Recent State Tax Cases in Southeastern States

By Mace Gunter and Eric Reynolds[*]

Mace Gunter and Eric Reynolds discuss recent state tax cases in Georgia, Alabama, North Carolina, Louisiana and Tennessee.

Georgia Nonprofit Entity That Raised Money by Renting Out Facility Exempt from *Ad Valorem* Tax

In *Nuci Phillips Mem'l Found., Inc. v. Athens-Clarke County Bd. of Tax Assessors*,[1] the Georgia Supreme Court addressed the application of an *ad valorem* tax exemption to a nonprofit entity that raises money by occasionally renting out its facility. The Nuçi Phillips Memorial Foundation (the "Foundation") owns and operates a facility called Nuçi's Space, which provides local musicians and others with help for depression, anxiety and other emotional disorders. Occasionally, the Foundation rents its facility for rehearsal space, wedding receptions and birthday parties, using the income to help fund its activities. It applied to the Athens-Clarke County Board of Equalization for an exemption from *ad valorem* taxation for the property on which its facility is located. The Board of Equalization granted the exemption, but the Athens-Clarke County Board of Tax Assessors challenged the grant of exemption in trial court. The trial court upheld the exemption, but the Georgia Court of Appeals reversed, basing its decision on the fact that the Foundation occasionally receives income from the rental of its facility for rehearsals, receptions and parties. The Foundation appealed to the Georgia Supreme Court.

At issue was whether the occasional rental of the facility to raise income for the Foundation's operations means that the property was not used exclusively in furtherance of charitable pursuits, as required for *ad valorem* tax exemption under O.C.G.A. §48-5-41(d)(2).

Prior to the passage of the Georgia Constitution of 1945, properties exempted from *ad valorem* taxation were not permitted to engage in any type of income-producing activity, whether charitable or noncharitable. After 1945, exempt properties were allowed to engage in income-producing activity as long as the primary purpose of the property was not to secure income and any income earned was used exclusively for the institution's charitable purposes. After the amendments of 2006 and 2007, O.C.G.A. §48-5-41(d)(2) stated that:

> [A] building which is owned by a charitable institution that is otherwise qualified as a purely public charity and that is exempt from taxation under Section 501(c)(3) of the federal Internal Revenue Code and which building is used by such charitable institution exclusively for the charitable purposes of such charitable institution,

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> and not more than 15 acres of land on which such building is located, *may be used for the purpose of securing income so long as such income is used exclusively for the operation of that charitable institution.* [Emphasis added.]

The Georgia Supreme Court reversed the court of appeals, finding that the Foundation established that its facility qualifies for *ad valorem* tax exemption. The facts showed that the facility is devoted entirely to the charitable purpose of helping those with emotional disorders and that such help is available to the general public. The occasional rental of the facility is an incidental use of the property, and the Foundation provided evidence that all income raised is used to further its charitable services or to offset expenses incurred in maintaining the property. Accordingly, the facility qualifies for ad valorem tax exemption under Georgia law.

Alabama and North Carolina Courts Rule for Taxpayers Challenging Nexus

Alabama–Intrastate Taxpayer Nexus with Local Jurisdictions

The Alabama Administrative Law Division (the "ALD") recently addressed the contacts with a local jurisdiction necessary to sustain a duty on an intrastate taxpayer to collect local sales/use taxes in *Cohens Elecs. & Appliances, Inc. v. Ala. Dep't of Revenue*.[2] The decision is instructive of the limited protection afforded by the Commerce Clause of the U.S. Constitution, the low threshold necessary to establish Due Process Clause nexus, and the higher protections often provided by state law.

Cohens Electronics & Appliances, Inc. (the "Taxpayer"), operated a retail store in Montgomery, Alabama. The Taxpayer did not have a store or other physical facility outside Montgomery but did have repairmen that made service calls and repaired the electronics and appliances previously sold to its customers, including those customers residing outside Montgomery. The repairmen were sometimes required to provide a new part or parts to complete their repairs. In those cases, the Taxpayer would issue an invoice that separately stated the charge for the repair part(s) and the service charge. The Taxpayer did not charge sales tax on the parts it sold and was therefore issued an assessment. The Taxpayer asserted that it did not have sufficient nexus with any jurisdiction outside Montgomery to be subject to a tax collection obligation.

