

# Sales & Use Tax Review

*A monthly briefing for professionals involved in  
sales and use tax planning and compliance*

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Views expressed herein do not necessarily reflect those of the Editorial Advisors.

## Use Tax Collection

### Massachusetts

**Tire retailer with stores in Massachusetts must collect use tax on sales at its New Hampshire stores to Massachusetts residents**

*A tire retailer with stores in both Massachusetts and New Hampshire is required to collect Massachusetts use tax on sales made at its New Hampshire stores to residents of the commonwealth. From both information obtained for its invoices and a visual inspection of a customer's vehicle on which the retailer installs tires, the retailer could determine the intended place of use of the tires. Further, imposing a use tax collection obligation does not violate due process because of the connection between the retailer and the commonwealth, as well as the link between the tires and the commonwealth, i.e., the tires at issue are destined for use in Massachusetts.*

*Town Fair Tire Centers, Inc. v. Commissioner of Revenue  
Massachusetts Appellate Tax Board, June 9, 2008*

Massachusetts residents are very aware that if they go shopping in New Hampshire, they won't be paying New Hampshire sales tax. That's because New Hampshire has no sales tax. Of course, Massachusetts residents may owe use tax on their purchases, but how much is the commonwealth going to see from this revenue stream? That's why the Commissioner of Taxes went after one particular retailer for *use taxes* on sales made to residents of Massachusetts at the retailer's New Hampshire stores. Here are the details of this unique controversy.

**Tire sales to Massachusetts residents:** Town Fair Tire Centers is a Connecticut corporation engaged in the retail sale and installation of tires at its stores in New England, including Massachusetts and New

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Hampshire. At all of its stores, Town Fair Tire produces a sales invoice that includes the customer's name, telephone number and address; if payment is made by check, the invoice includes the purchaser's driver's license information.

Since New Hampshire does not have a sales tax, Town Fair Tire collected no tax on tire sales made at its three New Hampshire locations. The Massachusetts Commissioner of Taxes asserts, however, that Town Fair Tire has a statutory obligation to collect Massachusetts use tax on tire sales to Massachusetts residents at the New Hampshire stores. Town Fair Tire challenges an assessment based on its failure to collect use tax on grounds that Massachusetts's tax statute does not impose this obligation on the transactions at issue or, if it does, that requiring use tax collection under these circumstances would be unconstitutional.

**Liability for use tax:** Massachusetts imposes use tax on "the storage, use, or other consumption in the commonwealth of tangible personal property... purchased from any vendor... for storage, use, or other consumption within the commonwealth." (See G.L. c. 64I, section 2.) While use tax is generally the liability of the person who uses the property, Massachusetts law also imposes a collection responsibility on certain vendors as follows:

*Every vendor engaged in business in the commonwealth and making sales of tangible personal property... for ... use... in the commonwealth not exempted under this chapter... shall at the time of making the sales... collect the tax from the purchaser. [G.L. c. 64I, section 4]*

Town Fair Tire first contends that its tire sales in New Hampshire to Massachusetts residents are not subject to use tax "because, as retail sales completed outside of the Commonwealth, they were not subject to the Massachusetts sales tax." According to the Appellate Tax Board, this reading of the use tax statute would "render the use tax meaningless," since the sales tax and the use tax are "complementary elements of a unitary taxing program intended to reach all transactions, except those expressly exempted, in which tangible personal property is sold inside or outside the Commonwealth... for use... within the Commonwealth." Indeed, the Board explains that the purpose of the use tax is "to reach those transactions which are not subject to the sales tax by virtue of being completed outside of the Commonwealth."

