State Tax DEVELOPMENTS: A National View National Association of State Bar Tax Sections

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Mr. Faber has lectured on state and local taxation at the Georgetown University Institute on State and Local Taxation, the National Institute on State and Local Taxation, the Committee on State Taxation (COST), the Hartman State and Local Tax Forum, the National Tax Association, The NYU Annual Institute on State and Local Taxation, the National Conference of State Tax Judges, the Multistate Tax Commission, and before many other professional groups. He is a member of the Advisory Committees of the Georgetown and NYU Institutes. He is the author of many articles on state and local taxation.

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TABLE OF CONTENTS

PAGE

I. The environment 1

II. Economic substance and business purpose..5

III. Business activity tax nexus...37

IV. Passive investment companies..46

V. Telecommuters...51

VI. Miscellaneous apportionment developments...53

VII. Sales and use tax nexus..71

VIII. Miscellaneous Sales Tax Developments...77

IX. Future trends..82

STATE TAX LITIGATION: A NATIONAL VIEW

I. THE ENVIRONMENT.

A. Causes.

1. Revenue.

a. Most of the states have serious budgetary and cash flow problems.

b. Because raising tax rates is politically difficult, the states have used other means to raise revenue.

(i) Different types of taxes (e.g., gross receipts).

(ii) Expanding the tax base (e.g., eliminating deductions).

(iii) More aggressive audits.

2. General lack of trust of business.

3. Tax shelter anger.

a. Abusive Tax Shelters Pursued by Twenty-Three States, Multistate Tax Commission (June 11, 2007).

b. Peter L. Faber, Planning is not Sheltering: a Practitioner's Response to the MTC, State Tax Notes (Aug. 11, 2003).

c. Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, Multistate Tax Commission (July 15, 2003).

d. Delaware Holding Companies: Glenn R. Simpson, *Popular Corporate Tax Shelter In Delaware Takes Some Heat*, WALL ST. J., June 11, 2003.

4. Increase in inter-governmental information reporting and sharing.

a. FTA-sponsored multilateral agreement: *45 States Have Signed Agreement to Share Data on Abusive Tax Shelters,* Federation of Tax Administrators, FTA Press Release (July 15, 2004), http://www.taxadmin.org/fta/release0304.pdf.

b. Federal-State information sharing: IRS and State Partnership Moves Forward to Improve Compliance and Service, Internal Revenue Service Notice IR-2004-77 (June 7, 2004).

B. Results.

1. Burdensome legislation.

a. New Jersey "alternative minimum assessment."

(i) The New Jersey Corporation Business Tax was amended effective in 2002 to impose a gross profits/gross receipts tax.

(ii) After June 2006, these "gross" taxes apply *only* to businesses protected by Public Law 86-272.

b. Ohio commercial activity tax

(i) Ohio enacted a "Commercial Activity Tax" that, effective July 1, 2005, replaced its income/franchise tax.

(ii) The CAT is similar to the MTC's factor-presence nexus standard; a business will be considered to have "substantial nexus" for purposes of the CAT if it has at least $500,000 in taxable gross receipts (even if it has no property or employees in Ohio).

(iii) The CAT is based on gross receipts and, thus, the protections of P.L. 86-272 are not available to out-of-state businesses performing solicitation activities in Ohio.

c. Michigan – S. B. 94 creates a bright line rule for nexus in Michigan. Out-of-state firms will have nexus if they engage in any of the following activities: have at least one employee in Michigan; own, rent, maintain or have the right to use tangible personal or real property in the state; have employees who own, rent, maintain or use an office within the state, have agents, representatives, independent contractors or others acting on its behalf who own or rent an office within the state that enables the firm to establish and maintain a market in the state; have goods delivered to Michigan in vehicles the firm owns or uses or have goods delivered by third parties; regularly and systematically conduct business activity in the state through employees, agents, independent contractors, or others acting on their behalf irrespective of whether those individuals reside in the state. The law will become effective on January 1, 2008.

d. Tax shelter reporting and registration

(i) California: Chapter 656 (SB 614/AB 1601) - General Information: Registration & Reporting Requirements, http://www.ftb.ca.gov/law/tax_shelter/reporting.html

(ii) Illinois: *Abusive Tax Shelter Disclosure Requirements for Composite Return Filers*, Informational Bulletin FY 2005-17, Illinois Department of Revenue (June 2005).

(iii) New York: Disclosure of Certain Transactions and Related Information Regarding Tax Shelters, N.Y.S. Department of Taxation and Finance, TSB-M-05(2)C, (4)I (June 1, 2005); Supplement to Disclosure of Certain Transactions and Related Information Regarding Tax Shelters, N.Y.S. Department of Taxation and Finance, TSB-M-05(2.1)C, TSB-M-05(4.1)I (July 28, 2005).

(iv) MTC: Proposed Draft Model Uniform Statute on Reportable Transactions and Inconsistent Filing Positions, Multistate Tax Commission (Adopted September 7, 2006).

2. More comprehensive audits.

   a. IDRs are exploding

   b. Interviews are getting common, sometimes under oath and on the record

   c. Personal assessments against officers.

   d. North Carolina Secretary Decision No. 2004-232, released October 28, 2005. The North Carolina Department of Revenue is authorized to audit and assess taxes multiple times for the same years against the same taxpayer, provided the statute of limitations has not expired.

   e. N.H. Laws 2005, Ch. 177 (effective July 1, 2005), gives the New Hampshire Revenue Commissioner the authority to disallow any sham transaction in determining any taxpayer's tax liability. Moreover, in administering any tax, the commissioner may apply the doctrines of economic reality, substance over form, and step transaction.

3. Settlements easier early, more difficult later.

   a. A need for cash

   b. More invested in controversy

4. Litigation more formal and adversarial.

   a. Discovery becoming more comprehensive

   b. Evidentiary rules being tightened

   c. Subpoena abuse growing

   d. Fraud threats being used

5. Lobbying more focused on economic development.

   a. Policy less important

   b. Horizontal equity less important

C. Implications.

1. More thorough decision-making regarding tax return positions is necessary

2. Must consider adversarial/litigation possibilities earlier in the process

3. Stand-alone tax planning requires close, comprehensive scrutiny

4. Early disclosure of uncertain tax positions may be required.

   a. The Internal Revenue Service has announced that SEC-reporting corporations will be required to disclose uncertain tax positions, including a revenue estimate of their significance, when filing their income tax returns (although the taxpayer's estimate of the chances of success will not have to be disclosed). Announcement 2010-9 (January 26, 2010).

   b. It is likely that states will adopt similar requirements.

5. Operational and M&A planning must consider SALT issues

6. Other planning must be done in context of entire enterprise's operations and plans

7. Effect of tax accruals on financial statements must be considered.

8. Privilege issues.

   a. Be sensitive to privilege considerations during audits. A privilege cannot be asserted after the information or document has been given to the auditors.

   b. Having lawyers retain the accountants and other consultants to try to bring them within the attorney-client privilege works only if the retention is intended to help the lawyers give legal advice. In many cases the technique will not work.

   c. The work-product doctrine may be more useful than the attorney-client privilege.

      (i) It is not waived when information is given to the company's accountants.

      (ii) A divided United States Court of Appeals for the First Circuit held that the privilege did not apply to tax accrual work papers in *U.S. v. Textron Inc.*, 577 F.3d 21 (1st. Cir. 2009). The court said that the papers would have been

prepared even if no litigation were contemplated and would not have been used in conducting litigation. On the other hand, they reflect the taxpayer's assessment of the case and could be used by the taxpayer in evaluating settlement. A more taxpayer-friendly view was taken by the D.C. Circuit in *U.S. v. Deloitte,* ____ F.3d ___ (D.C. Cir. 2010).

II. ECONOMIC SUBSTANCE AND BUSINESS PURPOSE.

A. Introduction.

1. The cases and rulings fail to define "economic substance" and do not clearly delineate the relationship of the economic substance doctrine and the business purpose doctrine.

2. Much of the confusion has resulted because the courts have been confronted with situations that they felt involved abusive tax shelters. They have applied the "smell test" and have often used somewhat loose language.

B. Federal cases.

1. *Gregory v. Helvering,* 293 U.S. 465 (1935), *aff'g,* 69 F. 2d 809 (2d Cir. 1934).

a. Mrs. Gregory had Newco formed as a subsidiary of Corporation, of which she was the 100% owner. It was capitalized with the stock of Investment, which was a subsidiary of Corporation. The Newco stock was distributed to Mrs. Gregory and Newco made a liquidating distribution of the Investment stock to Mrs. Gregory. Mrs. Gregory sold the Investment stock for a substantial gain, hoping to avoid the dividend treatment that would have resulted from a distribution of Investment stock by Corporation.

b. The contribution of the Investment stock to Newco complied with the literal language of the reorganization provisions of the tax law.

c. Court's opinion:

(i) "[T]he question for determination is whether what was done, apart from tax motive was the thing which the statute intended."

