

A Chat with Pat Derdenger

By Bruce M. Nelson

Continuing the JOURNAL's series of interviews with SALT practitioners, Bruce M. Nelson talks with Pat Derdenger, a partner with Lewis Roca Rothgerber Christie in Phoenix, Arizona tax.



Bruce: I always like to begin by inquiring how someone ended up working in tax, particularly state and local tax (SALT). I mean, when you were eight years old running around in your backyard, I cannot believe you were saying to yourself, “I want to grow up and be an attorney and work in state and local tax.” So, how did that happen?

Pat: Well, I think it's kind of an interesting story. And let me tell it to you. I had no idea when I was eight years old in the backyard digging holes what I was going to be doing for a career.

Bruce: What was your undergraduate major before you went to law school?

Pat: English. Primarily English literature and Shakespeare. I had two minors, one in philosophy and the other in Communication Arts.

Bruce: Well, that's a good combination for an interview.

Pat: You would think. Well, I had no idea when I graduated that I would end up being a lawyer. As an undergraduate, I was in the Air Force Reserve Officers' Training Corp (ROTC). This was 1968, and I graduated as a commissioned officer in the Air Force, where I served for four years.

My first assignment was in Los Angeles, and it was getting my master's in business. The Air Force had a program that until you were assigned active duty, they wanted officers to pursue graduate studies, primarily in business, engineering, and so on. I went into business, got my MBA from USC, and was assigned to Washington, D.C. I did not work in the Pentagon but in the Forrestal Building. I was an intelligence officer handling intelligence that came out of Vietnam. And that's the most I can probably say on the subject.

Bruce: Interesting, but still a long way from SALT.

Pat: Yes, but when my four years with the Air Force were up, I went to law school at the University of Southern California. While there USC had a visiting professor from NYU who taught the first-year introductory federal

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income tax course, and I was enthralled. I enjoyed it. I liked it. I did well. I said, “Hey, I am interested in federal income tax.”

In my third year of law school, my interview process was going quite well. But then a notice from the Department of Justice popped up on the job board, and I signed up for an interview. I really enjoyed talking with the person conducting the interview, and he sold me on signing up for the tax division of the Department of Justice (DOJ) in Washington, D.C.

And so, gradually my practice in SALT grew from not just property tax, but to also include income and sales tax, the traditional three legs of state revenue.

Bruce: So you left sunny Southern California for Washington, D.C.?

Pat: Yes, my wife and I drove all the way from Southern California. It was a road trip with just my wife and me in our car, no kids at the time. But we did have a cocker spaniel. She was in the back-seat of the car. We did not take a direct route. We went up through Yosemite and across the top tier of the United States and to Niagara Falls, New York City, Philadelphia, and down into Washington, D.C.

Bruce: Wow. So what did you do at the DOJ?

Pat: I spent four years at the Department of Justice in the tax division litigating federal tax cases all over the United States. I was in the United States Court of Claims section of the tax division. The Court of Claims is now known as the United States Court of Federal Claims. It was very interesting because it was completely different from any other court in the United States. It had both a trial and an appellate division. The trial division had their trial judges, the appellate division their appellate judges. Appeals would go from the trial division to the appeals panel, and that is where you got your final decision.

It was a good, interesting time, and while there, I attended George Washington University and got my master’s in tax. I took a state and local tax course, from Tom Fields, the founder of Tax Analysts. You know, he

was a great guy, and it was a tremendously interesting course. It was like taking a constitutional law course back in law school—which it was because most of the issues for SALT were constitutional issues involving the Due Process or Commerce Clause. It was something that really stuck with me, and I liked it.

After four years at the DOJ, I ended up at Lewis and Roca in Phoenix. A very good friend had gone there, and he recommended I apply. Anyway, I was a new attorney in their tax group. The firm had a new client who needed help with some property tax issues. Someone at the firm said, “Hey, Pat, I’ve seen that you did some valuation work at the DOJ. Would you be interested in learning property tax and working on this case?” I said, “Absolutely.”

The issue was whether an income approach or cost approach should be used in valuing producing copper mines. The Department was using a cost approach, but we thought an income approach was more appropriate because that’s the approach most often used by buyers and sellers of copper mines. After we won, the Department gave up and issued a regulation that blessed the income approach.