Next, Town Fair Tire argues that any use tax liability on the New Hampshire tire sales arises after the sales are completed outside Massachusetts and, therefore, it cannot be held responsible for collecting the commonwealth's use tax. The Appellate Tax Board disagrees with this view of the use tax:

*Contrary to [Town Fair Tire's] assertion that the use tax liability arises only after a purchaser brings the*

*property into the Commonwealth for use, the liability for the tax arises at the time of the purchase if the purchaser's intent is to use the property in the Commonwealth.*

In sum, the Board finds that "use tax is properly imposed if the purchaser intended to use the tires in the Commonwealth at the time of the purchase." In this particular case, the intent of Massachusetts customers to use their newly purchased tires in the commonwealth was clear to Town Fair Tire, says the Board. These customers provided their Massachusetts addresses to the store and, when payment was made by check, gave their Massachusetts driver's license information. According to the Board, "[t]his evidence provided a sufficient basis for the finding that the tires at issue were installed on vehicles owned or operated by Massachusetts residents, and as such would be used in the Commonwealth."

**Constitutional challenge:** Town Fair Tire asserts that its due process rights are violated by the imposition of use tax collection duties on its New Hampshire sales of tires to Massachusetts residents. The Board rebuffs this suggestion, reasoning that since Town Fair Tire has stores in Massachusetts, "the Commonwealth has given [the retailer] something in exchange for which it may ask that [Town Fair Tire] collect and remit the use tax at issue." Further, the Board finds that "there was a definite link between the tires at issue and the Commonwealth, namely that the tires installed by [Town Fair Tire] on vehicles were destined for use in the Commonwealth."

The Board also rejects Town Fair Tire's argument that "in order for the imposition of use tax collection duties on out-of-state vendors to withstand constitutional scrutiny, a vendor must make certain, by its own actions, the use of the property within the taxing state, such as by shipping or delivering the property into that state." According to the Board,

*[T]he relevant constitutional inquiry... is the sufficiency of the vendor's connections with the taxing state, not whether the vendor's own actions ensured use of the property in the taxing state.*

### ■ Review Observations:

Who should bear responsibility for enforcing the use tax when Massachusetts residents shop outside the commonwealth? Should it be an out-of-state retailer who happens to have nexus with the commonwealth or the Commissioner of Taxes? The typical rule is that a sales or use tax collection duty imposed on a seller is based on where a transfer of title and possession occurs. In this case, the Commissioner is insisting that the retailer collect use tax even though the transaction — transfer of title and possession — occurs outside Massachusetts.

Perhaps the conclusion reached by the Appellate Tax Board in this case will result in retailer use tax collection responsibility only in limited circumstances, *i.e.*, where the seller knows with near certainty that the purchased items will be used in the commonwealth by a Massachusetts resident.

## Use Tax

### California

#### Completion of gift outside state would preclude use tax on merchandise subsequently mailed from within state

*A company that sells personalized merchandise would not owe California use tax on personalized pens assembled by a third-party in Mexico and then transported by the assembler by truck to a post office in California for mailing to potential customers as free samples. The company's allegation that the pens were personalized and packaged for mailing before they arrived in California, if true, is sufficient to demonstrate that the company intended to transfer ownership to potential customers upon shipment of the pens from the assembler's plant in Mexico, i.e., the company would not have exercised any right or power over the pens in California.*

*Modern Mold International, Inc. et al. v. State Board of Equalization*  
California Court of Appeal, Second Appellate District,  
Division Three, November 6, 2008

California provides an exclusion from use tax for "the keeping, retaining or exercising [of] any right or power over tangible personal property for the purpose of subsequently transporting it outside the state for use thereafter solely outside the state." (See Cal. Rev. and Tax. Code section 6009.1.)

This exemption was the focus of a 1999 California appeal court decision involving a California-based manufacturer of musical instruments. The court ruled that the manufacturer owed California use tax on instruments it removed from inventory to send via common carrier as promotional gifts to out-of-state musicians and musical instrument retailers. According to the court, the instruments did not qualify for the above exemption since, by completing the gifting of the instruments within California when the instruments were placed with the common carrier, the instruments were "used" by the manufacturer before they were shipped outside the state. (See *Yamaha Corp. of America v. State Bd. of Equalization*, 73 Cal.App.4th 338.)