(ii) The reorganization was "a mere device which put on the form of a corporate reorganization as a disquise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business... No doubt, a new and valid corporation was created. But that corporation was nothing more than a

contrivance." "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

d. This case has been interpreted as introducing:

(i) The Sham Transaction Doctrine in which a transaction must be evaluated for economic substance and business purpose.

e. Federal and state courts have reached divergent results on whether economic substance and business purpose are conjunctive or disjunctive factors.

(i) The Substance Versus Form Doctrine in which economic substance and business purpose are evidence considered along with other factors.

2. Other federal cases applying or interpreting *Gregory*.

a. *Chisholm v. Comm'r,* 79 F.2d 14 (2d Cir. 1935). Interpreted *Gregory* as applying the substance versus form doctrine, in which business purpose was not a separate factor from economic substance but one that was evidence of whether the substance should be respected.

(i) "The question always is whether the transaction under scrutiny is in fact what it appears to be in form."

(ii) "[T]he purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not whole, transaction would realize."

b. *Bass v. Comm'r,* 45 B.T.A. 1117, *vacated*, 129 F.2d 300 (1st Cir. 1942).

(i) A recapitalization of common stock in exchange for common and preferred stock was determined by the Board of Tax Appeals to be in substance a stock dividend.

(ii) The Board found the transaction to lack substance based on the absence of a business purpose for the recapitalization.

c. *Lea v. Comm'r*, 96 F.2d 55 (2d Cir. 1938). Business purpose was viewed as an independent factor in a disjunctive consideration of substance and business purpose.

(i) Patents from two related companies were transferred to a new intangible holding company which was to be sold. Because the buyer worried that the inventor might hold some rights to the patents and depreciation would be

limited to historic basis if the rights to the patents were transferred by sale of the company, the company was liquidated and the patents were distributed to the shareholders.

(ii) The court respected the reorganization transaction despite the transitory nature of the holding company because it had been formed for a legitimate business purpose and was intended to exist indefinitely.

d. *Wellhouse v. Comm'r*, 3 T.C. 363 (1944).

(i) A recapitalization was not respected as a reorganization in part because it lacked a business purpose. Enabling shareholders to pay off their debts was not "germane to the conduct of the venture."

(ii) "Under the well crystallized doctrine of *Gregory v. Helvering*, … there must be a corporate business purpose in the transaction."

e. *Goldstein v. Comm'r,* 364 F.2d 734 (2d Cir. 1966). The court accepted the position of the IRS, often relied on by the IRS in other cases, that a transaction motivated mostly by tax purposes or providing little expectation of economic profit was necessarily without a business purpose.

(i) The taxpayer used borrowed funds to purchase securities with a yield lower than the interest rate on the borrowed funds in order to secure interest deductions to offset income from a sweepstakes that the taxpayer won.

(ii) The transactions "can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.'

f. *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978).

(i) "Where . . . there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."

(ii) This case is one of the federal cases most cited by state courts in addressing economic substance and business purpose in the context of the sham transaction doctrine.

g. *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89 (4th Cir. 1985).

(i) "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."

(ii) This case applies a disjunctive test in which economic substance is viewed as the objective prong and business purpose is viewed as the subjective prong.

h. *IES Industries Inc. v. Comm'r*, 253 F.3d 350 (8th Cir. 2001).

(i) IES purchased American Depository Receipts ("ADRs") *cum dividend* and sold them *ex dividend* realizing a loss. The dividends were subject to withholding tax. The entire transaction, net of foreign taxes, generated a loss until foreign tax credits were applied in the United States, resulting in a small gain.

(ii) The Eighth Circuit held that the transaction had economic substance and business purpose, noting that a transaction need not have excessive risk to be respected.

(iii) The court stated that under the law IES was deemed to have realized as income the full amount of the dividend despite having received only the post-tax amount, and thus the transaction was profitable, and motivated by profit. This economic benefit was determinative of whether the transaction had economic substance.

(iv) Where economic substance exists, the court determined, a subjective intent to avoid taxes would not cause the transaction to be disregarded because a taxpayer has the legal right to decrease the amount of its taxes.

(v) The same result was reached by the 5th Circuit in *Compaq Computer Corporation v. Commissioner,* 277 F.3d 778 (5th Cir. 2001), on similar facts.

i. *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), rev'g and remanding, T.C. Memo 1999-268 (1999).

(i) UPS collected fees from customers desiring to be reimbursed for damages to packages exceeding $100 ("excess value" fees). UPS paid the fees to an insurance company (National Union), which reinsured the risk to a Bermuda company (OPL) commonly owned by UPS' shareholders.

(ii) UPS put forth a number of purported business reasons for the restructuring of the fees, including that without such restructuring the payments would run afoul of restrictions under certain state insurance laws, that it intended to leverage the profits into the creation of a new reinsurer that could become a full-line insurer, and that by restructuring the fees it protected its transportation business from the risk of increased liabilities.

(iii) Economic substance analysis.

(a) Subjective economic substance:

(1) "A business purpose does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business." The Court distinguished cases involving transactions that would not have occurred in any form but for tax considerations.

(2) A transaction need not be free from tax considerations, as long as it facilitates genuine profit-seeking business activities.

(3) A taxpayer is free to choose an organizational structure that is tax-efficient. If it does not do so initially, it can convert to one later on. If it does so, the new structure will be respected if it has economic reality and is intended to carry out genuine business operations. This principle will be helpful in defending intangible holding company structures.

(b) Objective economic substance:

(1) "The kind of 'economic effects' required to entitle a transaction to respect in taxation includes the creation of genuine obligations enforceable by an unrelated party."

j. *Shell Petroleum Inc. v. U.S.*, 2008 U.S. LEXIS 51180; 2008-2 U.S. Tax Cas. (CCH) P50,422; 102 A.F.T.R.2d (RIA) 5085 (U.S. Dist. Ct., S.D., Texas 2008).

(i) Shell entered into a complex transaction involving the transfer of property to a subsidiary in exchange for auction-rate preferred stock.

(ii) Although the transaction was initiated by the company's tax department to save taxes, the tax people concealed this from the company's management. When the plan was presented to management, only non-tax business purposes were mentioned.

(iii) In finding for the taxpayer, the court said that a corporation's purpose for taking any action is the purpose of the corporation's decision-makers. The people who made the decision for the corporation to enter into the transaction were ignorant of the tax considerations and their intent, and not that of the tax people, was imputed to the corporation.

C. State cases addressing economic substance.

1. Cases addressing whether to ignore a transaction and deny a deduction.

a. *Syms Corp. v. Comm'r of Revenue*, 436 Mass. 505 (2002).

(i) Syms is a New Jersey corporation engaged in "off-price" retailing that operates two stores in Massachusetts. SYL was incorporated in Delaware as a trademark holding company to hold the Syms marks. Syms made an annual royalty payment to SYL. SYL held the royalty payment for a few weeks in Delaware and returned the payments to Syms as a tax-free dividend.

(ii) Syms appealed the Commissioner's disallowance of deductions against corporate excise tax for royalty payments made to SYL. The Massachusetts Supreme Judicial Court held that the creation of SYL was a sham transaction that had no economic substance or business purposes other than tax avoidance. Thus, the transfer and leaseback of the marks were disregarded and the royalty payments were not deductible. In this determination, the SJC relied on the Appellate Tax Board's finding "that the transfer and license back transaction had no practical economic effect on Syms other than the creation of tax benefits, and that tax avoidance was the clear motivating factor and its only business purpose." The Court noted that royalties were "paid" before the holding company was formed.

(iii) The Court also held that the royalty payments to SYL were not "ordinary and necessary" business expenses and could not be deducted from income.

(iv) The Court noted that the value of the marks had been created entirely by Syms, and, even after their transfer and the payment of royalties, Syms continued to pay the expenses associated with owning the marks, including the legal expenses incurred in maintaining them. Given these facts, the Court concluded that the formation of SYL and the payment of royalties for the use of the marks were unnecessary.

b. *Sherwin-Williams Company v. Commissioner of Revenue*, 438 Mass. 71 (2002).

(i) The Court held that an intangible holding company should be respected, reversing the Appellate Tax Board. The parent was allowed to deduct the royalties.

(ii) The holding company arrangement had economic substance in that it changed the economic relationships among the parties. Royalties were retained by the holding company and invested and were not immediately repaid to the parent, as was the case in *Syms*.

(iii) The Supreme Judicial Court held that a legitimate reorganization of an ongoing business that affected economic relationships would be respected, even if it was tax motivated, citing *United Parcel Service v. Commissioners, supra*.

(iv) Under Massachusetts' application of the sham transaction doctrine, "the taxpayer must demonstrate that the reorganization results in 'a viable business entity,' that is one which is 'formed for a substantial business purpose or actually engage[s] in substantive business activity.'"

c. *Cambridge Brands, Inc. v. Commissioner of Revenue,* Appellate Tax Board, MA, No. C259013 (July 16, 2003).

