How Do You Win an External Consistency Challenge, Anyway?

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In this installment of Audit & Beyond, the authors examine three Pennsylvania cases that they argue should form a basis for how courts and taxpayers think about external consistency in the age of economic nexus and single-sales-factor apportionment.

A state tax must be fairly apportioned, which includes the complementary concepts of internal and external consistency.[1] At the same time, outside the pre-*Wayfair*[2] sales and use tax context, taxpayers have lost most of their challenges to impositions of tax based on economic nexus and the doctrine of dissociation appears to be dead.[3] A majority of states now impose either a corporate income tax using a single sales factor or a gross receipts tax based solely on receipts from the in-state market. Yet there is no published guidance holding that a state's single sales factor is unconstitutional, nor are we aware of any written ruling in which a taxpayer successfully petitioned to deviate from the single sales factor using an alternative apportionment formula.

The U.S. Supreme Court has held that single-sales-factor apportionment is facially constitutional for both gross receipts taxes and net income taxes.[4] And if it was ever in doubt after *Jefferson Lines*,[5] the Court in *Wynne*[6] unequivocally confirmed that income taxes and gross receipts taxes are subject to the same commerce clause scrutiny. The Court wrote: "We see no reason why the distinction between gross receipts and net income should matter, particularly in light of the admonition that we must consider 'not the formal language of the tax statute but rather its practical effect,'" later adding "and we have now squarely rejected the argument that the Commerce Clause distinguishes between taxes on net and gross income."[7]

Wynne thus confirmed the vitality of the internal consistency test, and taxpayers have had recent success challenging state taxing statutes based on a lack of internal consistency.[8]

The external consistency test, on the other hand, has received less serious attention, both

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[1] *See Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977); and *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

[2] *South Dakota v. Wayfair Inc.*, 585 U.S. ___ (2018).

[3] For a full discussion of dissociation's burial and exhumation, see John A. Swain, "The Zombie Precedent: *Norton Co. v. Department of Revenue*," *State Tax Notes*, Apr. 17, 2017, p. 301.

[4] *See Tyler Pipe Industries Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987); and *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978). In *Tyler Pipe*, the Court dismissed the taxpayer's fair apportionment argument on the basis that wholesaling is conducted entirely within the state of the sale — a conclusion that Dirk Giseburt calls a "gimmick." Giseburt, "Relocating 'Dissociation' Under the Fair Apportionment Prong," *State Tax Notes*, Mar. 12, 2018, p. 987.

[5] *See Oklahoma Tax Commission v. Jefferson Lines*, 514 U.S. 175, 190 (1995).

[6] *Comptroller of Treasury of Maryland v. Wynne*, 575 U.S. ___, 135 S. Ct. 1787 (2015) (internal citations omitted).

[7] *Wynne*, 135 S. Ct. 1787, 1795-1796.

[8] *See id.* at 1795-1796; *see also Matkovich v. CSX Transportation Inc.*, 793 S.E.2d 888 (W. Va. 2016).

judicially and from an academic perspective. To be externally consistent, gross receipts taxes and income taxes must tax "only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."[9] A state might logically assert that due process and the dormant commerce clause (including its external consistency test) are usually satisfied when a seller of tangible personal property agrees to sell to a purchaser in the other state, accepts payment, arranges shipment, uses the state's roads for delivery, and counts that state's services to guard against theft.

That argument becomes less defensible regarding a service provider that agrees to provide its services at an industry sales conference or a meeting at a customer's headquarters, sometimes without the ability to control their distribution or knowledge of where the services are used. Has fair apportionment been achieved when high-population states are able to capture a significant apportionment percentage of receipts from remotely delivered services, when the inputs are located elsewhere and the location of customers and users is often accidental or unknown to the seller? Does that apportionment tax "only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed"?[10]

There must be a practical basis to evaluate the constitutionality of a state tax scheme that uses economic nexus to assert jurisdiction over remote businesses and that applies a single sales factor using market-based sourcing. How can a taxpayer or state taxing agency evaluate whether a state taxing statute is fairly apportioned, and is there any guideline or common thread that a court should use to consider such challenges, beyond a subjective fact-specific smell test? As Dirk Giseburt explored in his March 2018 *State Tax Notes* article, the answer may lie in the external consistency test and the concepts underlying the anachronistic principle of dissociation.[11]

[9] *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989).