**Mexican assembler of company's samples:** A recent case puts a twist on the gift/use tax issue with a California-based company seeking a \$600,000 use

#### Iowa: Paint-Mixing Equipment in Manufacturer's Retail Stores Exempt from Tax

Sherwin-Williams, a paint manufacturer, sells its products to consumers through its retail paint stores in Iowa. Each store mixes its own paint from base and colorants. (Untinted base requires the addition of colorant to make it usable.) A recent Iowa appeals court decision considers whether the purchase of equipment to mix and tint one-gallon and five-gallon cans of paint at each store qualifies for an exemption from Iowa sales and use tax as machinery and equipment "[d]irectly and primarily used in processing by a manufacturer." (See Iowa Code section 422.45(27)(a)(1).)

The Department of Revenue insists that the manufacturing exemption is unavailable because the mixing and tinting process is incidental to the primary purpose of the retail stores, *i.e.*, to sell paint and related supplies.

The appeals court's response is that the statute contains no "primary purpose" test. Further, the term "manufacturer" as defined in the statute ("[a] person who purchases, receives, or holds personal property for the purpose of adding to its value by a process of manufacturing... [or] combining of different materials... with a view to selling the property for gain or profit") does not exclude businesses that make retail sales. In this case, Sherwin-Williams's stores meet the statutory definition of "manufacturer" since the stores receive and hold property — base and colorants — for the purpose of adding value by combining the materials to sell for profit.

The court also finds that a color-matching machine qualifies for the machinery and equipment exemption because it is "directly and primarily used in processing." This machine is used to analyze a color and create a formula that can be used to recreate that color. The color-matching machine initiates the final step in the manufacturing process by sending the formula electronically to an automatic color dispenser. (*The Sherwin-Williams Company v. Iowa Department of Revenue*, Iowa Court of Appeals, October 15, 2008)

tax refund on personalized pens mailed from California to prospective customers outside the state.

Modern Mold International manufactures and sells personalized pens and similar items. Some merchandise is provided to potential customers as free samples to generate business. The samples in question were assembled by a third party in Mexico and were personalized there. The assembler then inserted the samples into individually addressed

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packages that were sorted and bundled by zip code and placed in U.S. postal service mail bags. Multiple mail bags were shrink-wrapped on post office mail palettes. The assembler delivered the palettes by truck to a post office in San Diego.

**Refund denied:** The manufacturer's contention that it made no taxable use of the pens in California was rejected by the State Board of Equalization. On appeal, the trial court sustained the Board's position that delivery of the pens to the post office in California constituted a "gift" and a taxable use in California. A California trial court similarly ruled against the manufacturer.

On appeal, the legal issue is whether the manufacturer's assertions in its refund claim — assuming they are true — adequately allege that a gift of the pens was made in Mexico and that no taxable use occurred in California. (The suggestion is that the *Yamaha* decision would not control the use tax consequences.) The court's analysis focuses on technical aspects of when a gift occurs, with the emphasis being that a gift occurs when the gift-giver's "acts unequivocally show that it intended to divest itself of ownership in the property." Further, a gift would occur when a third party is involved (as here) if the gift-giver intends to transfer ownership to the recipient, "even if the third party ordinarily would be considered an agent of, or otherwise under the dominion and control of, [the gift-giver]."

With these principles in mind, the court concludes that the manufacturer's factual assertions, if true, would result in no "use" within California. According to the court, "[t]hese allegations... are sufficient to show that the [manufacturer] intended to effect a present transfer of ownership to the intended recipients upon shipment of the merchandise from [the assembler's] plant in Mexico."

### ■ Review Observations:

A use tax case involving Hewlett Packard's donation of computers to out-of-state universities sheds additional light on the gift/use tax issue in California. (See *Matter of Hewlett Packard*, State Board of Equalization, June 15, 2000.)

Hewlett Packard donated computers and related software to universities and other nonprofit organizations located both in California and elsewhere. Donated equipment was removed from inventory in California and shipped via common carrier to the universities. The company sought a refund of use tax it paid on donated equipment shipped to out-of-state schools, pointing to the statutory exemption for a "use" that is for the purpose of transporting the merchandise outside California for use solely outside the state.