(i) The Appellate Tax Board ("Board") held that the Tax Commissioner improperly denied Cambridge Brands, Inc.'s ("CBI") deductions for royalty payments made by CBI to a related entity. In doing so, the Board held that the royalty fees were deductible as ordinary and necessary business expenses.

(ii) CBI was a wholly-owned subsidiary of Tootsie Roll Industries, Inc. ("TRI"). CBI operated solely as the

manufacturer of the Cambridge Brands of candy, and it employed about two hundred manufacturing employees. CBI's staff consisted of manufacturing personnel at a factory in Cambridge ("Cambridge Factory"); there were no brand managers or any other employees who performed marketing, advertising, or promotional tasks. No management activities were performed at the Cambridge Factory.

(iii) TRI had adopted an acquisition strategy under which it managed its trademarks and other intangible assets relating to products manufactured by TRI and its subsidiaries on a centralized basis. The same marketing staff who performed planning for the other brands owned by TRI and its subsidiaries designed and implemented marketing plans for the Cambridge Brands. This same marketing staff was also responsible for preparing sales forecasts that determined the production schedules for the Cambridge Factory, marketing the Cambridge Brands, establishing wholesale list prices for the brands, and performing other similar management activities.

(iv) The license agreement for CBI's use of the Cambridge Brands trademarks and formulas originally entered into between CBI and TRI provided for CBI to pay TRI a license fee equal to 10 percent of "sales," subject to a minimum annual payment of $4.5 million. An independent appraisal report indicated that a reasonable, arm's length royalty rate would range from 9 to 11 percent of the wholesale list price for the Cambridge Brands products. The royalties at issue amounted to approximately $6 million for each of the years at issue.

(v) The royalties were the only costs that CBI incurred for the use of the Cambridge Brands. Financial statements for CBI, prepared from its general ledgers maintained in the regular course of business, demonstrated that even after accounting for the royalty payments it made, CBI was very profitable, earning about a 24 to 27 percent annual return on its assets. That CBI was profitable despite the royalty payments was an important factor to the Board.

(vi) According to the Board, a significant factual distinction between the facts of this case and those of *Syms v. Comm'r of Revenue,* 436 Mass. 505, 765 N.E.2d 758 (2002) is that the trademarks at issue were never owned by the entity that was leasing them. This was because the trademarks were separately allocated at the time of TRI's purchase of the

Cambridge Brands and CBI's purchase of the Cambridge Factory.

(vii) In *Syms*, the subsidiary did not do business other than to act as a conduit for the circular flow of royalty money. The parent continued to pay all of the expenses of maintaining and defending the trademarks it had transferred to the subsidiary. In the licensing arrangement at issue, however, there was no circularity of payments between entities. There was no mismatch of expenses where one entity paid licensing fees to an entity while still paying all of the expenses of maintaining the trademarks, no payment of dividends with the funds that had been previously paid as royalty expenses, and no other evidence suggesting that tax avoidance was the only, or even primary, consideration for the transaction.

(viii) According to the Board, for a business reorganization that results in tax advantages to be respected for taxing purposes, the taxpayer must demonstrate that the reorganization results in "a viable business entity." The Board defined a viable business entity as one that is formed for a substantial business purpose or actually engages in substantive business activity.

(ix) The Board found that a valid business purpose justified the payment of the license fee because the use of the Cambridge Brands enabled CBI to sell its products at a higher price than if it had not had the benefit of using those trademarks. The payment of the license fee, therefore, was "ordinary" because it enabled the business to turn a profit, and it was also "necessary" because the use of the trademarks was not only helpful but essential to CBI in the realization of its high profit margin.

d. *TJX Companies v. Commissioner of Revenue*, Mass. App. Tax Bd. No. C262229-31 (2007).

(i) The Massachusetts Appellate Tax Board held that TJX, a corporation with its principal place of business in Massachusetts, could not take deductions for royalties that it paid to its subsidiaries in Nevada and interest payments made to those same subsidiaries. In making its determination, the court relied on the principles set forth in *Sherwin-Williams* and *Syms*.

(ii) TJX incorporated subsidiaries in Nevada, and placed its trademarks into these subsidiaries. TJX then paid royalties to the subsidiaries for the use of the trademarks. These

royalty payments were either lent back to TJX at favorable rates or invested in short term investments at the direction of TJX. TJX attempted to take deductions in Massachusetts for the royalty payments and the interest payments on the loans.

(iii) The Board found that the royalty expenses were not deductible under the sham transaction analysis. In making this determination, the board relied on Sherwin-Williams and Syms for the proposition that a transaction is a sham if it lacked any other practical economic benefits besides tax benefits. The Board went on to state that this structure was a sham for the following reasons: (1) TJX retained the benefits and burdens of owning the marks; (2) the subsidiaries licensed the marks only to TJX and not to any third parties; (3) the royalty payments were controlled by TJX either by way of the loan proceeds or by way of control over the subsidiaries' investments; and (4) TJX was still in charge of maintaining, managing, and defending the marks.

(iv) The Board went on to state that the management of the marks by the subsidiaries lacked economic effect. It stated that the purported business purposes of insulating the marks from creditors and more efficient management of the marks were not present in the facts of the case.

(v) With regard to the loan interest deductions, the Board stated that the loans were closer to equity than debt. The Board came to this conclusion based on its determination that the loans were not made at arm's length and an independent third party would not have entered into such loans. The Board noted that: (1) TJX was never under any obligation to repay the principal because the loans were refinanced when they came due; (2) the loans lacked customary inclusions such as default provisions, amortization schedules, collateral, and other security mechanisms; (3) loan formalities were not kept; and (4) TJX borrowed from its subsidiaries at below market rates.

e. *Fleet Funding v. Commissioner*, C271862-63 (February 21, 2008).

(i) The Massachusetts Appellate Tax Board considered denial of the dividends-paid deduction for two real estate investment trusts ("REITs") and the assessment of the financial institutions excise tax against these entities. Parent banks transferred real estate loans to two Massachusetts REITs, which received interest income solely from these transferred loans and paid out

"substantially all" of this income in the form of dividends to two Rhode Island passive investment companies ("PICs") in order to qualify for the dividends-paid deduction. These Rhode Island PICs, which were exempt from state tax on the dividends under Rhode Island law, in turn paid out the dividends they received to the parent banks, which qualified for a 95% dividends received deduction under Massachusetts law.

(ii) The Board, in applying the sham transaction doctrine as developed in the *Sherwin-Williams* and *Syms* cases, considered the business purposes and economic substance of the REITs and the PICs. The Board found that the stated purpose of the REITs, to raise financing, not to be supported by the evidence. Communications about the establishment of the REITs focused on tax minimization and no evidence was presented as to a business purpose for interposing the PICs between the REITs and the parent banks. Further, the Board found no economic substance because they were not viable entities- they had no employees, had no transactions with third parties, had expenses that were minimal when compared to income, and did not benefit from the income they received, as substantially all of it was paid out. The dividend payments to the PICs, which were characterized as conduits for the return of income to the parents, were determined to be sham transactions and thus denial of the dividends paid deduction was appropriate.

f. *SLI Int'l Corp. v. Crystal*, 236 Conn 156 (1996).

(i) Commissions paid to a sister corporation (an FSC) were respected because the expenses were incurred for a legitimate business purpose and were not a mere device for the payment of a dividend to the corporations' common parent.

(a) The taxpayer entered into the marketing contract to pay the FSC commissions on sales of goods to buyers outside of the United States. Under federal law, FSC only paid U.S. tax on 8/23 of its "foreign source income" and was not subject to tax in Connecticut and the subsequent payment of dividends from FSC to the parent was not subject to Connecticut tax or federal tax.

(ii) The Commissioner disallowed a portion of the commission deduction as an "expense related to the payment of a

dividend" and argued that FSC was an arrangement to avoid Connecticut tax on export income.

(iii) The Connecticut Supreme Court ruled that the taxpayer was entitled to deduct the entire commission expense paid because the arrangement had a legitimate business purpose and had an actual economic effect.

(iv) The court found that FSC was a legitimate business entity because it: (a) received income from sources other than the taxpayer, (b) had a permanent place of business in the Virgin Islands, and (c) maintained its business records and paid its expenses.

(v) The Connecticut test looks to whether "the companies are motivated by business purposes other then tax avoidance or are principally motivated by tax avoidance purposes," and "the separate businesses of the companies have economic substance because a reasonable possibility of obtaining a profits exists, apart from achieving tax benefits."