[10] *Id*. at 262.

[11] Giseburt, *supra* note 4, at 993-994.

External Consistency Applied

Three Pennsylvania cases involving municipal business privilege taxes (BPTs) demonstrate some useful contours in an external consistency analysis. In *Philadelphia Eagles*,[12] the Pennsylvania Supreme Court held that Philadelphia violated external consistency by imposing the BPT on 100 percent of the team's share of the revenue from television broadcasts of NFL games (media receipts). Under the BPT, all copyright royalties were allocated to the taxpayer's domicile. The Eagles argued that only half of the media receipts should be subject to Philadelphia's BPT because the team played only half of its games at home.

Addressing whether gross receipts taxes are exempt from the fair apportionment requirement, the court noted that the Supreme Court "has not required apportionment of gross receipts from activities involving manufacturing and sales" because these are "separate and discrete activities, each of which transpire completely within a single jurisdiction."[13] But the court distinguished *Tyler Pipe*, *Standard Pressed Steel*,[14] and *General Motors*,[15] explaining that:

> The Supreme Court has never held that gross receipts taxes as a whole are immune from apportionment. In fact, since the last of the trio of cases on which the City relies, the Supreme Court has distanced itself from the gross receipts tax and sales tax analogy and made clear in *Oklahoma Tax Commission v. Jefferson Lines* that a gross receipts tax is simply a variety of tax on income, which is required to be apportioned to reflect the location of the various activities by which it is earned. . . . Thus, we simply cannot agree with the City's argument that a gross receipts tax, such as the BPT, is wholly immune from the constitutional requirement of fair apportionment.[16]

[12] *Philadelphia Eagles Football Club Inc. v. City of Philadelphia*, 573 Pa. 189 (2003).

[13] *Id*. at 223.

[14] *Standard Pressed Steel v. Department of Revenue*, 419 U.S. 560 (1975).

[15] *General Motors Corp. v. Washington*, 377 U.S. 436 (1964).

[16] *Philadelphia Eagles*, 573 Pa. at 223-24 (internal citations and quotation marks omitted).

Philadelphia's BPT easily passed the internal consistency test because each taxpayer has only one commercial domicile, and there is no risk of multiple taxation if each jurisdiction imposed a tax on the copyright royalties of taxpayers commercially domiciled within its boundaries. However, the court held that the BPT violated the external consistency test by taxing "business activity that occurred in other taxing jurisdictions."[17] According to the court, a taxpayer can successfully challenge a tax under the external consistency test if it demonstrates by clear and cogent evidence that the income attributed to the state is out of all appropriate proportion to the business transacted by the taxpayer in that state, has led to a grossly distorted result for the taxpayer, is inherently arbitrary, or produced an unreasonable result.[18]

The court found that the BPT assessment was "out of all appropriate proportion to the business transacted" by the Eagles in Philadelphia. The football games that generated the media receipts were conducted in an easily identifiable location, and because the Eagles played only half of their games in Philadelphia, only half of their media receipts could be apportioned there under the BPT. The court wrote that

> by imposing the BPT on 100% of the media receipts when only 50% of the receipts were generated from games played in and broadcast from Philadelphia, the City actually doubled the Football Club's tax assessment on the media receipts. In this regard, the City's BPT assessment was plainly 'out of all proportion' to the Football Club's business activities in Philadelphia that generated the payment of media receipts.[19]

In *Northwood Construction Co. v. Township of Upper Moreland*,[20] a construction contractor had its principal place of business in Upper Moreland but worked on construction projects throughout Pennsylvania, Delaware, Maryland, and New Jersey. Upper Moreland's BPT, which is based in part on gross receipts, excluded gross receipts that had been subject to a BPT or similar tax in another jurisdiction. Northwood Construction challenged the taxation of 100 percent of its receipts generated from construction sites outside Pennsylvania as violating *Complete Auto*'s fair apportionment requirement.

