TaxNewsFlash

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KPMG report: Year-end state and local tax updates (Kentucky, Massachusetts, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania)

Significant state and local tax developments that occurred during the last few weeks of 2022 are summarized below:

Kentucky Supreme Court holds that purchases are exempt supplies, not taxable replacement parts

The Kentucky Supreme Court concluded in *Century Aluminum of Kentucky, GP v. Dep't of Revenue* that an aluminum manufacturer's purchases qualified as exempt "supplies" as opposed to taxable "repair, replacement, or spare parts." To be classified as a "supply" an item must be tangible personal property, consumed in manufacturing or industrial processing, used directly in manufacturing or industrial processing, and have a useful life of less than one year. "Repair, replacement or spare parts" are tangible personal property used to maintain, restore, mend, or repair machinery or equipment. In the court's view, the plain language of the definition of repair, replacement, and spare parts restricted the part's use to maintaining, restoring, mending, or repairing the actual manufacturing machinery or equipment. As such, tangible personal property that maintained the "manufacturing process," but did not actually replace an existing part of the permanent machinery, did not fit within the definition of a taxable repair part. The court further concluded that the question as to whether tangible personal property is a tax-exempt supply or a taxable part, if all the other characteristics of a tax-exempt supply are met, may be resolved by whether the tangible personal property has the characteristics of being consumed in the manufacturing process and having a useful life of less than one year. The court specifically stated, "[w]ith the conclusion that specific tangible personal property is a supply, its defining characteristics exclude it from being categorized as a repair, replacement or spare part, and the statute

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cannot be construed in an absurd, inconsistent manner to allow the same tangible personal property to be viewed also as a part."

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Massachusetts Supreme Judicial Court holds that cookies not sufficient to establish physical presence nexus

The Massachusetts Supreme Judicial Court on December 22, 2022, held in *U.S. Auto Parts Network, Inc. v. Commissioner of Revenue* that for tax periods prior to *Wayfair*, the state tax authority could not impose a use tax collection and remittance responsibility on an out-of-state online retailer whose presence in Massachusetts was limited to the placement of "cookies" and "apps" on the computers and portable devices of its Massachusetts customers. The state court first rejected the tax authority's position that the *Wayfair* decision could be applied retroactively—regardless of whether the presence of apps and cookies constituted a physical presence in the Commonwealth. In *Harper v. Virginia*, the U.S. Supreme Court stated that decisions on issues of federal law "must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate [the Court's] announcement of the rule." Although the tax authority asserted this meant that the *Wayfair* holding applied retroactively, the state court disagreed on the basis that the tax authority's own regulation limited its reach to vendors that satisfied the physical presence test in *Quill*. In other words, regardless of whether U.S. Supreme Court decisions applied retroactively, the regulation itself required a physical presence. The state court also noted that the U.S. Supreme Court in *Wayfair* identified the South Dakota statutory prohibition on applying a favorable decision retroactively as contributing to its determination to abrogate the *Quill* physical presence rule. It further noted that Massachusetts was part of a coalition of states filing an amicus brief in *Wayfair* arguing that "there was no reason to expect" retroactive application of *Wayfair* by states because of regulations and processes that would bar imposition of a new rule on retailers on retailers meeting the terms of the *Quill* rule. The state court then held that the use of cookies, apps, and content delivery network servers did not constitute sufficient physical presence under *Quill*. In the state court's view, it was clear the *Wayfair* court did not view the "physical aspects" of modern technology (e.g., cookies, apps, and use of in-state servers) as satisfying the physical presence rule under *Quill.*

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North Carolina Supreme Court rejects U.S. Supreme Court holding addressing distinction between sales and use taxes

The North Carolina Supreme Court on December 16, 2022, held in *Quad Graphics, Inc. v. N.C. Dep't of Revenue* that the taxpayer had sufficient nexus with North Carolina to support the imposition of a sales tax collection obligation on the taxpayer despite the U.S. Supreme Court's 1944 decision in *McLeod v. Dilworth*. In *Dilworth*, the U.S. Supreme Court determined that Arkansas had no authority under the Commerce Clause to impose a tax on the sale of machinery or mill supplies purchased from Tennessee corporations when title passed upon delivery to a common carrier within Tennessee before the goods were ultimately brought into Arkansas for delivery. In the *Dilworth* court's view, these sales were consummated in Tennessee and were not subject to Arkansas sales tax. Similar to the sales at issue in *Dilworth*, title passed to the taxpayer's customers outside of North Carolina. As such, it was the taxpayer's position that the state tax authority could not assess sales tax on those sales. The North