(vi) Considerations include whether:

(a) The related person has an identifiable place of business with supporting business records;

(b) the related person maintains books and related accounting records;

(c) The related person has a staff of employees or engaged contractors adequate in number and with sufficient expertise to conduct its business affairs;

(d) The company so controls and dominates the finances, policies, and business activities of the related person that the related person has virtually no separate existence;

(e) The form employed for doing business is a sham; and

(f) The separate businesses have economic substance because a reasonable possibility of obtaining a profit exists, apart from achieving tax benefits

(vii) *Carpenter Technology Corp. v. Department of Revenue Services*, 772 A.2d 593 (Conn. 2001).

g. The Connecticut Supreme Court allowed the deduction of interest payments on an intercompany loan, holding that the creation of the subsidiary had a valid business purpose and economic substance. The court did not pay much attention, however, to the transaction,

a capital contribution by the parent to the new subsidiary and an immediate loan back to the parent, creating an interest-payment obligation for the parent.

(i) The Connecticut Supreme Court adopted the lower court's holding that the subsidiary had economic substance because it was viable and functioning and was capitalized with sufficient assets to enable it to withstand the claims of potential creditors. Both courts also found that it was unreasonable for the Commissioner to exercise his statutory discretion to adjust income because the arrangement did not result in distortion of income.

h. *In the Matter of Carpenter Technology Corp. v. Commissioner of Taxation and Finance*, 745 NYS2d 86 (App. Div. 3d Dep't 2002).

(i) For corporation franchise tax purposes, the Division of Taxation properly disallowed a parent corporation's interest expense deduction as having been directly attributable to subsidiary capital.

(ii) The parent formed a subsidiary to own foreign (non-U.S.) entities in order to protect its domestic business assets from liabilities relating to conducting business in foreign countries. To achieve its goal, the parent contributed $300 million to the subsidiary and, in turn, the subsidiary lent this amount back to the parent and received a promissory note in exchange.

(iii) It was found that the only reasonable explanation for this exchange of assets was that the parent sought a double tax benefit, i.e., it would gain tax-exempt income from the subsidiary under Tax Law section 208(9), which provides that entire net income does not include income or gain from subsidiary capital, while it could obtain a deduction for the interest payments made to the subsidiary on borrowing back the funds used to capitalize the subsidiary. This was precisely the purpose of denying the deduction of interest attributable to subsidiary capital.

(iv) While capitalizing the subsidiary with sufficient assets to provide it with the economic substance necessary to "protect Carpenter's business assets from liabilities related to conducting business in foreign countries" was a legitimate business purpose for forming and funding the subsidiary, that alone did not negate the Division's determination that the interest payments were expenses attributable to subsidiary capital.

(v) Both the Tax Appeals Tribunal and Appellate Division quoted *Matter of F.W. Woolworth Co. v. State Tax Commn.*, 126 AD2d 876 (App. Div. 3d Dep't 1987), *affd,* 71 NY2d 907 (N.Y. 1988), stating that "it is not alone sufficient to defeat disallowance of the interest deduction that the incurrence of the indebtedness can be directly attributed to a separate, bona fide business purpose."

i. *Homel Foods Corp. v. Wis. Dep't of Rev.*, Docket No. 07-1-17 (Wis. Tax App. Comm., 2010).

(i) Royalties paid to an intangible holding company were held not deductible. Although royalty rate met arms-length standards, tax savings was the primary purpose of the arrangement.

(ii) The Commission said that saving taxes was a legitimate purpose for a transaction but it could not be the transaction's primary purpose.

j. *Appeal of Bender Machine, Inc.*, California State Board of Equalization, 92-SBE-004, April 23, 1992.

(i) The SBE affirmed the Franchise Tax Board's disallowance of depreciation deductions for computer equipment purchased through sale and leaseback transactions. The SBE found the "computer purchase and leaseback transactions had no economic substance because there was no reasonable possibility of making a profit," without the tax benefits.

(ii) "In the sale and leaseback context, it appears the standard established by the U. S. Tax Court is that: (1) the nonuser recipient of tax benefits must establish that entry into the transaction was motivated by a business purpose apart from the tax benefits, and (2) the transaction must be supported by economic substance. *(Rice's Toyota World, Inc. v. Commissioner, supra,* 81 T.C. at 201-203 .) However, even if a business purpose is present, the transaction is not entitled to recognition for federal tax purposes where objective indicia of economic substance indicating a realistic potential for economic profit are not manifested. (*Cherin v. Commissioner,* 89 T.C. 986 (1987)."

k. *Indiana Department of Revenue, Letter of Findings No.* 02-0026 (Jan. 1, 2003).

(i) An out-of-state taxpayer in the business of providing computer services formed a Delaware holding company in order to hold certain items of the taxpayer's intellectual

property. Thereafter, the taxpayer transferred ownership of the intellectual property to the holding company in exchange for a 100% ownership interest in the holding company.

(ii) The Letter of Findings determined that the taxpayer could not calculate royalty payments made the holding company as expenses for purposes of Indiana adjusted gross income tax because the taxpayer failed to demonstrate that its transfer of intellectual property to the holding company and later royalty payments were supported by any business purpose other than tax avoidance.

(iii) For purposes of the Indiana adjusted gross income tax, no legitimate business purpose was found for the transfer of the intellectual property and the royalty payments were simply arbitrary shifts of income lacking any economic substance.

(iv) The holding company itself had no assets and did nothing to earn the royalty payments and the taxpayer, as owner, retained the right to control the ultimate disposition of the intellectual property.

(v) Consequently, the royalty and interest deductions were not allowed.

l. *Indiana Department of Revenue, Supplemental Letter of Findings No. 01-0063* (Feb. 1, 2003).

(i) The issue addressed was a taxpayer appeal of an auditor's disallowance of a deduction for royalties paid to an affiliate. The taxpayer paid its Delaware affiliate intangible holding company a royalty fee for the use of various corporate logos.

(ii) The common parent formed the Delaware holding company and transferred intellectual property to it. The Delaware company then licensed to the intangibles to the taxpayer and entered 16 other licensing transactions with affiliates, all at rates based on appraisals, which were unchallenged.

(iii) The auditor disallowed the royalty deduction based on the sham transaction doctrine because the owner of the logos was completely controlled by the licensee.

(iv) This ruling clarified the Commissioner's determination in the original Letter of Findings, LOF 01-0063, in which the deductions were disallowed. Despite the arm's length rates charged the Commissioner disallowed the royalty

deductions under the sham transaction doctrine on the basis that little evidence was presented as to services performed by or economic substance of the Delaware holding company, other than "holding" the intellectual property, and that there was no business purpose for the transfer of the property to the Delaware company other than tax benefits.

(v) In disallowing the deductions under IC 6-3-2-2-1(1) as producing an income figure that does not fairly represent Indiana income, the Commissioner stated that "'[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit' but are devoid of any economic substance." Quoting *Horn v. Commissioner of Internal Revenue,* 968 F.2d 1229 (D.C. Cir. 1992).

(vi) The ruling differentiated this case from Letter of Findings 01-0094 (June 1, 2002), in which the transactions between two affiliates were respected because of the economic substance each possessed.

(vii) Applying a similar analysis, the Indiana Department of Revenue upheld the Commissioner's forced combination of affiliates' income in Letter of Findings No. 02-0304 (May 1, 2003) and Letter of Findings No. 00-0379 (Feb. 1, 2004), and upheld consolidation of an intangible holding company with affiliates in Letter of Findings No. 02-20030112 (Jan. 1, 2006).

m. *Jan T. and Marsha M. Baisch v. Department of Revenue*, 316 Or. 203, 850 P.2d 1109 (1993).

(i) Four separate properties were sold to separate individuals and then leased back to the seller at favorable terms, including the right to purchase back the properties at prices roughly the same as the amount due under the respective mortgages, rather than at market rates. Rents were below market rates and structured to yield returns as required by the investors. The stores were then packaged and eventually sold with the wrap-lease to a limited partnership.

(ii) Loss, depreciation, and interest deductions claimed by limited partners who invested in the partnership's purchase and leaseback transaction were disallowed because the transaction had no business purpose other than tax avoidance. Among other facts, the Court noted the fact that only individuals whose income was subject to a joint

federal and state tax rate of 49% were allowed to participate.

(iii) The Oregon Supreme Court discussed federal cases and chose to analyze the transactions, as per Frank Lyon, under the two-part sham transaction doctrine.

(iv) Addressing the standard it used in evaluating business purpose, the Oregon Supreme Court stated "Federal courts scrutinizing business purpose have considered the investor's testimony regarding motive, the extent to which the investor had sufficient experience with the particular type of transaction to assess the tax-independent value of the transaction, the extent to which the investor directly investigated or sought expert advice as to the tax-independent value of the investment, the extent to which investment literature stresses tax-independent value, and the extent to which an inflated purchase price financed by nonrecourse debt suggests an intent to abandon the transaction after the tax benefits have been realized." (citations omitted).

(v) The Court also reviewed the transactions for economic substance, evaluating "whether, objectively, there was any reasonable possibility of profit from the transaction other than its tax benefits," and found that there was not.