Hewlett Packard's gifts were governed by documents which provided that title to the equipment

and risk of loss passed to the university at the destination. The company's purpose in retaining title until delivery included its ability to recall the equipment before it reached the intended recipient.

In concluding that California use tax did *not* apply to equipment shipped outside the state under these circumstances, the State Board of Equalization gave "significant weight" to (1) the passage of title outside California, coupled with the ability of the company to recall a gift before it reached the university; (2) the fact that warranties became effective only after delivery to the university; and (3) delaying an income tax deduction until the university received the equipment. The Board also said it considered the fact that Hewlett Packard's personnel were required to install the equipment at the recipient's location an indication that the company intended to complete the gifts outside California.

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## Tax Base

### Missouri

#### No trade-in allowance for airplane acquired in Section 1031 exchange

*A company acquiring an airplane for use in its business through a Section 1031 exchange using an intermediary in accordance with federal tax guidelines is subject to tax on its acquisition based on the full purchase price it paid for the replacement airplane. The economic reality of the transaction is that the company sold its airplane to one business entity and purchased the replacement from a second business entity. Since there was no exchange of the airplanes, the statutory "taken in trade" exemption or allowance, which exempts the trade value of the exchanged property from tax, does not apply.*

*Great Southern Bank v. Director of Revenue*  
Missouri Supreme Court, November 21, 2008

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The Missouri Supreme Court recently considered a dispute centered around a Section 1031 exchange of aircraft and the state's sales and use tax exemption or allowance for personal property "taken in trade." We begin our look at the court's decision with a review of Section 1031 exchanges.

**Section 1031 exchanges:** Section 1031 of the Internal Revenue Code allows for the exchange of certain types of "like-kind" property — including tangible personal property — with a deferral of capital gains otherwise due on a sale. To qualify, the properties must be held for productive use in a trade or business or for investment. The basic premise behind the Section 1031 exchange is that the taxpayer is merely exchanging one property for another of like-kind and, therefore, the taxpayer receives nothing that can be used to pay federal income tax. Gain

is not eliminated; recognition of gain is merely deferred.

A sale of the taxpayer's property and the acquisition of the replacement property does not have to occur simultaneously. However, if the exchange is not simultaneous, a taxpayer must use an "intermediary" and follow other IRS guidelines. Replacement property must be identified within 45 days of the taxpayer's sale and acquisition of the replacement property must be completed within 180 days of that sale. The sold property must be exchanged for other property as opposed to being sold for cash that is used to buy replacement property.

An intermediary is used in a delayed exchange because the exchange is considered to end when the taxpayer has receipt of the proceeds for its sale. Under IRS guidelines, the taxpayer is not considered to be in receipt of cash when the sale proceeds go directly to the intermediary.

**"Taken in trade" exemption:** Missouri's sales and use tax statute provides a "taken in trade" exemption or allowance:

*[W]here any article on which sales or use tax has been paid, credited, or otherwise satisfied or which was exempted or excluded from sales or use tax is taken in trade as credit or part payment on the purchase price of the article being sold, [sales or use tax] shall be computed only on that portion of the purchase price which exceeds the actual allowance made for the article traded in or exchanged, if there is a bill of sale or other record showing the actual allowance made for the article traded in or exchanged. [Section 144.025.1, RSMo 2000; emphasis added]*

In effect, this provision exempts the trade value of exchanged property from sales and use tax.

**Section 1031 exchange of aircraft:** Great Southern agreed to sell a Beechcraft airplane to Jet 1, Inc. for a price of \$1.025 million. Nine days later, Great Southern agreed to buy a Cessna airplane from Scag Engineering for \$1.925 million. That agreement included blank lines for "Trade-in Aircraft (if applicable)" which also included the make and model of the aircraft, trade-in delivery date, and delivery destination. None of these blanks was filled in.