The ALD agreed with the Taxpayer but did so on the grounds of state law (not U.S. constitutional law). The ALD held that the Taxpayer was not subject to assessment because the regulations of the Alabama Department of Revenue (the "Department") as well as Alabama precedent insulated the Taxpayer from tax liability.[3] Quoting generously from its prior orders, the ALD provided a thorough analysis of the U.S. constitutional nexus requirements, ultimately finding that the Constitution afforded no protection to the Taxpayer.

The ALD first noted, consistent with existing Alabama decisional law, that in the *interstate context* the nexus analysis involved both the Due Process and the Commerce Clauses. However, in the *intrastate context*, only the Due Process Clause requirements had to be satisfied. Interstate commerce is generally not affected when sale transactions involve only one state. The ALD noted that the much more relaxed standard of the Due Process Clause does not require physical presence to establish nexus with a jurisdiction.[4] Rather, if an out-of-jurisdiction taxpayer purposefully avails itself of the benefits of an economic market in the jurisdiction, it may be subject to the jurisdiction's *in personam* jurisdiction even if it has no physical presence there.[5] Further, the Due Process Clause requirements are satisfied if a taxpayer has fair warning that its activities may subject it to the jurisdiction of a foreign sovereign.[6] The Court noted that the repairmen all physically visited the local jurisdictions in which customer repairs were performed. However, the facts did not show the number of repairmen employed by the Taxpayer during the assessment period, nor the number and frequency of visits they made to the local jurisdictions. The ALD noted that the number and frequency of visits made by the repairmen to the local jurisdictions would be relevant in deciding whether the Taxpayer had sufficient activity in or contact with the local jurisdictions to constitute Due Process Clause nexus under *Quill v. North Dakota*.

The Court ultimately concluded that the more significant contacts required by the Department regulations and Alabama precedent required that the assessment be abated. Without evidence that the Taxpayer had a retail location outside Montgomery or that the repairmen solicited sales for the Taxpayer in the various local jurisdictions, the Department's assessment could not be upheld.

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North Carolina—Due Process Clause Limitations on Penalty Imposition

On January 12, 2011, the Superior Court of Wake County, North Carolina, in *Delhaize America, Inc. v. Lay*,[7] addressed (among other issues) the U.S. constitutional restraints imposed on penalty imposition. Delhaize America, Inc. (formerly Food Lion) ("Delhaize"), a North Carolina company, reorganized its operations in an effort to effect North Carolina tax savings. To achieve the savings, assets of Delhaize were transferred to related entities outside North Carolina and payments were made by Delhaize to its out-of-state affiliates for services and the use of certain intellectual property. The end result was less North Carolina state income tax.

On audit, the North Carolina Department of Revenue (the "Department") forced Delhaize and its affiliates to file a combined North Carolina return and imposed an *automatic* 25-percent penalty based on the assessed tax. Under North Carolina law in effect during the years at issue, separate company returns were required, and no guidelines informing taxpayers of when the Department would require a combined return were published. The court summarized the state of North Carolina law as follows:

> [T]axpayers, including this taxpayer [Delhaize], were faced with a tax structure intentionally designed by the Department under which they: (1) would be permitted to file only a single entry return, (2) had no guidelines for when the Department would require them to file a combined return, and (3) face a virtually automatic twenty-five percent (25%) penalty if they were forced to file a combined return . . . when due. Thus, after an audit, the taxpayer receives a substantial penalty for following the law.[8]

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The issue was whether, under these circumstances, an automatic penalty comported with the protections of the federal Due Process Clause.

The court began its analysis by noting that penalties paid by taxpayers to the government are property interests protected by procedural due process. As a result, taxpayers must receive notice and an opportunity to be heard before the government may deprive them of their property. When conduct is prohibited, procedural due process requires that the conduct be described so that the ordinary person exercising ordinary common sense can sufficiently understand and comply. Under these guidelines, the court concluded that the Due Process Clause prohibited imposition of the 25-percent penalty on Delhaize. The court reasoned as follows:

> When guidance from the Secretary is so elusive that the Department's own auditors do not know the conditions that will give rise to a twenty-five percent (25%) penalty, and when decisions about the imposition of the penalty are made by a guarded coterie applying unpublished criteria … then ordinary taxpayers "exercising ordinary common sense" cannot sufficiently understand or predict when a penalty will be assessed. … Additionally, taxpayers cannot arrange their affairs to avoid punishment because no published criteria exists with which they can comply. … Here, the Department punished Delhaize for properly filing separate returns according to the only method permitted under North Carolina law. It assessed a substantial penalty for understating a tax obligation that Delhaize had no duty to pay when it filed its original return and could not have known it would be required to pay later. The tax structure resulting in this penalty assessment was fundamentally unfair . …[9]

Louisiana and Tennessee Courts Rule on Apportionment of Gains from Business Dispositions and Reorganization

Recent Louisiana and Tennessee cases reflect a presumption of that income or loss from sales or restructuring of business assets is generally treated as apportionable business income or loss. The most recent Louisiana case addressing the treatment of a Code Sec. 338(h)(10) election furthers the trend of states to conform to the federal tax treatment, which helps to reduce unexpected results for multistate taxpayers.[10]

Louisiana—Gain from Sale of Business Assets

The Louisiana Court of Appeal, in *BP Products North America, Inc. v. Bridges*,[11] addressed whether gain from the taxpayer's sale of a refinery was apportionable or allocable. The taxpayer is engaged in the business of refining crude oil. As part of an annual examination of all its refineries, it made the decision to sell its Belle

Chasse, Louisiana, facility. The sale took place during the 2000 tax year, and the taxpayer reported the gain on the sale as apportionable income on its Louisiana corporate income tax return. The Louisiana Department of Revenue (the "Department") audited the taxpayer in 2004 and determined that the gain from the sale should have been classified as allocable income, with all of the associated state income taxes paid to Louisiana.

At issue was whether the gain was allocable on the basis of the Department's assertions that: (1) the taxpayer was not engaged in the business of buying and selling refineries for profit; (2) the refinery was used to produce the products the taxpayer sells in the regular course of its business; and (3) the divestiture constituted the one-time sale of an entire business operation.

The district court granted summary judgment in favor of the taxpayer, and the Louisiana First Circuit Court of Appeal affirmed. Both courts found that the sale of the refinery was made in the regular course of the taxpayer's business and that the gain from the sale was thus apportionable despite the fact that the refinery was used for the production of the taxpayer's products. The court based its decision upon the following facts: (1) the sale was not of fixed assets only; instead, it was the sale of an operating business, including the inventory, people, training, records and equipment necessary to run the business; (2) the taxpayer remained in the refining business after the sale and retained other refineries that it owned; and (3) the sale of a refinery was not a one-time event for the taxpayer.

Louisiana–State Treatment of a Code Sec. 338(h)(10) Election

In *ConAgra Foods, Inc. v. Bridges*,[12] the Louisiana Court of Appeal addressed the state treatment of a federal Code Sec. 338(h)(10) election. The taxpayer, ConAgra Foods, Inc., was the parent company of three wholly owned subsidiaries that operated in Louisiana. It entered into an agreement with two unrelated third parties under which ConAgra sold the stock of the wholly owned subsidiaries to the unrelated parties. For federal income tax purposes, the sellers and the purchasers made a joint election under Code Sec. 338(h)(10) to treat the stock sale as a deemed-asset sale.

Pursuant to a Code Sec. 338(h)(10) election, the following steps occur:

- First, the selling corporation receives consideration from the purchaser for the stock of the selling corporation's subsidiary.
- Second, the subsidiary's assets are deemed to have been transferred to a newly created corporation.
- Third, ownership in the new corporation is deemed to be transferred to the purchaser.
- Fourth, the original subsidiary entity is treated as retaining all of its tax attributes, including net operating losses ("NOLs") but no longer owns the assets that were transferred to the new corporation.
- Finally, the original subsidiary is liquidated into the parent company (the seller) pursuant to Code Sec. 332, and the NOLs transfer to the parent company.

The Louisiana Department of Revenue (the "Department") did not dispute that ConAgra was the owner of the NOLs for federal income tax purposes but asserted that it was not the owner for Louisiana state income tax purposes. The trial court granted summary judgment in favor of the taxpayer, and the Department appealed. At issue was whether an election under Code Sec. 338(h)(10) operates to transfer NOLs to the selling corporation under Louisiana law.