(vi) But see *Lawrence H. and Linore L. Allison v. Department of Revenue*, 11 OTR 431 (Ore. Tax Ct. 1990) (similar sale and leaseback transaction involving the same main individuals was held not to be a sham or illegal transaction and thus the business purpose doctrine did not apply).

2. Cases ignoring the separate existence of a corporation.

a. *General Mills, Inc. v. Commissioner of Revenue*, 440 Mass. 154 (2003).

(i) Among other transactions at issue, Talbots formed an intangible holding company, Tal HC, to which it transferred certain intangible assets and shortly thereafter Tal HC sold these intangibles. On audit Talbots argued that the creation of the subsidiary and series of transfers were undertaken to "obtain certain advantages in the international market and advantages under certain international accounting practices."

(ii) The Supreme Judicial Court applying the step transaction doctrine stated that "the substance of each of a series of steps will be recognized and the step transaction doctrine

will not apply, if each step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes."

(iii) The Court also stated that "[t]he intermediate transaction served no legitimate business purpose and was designed solely to avoid Massachusetts tax," and thus it was irrelevant that the end result may have had a business purpose, because "Tal HC was merely a conduit through which the legitimate transactional route passed, and its involvement was properly compressed into a single sale of the Talbots intangibles."

b. *Rulings of the Tax Commissioner*, PD 95-229, 1995 WL 624375 (Va. Dept. Tax Sept. 6, 1995).

(i) Taxpayer, incorporated outside Virginia, produces and sells computer software within and without Virginia. Several taxpayer executives are physically located at the taxpayer's Virginia headquarters.

(ii) In 1990, taxpayer transferred all its software to a newly formed Delaware subsidiary (S1) in exchange for all of S1's stock. Subsequently, S1 licensed the software to taxpayer in return for royalties based upon a percentage of taxpayer's sales. S1 did not license the software to any third parties, and all the royalty income S1 received was from taxpayer. S1 made significant loans to taxpayer that nearly equaled S1's total income. Most of the interest income S1 earned in a given year was attributable to interest earned on the loans to taxpayer. All S1's officers and directors were taxpayer employees, and several worked at taxpayer's Virginia headquarters.

(iii) Taxpayer formed another Delaware subsidiary (S2) to hold cash and various investments which were primarily loans to, or investments in, related parties. S2 earns interest income and dividends. All the interest income S2 earned came from loans made to taxpayer. All S2's officers and directors were taxpayer employees located at taxpayer's Virginia headquarters.

(iv) The Commissioner found that taxpayer could undo the transaction with S1 at any time. S1 was a wholly-owned subsidiary of taxpayer; as such, taxpayer never lost its ability to control the subject assets, the rates or terms of the royalty agreement, or the unrestricted use of the assets.

(v) S2 received 100% of its interest income from taxpayer. S2 essentially loaned its earnings back to taxpayer. Consequently, there was "little merit to the business purposes cited for the arrangement." Instead, the Commissioner found that the arrangement merely shifted income to S2 and then returned it to taxpayer as a loan.

(vi) The Commissioner concluded that S1 and S2 were shell companies. Taxpayer controlled and managed S1 and S2 from taxpayer's facilities in Virginia. Most S1 and S2 officers and directors were physically present at taxpayer's Virginia headquarters, with the remnant involved in taxpayer's operations carried on in Virginia and elsewhere. The S1 and S2 directors and officers acted on an "as needed basis," leading the Commissioner to render irrelevant that the directors and officers traveled to Delaware each time they had to act.

(vii) Consequently, the Tax Commissioner affirmed the Tax Department auditor's finding that S1 and S2 lacked economic substance. As a result, the auditor appropriately consolidated S1's and S2's taxable income and properly apportioned the consolidated total to Virginia.

(viii) The Commissioner reached similar results in P.D. 06-52 (Va. Dept. Tax Apr. 28, 2006), P.D. 03-73 (Va. Dept. Tax Oct. 15, 2003), P.D. 96-393 (Va. Dept. Tax Dec. 30, 1996), P.D. 96-310 (Va. Dept. Tax Oct. 31, 1996), and P.D. 94-179 (Va. Dept. Tax June 8, 1994). The Commissioner overturned consolidation in P.D. 96-366 (Va. Dept. Tax Dec. 10, 1996). A similar review of economic substance was used to uphold denial of deduction for royalty payments in P.D. 05029 (Va. Dept. Tax Mar. 2, 2005) and overturn a similar adjustment in P.D. 96-322 (Va. Dept. Tax Nov. 6, 1996).

c. *TD Banknorth, N.A. v. Department of Taxes* 2008 Vt. 120, 967 A.2d 1148 (2008).

(i) Taxpayer was the sole shareholder of three Vermont banks. It established a holding company for each bank and transferred the bank's income-producing assets to the holding company. The taxpayer conceded that the structure was designed to avoid taxes.

(ii) The court held that the holding companies lacked economic substance. They had no separate property, tangible assets, or employees. Their formation lacked a non-tax business

purpose. It ignored them and held that their income was taxable directly to the banks.

d. HMN Financial, Inc. v. Commissioner of Revenue, ___ Mn. ___, 782 N.W. 2d 558 (2010).

(i) The taxpayer established a real estate investment trust (REIT) structure for the purpose of converting taxable interest income on a book of mortgage loans into tax-free dividends. The REIT was a "captive" that was controlled by the taxpayer. The structure met Internal Revenue Code and other statutory requirements.

(ii) The Minnesota Supreme Court, reversing the Minnesota Tax Court, held that the Commissioner of Revenue had no authority to disregard the REIT structure on "common law" (i.e., business purpose) grounds, saying that "if we conclude a taxpayer has complied with the relevant statutes, that ends our analysis.".

3. Cases addressing whether to require combination.

a. *Petition of Express, Inc. et al.,* NYS Division of Tax Appeals, DTA Nos. 812330, 812331, 812332, and 812334 (September 14, 1995).

(i) Taxpayers, each incorporated in Delaware, engaged in retail clothing and accessories sales. Various holding companies were incorporated in Delaware to protect the taxpayers' trademarks.

(ii) The holding companies held quarterly board meetings in Delaware, maintained separate checking accounts in Delaware banks, and paid expenses from these checking accounts. Additionally, the holding companies had three directors in common. Finally, the holding companies did not have any employees; instead, the holding companies outsourced to an accounting firm, a law firm, and a bank for needed services.

(iii) Under the licensing agreements, the taxpayers paid royalties to the holding companies and the holding companies lent money to the taxpayers. Each holding company's board of directors authorized loans from the particular holding company and established minimum interest rates for the loans. Taxpayers repaid the loans in cash or "rolled the loans over."

(iv) Under the licensing agreements, taxpayers were required to (1) use their best efforts and skills in the operation of the

stores and to insure the quality of the merchandise, (2) conduct inspections of each of their stores annually and submit the reports to the holding companies, (3) submit samples of all advertising to the holding companies, and (4) allow themselves to be subject to an audit by the trademark corporation in order to verify the retailers' actual revenues. In return, the holding companies were required to (1) when requested by the retailer, make applications for the registration of the retailer as a permitted or registered user of the transferred trademarks, and (2) use "reasonable efforts" to register and maintain the trademarks throughout the world.

(v) The issue was whether the Division of Taxation could require the taxpayers and holding companies to file combined corporate franchise tax reports.

(vi) The Division of Tax Appeals found that the holding companies were viable trademark corporations engaged in the registration and protection of the trademarks. The Division of Tax Appeals appears to have been influenced by testimony regarding the extensive activities of the trademark companies with respect to the protection and registration of the marks. The Division of Tax Appeals also found numerous other business reasons for choosing to create the trademark companies, including limited liability, takeover defense and a centralizing a system to manage the marks.

(vii) As a result, the Division of Tax Appeals reversed the Division of Taxation's finding that taxpayers and the holding companies had to file combined corporate franchise tax reports with their respective trademark affiliates.

(viii) This case, which is representative of a large number of New York cases dealing with rebutting the presumption of distortion, avoided an economic substance inquiry and focused on an IRC 482-type approach addressing the fact that the intercorporate transactions were at arm's length rates.

b. *Sherwin-Williams Co. v. Tax Appeals Tribunal*, 784 N.Y.S. 2d 178 (App. Div. 3d Dep't 2004), aff'g, N.Y. Tax Appeals Tribunal, DTA No. 816712 (June 5, 2003).

(i) Sherwin-Williams ("S-W") (an Ohio corporation whose principal place of business and domicile was in Ohio), sold architectural coatings, industrial finishes, paints, and

associated supplies through company-operated paint and wall covering stores under the label "Sherwin-Williams." S-W also used many trademarks, trade names, and service marks in conducting its business.