So, with that experience, anyone in Lewis and Roca who had a SALT issue would say, “Hey, ask Pat, he should know the answer.” And so, gradually my practice in SALT grew from not just property tax, but to also include income and sales tax, the traditional three legs of state revenue.

The timing was right. You may recall that under the Reagan administration, a lot of the grant funds and money flowing from the federal government to the states dried up. The states became much more aggressive on tax issues, began to audit more, and my practice just grew from that. I still do federal tax work, but probably 80 percent of my work is SALT work.

Bruce: Well, let’s change gears a little bit. I am curious. Was the *Wayfair* decision a surprise to you? Or did you expect its outcome? [*South Dakota v. Wayfair, Inc.*, 585 US ____ (2018) was a U.S. Supreme Court case in which the Court held that South Dakota’s requirement that out-of-state sellers with more than \$100,000 in annual sales or 200 annual sales transactions must collect and remit the state’s sales tax.]

Pat: I suspected the outcome.

Bruce: Why?

Pat: Because Justice Kennedy, in his concurrence in the Colorado *Direct Marketing Association* case on reporting

requirements, said the time had come to revisit *Quill*. He basically asked the legal community to set up a challenge to *Quill*. And when he said that, I said, “Hey, you know, *Quill* is dead.” Over the years, I have seen the states getting more and more aggressive, and so I suspected that the time was over for *Quill*, that the states would jump on economic nexus and they did, boy oh boy, let me tell you, they did. [*Quill Corp. v. North Dakota*, 504 US 298 (1992) was a U.S. Supreme Court decision in which the Court held that a state could not impose a use tax collection on vendors who had no physical presence in the state. In *Direct Marketing Association v. Brohl*, 575 US ____ (2015) the U.S. Supreme Court held that Colorado’s requirements that out-of-state sellers collect and report selected information on their sales did not violate the Due Process or Commerce Clause.]

Bruce: I shared your suspicions, but one of the things that surprised me was how quickly states followed up with marketplace facilitator statutes.

Pat: Yes.

Bruce: And I did not really see a necessary connection between that and *Wayfair*. So that surprised me. Did that surprise you?

Pat: No, it did not surprise me because I saw it as just an extension of *Wayfair* and economic nexus from remote sellers to marketplace facilitators. In fact, Arizona, years before the *Wayfair* decision, issued a ruling imposing tax collection on marketplace facilitators. So bottom line, no, it did not come as a surprise. I saw it as just part of the continuum of economic nexus.

Bruce: State budgets are just getting hammered by the pandemic. In Colorado, we have about a \$30 billion budget, and they had to cut \$3.6 billion out the budget this year. Do you think the states will start targeting new revenue sources, such as Maryland’s efforts to tax digital advertising?

Pat: Yes, I think so. The COVID pandemic is reminiscent of the late 1980s when the feds cut back their funding to the states. State revenue is declining, and they must fill that void. Sales tax revenue is down, income tax revenue is down, unemployment costs are up, so, yes, I do see states becoming much more aggressive. Now, whether that means more aggressive in the audit sense or being more aggressive in state legislatures enacting new taxes, or both, I don’t know. We’ll see. Yeah, it is crazy. And I do not believe the marketplace facilitator statutes are going to solve state’s

budget shortages. Sure, they will capture the income from smaller retailers, but I suspect it isn’t going to be the goldmine some expect.

So, there will always be a need for tax practitioners. It is an exciting area, especially on the state and local side because we get all types of constitutional issues.

Bruce: I must ask you about an Arizona case. It is a California decision involving a non-resident living in Arizona, *Appeal of Blair Bindley*, OTA Case No. 18032402 (May 30, 2019) (precedential). Bindley contracted with two California businesses to write screenplays. Based upon \$40,000 in income reported on two 1099 forms, the FTB demanded that he file a California return, and the OTA concluded that Bindley, as a sole proprietor, was engaged in a unitary business in California. Any thoughts on that one?