As in *Philadelphia Eagles*, the tax passed the internal consistency test. The commonwealth court and the Pennsylvania Supreme Court agreed that the exclusion of gross receipts similarly taxed by another jurisdiction eliminated the risks of multiple taxation. According to the commonwealth court, the tax was externally consistent because "the Township can justify a tax on the privilege of maintaining an office within the Township where, from that office, a company is able to manage, direct and control *all* its interstate business."[21] But the Pennsylvania Supreme Court rejected this reasoning. Applying the test from *Philadelphia Eagles*, the court found that "Northwood has adequately established that income attributed to the Township is 'out of all appropriate proportion to' the business transacted in the Township and has no 'rational relationship' to Northwood's business in the Township."[22] The court continued:

> When considering the constitutionality of a gross receipts tax, it is the activities that generate those gross receipts that are determinative in an apportionment analysis as it is only the receipts generated from the instate component of the underlying activity that the Township may properly tax under constitutional apportionment principles.[23]

Because a significant portion, if not all, of Northwood Construction's gross receipts from out-of-state construction projects were generated by activity outside Upper Moreland, Upper

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[17] *Id.* at 226.

[18] *Id.* at 227 (quoting *Hans Rees' Sons Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931); *Norfolk & Western Ry. Co. v. Missouri State Tax Commission*, 390 U.S. 317, 326 (1968); and *Moorman Manufacturing*, 437 U.S. at 274.

[19] *Philadelphia Eagles*, 573 Pa. at 227-228.

[20] 579 Pa. 463 (2004).

[21] *Northwood Construction Co. v. Township of Upper Moreland*, 802 A.2d 1269, 1276 (Pa. Commw. Ct. 2002) (emphasis in original).

[22] *Northwood Construction*, 579 Pa. at 486.

[23] *Id.* at 487-488 (citing *Jefferson Lines*, 514 U.S. at 190; *Philadelphia Eagles*, 823 A.2d at 133; and *General Motors Corp. v. City & County of Denver*, 990 P.2d 59, 71 (Colo. 1999)).

Moreland could not tax all of Northwood Construction's gross receipts without violating fair apportionment.

In *Upper Moreland Township v. 7 Eleven Inc.*,[24] a court again held that Upper Moreland's BPT violated the external consistency test. 7-Eleven franchise stores pay franchise fees to 7-Eleven corporate for services, including marketing and information technology. 7-Eleven maintained a corporate regional office in Upper Moreland that served franchise stores in Pennsylvania and other states in the Northeast. The township imposed the BPT on all the franchise fees received by 7-Eleven from Pennsylvania stores. But these franchise fees were generated at least in part by 7-Eleven's activities in other states. For example, the marketing and information systems departments were located entirely in Texas. Therefore, the court held that 7-Eleven's assessment was disproportionate to the activity conducted in the township and remanded the case for a BPT recalculation.[25]

Other state courts have occasionally considered external consistency challenges, but the analysis has generally been conclusory without providing much meaningful guidance for states or taxpayers. In *General Motors Corp. v. City of Kansas City*, a Missouri appellate court held that Kansas City's gross receipts tax violated external consistency when it required GM to include all receipts from vehicles manufactured or assembled at its manufacturing facility in its Kansas City gross receipts tax base.[26] The problem with the city's method was that it required the inclusion of receipts from all sales of vehicles that were either manufactured at the Kansas City facility or assembled there, even though the facility did not earn any receipts for vehicles that were merely assembled there.[27]

Similarly, in *American Woodmark*, the Virginia Supreme Court held that the Virginia business, professional, and occupational license tax (a gross- receipts-based tax) violated external consistency as applied to that taxpayer, when the state asserted that 100 percent of the receipts were attributable to the taxpayer's Virginia headquarters.[28] The court wrote that "common sense compels the conclusion" that the taxpayer's facilities in 13 other states must be responsible for producing some of the revenue that Virginia sought to include in its tax base. Surprisingly, the court then declared the entire assessment invalid.[29]

More recently, the Delaware Supreme Court rejected an external consistency challenge brought by Ford against the state's gross-receipts-based wholesalers' tax, finding that despite Ford's transfer of title to vehicles to its dealers outside the state, it still conducted substantial direct solicitation in Delaware, directed advertising to the state, and retained "continuous and considerable control" over the delivery process.[30] Thus, finding that Ford's in-state activities were roughly commensurate to its in-state receipts, the court held that the tax was externally consistent as applied to Ford.