The transaction was structured to meet the requirements for a like-kind exchange under Section 1031. (Great Southern employees had used the airplane to travel and oversee the company's projects across the country.) The acquisition agreement provided that Great Southern would acquire the Cessna from an intermediary (Wachovia) and relinquish the Beechcraft to that intermediary. Both Great Southern and Jet 1 directed their payments to the intermediary. In turn, the intermediary sent Great Southern's payment for the Cessna to Scag Engineering.

Based on the "taken in trade" allowance, Great Southern paid use tax on its acquisition of the Cessna on \$900,000 — the difference between the sales price of the Beechcraft and the purchase price of the Cessna. (Great Southern had paid Missouri use tax on the purchase price of the Beechcraft.) Great Southern maintains that the Beechcraft was traded for the Cessna, reasoning that the intermediary acquired the Beechcraft and transferred the Cessna to Great Southern.

The Missouri Director of Revenue argues that Great Southern owes use tax on the full price (\$1.925 million) of the Cessna. The Director's assertion is that Great Southern was not eligible for the allowance because there was no "trade," *i.e.*, the agreement for the purchase of the Cessna did not provide for a trade-in.

**What constitutes a "trade"?** Because the phrase "taken in trade" is not defined by the statute, the court applies the dictionary definition. Under that definition, a "trade" requires that the parties each have title or ownership of their respective properties and then exchange them. Applying this concept, the court finds that there was no trade in this case:

*[T]he sale of the Beechcraft and the purchase of the Cessna were two separate transactions. Great Southern sold its Beechcraft to Jet 1, purchased the Cessna from Scag Engineering, and used Wachovia as an intermediary to facilitate the transaction. Although Wachovia acted as an intermediary to facilitate a transaction under Section 1031..., it does not follow that there was a "trade" exempting Great Southern from paying Missouri use taxes.... Wachovia could not keep the Beechcraft or the Cessna or sell the Beechcraft to someone other than Jet 1.... Wachovia never took the Beechcraft in trade for anything. Wachovia effectively was acting as Great Southern's agent for the purpose of complying with federal regulations to take advantage of the tax deferral provisions of Section 1031. That is not enough, under Missouri sales and use tax law, to conclude that Great Southern and Wachovia engaged in a trade.*

Further confirmation of the lack of a trade is found in the purchase agreement that Great Southern used with Scag Engineering. Although the form had blanks to be used if there had been a trade-in, no trade-in was identified. The reason, says the court, "is that there was a sale and a purchase, but no trade."

#### ■ Review Observations:

The Missouri Supreme Court declines to have the form of the transaction, *i.e.*, a Section 1031 exchange, control over the substance of the transaction. The court makes the point that the Internal Revenue Code does not govern how a Section 1031 transaction should be treated for sales and use tax purposes. Instead, the emphasis is on the economic reality of the transaction: Great Southern sold the Beechcraft to Jet 1 and purchased the Cessna from Scag Engi-

neering. Accordingly, the Beechcraft was not traded for the Cessna and the “taken in trade” exemption is unavailable to Great Southern.

## Interstate Commerce

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### Delaware

#### Unapportioned gross receipts tax on sales into taxing state by out-of-state manufacturer constitutional

*Delaware may constitutionally impose its unapportioned wholesalers’ gross receipts tax on an out-of-state manufacturer’s receipts from sales of motor vehicles to independent dealerships located in Delaware. Applying the tax to proceeds of these sales in which title to the vehicles passes outside Delaware before being physically delivered to the dealers does not violate the Commerce Clause.*

*Ford Motor Company v. Director of Revenue*  
Delaware Supreme Court, December 8, 2008

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Delaware’s wholesalers’ tax is imposed on any entity doing business in the state as a wholesaler. The tax is based on gross receipts attributable to sales of tangible personal property physically delivered within Delaware to the purchaser. Accordingly, the determinative factor in imposing the tax is the destination to which the seller delivers (or causes delivery) of goods to the purchaser, not where title passes. A recent Delaware Supreme Court focuses on whether imposition of the unapportioned wholesalers’ tax on Ford Motor Company’s receipts from sales of motor vehicles to independent dealerships located in Delaware is constitutional.