(ii) In January 1991, S-W formed two Delaware corporations, SWIMC and DIMC (the "Trademark Companies"), to hold and manage its marks. The Trademark Companies licensed the marks to S-W in return for the payment of royalties at a market rate. The Trademark Companies also licensed some marks to other corporations, and operated as investment companies.

(iii) S-W provided certain trademark services (such as identifying renewal and affidavit dates for the trademarks and providing registration services, licensing assistance and advice relating to trademark protection and enforcement) to the Trademark Companies at a market rate.

(iv) The Tax Appeals Tribunal ("TAT") found that the transactions were inherently illogical and not rational from a business or economic standpoint. As a result, the TAT forced S-W to file combined returns with its Trademark Companies.

(v) The TAT noted that S-W was performing all the functions that the Trademark Companies were authorized to perform. Instead of the subsidiaries conducting any of the activities regarding the Marks, the subsidiaries engaged S-W as their trademark service provider. The TAT concluded that the functions of S-W did not change after the transactions creating the assignment and license-back of the Marks. According to the TAT, no non-tax benefit was realized.

(vi) The administrative law judge determined that there were additional benefits in forming the subsidiaries such as: the benefit of incorporating in Delaware, the ability to use the Trademark Companies as possible shields should a hostile takeover attempt ensue, the ability to use the Trademark Companies as investment and financing vehicles, tax considerations, the ability to insulate the Marks from liabilities of petitioner, to increase the focus on third-party licensing, and limiting petitioner's liability with regard to third-party licenses.

(vii) The TAT determined that the nontax benefits outlined by the administrative law judge and the business plan were not achievable. The TAT found that the hostile takeover defense had no merit, that S-W was prohibited from using

the assets of the Trademark Companies as security for financing purposes, and that there was no focus on third-party licensing.

(viii) Relying on the standard presented in Frank Lyon, the Appellate Division affirmed the finding of the Tax Appeals Tribunal that S-W failed to rebut the presumption of distortion arising from the presence of substantial intercompany transactions because the transactions lacked a business purpose or economic substance. Combination was required because separate filing would distort the companies' incomes.

c. *Petition of Kellwood Company*, NYS Division of Tax Appeals, DTA No. 820915 (March 27, 2008), remanded for further factual development, NYS Tax Appeals Tribunal (2009), decision on remand (2010), aff'd, September 22, 2011.

(i) Kellwood challenged the Commissioner's requirement that Kellwood file a combined report for itself and its subsidiaries, including those to which it sold receivables, in consideration of the subsidiaries servicing the receivables and advancing the face value of the receivables at discounted present value. The ALJ found that the conditions authorizing the Commissioner to require a combined report were satisfied because the 80% ownership and unitary business requirements were met, in addition to the presumption that separate reporting would distort New York income as a result of the significant intercorporate transaction involving the receivables. The remaining issue was whether Kellwood had sufficiently rebutted this presumption of distortion.

(ii) Finding that Kellwood had not, the ALJ rejected Kellwood's argument that the "profit potential test" of *Rice's Toyota World* did not apply because it was not specifically applied in *Sherwin-Williams*, and it applied this test not to the subsidiaries but to the transactions as a whole. The ALJ found that Kellwood's stated goal for the transfer of the receivables to the subsidiary, facilitating needed financing, lacked economic substance, as the same result could have been achieved without transfer to an affiliate, better financing terms were available to Kellwood from a non-factoring transaction, and the cost of the transactions did not justify the level of savings from which Kellwood benefited.

(iii) The ALJ also found Kellwood's stated business purposes to be illusory. The ALJ was not convinced that facilitation of

asset securitization was an actual motive for the transactions because the subsidiary involved was not bankruptcy remote and thus could not be used for the securitization and because creation of such intermediate entities is not a customary step or means of saving costs in facilitating securitization. The ALJ noted that centralization of credit and collections was a valid business purpose but found that the transactions with the subsidiary were not a legitimate means of accomplishing this purpose because the motivation and costs associated with the transactions reflected financing rather than centralization of credit and collections as the motivation.

(iv) On remand from the Tax Appeals Tribunal, the ALJ found that one of the subsidiaries had economic substance and a business purpose and that it had dealt with related corporations on arm-length terms.

d. *Petition of The Talbots, Inc.,* NYS Tax Appeals Tribunal, DTA No. 820168 (September 8, 2008).

(i) The taxpayer did not rebut the presumption of distortion and was therefore required to file its corporation franchise (income) tax report on a combined basis to include its wholly-owned intangible holding company subsidiary.

(ii) The corporation did not dispute that its royalty payments to the subsidiary for the use of the corporation's trademarks pursuant to a licensing agreement between the two entities gave rise to the rebuttable regulatory presumption that the corporation's income was distorted such that it must file a combined report to avoid distorting its income. However, the corporation contended that, because the royalty rates and resulting payments constituted arm's length rates, the income was not distorted and the presumption was rebutted.

(iii) The ALJ determined that although intercompany payments may be made at arm's length, they still must serve a business purpose and economic substance apart from tax avoidance. There was substantial evidence that the corporation failed to rebut the presumption of distortion and that the trademark assignment and licensing agreement lacked a business purpose, apart from tax avoidance, and economic substance.

e. *Petition of Premier National Bancorp, Inc.,* NYS Tax Appeals Tribunal, DTA No. 819746 (August 2, 2007).

(i) Where a financial corporation made a valid election to be taxed under Article 9-A (as a general business corporation) rather than Article 32 (as a banking corporation) and never revoked the election by filing as an Article 32 taxpayer, the Division of Taxation abused its discretion by making an adjustment under N.Y. Tax Law § 1462(g) to include income earned and reported on the Article 9-A return of the taxpayer's investment subsidiary. (Under the Article 32 tax, a banking corporation allocates investment income to New York based on its presence within the state, whereas an Article 9-A corporation allocates the same income based on the presence in the state of issuers of securities in the taxpayer's portfolio.)

(ii) In the instant case, the Division claimed that the taxpayer's transactions with the subsidiary lacked a business purpose and economic substance and that the investments were transferred to the subsidiary solely for tax avoidance.

(iii) The Tax Appeals Tribunal disagreed, finding that the investment objectives of the subsidiary differed from those of the taxpayer and that the taxpayer invested in the subsidiary for the purpose of making a profit. At no point did the taxpayer create fictitious losses or deductions to minimize its gains. Given that the Tax Law empowers the Commissioner to make a discretionary adjustment under N.Y. Tax Law § 1462(g) only if assets are improperly or inaccurately reflected on the return, the Division's adjustment amounted to an abuse of discretion.

f. *Toys "R" Us – NYTEX, Inc.*, NYC Tax Appeals Tribunal, TAT(E) 93-1039(GC) (January 14, 2004).

(i) Combination was not required between a taxpayer and three nontaxpayer corporations (one that owned trademarks and tradenames, one that owned mortgages on property owned by related corporations, and one that owned the stock of several subsidiaries and that made loans to related corporations), even though (1) there was common ownership among the corporations, (2) the corporations were involved in a unitary business, and (3) the presumption of distortion was present.

(ii) The taxpayer proved that there was no distortion from computing its tax on a separate basis.

(a) To prove that there was no distortion from its filing of a separate return, the taxpayer offered two appraisals.

(b) The appraisals demonstrated that the royalty rate charged for the use of the trademarks and tradenames was an arm's length rate and that the service agreements between the corporations provided arm's length rates for the services. (The Division did not offer any evidence to rebut these conclusions.)

(iii) During the Administrative Law Judge hearing the Division argued that combination was necessary because income was not properly reflected since the original transfers of the intangibles to the non-taxpayer corporations lacked economic substance.

(iv) In affirming the ALJ the Tax Appeals Tribunal prevented the Commissioner from amending facts to support the City's position because the facts had been mutually stipulated and not objected to during the ALJ hearing.

(v) The Tribunal also decided that, under the law for the period in question, the issue in determining whether the taxpayer had sufficiently rebutted the presumption of distortion was not whether the transactions had economic substance and a business purpose, but rather whether the substantial intercompany transactions were at arm's length. The Commissioner failed to offer any significant evidence contrary to that presented by the taxpayer.

(vi) The Department of Finance takes the position that *Toys "R" Us* has been overturned by the State *Sherwin-Williams* case.

g. *Lowe's Home Centers, Inc.*, NYS Division of Tax Appeals, DTA No. 818411 (September 30, 2004).

(i) The Division of Taxation proved that combination of a retailer of home improvement products and its wholly owned trademark holding company was required in order to prevent the distortion of the retailer's New York income. Distortion resulted from the assignment of the retailer's trademarks to the holding company and the license-back of those trademarks by the retailer. This arrangement caused the retailer's "activity, business, income or capital" within New York to be inaccurately reflected on a separate-return basis because the effect of the arrangement was to divert taxable income out of New York in the form of royalties paid to the holding company.