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Carolina Supreme Court held that although *Dilworth* was never explicitly overturned, the formalism doctrine established in *Dilworth* had not survived more recent U.S. Supreme Court decisions in *Complete Auto* and *Wayfair*, and therefore the imposition of North Carolina **sales tax** as opposed to **use tax** passed constitutional scrutiny. This decision has implications outside the sales and use tax context, as there are cases holding that only the U.S. Supreme Court, rather than lower federal courts or state courts, can overrule its prior holdings. It is not yet clear whether the taxpayer will file a petition for certiorari with the U.S. Supreme Court.

Pennsylvania Commonwealth Court held taxpayer entitled to refund in NOL cap case

The full Pennsylvania Commonwealth Court held in *Alcatel-Lucent USA Inc. v. Commonwealth of Pennsylvania* that the taxpayer was entitled to refund in a case involving the state's unconstitutional flat dollar net operating loss (NOL) cap, which was struck down in the 2017 *Nextel* decision. In light of the Pennsylvania Supreme Court's conclusion in a different case (*General Motors II*) that the *Nextel* decision applied retroactively, the court revised its original panel decision and held that the only remedy available to equalize the tax positions between favored and non-favored taxpayers was to issue the taxpayer a refund. Although the taxpayer calculated its tax liability for the tax year applying the valid percentage cap, the court noted that the taxpayer was disadvantaged when compared to small corporate taxpayers that utilized the flat dollar NOL cap and paid no taxes. To equalize the actual tax positions and provide "meaningful backward-looking relief" as required to remedy the Due Process violation, *McKesson Corp.* requires that either the favored taxpayers be assessed additional taxes or the unfavored taxpayer be refunded the taxes it paid. Because the statute of limitations precluded Pennsylvania from assessing the favored taxpayers, the court concluded that the only remedy available to cure the Uniformity Clause violation was to issue the taxpayer a refund of the taxes paid after it applied the percentage cap. It is not yet known whether the decision will be appealed.

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Legislative updates

In legislative news, Michigan Governor Whitmer vetoed Senate Bill 195, which would have revised the computation of the 163(j) limitation for Michigan corporate income tax purposes retroactively for tax years beginning on and after January 1, 2022.

In New Jersey, legislation was signed that ends the extended statute of limitations on assessments. As background, on March 9, 2020, Governor Murphy declared both a Public Health Emergency and a State of Emergency. The Legislature subsequently enacted the "COVID-19 Fiscal Mitigation Act" extending the original tax assessment period and consent period by an additional 90 days after the New Jersey State of Emergency had ended. In other words, if the normal three-year or four-year statute of limitations period would have expired during the emergency period, it was extended until 90 days after the State of Emergency declaration was lifted. The tax authority normally pays interest on refunds that are issued more than six months after the date the refund claim was filed, the tax was paid, or the due date of the return, whichever is later (the original interest payment period). The 2020 legislation also extended the original interest payment period by an additional six months after the State of Emergency ended. The New Jersey State of Emergency Declaration has remained in effect, even after the Public Health Emergency was lifted on June 4, 2021. On December 22, 2022, Governor Murphy signed Assembly Bill 4295 which, as of the bill's enactment date, ends the extended statute of limitations and the six-month extension on the payment of interest. Any assessment of tax related to the COVID-19 extension that was made after the December 22, 2022, enactment date must be voided. Assembly Bill 4295 also adopts the new federal partnership audit regime and eliminates the requirement to affirmatively elect New Jersey S Corporation status.

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Finally, in Ohio, House Bill 223, which allows vendors to deduct bad debts written off as uncollectible by certain third-party lenders, was signed into law. Under existing law, only vendors or certified service providers that generated a bad debt and charged that debt off as uncollectable may claim the bad debt deduction. As amended, a vendor is allowed to deduct bad debt held by a third party through a "private label credit account" that is associated with a sale that the vendor reported on a previous return. A private label credit account is defined as an account with a lender (typically a bank) that "carries, refers to, or is branded with" the name of the vendor and which is used to finance sales on credit by the vendor's customers. Unlike situations in which the vendor held the debt directly, the vendor will not be permitted obtain a refund from the deduction of third-party debt, but unused third-party bad debt may be carried forward indefinitely and used to offset future taxable receipts. A vendor taking a deduction under this section is required to maintain books and records verifying the transaction.

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