On appeal, the court upheld the grant of summary judgment. It first noted the Department's stipulation that ConAgra was the owner of the NOLs for federal income tax purposes. Next, the court compared Code Sec. 381, which supports ConAgra's ownership of the NOLs at the federal level, with the state NOL carry-over provision.[13] The court found the provisions to be "nearly identical" and, accordingly, found that ConAgra was entitled to the NOL carry-forwards for state income tax purposes.

Tennessee–Capital Gain Resulting from Reorganization Stock Sale

The Tennessee Supreme Court in *Blue Bell Creameries, LP v. Roberts*,[14] addressed the taxability of capital gains resulting from the acquisition and sale of stock in the course of a corporate reorganization. The taxpayer is a Delaware limited partnership with its principal place of business in Texas. It produces, sells, and distributes ice cream products in various states, including Tennessee. The taxpayer was formed as a limited partnership so that the operations of its predecessor organization, a corporate entity, would be subject to passthrough treatment for income tax purposes. Soon after the taxpayer's formation, all of the assets and liabilities of the predecessor corporation were transferred to the taxpayer.

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In addition, BBC USA, Inc., the parent company of both the taxpayer and the predecessor corporation, decided to reorganize as an S corporation. Because an S corporation can have no more than 75 shareholders, BBC USA could allow only 75 shareholders to retain an interest in the S corporation. The shareholders who could not retain an interest in BBC USA were permitted to exchange their BBC USA shares for equivalent limited partnership interests in the taxpayer. BBC then redeemed the shares of its stock contributed to the taxpayer in exchange for $142,506,000. The taxpayer reported capital gains of $119,909,317 on its 2001 federal income tax return and classified the capital gains on its Tennessee excise tax return as nonbusiness earnings, not subject to excise tax. The Tennessee Department of Revenue classified the capital gains as business earnings subject to tax, and the Supreme Court of Tennessee agreed.

The court found that the taxpayer's gain from the one-time purchase and sale constituted business earnings under a functional test and was therefore subject to tax. The interest sold was integral to the taxpayer's generation of income. The transaction served an operational, rather than investment, function and was thus unitary with the taxpayer's ice cream business as well as with the business of its parent company.

ENDNOTES

* This article is a compilation of three articles originally printed in the STATE TAX RETURN, a Jones Day monthly newsletter reporting on recent developments in state and local tax.

[1] *Nuci Phillips Memorial Foundation, Inc. v. Athens-Clarke County Board of Tax Assessors*, Ga. SCt, 288 Ga. 380, 703 SE2d 648, [Ga.] ST. TAX REP. (CCH) ¶200-737 (2010).

[2] *Cohens Elecs. & Appliances, Inc. v. Ala. Dep't of Rev.*, Ala. Admin. Law Div., No. S. 10-989, [Ala.] ST. TAX REP. (CCH) ¶201-569 (July 12, 2011).

[3] *See* ALA. ADMIN. CODE r. 810-6-3-.51(2); *Yelverton's, Inc. v. Jefferson County, Alabama,* Ala. Civ. App., 742 So2d 1216, [Ala.] St. Tax Rep. (CCH) ¶200-655 (1997).

[4] *See Quill Corp. v. North Dakota,* SCt, 504 US 298, 112 SCt 1904, at 1911 (1992).

[5] *Id.*, 112 SCt at 1910.

[6] *Id.*, 112 SCt at 1911.

[7] *Delhaize America, Inc. v. Lay*, NC Super. Ct., Wake County, No. 06 CVS 08416, [N.C.] ST. TAX REP. (CCH) ¶202-487 (Jan. 12, 2011).

[8] *Id.*

[9] *Id.*

[10] Unless otherwise noted, all "Code Sec." references are to the Internal Revenue Code of 1986.

[11] *BP Products North America, Inc. v. Bridges*, La. Ct. App., 77 So3d 27, [La.] ST. TAX REP. (CCH) ¶202-398 (2011).

[12] *ConAgra Foods, Inc. v. Bridges*, La. Ct. App, 48 So3d 1249, [La.] ST. TAX REP. (CCH) ¶202-352 (2010).

[13] La. Rev. Stat. Ann. §47:287:86.

[14] *Blue Bell Creameries v. Roberts*, Tenn. SCt, 333 SW3d 59, [Tenn.] ST. TAX REP. (CCH) ¶401-373 (2011).

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