

Total working time for examination questions of Professor Dewey—Three (3) hours.

EXAMINATION SUGGESTIONS

1. Please write every other line in the blue books - it facilitates effective communication.
2. Please respond to the Questions in the order set forth in the exam--otherwise you may omit a question by inadvertence. The Questions are of equal weight in grading process.
3. Three (3) working hours will be allowed for exam completion.
4. Please do not strive to make your exam response a triumph of Biology brevity. Discuss the issues fully - the idea in this exam is to reveal and not to conceal your conceptual depth.
5. Please respond to the issues of the precise Question. Do not respond with mere legal-surfing abstractions.
6. Please express rationale for concepts discussed, judicial views expressed as applicable to the Question and for arguments presented as an advocate.
7. Please complete cover page of each blue book used.
8. Please do well on the exam.
9. Please do not view the exam as a "call to martyrdom."

QUESTION NO. 1

Smile, Inc. (hereafter referred to as Smile) is a Minnesota corporation engaged in the business of mechanical contracting. Its principal office is in Minneapolis, Minnesota.

During the tax year 1989 here in issue Smile received interest income from United States Bonds, Treasury Notes and other legal obligations of the United States in the amount of \$350,000.

Smile timely filed its 1989 corporation tax return with the Minnesota Commissioner of Taxation but excluded from the return the sum of \$350,000 received by Smile during such tax year as interest on above described legal obligations of the United States. Smile tax officials appended to the 1989 corporate tax return the explanation that the interest from the bonds, Treasury Notes and other legal obligations of the United States was exempted from any state taxes by the constitutional tax immunity of the federal government reflected in federal statutory law (set forth in full later in this question).

The Minnesota Tax Commissioner added the \$350,000 of interest from obligations of the United States back into taxable net income and accordingly made a deficiency tax assessment against Smile for additional taxes by virtue of the following tax levy statute in Minnesota.

"An annual excise tax is hereby imposed upon every domestic corporation for the privilege of existing as a corporation during any part of the tax year and upon every foreign corporation for the grant to it of the privilege of transacting or for the actual transaction by it of any local business within this state during any part of the tax year in corporate form. The tax so imposed shall be measured by such corporation's taxable net income for the taxable year for which the tax is imposed, and computed, allocated and apportioned in the manner and at the rates provided in this chapter."

Smile concedes that the proper quantum of its income attributable to its business done in Minnesota was properly computed, allocated and apportioned to such state but Smile contends solely that its interest from obligations of the United States in the amount of \$350,000 for the tax year in issue is exempt from the Minnesota tax levy by virtue of the federal constitutional tax immunity of the federal government as reflected in the following existent federal statute which provides:

"Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under state or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of tax, except non-discriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes."

1. Assume that Smile has properly exhausted all administrative and judicial remedies relative to the deficiency tax assessment by the Minnesota Tax Commissioner and has properly perfected an

appeal to the Supreme Court of the United States which Court will decide on the merits the validity of the deficiency tax assessment against Smile. Will the assessment be held valid or invalid?

2. Assume only for this portion of the question that the Minnesota tax statute set forth in Part (1) of this Question further provided specifically that the interest earned on Bonds, Notes and any other legal obligation of the State of Minnesota and its political subdivisions is not included in the corporation's taxable income under that portion of the Minnesota tax statute set for forth in Part (1) of this question which provides:

"The tax so imposed shall be measured by such corporation's taxable net income for the taxable year for which the tax is imposed, and computed in the manner and at the rates provided in this chapter."

Assume as in Part (1) that Smile has its case before the Supreme Court of the United States for a decision of the merits. Will the tax assessment be held valid or invalid?

QUESTION NO. 2

Ned feels that the "cosmic tax night" has descended upon him because of the following factual scenario:

- a. It is conceded that Ned lives in State A and is legally domiciled in State A. The income tax law of State A provides for progressive income tax rates which impose a maximum tax rate of 10 % on the taxable income of residents of State A when taxable income of such resident reaches \$100,000 or more.

Ned is piqued because his conceded taxable income in State A for 1989 was \$200,000 and thus Ned was required by the income tax law of State A to pay an income tax rate of 10 % on his taxable income. Ned's complaint as to the validity of this income tax imposed upon him is that the income tax law of State A only imposes a maximum income tax rate of 7 % on the taxable income of non-residents of State A on that taxable income of such non-residents properly attributable to State A under constitutional limitations when such taxable income reaches \$100,000 or more.

Ned further contends that the State A income tax rate of 10 % as applied to Ned is "too high" and is therefore invalid and unconstitutional.

- b. Ned is further mystified about the vagaries of income taxation because Ned concedes that 52% of his taxable income was properly taxable for the tax year 1989 under the income tax law of neighboring State B where Ned worked in a corporate executive position for 10-12 hours per day.