**Background:** Ford Motor Company sells its vehicles to independent dealers for resale to retail customers. There are eleven dealerships in Delaware that purchase Ford’s vehicles and related products. After a vehicle is assembled at one of many assembly plants, all of which are located outside Delaware, the vehicle comes into the possession of a rail or motor carrier that inspects the vehicle and drives it through a “gate” that typically is located near the assembly plant. At this point, title to the vehicle passes from Ford to the dealer to which it is to be delivered. Vehicles destined for Delaware are taken to a “mixing center” in Ohio and then to “destination ramps” in either Maryland or Pennsylvania. Ford contracts with rail and motor carriers to move the vehicles along this chain to the purchasing dealer in Delaware.

Between January 1999 and October 2002, Ford paid Delaware wholesalers’ tax of \$3.6 million on sales of products shipped to locations in the state. It now seeks a refund of its tax payment, arguing that the tax — as applied to Ford — violates the Commerce

Clause. Ford’s basic contention is that the wholesalers’ tax, as applied to sales where title passes outside Delaware before the vehicles are physically delivered to dealers in Delaware, violates the Commerce Clause, *i.e.*, the fair apportionment and nondiscrimination against interstate commerce prongs of *Complete Auto*.

**Fair apportionment requirement:** Fair apportionment essentially means that a state taxes only its fair share of an interstate transaction. An apportioned — or unapportioned — tax must be both internally and externally consistent. *Internal consistency* — conceded by Ford in this case — is met when imposition of a tax identical to the one in question by every state would add no burden to interstate commerce that intrastate commerce would not also bear. *External consistency* considers whether the tax reaches activity beyond that fairly attributable to economic activity within the taxing state. The burden is on the taxpayer, Ford, to show “that there is no rational relationship between the tax measure attributed to the state and the contribution of local business activity to the entire value.”

The Delaware high court finds that the wholesalers’ tax is imposed only on sales consummated by physical delivery in the state. According to the court, this meets the external consistency requirement, despite Ford’s insistence that it does not deliver any vehicles in Delaware because title to all vehicles passes outside Delaware (at the “gate”):

*[T]his ignores the fact that Ford’s customers contracted not just to purchase goods, but to have them delivered to a destination in Delaware as well. Although title and risk of loss pass to Ford’s customers at gate release, Ford retains continuous and considerable control over the delivery process, stands in a contractual relationship with the carrier, is the named beneficiary on the cargo insurance, and takes responsibility for issues arising during delivery.*

Ford’s contention that the tax poses a risk of impermissible multiple taxation, *i.e.*, it permits taxation by states in which the vehicles are delivered to the “mixing areas” and “destination ramps,” is misplaced. The court explains:

*[T]his argument overlooks that the dealer is the purchaser and that physical delivery to the dealer occurs only in Delaware. Only Delaware has the jurisdiction to tax this separate activity conducted wholly within [Delaware]. [Emphasis in the original; footnote omitted.]*

**Discrimination:** Ford’s discrimination argument centers on the fact that even if it conducted *all* of its wholesaling in Delaware and had the same gross receipts from sales to in-state dealers, its wholesalers’ tax liability would not change. The assertion is that this is discriminatory since Ford is “penalized for conducting most of its wholesaling activity outside”

Delaware. Ford buttresses its argument by noting that a Delaware wholesaler that sells vehicles only to out-of-state dealers would pay *no* Delaware wholesalers' tax.

The court's response is that the tax treats all wholesalers engaged in business in the state identically. "All must pay a tax on the gross receipts of the wholesaling activity without regard to where or how the goods were manufactured or assembled." In sum, Delaware wholesalers are given no advantage over out-of-state wholesalers: "both pay a tax on the gross receipts on goods physically delivered to customers in Delaware."