A recent Illinois decision shows that many courts are still not ready to provide serious analysis of an external consistency challenge, even when the interstate nature of the services is undisputed. Chicago has long imposed a 9 percent amusement tax on admissions to some entertainment activities, including concerts, theaters, and sporting events.[31] In *Labell v. City of Chicago*,[32] a group of Chicago residents challenged the city's administrative extension of the amusement tax to internet-based streaming services such as Netflix and Spotify. The tax applies to consumers with a Chicago billing address, regardless of the consumers' location when using the services. The residents argued, among other things, that the tax failed the external consistency test by taxing the use of streaming services that occurs outside Chicago.

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[24] 160 A.3d 921 (Pa. Commw. Ct. 2017).

[25] *Id.* at 927.

[26] *General Motors Corp. v. City of Kansas City, Missouri*, Nos. WD 46246 and 46256, 1994 WL 49620 (Mo. Ct. App. 1994), *aff'd on other grounds*, 895 S.W.2d 59 (Mo. Ct. App. 1995).

[27] *Id.* at *9 ("The portion of the value of the assembled automobile[s] derived from . . . component parts should be excluded . . . and taxed instead by the jurisdiction where such parts were manufactured.").

[28] *City of Winchester v. American Woodmark Corp.*, 252 Va. 98 (1996).

[29] *Id.* at 103.

[30] *Ford Motor Co. v. Director of Revenue*, 963 A.2d 115, 122 (Del. 2008).

[31] *See* Chicago Mun. Code 4-156-020.

[32] No. 15 CH 13399 (Cook County Cir. Ct., May 24, 2018).

The court, however, swiftly dismissed the residents' concerns about fair apportionment. First, in the court's view, the "limited possibility of multiple taxation is not sufficient to invalidate the ordinance based on external consistency."[33] Second, because the customers' "primary use of the streaming services will take place at their residences,"[34] the court concluded that the city's use of the customer's billing address to impose the tax was a "practical solution to the technology of the 21st century" that satisfies the fair apportionment prong of *Complete Auto*.[35]

The 'Road Game': A Tool for Evaluating External Consistency

The Pennsylvania Commonwealth Court remanded *7-Eleven* for a BPT recalculation that would be proportionate to 7-Eleven's activity in the township. But how should the trial court fairly apportion 7-Eleven's gross receipts to Upper Moreland? The Pennsylvania Supreme Court in *Philadelphia Eagles* used a method like the cost of performance to apportion the team's media receipts. Because 50 percent of the receipts were from games performed outside Philadelphia, 50 percent of the receipts were sourced outside the city. That seems straightforward enough.

Giseburt suggests dissociation as "one ready answer" to an external consistency challenge.[36] Whether we call it dissociation or something else, the idea is best exemplified by the Eagles' media receipts from road games that could not be taxed by Philadelphia. While the team's activities in Philadelphia (home games, office operations, etc.) contributed in a macro-sense to the television broadcasting revenue generated by away games, this link was deemed insufficient to support apportioning all of the media receipts to Philadelphia. As the court explained, Philadelphia, as the Eagles' commercial domicile, obviously had jurisdiction to tax *some* of the team's gross receipts, but Philadelphia "may not tax all of that income where another state taxes, or has the authority to tax, an apportioned share of that income."[37]

Though the courts in *Northwood Construction* and *7-Eleven* did not provide a clear rule on how the lower courts should apportion receipts, those holdings were also rooted in the same principle that drove the "road game" rule from the *Eagles* case: External consistency is not met when the taxpayer demonstrates that its receipts were generated by out-of-state activity so as to produce a grossly distorted or unreasonable result. How much of a disconnect must there be between a taxpayer's in-state activity and its tax liability under an economic nexus/single-sales-factor regime to constitute an unconstitutionally unreasonable result? That is far from clear, but the important lesson from these cases is that there *is* a limit, and that taxpayers, states, and courts need to recognize the existence of that limit and work to define its contours.

The concept behind this limitation may historically have been called dissociation, but given the baggage and history of that concept, it is probably confusing and unhelpful to revive or rehabilitate that term. We think that something like the road game rule avoids the confusion of using the historical dissociation label, and provides a helpful, descriptive tool for evaluating whether external consistency has been met.

