Exam Number ______

UNIVERSITY OF KENTUCKY
COLLEGE OF LAW
STATE AND LOCAL TAX PROFESSOR MOORE
FINAL EXAMINATION FALL 1994
TIME LIMIT: 3 HOURS

INSTRUCTIONS

This examination is closed book. Casebooks, class notes, and other materials may not be used and should not be left near your desk.

The exam consists of 4 questions. The point allocation for each question is as follows:

Question I 95 points
Question II 45 points
Question III 20 points
Question IV 20 points

The number of points allocated to each question indicates how much time you should spend on it.

Write your answers in pen in the blue books. Only write on the front side of each page of the blue book(s). Be sure to put your exam number on this page and the cover of each blue book. At the end of the examination, please number your blue books, e.g., 1 of 2, 2 of 2, and turn in your exam and your blue book(s). These materials should be collected and turned in together inside one blue book. Although you may use scratch paper, I will only consider materials written in the blue books in grading the exam.

All academic endeavors of the students of the University of Kentucky College of Law are governed by the Honor Code. The Honor Code prohibits lying, cheating, stealing, and interference with academic pursuits. In addition, the Honor Code places an affirmative duty to report a breach of the Code on all students. A failure to report is a violation of the Honor Code.

In turning in this exam, I hereby pledge on my honor as a student that I have neither given nor received any unauthorized aid on this exam.

QUESTION ONE

(SUGGESTED TIME: 95 MINUTES)
Rex Chapman has come to you for advice. Rex is a resident of the State of Kentucky and plays basketball for the Washington Bullets. Last year, the Bullets played a total of 82 regular season games. Forty-one of these games were played at the Capitol Center in Landover, Maryland and the other 41 games were played "on the road." Of these 41 away games, the Bullets played in 21 States, including California, Illinois, New York, North Carolina, and Pennsylvania. In addition, the Bullets played another 12 post-season games in North Carolina and Illinois, and trained at the Cap Center for 6 weeks and played several exhibition games before the start of the season.

Currently, the State of Kentucky taxes residents on their income from all sources. Kentucky allows a tax credit for the amount of source-based taxes paid to nonresident jurisdictions if, but only if, the nonresident jurisdiction grants its residents a similar credit.

None of the States in which Rex played basketball last year tax nonresident attorneys, accountants, or engineers on their income earned within the State. Five of these States, California, Illinois, New York, North Carolina, and Pennsylvania, however, tax nonresident athletes on their income earned within the State. These States use one of two methods, the "duty days" method or the "games played" method, to allocate income between the States.

Under the duty days method, used by California, Illinois, North Carolina, and Pennsylvania, income is allocated using a ratio of the number of days an athlete is present in the taxing jurisdiction to the total number of days (including practice and meeting days) that the athlete is required to work.

California and Illinois use one allocation formula which includes the preseason, regular season, and postseason. North Carolina uses two allocation formulae which allocate postseason compensation separately from regular season and preseason compensation, which are combined, while Pennsylvania uses three allocation formulae which allocate preseason compensation separately from regular season compensation, which is allocated separately from postseason compensation.

Under the "games played" method, used by New York, income is allocated based on the ratio of games played in a particular jurisdiction to the total games played. The method takes into account games played in the postseason as well as the regular season and preseason, but does not take into account practice days. New York uses one allocation formula which includes all games, whenever played.

Kentucky uses a "games played" method to calculate the amount of credit a resident athlete may receive for source-based taxes paid to a visiting State, regardless of the allocation method that the visiting state uses to impose its tax. Kentucky uses two separate allocation formulae: one for the preseason and regular season and one for the postseason.

California, Illinois, and New York grant residents tax credits for any income taxes paid to other States. North Carolina grants no tax credits for taxes paid to other States. Pennsylvania allows residents a credit for taxes paid to another State, but only for taxes paid on income derived from sources within that State.

Beanie, Rex's accountant, prepared income tax returns for Rex for the States of Kentucky, California, Illinois, New York, North Carolina, and Pennsylvania. She advised Rex that he would not receive a credit against his Kentucky taxes for any of the taxes paid to North Carolina and would only receive a partial credit for taxes paid to California and Illinois. She also noted that some of Rex's income that was subject to tax in New York was also subject to tax in Pennsylvania and California.
Discuss whether the Kentucky and New York taxing statutes are likely to violate any of the pertinent state and federal constitutional limitations on state and local taxation. Be sure to discuss both the strengths and the weaknesses of any position or issue you address.