(ii) The retailer's efforts to rebut the presumption of distortion (which arose as a result of substantial intercompany

transactions among the related corporations) and prove that its royalty payments were arm's-length based on Internal Revenue Code Sec. 482 principles failed because the analyses offered by the retailer's experts were determined to be flawed.

(iii) In addition, to the extent that the retailer provided trademark maintenance services that the holding company was contractually obligated to provide in return for the royalties it was paid, the retailer's payment of those royalties for these services created distortion.

(iv) Further, the transfer and license-back transactions were determined to lack a valid business purpose and economic substance. After the creation of the trademark holding company, the retailer itself continued to perform nearly all the duties of a trademark service provider.

(v) Moreover, while money flowed between the retailer and the holding company, the economic positions of the entities were essentially unchanged, i.e., royalty payments were basically returned to the retailer in the form of tax-free dividends. This circular flow of funds was an indication that the holding company lacked economic substance.

4. Cases addressing nexus with a wholly out-of-state corporation.

a. This appears to be the result of the economic substance analysis in a state without combined reporting.

b. *Comptroller of the Treasury v. SYL, Inc.,* 825 A.2d 399 (Md. 2003), rev'g, *Crown, Cork & Seal (Delaware), Inc. v. Comptroller of the Treasury,* No. C-97-0028-01, 1999 Md. Tax LEXIS 4 (Md. Tax Ct., Apr. 26, 1999) & *SYL, Inc. v. Comptroller of the Treasury,* 1999 Md. Tax LEXIS 3 (Md. Tax Ct., Apr. 26, 1999).

(i) The Maryland Court of Appeals reversed two Maryland Tax Court opinions and held that the income of an out-of-state affiliate of a Maryland parent corporation was subject to income tax.

(ii) Crown, Cork & Seal (Delaware) ("Crown") was a wholly owned subsidiary of Crown, Cork & Seal Company, Inc. ("Crown Parent"), a public corporation in the business of manufacturing and selling metal cans, crowns, and closures for bottles. Crown Parent owned and operated manufacturing plants in Maryland and filed Maryland corporate income tax returns for the years in question.

(iii) Crown was formed in Delaware and Crown Parent contributed its trademarks and patents to Crown. The marks were licensed back to Crown Parent for an agreed-upon royalty fee. As a result of the licensing arrangement between the related entities, Crown Parent's Maryland income was reduced by the amount of the royalties paid to Crown. Treasury Comptroller assessed Crown on the basis that it was a "phantom" corporation.

(iv) Crown did not own or lease property in Maryland. Crown had no employees, agents, or offices in Maryland. Its income producing activity all occurred outside of Maryland. Crown Parent was the only contact taxpayer Crown had with Maryland.

(v) SYL, Inc. ("SYL"), a Delaware corporation, was a wholly-owned subsidiary of Syms, Inc. ("Syms"), a New Jersey corporation in the business of selling men's, women's, and children's clothing in numerous states, including Maryland.

(vi) SYL was formed in Delaware and Syms contributed its trademarks and patents to SYL. The marks were licensed back to Syms for an agreed-upon royalty fee. As a result of the licensing arrangement between the related entities, Syms's Maryland income was reduced by the amount of the royalties paid to SYL. Treasury Comptroller assessed SYL on the basis that it was a "phantom" corporation.

(vii) SYL did not own or lease property in Maryland. SYL had no employees, agents, or offices in Maryland. Its income producing activity all occurred outside of Maryland. Syms was the only contact SYL had with Maryland.

(viii) According to the Court of Appeals, the record in each case demonstrated that SYL and Crown had no real economic substance as separate business entities. Neither Crown nor SYL had full time employees, and the part-time "employees" were nothing more than officers and employees of independent "nexus service" companies. The Delaware "offices" of Crown and SYL were little more than mail drops.

(ix) Crown and SYL did virtually nothing. With respect to the operation of the parents and the protection of the trademarks, nothing changed after the creation of the subsidiaries. Since the intangible assets were still being managed by the parent companies, management of the intangible assets could not be a business purpose for creating the subsidiaries. Sheltering income from state

taxation was the predominate reason for the creation of SYL and Crown.

(x) In the absence of economic substance, the subsidiaries had nexus with Maryland because they were unitary with their parents and their parents were engaged in business in Maryland.

(xi) The Court of Appeals reversed the determinations of the Maryland Tax Court and held that both SYL and Crown had substantial nexus with Maryland that would permit assessment of income tax.

(xii) In reaching a decision that quoted heavily both the Massachusetts *Sherwin-Williams* case and the South Carolina Geoffrey case, the Court of Appeals never addressed why the existence of a unitary business automatically resulted in nexus or why the subsidiary was taxed as a separate entity once the court determined that it had no economic substance as a separate business entity.

c. *MCI International Telecommunications Corp. v. Comptroller of the Treasury*, Dkt. No. 24-C-99-002387 AA (Circuit Court for Baltimore City March 17, 2000)

(i) In a case predating SYL, the Circuit Court rejected the Comptroller's determination that MCI's affiliate, the primary activity of which was the transfer of inbound and outbound telephone calls over international territory, lacked economic substance, stating that "[i]t is conceivable that, for legitimate business purposes, a seemingly insignificant affiliate (i.e. one employee and/or one computer) can exist which generates substantial income yet have little or no expense. To attribute nexus solely on the basis that there is reliance on Maryland affiliates for some or all of that income … ignores the reality that they are separate non-phantom entities required to report their income separately."

(ii) "Its only Maryland contact was an affiliation with an entity with a Maryland presence." "The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-phantom out-of-state affiliate of the same group."

5. Cases addressing economic substance and business purpose in other contexts.

a. *Petition of RCA Corporation and Subsidiaries*, NYC Tax Appeals Tribunal, TAT(E) 93-128(GC) (December 11, 1996).

(i) A subsidiary of RCA, Holdings, was formed to acquire a financing company with which RCA regularly dealt. Following the transaction and for the year at issue, the surviving entity continued to deal with RCA on the arm's length, pre-transaction terms.

(ii) The Commissioner of Finance attempted to include the capital of the newly acquired subsidiary in RCA's subsidiary capital tax base for corporate income tax calculation, but the ALJ rejected this on the grounds that there was non-tax economic substance to the structure of the transaction. Therefore the subsidiary capital was excluded from the income tax calculation for the year at issue.

b. *Indiana Department of Revenue, Letter of Findings No. 05-0363* (Feb., 2006).

(i) A limited liability company purchased an aircraft for lease to its affiliate, claiming that the transaction was structured to protect the affiliate company assets from potential liability. Upon registration, the LLC claimed a purchase-for-rental exemption to the Indiana use tax.

(ii) To comply with and be covered by certain FAA regulations the LLC entered into a "dry lease" in which it merely held ownership of the aircraft, but the lessee affiliate was responsible for "operating expenses, pilot services, maintenance, fuel, and insurance." However, because of this arrangement the only significant insurance coverage on the aircraft was held by the LLC despite the fact that under federal law operators are separately liable.

(iii) Applying the step transaction doctrine the Commissioner noted that the terms of the dry lease provided the affiliate with full control of the aircraft, but without any of the burdens of tax liability. The Commissioner also noted that the member of the LLC that signed the lease also signed on behalf of the affiliate lessee, and that the lease payments "remain[ed] in the coffers of those who ha[d] owners interests" in both companies, effectively creating a wash. The Commissioner further stated that "[t]he net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here."

(iv) In addressing the substance of the transaction to determine if the lease was within the statutory exemption, the

Commissioner stated that the "Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes."

(v) The Commissioner also indicated that the lack of insurance coverage undercut the stated business purpose, justifying collapsing the two companies, and relied on federal cases for the proposition that obtaining tax benefits is not a sufficient business purpose. The ruling does not address the fact that federal cases have held state tax benefits to be a legitimate business purpose so long as federal tax liability is not affected.

(vi) The Indiana Department of Revenue applied similar analyses and reached similar results in *Letter of Findings No. 05-0356* (May, 2006), *Letter of Findings No.05-0049* (Oct. 1, 2005), *Letter of Findings No.04-0050* (Sept. 1, 2005), *Letter of Findings No. 06-0213* (April 18, 2007), *Letter of Findings No. 05-0261* (Jan. 1, 2005), *Letter of Findings No. 05-0242* (Jan. 1, 2005), *Letter of Findings No. 05-0202* (Jan. 1, 2005), *Letter of Findings No. 06-0155* (Jan. 1, 2004), *Letter of Findings No. 05-0363* (Jan. 1, 2004), *Letter of Findings No. 04-0373* (Jan. 1, 2004).