Ned does not dispute that 52 % of his total income is properly taxed under the income tax law of State B where Ned works long hours in the Executive Suite and has a gold key to his private, restroom facility. Ned asserts that his constitutional rights are violated in the imposition of the income tax law of State B because the income tax officials of State B in accordance with the income tax statutes of such state only permit Ned to take as non-business deductions and the personal exemption on his State B income tax return only 52 % of the non-business deductions and personal exemption Ned would have been allowed had he been a resident of State B.

The proffered theory of the Tax Officials of State B in support of allowing Ned to take only 52 % of the non-business deductions and personal exemption Ned would have been allowed if Ned had been a resident of State B is considered by Ned to be "Parochial" and illegal. The State B Tax officials contend that since only 52 % of Ned's taxable income is legally taxable in State B, then the limitations of Ned's non-business deductions and personal exemption to 52 % of those same non-business deductions and personal exemption permitted to residents of State B is a "necessary corollary of the constitutional prohibition against taxing out-of State B income."

Ned contends that his tax treatment in State B limiting his non-business deductions and personal exemption to 52 % of the same non-business deductions and personal exemption accorded by law to residents of State B just because only 52 % of Ned's income is constitutionally taxable in

State B denies Ned "equal protection of Law" and is also violative of the Privileges and Immunities Clause of the United States Constitution which provides that:

"The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States."

Assume that both State A and State B made income tax assessments against Ned in accordance with the conceded facts set forth herein.

Assume that Ned has properly exhausted all of his administrative and judicial review legal requisites and that Ned has perfected an appeal of his income tax assessments in both State A and State B to the United States Supreme Court for a decision on the merits.

- (1) Will the income tax assessment of State A against Ned be held valid or invalid?
- (2) Will the income tax assessment of State B against Ned be held valid or invalid?

QUESTION NO. 3

The taxpayer, Metpath, Inc., (hereinafter referred to as Metpath) objects to a deficiency sales tax assessment of \$358,000 plus statutory penalty and interest made against it by the Tax commissioner of New Jersey.

The sales tax assessment was imposed on chemicals purchased by Metpath for the audit period in question.

The Tax Commissioner of New Jersey assessed the sales tax against Metpath as the consumer of chemicals pursuant to a New Jersey statute which grants the Commissioner the optional authority to impose the sales tax either on the consumer or upon the vendor when taxable sales occur and the tax is not properly paid to the state of New Jersey.

Metpath operates a laboratory in which it performs more than 800 laboratory testing service procedures on blood and other human body fluids primarily for hospitals, physicians and government agencies. The laboratory tests involve the processing operations by Metpath requiring the use of certain chemicals. When testing has been completed by Metpath, Metpath submits a computer-generated laboratory report of the test results to its customers. The chemicals used in these laboratory procedures do not become a component part of the report.

The issue presented is whether Metpath's purchase of these chemicals is exempt from the New Jersey sales tax.

The legislative scheme of the New Jersey sales tax calls for a tax on the receipts from every retail sale of tangible personal property and the following services are also subjected to the sales tax:

- (a) producing, fabricating, processing, printing or imprinting tangible personal property for persons who provide the property and do not intend to resell it.
- (b) installing, maintaining, servicing or repairing tangible personal property not held for sale in the regular course of business, with certain exceptions, such as laundering and dry cleaning.
- (c) storing tangible personal property not held for sale in the regular course of business.
- (d) maintaining, servicing or repairing real property.
- (e) advertising services, except when used primarily in newspapers and magazines.

Metpath contends that its purchases of chemicals are exempt by virtue of the "resale exemption" and by the following statute which is part of the New Jersey sales tax law:

"Receipts from sales of materials, such as chemicals and catalysts, used to induce or cause a refining or chemical process, where such materials are an integral or essential part of the processing operation, but do not become a component part of the finished product are exempt from the sales tax."

The New Jersey sales tax law defines the term "retail sale" to exclude a resale either (1) in the same form or as converted into or as a component part of a product produced for sale by the buyer,

or (2) for use by the buyer in performing services subject to the sales tax where the property becomes a physical component part of the property upon which the services are performed or the property is transferred to the purchaser of the service in conjunction with the performance of the service.

The Supreme Court of New Jersey in a prior sales tax decision made the following conclusion with respect to the "resale exemption" in New Jersey sales tax law:

"Thus it can be seen that the general legislative intent was to impose the tax on sales of tangible personal property unless that property was to be resold by the purchaser. The contemplation was that the tax in such a situation would be incurred on resale. The theoretical justification for the resale exemption was the desire to avoid pyramiding taxes as goods move along the channels of distribution toward the market place."

It is conceded by Metpath that Metpath does not charge its customers any separately designated price for the chemicals used by Metpath in its laboratory tests. However, properly admissible evidence by Metpath shows conclusively that the cost of the chemicals purchased by Metpath is factored into and becomes part of the ultimate price and charge that Metpath collects from its customers for the laboratory tests.