QUESTION TWO

(SUGGESTED TIME: 45 MINUTES)

Dana Enterprises ("DE"), which is a corporation formed under the laws of State A, manufactures trucs, a useful, patented product, from raw materials stored in the garage of the residence of DE's sole shareholder, Dana Harvey. Dana, a successful inventor resident in State A, does all the manufacturing work during the weekend in his garage. DE has no other employees nor any other business situs, except for the warehouse described below.

The existing, but growing, market for trucs is currently limited to States A and one adjoining State, State B. No sales have yet been made to customers in any other state; including another adjoining State, State C.

Fast Sales, Inc. ("FSI"), a State B corporation unrelated to DE and Dana, is DE's exclusive selling agent for the trucs. DE does not have any other sales representation. FSI, a manufacturer's representative which has several other manufacturing accounts and is paid on a commission basis for sales made on behalf of its clients, solicits orders for the purchase of trucs from customers in State A and State B. FSI sends its own employees into State A and State B from its office in State B, which is listed in the telephone directory as the sales representative for "trucs", to solicit sales for FSI's account. All orders that are secured are forwarded through FSI to DE for acceptance in State A and delivery of the trucs from DE's leased warehouse in State C.

In the year and one-half that FSI has handled the truc account, FSI has found that it promotes more sales and hence more commissions if it handles the infrequent issues of customer dissatisfaction with their purchases of the trucs. These issues largely arise from the customers' ignorance over the proper operation of the truc and the failure of the customers to maintain the trucs by use of the specialized tools bundled with the trucs by DE at the time of sale. DE has never formally authorized this action by FSI but it is aware of FSI's practice and has done nothing to stop it. DE has also lent to each of FSI's employees at least one truc and one set of specialized tools so that the proper operation of the truc can be demonstrated during the solicitation and the truc-demonstrators can be properly maintained.

Based on the foregoing facts and your general knowledge of State income taxing practices, please state with your reasoning the likely income tax treatment of DE in State A, State B, and State C, assuming that each of these States has adopted provisions like KRS 141.010(12), (13), and (14), and 141.120, and their accompanying regulations. Be sure to include in your answer to this question, without limiting your discussion of any other relevant aspects of the question, a determination of whether DE is subject to tax in each State, a specific description in as much detail as is possible from the recited facts of how much the income from the manufacture and sale of the trucs will be attributed to each State, and a description of how the States that you determine would in fact tax the truc operation would avoid duplicative taxation. Be sure to discuss both the strengths and weaknesses of any position or issue you address.
QUESTION THREE

I. (SUGGESTED TIME: 20 MINUTES)

State A's Tax Code imposes a tax, to be paid by the purchaser and collected by the vendor, upon the sale of transportation for hire by bus companies, where such sales occur within the state. The tax, equal to 4% of the total purchase price, applies to all ticket sales in the State whether the sale involves solely intrastate travel or travel which begins within the State and ends outside the State. The tax is added to the purchase price of the bus ticket, and constitutes a debt from the consumer/user to the vendor until paid. The vendor becomes liable if the vendor fails to collect or remit the tax.

Discuss the constitutionality of the tax. Be sure to discuss both the strengths and the weaknesses of any position or issue you address.

QUESTION FOUR

(SUGGESTED TIME: 20 MINUTES)

As in many other states, local property taxes are by far the most important source of revenue for public schools in Delaware. In recent years, however, property owners in many school districts in the State have balked at increasing their taxes to supply local schools with operating money. In fact, nearly all of the referenda called by school districts over the past several years have failed to pass, usually by large margins.

As a result, the State is being called on to provide more and more funding to make up for what local districts are declining to produce. Legislators, having seen the writing on the wall, recently passed House Concurrent Resolution 54 to create a 21-member School Tax Equity Tax Force to study the problem and find alternative solutions.

A member of this Tax Force has asked you to draft a memorandum discussing the alternatives to funding the public school system with local property taxes. In the memorandum, you should discuss the problems with the current system and how the alternatives do or do not remedy these problems, and point out any problems created by the alternatives.