There are numerous cases in which the rule may provide a compelling basis for an external consistency challenge. Imagine a consulting firm that sends its bill for services to a customer's headquarters in California but performs services for the customer in numerous states. The consulting firm provides virtually no services in California and has no property or payroll in the state. Because the consulting services that generated the receipts were provided almost entirely outside California, sourcing all the consulting firm's receipts to the state based on the customer's billing address would arguably be "out of all appropriate proportion" to the consulting firm's business conducted there. Further, the possibility that the state where those

[33] *Id.* at *6.

[34] *Id.*

[35] *Id.*

[36] Giseburt, *supra* note 4, at 992. The concept of dissociation originated in *Norton Co. v. Illinois Department of Revenue*, 40 U.S. 534 (1951), which held that a Massachusetts manufacturer's direct sales to Illinois customers were not subject to Illinois's gross receipts tax if the sales were "dissociated from the local business" of the manufacturer in the state. *Id.* at 537.

[37] *Id.* at 230 (citing *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979)).

inputs are located could tax those inputs more heavily than California (for example, under a three-factor formula using costs of performance for the sales factor) should heighten the concern that the tax is not fairly apportioned and therefore is externally inconsistent if subjected to California's single-sales-factor formula.

Or consider a cloud services provider whose employees are located entirely in Washington state but whose client's employees access cloud services while traveling throughout the country to states where the cloud services provider does not operate or solicit sales. Sourcing the cloud services provider's receipts to the states from which its client's employees access the services has no rational relationship to the cloud services provider's nonexistent activities in those states.[38] Applying the road game rule, the service provider's receipts should be predominantly apportioned to the states where it conducts the activities generating the receipts.

Courts have at times struggled to impart real teeth into the external consistency test, particularly in cases which the parties present related arguments regarding nexus, sourcing, or whether there is a unitary business. But with economic nexus and the single sales factor in place in numerous jurisdictions across the country, external consistency is one of the few remaining protections to ensure that a tax is commensurate with a taxpayer's activities in the taxing state. Taxpayers and courts have struggled to give external consistency a meaningful scope, but the concepts in the Pennsylvania trio of cases offer a useful starting point.

An Aside About Multiple Taxation

Although the fair apportionment principle descended from the prohibition on multiple taxation, external consistency analysis does not end merely because a tax does not create risks of multiple taxation. As the court explained in *Northwood Construction*, external consistency "ultimately mandates that a tax not 'reach beyond that portion of value that is fairly attributable to economic activity within the taxing State,' irrespective of whether there is a genuine risk of multiple taxation."[39] Under this reasoning, even if every state adopted singles-sales-factor apportionment and market-based sourcing of sales of services — therefore eliminating the risk of double taxation — market-based sourcing could still violate the dormant commerce clause in some circumstances.

Stated another way, while evidence of multiple taxation is not required to show that a tax has failed internal or external consistency, courts have become too quick to end their analysis after finding an absence of real or likely multiple taxation.[40] Proper constitutional analysis should recognize that when there is material risk of multiple taxation, that is a signal that the tax may be reaching extrajurisdictional activity and should be given closer consideration under the external consistency test.

Conclusion

In a state tax world that is deep in the midst of a significant shift toward economic nexus and single-sales-factor apportionment, the external consistency test is a crucial constitutional limitation that protects taxpayers — and specific taxpayer receipts — from being taxed in jurisdictions that have no claim to such receipts. In recent years, courts and taxing agencies have recognized external consistency but have interpreted it to have virtually no field of operation. This is an odd outcome considering that an increasing acceptance of economic nexus corresponds to a recognition that the other prongs of *Complete Auto* — including the internal and external consistency tests under the fair apportionment prong — provide some of the few limitations on governments' taxing authority. The Pennsylvania decisions have pointed the way, but it is important for taxpayers, state agencies, and courts to continue to grapple with the real limitations imposed by the external consistency test. ■

[38] *Northwood Construction Co.*, 579 Pa. at 486.

[39] *Id.* at 488 (quoting *Jefferson Lines*, 514 U.S. at 185).

[40] *See, e.g.*, Labell, No. 15 CH 13399 at *6.