1. Assume that Metpath has properly exhausted all of its administrative and judicial remedies and that the validity of the sales tax assessment against Metpath is before the Supreme Court of New Jersey for a decision on the merits. Will the assessment be held valid?
2. Assume only for this portion of the question that Metpath did not exhaust, its administrative remedy provided by the statutory law of New Jersey which grants an administrative hearing and review by a hearing board appointed by the New Jersey Tax Commissioner to afford the Tax Commissioner the opportunity to correct any improper or illegal tax assessments. These hearing referees conduct a review of tax assessments and recommend affirmance or nullification (in whole or part) to the Tax Commissioner who usually (but not always) adheres to the recommendations of the hearing board. Metpath did not seek this hearing because Metpath felt this complex legal question could not be properly considered by a "pedestrian" hearing board.

Assume that a statute in New Jersey provides for review of final orders of the Tax Commissioner by a separate and independent agency (the State Board of Tax Appeals) that has the statutory jurisdiction to affirm, modify or reverse final orders of the New Jersey Tax Commissioner. Assume also that Metpath has never before received a deficiency sales tax assessment in New Jersey other than the assessment here in issue.

Is Metpath entitled to judicial review of the sales tax assessment here in issue?

QUESTION-NO. 4

The taxpayer, Joy, Inc., (hereinafter referred to as Joy), a Louisiana Corporation, challenges the validity of the State's imposition of its use tax on catalogs printed at Joy's direction outside of Louisiana and shipped to prospective customers of Joy within Louisiana.

The taxpayer, Joy, is a Louisiana corporation with its principal place of business and registered office in New Orleans. Joy owns and operates 13 department stores in various locations throughout Louisiana that employ about 5,000 employees. Joy has approximately 500,000 credit card holders and an estimated 1,000,000 other customers within Louisiana.

During the tax years 1984-86 Joy contracted with several New York companies for the design and printing of merchandise catalogs. The catalogs were designed in New York, but actually printed in Atlanta, Boston and Oklahoma City. From these locations 82 % of the catalogs were directly mailed to residents of Louisiana; the remainder of the catalogs were mailed to customers of Joy in Alabama, Mississippi and Florida.

The catalogs were shipped free of charge to the addressee, and their entire cost (about \$2,000,000 for the audit period of 3 years), including mailing, was borne by Joy. Joy did not, however, pay any sales tax in the states where the catalogs were designed or printed.

Joy freely concedes that the purpose of the catalogs was to promote sales at its stores and to instill name-recognition in future buyers. The catalogs included inserts which could be used to order Joy's products by mail.

The Louisiana Department of Taxation conducted an audit of the Joy tax returns for the above three-year period and determined that Joy was liable for delinquent use taxes on the value of the catalogs shipped to Louisiana residents from Atlanta, Boston and Oklahoma City.

The appropriate Louisiana statutes impose a use tax of 5% on all tangible personal property used in Louisiana. "Use, is defined in such statutes;

"As the exercise of any right or power over tangible personal property incidental to ownership, and includes consumption, distribution, and storage."

Joy contends that the use tax imposed by Louisiana on the value of the catalogs mailed from outside Louisiana to residents of Louisiana is invalid as a contravention of the Commerce Clause of the Federal Constitution which provides that "Congress shall have the power to regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes." Joy claims that in legal effect the nature of its operations in Louisiana does not form a sufficient "nexus" to subject it to the state's use tax law.

Joy further asserts that the use tax assessment is invalid because Joy lacked sufficient control over the catalog's distribution in Louisiana to be subject to the Louisiana Use Tax. In this contention Joy relies upon the following statutory provision in the Louisiana Use Tax Law:

"It is not the intention of this Chapter (Use Tax Law) to levy a tax upon articles of tangible personal property imported into this state, or produced or manufactured in this state, for export; nor is it the intention of this Chapter (Use Tax Law) to levy a tax on bona fide interstate commerce. It is, however, the intention of this Chapter (Use Tax Law) to levy a tax on the use, the consumption, and the storage to be used or consumed in this state, of tangible personal property after it has come to rest in this state and has become a part of the mass of property in this state.

Joy concedes that the distribution of catalogs to approximately 400,000 Louisiana customers was directly aimed at expanding its Louisiana business and that its 13 stores in Louisiana had over \$100,000,000 in annual sales in such state.

The Louisiana Use Tax statutes provide a credit against such use tax for any sales taxes that have been paid in other States. The germane Louisiana Use Tax statute states that:

"A credit against the use tax imposed by this chapter shall be granted to taxpayers who have paid a similar tax upon the sale or use of the same tangible personal property in another state."

It is conceded that the Louisiana use tax is designed to compensate that state for revenue lost when residents of Louisiana purchase out-of-state goods for use within the state. The Use Tax is equal to the Louisiana sales tax applicable to the same tangible personal purchased in-state.

Assume that Joy has properly exhausted all required administrative and judicial remedies relative to this use tax deficiency assessment against Joy by the State of Louisiana and that Joy has properly perfected an appeal to the Supreme Court of the United States which Court will decide on the merits the validity of the use tax assessment here in issue. Will the Use Tax assessment against Joy be held valid or invalid?