#### ■ Review Observations:

Although the Delaware wholesalers' tax is a gross receipts tax, it closely resembles a sales tax, *i.e.*, a tax on a sale of tangible personal property. As noted by the U.S. Supreme Court in *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995), "[a] sale of goods is most readily viewed as a dis-

crete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed." (Of course, the Delaware tax falls on the seller.) Based on this notion, the U.S. Supreme Court observed that it has "consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future."

The Delaware high court's decision squares with *Jefferson Lines*, where the U.S. Supreme Court explained that "it is fair to say that because the taxable event of the consummated sale of goods has been found to be properly treated as unique, an internally consistent, conventional sales tax has long been held to be externally consistent as well."

## Nuts-and-Bolts Department

**Resale Exemption** A company that contracted to supply an on-line system (hardware, software, terminals, network, etc.) for Nebraska's lottery is not entitled to a resale exemption for its purchases of ticket stock and play slips required for the lottery terminals. (The on-line retailer uses play slips filled out by lottery players to produce a lottery ticket reflecting the player's choices.)

In so ruling, the Nebraska Supreme Court examined the contract between the company and the state lottery under which the company provides a complete on-line lottery system in exchange for a percentage of the lottery's net sales. The contract language reflects that the state lottery and the company included ticket stock and play slips as part of the system the company was paid to provide. As such, purchases of the ticket stock and play slips are part of the cost incurred by the company under the contract, *i.e.*, these items are purchased by the company for its own use in fulfilling its contract with the state lottery. (*Intralot, Inc. v. Nebraska Department of Revenue*, October 30, 2008)

**Officer Liability** In Texas, if a corporation's privileges are forfeited for failure to file franchise tax reports, directors and officers are liable for any taxes that become due after the date on which the franchise tax report was due and before corporate privileges are restored. (*See* Tex. Tax Code Ann. section 171.255.) As one corporate officer learned in a recent appeal, statute of limitations protections may not be available to preclude the assessment and collection of taxes from an officer of a delinquent corporation. (*Thomas Wilson v. State of Texas et al.*, Texas Court of Appeals, Third District, at Austin, November 21, 2008)

A sales tax audit against Wilson Nursery, Inc. for the period April 1, 1999, through January 31, 2003, was completed in June 2003. In December 2003, Wilson Nursery was granted an administrative hearing, but later filed a bankruptcy petition and the hearing process was stayed. Once the bankruptcy stay was lifted, an adverse determination was approved by the Comptroller, which became final in December 2005. Subsequently, the state was successful in an action filed against both Wilson Nursery and Thomas Wilson, its sole officer and director. Wilson's personal liability was based on Wilson Nursery's loss of corporate privileges for failing to report or pay franchise taxes.

Wilson argues on appeal that his liability was time-barred because (a) he was not assessed personally for sales taxes due from the corporation within four years from the date the tax became due (Tex. Tax Code Ann. section 111.201), and (b) the state failed to bring an action against him to collect the tax within three years from the date the tax deficiency became due (Tex. Tax Code Ann. section 111.202).

The appeals court finds no requirement that an officer be personally assessed before the state may hold him or her liable for the unpaid taxes of a corporation whose privileges are forfeited, provided those taxes have been properly assessed against the corporation.

With regard to the collection process, the state concedes that it did not file an action against Wilson within three years after the delinquent taxes became payable. However, the state notes that the three-year statute of limitations was tolled by the hearing requested by the corporation. The court finds no merit to the argument that the statute of

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limitations was not tolled by the hearing process as to Wilson himself. ("Under a plain reading of section 111.207, a corporation's [hearing] tolls the... statute of limitations for both the corporation and any director or officer who could be personally liable under section 171.255 for a portion of the amount at issue in the hearing.") Accordingly, the state's claims against Wilson were timely.