Pat: Wow! *Bindley* is quite an extension of the concept of doing business in a state. The OTA held that the fact that two California businesses issued 1099s to Mr. Bindley was evidence that he was doing business in California. To arrive at the holding it did, the OTA had to find that Bindley was engaged in a unitary business as a sole proprietor and it did, that he was doing business in California and it did based on the form 1099s, and under California’s marketplace sourcing statute, Bindley’s clients received the benefit of the screenplays in California, which it also found. It just strikes me as wrong that a person writing screenplays or whatever in his or her home state for a business located in another state, when the taxpayer has no office, employees or property in the other state, can be tagged for tax in that state. It sure smells of a due process or commerce clause violation. Also, let’s talk about Mr. Bindley’s home state of Arizona. Arizona still uses the costs of performance test for sourcing services and intangibles and under that test, Bindley’s screenwriting income is sourced to Arizona. This is a problem when states are not uniform with their sourcing rules and opens the door to double taxation. Whatever ever happened to UDIPTA?

Bruce: I must apologize, but what is it about Arizona's prime contracting tax on contractors? It seems such a mess. *[Instead of allowing contractors to pay tax on their building materials, Arizona provides that building materials sold to contractors are exempt, the "prime contractor is liable for the prime contracting tax, which is a tax on 65 percent of the prime contractor's gross receipts, and subcontractors are exempt from the contracting sales tax."*]

Pat: It sure is confusing. The legislature has tried to repeal it and replace it by having contractors pay sales tax on construction materials similar to contractors in most states, but no one has come up with an acceptable estimate of the fiscal impact of eliminating what we have, and the governor isn't going to change it without knowing the fiscal impact of the change.

A few years ago, the legislature tried to simplify compliance by allowing contractors performing maintenance, repair, replacement, or alteration (MRRA) work on existing structures to pay sales tax on their building material purchases rather than paying the prime contractor's tax. It was meant to help Mom and Pop contractors like electricians or plumbers, who were doing a lot of work for homeowners, not home builders. And this got them out of the contracting regime.

Bruce: Has it worked?

Pat: Not necessarily. In MRRA, maintenance, repairs, and replacement have been fairly easy to define. The bigger troubles have been with alteration. What is alteration? An alteration is anything that you do to change in some way an existing structure? At what point does alteration cross the line into modifying real property? Am I modifying or altering real property? If modification, then the prime contracting tax regime applies and if it is alternation, the MRRA regime applies. That is where the action is and where I provide a lot of advice to contractors. *[Modification, which is erecting or building something new, is considered to be taxable prime contracting.]*

The problem is determining whether a contractor is subject to the prime contracting tax or falls within the MRRA. Obviously, if you are building a brand-new

building, something that wasn't there before, you will fall under the prime contracting regime. But if you are doing something to a structure that's already there, you need to take a look because you may fall under the MRRA.

But let me tell you, for small contractors, it is as complicated as before because unlike large contractors who have tax expertise in-house, they are often on their own. So, the long and short of it is, we made contracting even more difficult with the addition of the MRRA regime. It is an even bigger problem for out-of-state contractors who do not take the time to look at the Arizona regime before working here. They often simply pay sales tax on their purchases of building materials and only later discover they are in a world of hurt because they should have been paying the contracting tax. Welcome to Arizona.

Bruce: If you were to run into some young person thinking about going into tax, would you recommend the field?

Pat: Yes. There will always be taxes. Governments will always need taxes, whether it is at the federal, state, or local level. So, there will always be a need for tax practitioners.

It is an exciting area, especially on the state and local side because we get all types of constitutional issues. So, you are going into a field that is always going to be there, and the SALT side gives you some nice exciting constitutional issues to boot. Let me leave you with one example.

I have a case going on right now involving property taxes on a large electrical generation plant. The plant is owned by non-Indians but is located on a reservation through a land lease with the local tribe. Here is the question: Does federal law preempt Arizona's ability to impose property tax on that electric generation plant? It has been a very interesting case that has gone on for several years. We are finally at the Court of Appeals, and this is the type of case that could go not only to the Arizona Supreme Court but to the U.S. Supreme Court. That is just one example of the really interesting constitutional issues that you encounter in state and local tax.

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