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FINAL EXAMINATION

January 10, 1973

State and Local Taxation

Mr. Madison

INSTRUCTIONS: The examination consists of three problems of equal weight. In answering the questions, you may find that additional facts are needed in order to reach even a tentative conclusion. In any such case, you should specify what additional information is needed, and indicate how it would be relevant to your reasoning or argument.

PROBLEM I (33 Points)

In response to public concern and pressure arising from recent Department of Health pronouncements on possible ill effects to health caused by eating fruits and vegetables sprayed by D.D.T. and like chemical insecticides, the legislature in State X has just enacted a statute which reads as follows: "An excise tax is hereby imposed on the storage, use, consumption, possession or transportation of plant insecticides and/or pesticides at the rate of 6 percent of the sales price of such property. For purposes of this statute the terms "storage, use, consumption, possession, and transportation" do not include the exercise of any right or power over said property incident to its resale in the regular course of business". Heretofore such property had been exempt from sale and use taxation under a general exemption covering "all chemicals of any kind, whatsoever". Said statute also exempts all services from sale and use taxation. The rate of the sales and use tax in respect to all other kinds of tangible personal property (including crops once they are harvested) is 3 percent. In the Constitution of State X there is language that says "all taxation shall be uniform upon the same class of subjects, and all property shall be taxed in proportion to its value". State X also imposes an annual personal property tax on all tangible personal property located in the state.

The XYZ Corporation, doing business only in the State of X, is engaged in the business of air-spraying crops and gardens with insecticides. Most of its customers are farmers who sell their produce to in-state wholesalers. This service is also rendered to farmers selling their produce to out-of-state wholesalers and to wealthy "gentlemen-farmers" who maintain farms and large flower gardens "for fun and not for profit" (none of the crops or flowers are sold). The XYZ Corporation purchases large quantities of D.D.T. and other insecticides (which are very expensive) from the Y Company located in State Y and transports them back to State X. Last year State Y enacted an all-inclusive sales tax.

Pat President, an officer of the XYZ Corporation, is worried about the "tax bite" to the Corporation of this new tax, and comes to your firm seeking your advice on whether the tax would apply to the activities of the Corporation, and if it does, is the tax valid. What do you tell him? Discuss all issues fairly presented.

PROBLEM II (33 Points)

The ABC Correspondence School, Inc. is a newly formed corporation organized under the laws of State X where it maintains a small home office in leased quarters. All the Corporation's financial affairs are handled out of the home office, to which all of its salesmen are attached. ABC is engaged in the business of furnishing art lessons to subscribers. Each student-subscriber is assigned a teacher-artist, an employee of ABC and resident of State X, who periodically sends by mail instructional materials to the student, along with his comments on the student's progress based on samples of art-work received from the student. At present ABC is only sending its salesmen to State Y to solicit orders from subscribers. All orders taken by the Salesmen are subject to approval by the home office, and payments are made to the home office. However, from time to time a salesman will accept a deposit from a subscriber and/or collect an overdue account. ABC has an arrangement with a large number of art studios located in State Y where by the studios permit, in exchange for some free publicity in ABC's mailings, the salesmen of ABC to use the studios to display promotional literature and price lists, and to meet with customers. These studios are not advertised as ABC's local offices. Approximately 49% of ABC's operating expenses are attributable to the following costs: purchases of instructional materials; cost of mailings; rental of home office; salaries paid to teachers and executives--the remaining 51% is attributable to salaries and commissions paid to salesmen.

State X levies an annual tax upon net income of domestic and foreign corporations, and utilizes two ratios in determining the portion of net income taxable under its law. The first is that of the taxpayer's sales assignable to State X during the year to its total sales. The second is that of taxpayer's total tangible property owned and used in State X for the year to its total tangible property owned and used in the business that year wherever situated. Said property does not include the inventory of the taxpayer.

State Y levies an annual franchise tax on the "realized income" of every corporation, foreign or domestic, for the privileges of engaging in any trade or business, and/or maintaining an office within the State. The statute provides that the measure of the tax shall be that portion of the corporation's "realized income" [defined as gross receipts or gross sales less cost of goods sold and/or cost of operations] attributable to the activities of the taxpayer in State Y. The regulations promulgated thereunder provide that "where the income for any taxable year is derived from the sale of tangible personal property or sale of services, the portion thereof attributable to State Y shall be the percentage of the total of such income as the gross sales made in State Y during such taxable year bears to the total gross sales made everywhere during such taxable year".

Regulations under both state statutes employ the UDITPA (Multistate Tax Compact) definition of the term "sale": "Sales of tangible personal property are in the [taxing] State if--the property is delivered or shipped to a purchaser . . . within the State regardless of the f.o.b. point or other conditions of the sale; . . . Sales, other than sales of tangible personal property, are in the State if: (a) the income producing activity is performed in the State; or (b) the income producing activity is performed both in and outside the State and a greater proportion of the income-producing activity is performed in the State than in any other State, based on costs of performance."

(a) On January 1, 1972 counsel for ABC receives a ruling from the State Y Tax Commissioner holding that the Corporation's entire realized income is subject to the State franchise tax. He comes to you and seeks your advice on whether he can "fight" the tax. If so, on what grounds?

(b) Assume that the above ruling by the State Y Tax Commissioner is correct, and that ABC's activities are held to be taxable under State Y's sales tax. Counsel for ABC comes to you and complains "this is ridiculous--ABC's sales in this State are being taxed twice!" "And to make matters worse, the application of the gross sales factor to measure the franchise tax makes the tax, a tax on gross income and not realized income, which was not the intent of the legislature". Do you agree with him? Explain briefly.

NOTE: Your answer to (a) shall be accorded considerably more weight than your answer to (b)--therefore you should allocate your time accordingly.

PROBLEM III (33 Points)

Discuss briefly what reforms--in your judgment--are most needed in the area of state and local taxation. Explain why, and give suggestions on how these reforms, if any, can best be implemented. Be as specific as possible, and your discussion should, of course, be based as closely as possible on issues considered in this course. MAXIMUM LENGTH OF ANSWER: seven pages--do not write on both sides of each page.