trustee) successfully obtained an order in a Texas probate court to strike the language referring to Illinois law from the January 2002 Trust Agreement. In 2006, Linda (the beneficiary of the Autonomy Trust 3), her children and the other contingent beneficiaries of the trust were not residents of Illinois. In fact, the plaintiff (trustee) resided in Texas, the trust was administered in Texas and the trust had no assets in Illinois.

In April 2007, the Autonomy Trust 3 filed a 2006 nonresident Illinois income and replacement tax return, reporting no income from Illinois sources and thus, owing no Illinois tax. The Department subsequently reclassified the Autonomy Trust 3 as an Illinois resident, taxed 100 percent of the trust’s income and assessed a deficiency liability. Linn paid the amount assessed under protest.

Key points of analysis and holding of the Court

The Court, in performing a due process analysis, focused on cases in other states which dealt with *inter vivos* trusts for persuasive precedent. In one Connecticut case, the court held that only the portion of the *inter vivos* trust’s undistributed income corresponding to the number of noncontingent beneficiaries living in Connecticut was subject to tax. *Chase Manhattan Bank v. Gavin*, 733 A.2d 782, 790 (Conn. 1999). Thus, in *Gavin*, the critical link between the state and the trust was the noncontingent beneficiary of the trust residing in the state. The court also noted that in *inter vivos* trust cases in other states, the grantor’s state residence was insufficient to establish a minimum connection under the due process clause.

While the Department argued that the Autonomy Trust 3 only exists by virtue of Illinois law, the court found that the Autonomy Trust 3 was created by provisions of the 1961 trust agreement allowing for powers of appointment and not Illinois law.

The Court also stated that the focus of the due process analysis is on the tax year in question, which was 2006. Furthermore, while the analysis would change if the underlying trust was a testamentary trust (where the decedent’s place of death would be more pertinent), this case involved an *inter vivos* trust, not a testamentary trust. Therefore, no Illinois probate court has jurisdiction over the Anatomy Trust 3. Additionally, the Court found that the trustee and beneficiary received the benefits and protections of Texas law, not Illinois law under the facts of this case. Finally, the Court found that the Autonomy Trust 3 had nothing in and sought nothing from Illinois. All the Autonomy Trust 3’s business, property, its trustee, its protector, and its noncontingent beneficiary resided outside of Illinois.

Based on these findings, the Court found that insufficient contacts existed between Illinois and the Autonomy Trust 3 to satisfy the due process clause. Accordingly, the income tax imposed on the Autonomy Trust 3 for tax year 2006 was unconstitutional and in violation of the due process clause. The Court did not address the plaintiff’s Commerce Clause challenge, as it was unnecessary to do so.

For additional information regarding these subjects or any other multistate tax issues, please contact:

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