**Hotel Chain Reward Program** An Administrative Law Judge in New York State's Division of Tax Appeals recently ruled that reimbursements paid or credited to Marriott hotels by Marriott Rewards are not consideration for hotel occupancy subject to sales tax. (*Marriott International, Inc. et al.*, November 26, 2008)

Marriott Rewards, a subsidiary of Marriott International, operates a frequent stay program designed to reward members who stay at participating hotels as part of a marketing promotion. A participating hotel receives no payment from a member who redeems Marriott Reward points for a free stay at the hotel. While Marriott Rewards reimburses the hotel for occupancy obtained through points, the amount of each reimbursement does not equal the hotel's actual charge for providing a specific hotel room or the hotel's cost of providing a particular room to a member. Further, the reimbursement from Marriott Rewards does not entitle Marriott Rewards to occupy a room or to distribute a room.

Participating hotels pay Marriott Rewards an agreed percentage of room payments made by members. Although the hotels are in turn paid by Marriott Rewards according to a formula that factors in occupancy by members redeeming points for a room, the primary purpose of Marriott Rewards's payments is reimbursement to the hotels for their participation in the marketing program. Accordingly, the reimbursements are not consideration for hotel occupancy.

**Party Credits Given by Direct Seller** Purchases made by hosts of parties at which a direct seller's home products are sold are subject to sales tax based on the retail selling price of the products, even though hosts could acquire the products for free or at reduced cost based on the volume of their party receipts. In reaching this conclusion, the Minnesota Tax Court rejects the direct seller's argument that the discounts it gives hosts are merely price reductions. (*Home and Garden Party, Inc. v. Commissioner of Revenue*, November 24, 2008)

The Minnesota Tax Court explains that the credits given by the direct seller to the hosts are not gifts. Instead, the credits are a form of payment the direct seller gives to the hosts for agreeing to hold a party and invite guests. In turn, when exchanged for free merchandise or price reductions, the credits constitute part of the consideration paid for the products. Under Minnesota's tax statute, the sales

tax base is the total consideration received, "whether received in money or otherwise." The fact that part of the purchase price is "paid" using the credits does not reduce the suggested retail price of the direct seller's products or the total amount on which the sales tax is calculated.

**Uniform and Linen Rental Company** Just because a uniform and linen rental company uses the latest technology and state-of-the-art laundering equipment is not enough to qualify its purchase of that equipment for an exemption from tax as capital equipment used in "manufacturing." (*AmeriPride Services, Inc. v. Commissioner of Revenue*, Minnesota Tax Court, October 3, 2008)

To qualify as "manufacturing," the rental company must show that the uniforms and linens are (1) raw materials (2) which are changed in form, composition or condition (3) by machinery and equipment (4) resulting in the production of a new article of tangible personal property. Elements (2) and (3) are met, the Minnesota Tax Commissioner concedes. The "raw materials" element is missing, however. Applying a dictionary definition, dirty laundry cannot be considered a "raw material" (a "crude or processed material that can be converted by manufacture, processing, or combination into... [a] new and useful product"). Further, even if dirty laundry were a "raw material," laundering the soiled uniforms and linens does not result in a new item of tangible personal property (element 4). Simply put, nothing new is created ("the laundering process merely turns dirty laundry into clean laundry").

**Federal Preemption** A Tennessee county tax imposed on customers participating in rafting excursions on navigable waters located in the county is preempted by a federal law (11 U.S.C. 5(b)) that bars the imposition of a tax on passengers or any water craft operating on a navigable waterway subject to federal authority. A Tennessee appeals court found no merit to the county's argument that the tax should not be preempted since it pre-existed enactment of the federal ban. While the basic assumption is that federal law does not displace state law in the absence of express preemptive language, the court explains that "the obvious and inescapable conflict between [the county tax] and the federal prohibition overcomes the assumption against preemption." Further, the court finds no hint in the federal law that the tax prohibition extends to "prospective state legislation only." (*High Country Adventures, Inc. v. Polk County*, Tennessee Court of Appeals at Knoxville, November 10, 2008)

The rafting operator will not reap a windfall from its successful challenge of the county tax. According to the court, refunds belong to the operator's customers. The court directs those refunds be held by the county pending claims from the operator's customers. If unclaimed after one year, a refund will be considered to be abandoned.

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