D. State legislation addressing economic substance.

1. Ohio

a. Am. Sub. H.B. No. 95 added R.C. 5703.56 to the Ohio tax code and allows the Tax Commissioner to disregard any "sham transactions" when determining a taxpayer's tax liability. This provision defines a "sham transaction" as any transaction (or series of transactions) that has no economic substance because its only purpose is to obtain tax benefits.

b. In order to disregard a transaction, the Tax Commissioner is required to prove that it is a sham, unless the transaction is between members of a controlled group. In that case, the taxpayer must prove by a preponderance of the evidence that the transaction is not a sham. A controlled group exists if two or more entities are related in such a way that one entity directly or indirectly controls

the business operations of another member of the group, or if one entity owns more than 50% of the other entity's common stock.

2. Massachusetts

a. Massachusetts General Laws ch. 62C § 3A appears to overrule *Sherwin-Williams* by requiring both a business purpose and economic substance. Furthermore, the business purpose must be commensurate with the tax benefits.

b. M.G.L.A. 62C § 3A states as follows: "[T]he commissioner may, in his discretion, disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit. In all such cases, the taxpayer shall also have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the asserted nontax business purpose is commensurate with the tax benefit claimed. Nothing in this section shall be construed to limit or negate the commissioner's authority to make tax adjustments as otherwise permitted by law."

E. The proper role of the economic substance doctrine.

1. Sham transactions and entities should be ignored.

- For example, a corporation that has no employees or assets and that purports to outsource all of its functions to related parties should be ignored.

2. A transaction that has economic substance, in that it involves the movement of assets and liabilities among entities, but that is intended to create a tax deduction or credit to offset unrelated income should be ignored, but not because of the economic substance doctrine.

3. A transaction that involves a reorganization of a legitimate business or investment operation and that does not involve sham entities should be respected, even if its only purpose is to bring about a more efficient tax structure.

a. It is generally accepted that a company can organize its business among different legal entities for tax purposes. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) *aff'd,* 293 U.S. 465 (1935).

b. That being the case, a company that adopts a poor tax structure at the outset should be able to change to a more efficient tax structure even if the only reason for the reorganization is to save taxes.

III. Business Activity Tax Nexus.

A. Federal Legislation.

1. H.R. 1083 The Business Activity Tax Simplification Act (BATSA).

a. This bill implements a bright-line physical presence standard of nexus for business activity taxes.

(i) A business would have a physical presence in a state if it had employees or tangible property in a state for more than 21 days during a year (a quantitative *de minimis* safe harbor); qualitative *de minimis* provisions provide that the presence of property or personnel in certain circumstances is disregarded.

(ii) The bill would also ensure that the protections of P.L. 86-272 apply to all types of business activity taxes, not just income taxes, and to solicitation activities in connection with all sales and transactions, not just sales of tangible personal property.

B. Economic Nexus Developments.

1. The debate over whether economic nexus is Constitutional continues. More and more states are enacting economic nexus legislation. The United States Supreme Court refuses to intervene, apparently feeling that it is Congress's responsibility to address the problem if it feels that a problem exists. *See,* Peter L. Faber, "Economic Nexus: Right or Wrong," 87 Taxes: the Tax Magazine 99 (2009).

2. *FIA card Services, N.A., f/k/a MBNA America Bank v. West Virginia*, 220 W. Va. 163, 640 S.E. 2d 226 (2006), *cert denied*, 127 S.Ct. 2997(2007.)

a. West Virginia is one of the states with a statute imposing tax on financial institutions based on a certain level of economic activity related to West Virginia customers.

b. The Office of Tax Appeals Administrative Law Judge had determined that the statute merely created a presumption of nexus that an out-of-state financial institution was entitled to rebut and that the "substantial nexus" requirement under the Commerce Clause "requires a finding of a physical presence in the taxing state, not merely an economic exploitation of the market."

c. The ALJ then determined that there must be more than a "slightest presence"; the taxpayer's in-state physical presence must be "significantly associated with the taxpayer's ability to establish and maintain a market in" the taxing state. Under this standard, the ALJ concluded that MBNA's use of the services of in-state lawyers and West Virginia courts for a *de minimis* number of credit card debt collection actions (three actions over a two year period) was insufficient to create nexus in West Virginia because it was merely the "slightest presence" and was not significantly associated with MBNA's ability to establish and maintain a market in West Virginia.

d. The Circuit Court reversed the decision of the ALJ and held that the corporate net income and business franchise taxes had been properly imposed on MBNA.

e. The Court found that MBNA's gross receipts attributable to a West Virginia source far exceeded the statutory threshold for nexus and concluded that MBNA had substantial nexus with the state for the years in question such that imposition of the corporate income and business franchise taxes was proper.

f. The Court rejected the "bright-line physical presence test" established in *National Bellas Hess* and adhered to in *Quill* because the taxes at issue in this case were not sales and use taxes. Specifically, the Court found as a matter of law that physical presence was not required to establish substantial nexus to satisfy the Commerce Clause when imposing corporate net income and business franchise taxes.

g. In reaching its decision, the Court focused on the many benefits MBNA was deemed to receive from the state, such as the banking and consumer credit laws and access to the state's courts, all of which enabled MBNA to generate income from West Virginia customers. The Court noted in particular that because MBNA extends substantial unsecured credit to citizens of West Virginia, the fact that MBNA had access to West Virginia courts was essential to its business operations.

h. The Supreme Court affirmed, emphasizing the presence of customers in West Virginia. The court's opinion appears to focus on Due Process Clause considerations. It does not discuss the effect of the tax on interstate commerce.

3. *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. den.*, 531 U.S. 927 (2005).

   a. The court held that a bank could not be subject to a net income tax by a state just because it had credit card customers in the state and solicited business from them.

b. Although the taxpayer technically owned the credit cards, the court said that this was of no significance.

c. The use of an agent to collect receivables did not establish nexus. This was different from using an agent to solicit sales. Similarly, the use of the state courts and infrastructure did not establish nexus.

d. The court stopped short of saying that physical presence was required for nexus, but it said that the contacts with the state that were present in the case before it did not establish nexus.

4. *Capital One Bank v. Commissioner of Revenue, Dkt.No. C262391* (Mass App. Tax Bd. June 22, 2007).

The Appellate Tax Board held that the imposition of excise tax on a financial institution was valid when the taxpayer received economic gain from the use of the state's markets, infrastructure, and resources. The Board rejected the taxpayer's contention that physical presence was required before an excise tax could be imposed. The Board found that the taxpayer had substantial nexus with the state, citing factors such as targeted marketing to Massachusetts customers, quarterly filings of reports with the state, use of the state's judicial system to collect debts, and receiving hundreds of millions of dollars in income from in-state transaction

5. *Annox v. Kentucky Revenue Cabinet*, Dkt. No. K-19039, Ky Bd. of Tax App. (Dec. 23, 2003), *aff'd*, No. 03-CI-1605, Franklin County Cir. Ct. (Feb. 17, 2005).

a. The Franklin County Circuit Court affirmed the Board of Tax Appeal's decision that a telecommunications reseller with no property or payroll in the state is nevertheless liable for the public service corporation property tax.

b. Annox was a telecommunications services reseller with Kentucky customers. Annox had agreements with local telecommunications companies to use their physical networks and to use their employees for customer service and connections.

c. The Board found that Annox had nexus with Kentucky on several different theories.

(i) First, since Annox was a utility that was regulated by the state Public Service Commission, Annox operated in the state only with permission of the state authority and thus had voluntarily accepted jurisdiction by the state.

(ii) Further, the Board found that Congress had consented to state nexus over telecommunications resellers because a federal telecommunication act granted the state utility

commission authority over telecommunications services in the state.

(iii) The Board also found that the *Quill* "physical presence" requirement did not apply outside of the sales/use tax area.

(iv) Nevertheless, the Board determined that Annox had physical presence as a result of its use of the local telecommunications companies' networks and employees.

6. *Accuzip, Inc. v. Director, Division of Taxation*, 25 N.J. Tax 158 (New Jersey Tax Court 2009).

a. The Tax Court held that the taxpayer was selling tangible personal property into the State and was protected by Public Law 86-272.

b. In connection with economic nexus, the Court said that *Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 380, 980 A.2d 176 (2006), cert. denied, 551 U.S. 1131 (2007), which had been viewed by some as supporting economic nexus (it involved licensing trademarks to an affiliate in New Jersey), was not an economic nexus case and that its holding rested on the fact that the taxpayer was using property (intangible) in the State.

7. *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308 (Ia. 21010), cert. den. (2011).

a. KFC has a franchise operation through which Kentucky Fried chicken stores operated.

b. The franchisees were unrelated third parties. Some were in Iowa.

c. The Iowa Supreme Court held that KFC had nexus in Iowa because it was using intangible property in Iowa.

8. Multistate Tax Commission Resolutions Committee Draft Policy Statement 2002-02, "Ensuring the Equity, Integrity and Viability of State Income Tax Systems," as amended October 17, 2002.

a. This statement establishes the MTC's position against codifying the physical presence nexus standard for business activity taxes.

b. The statement supports the creation of economic nexus standard for business activity taxes that is based on the "factors" of a business assignable to a state.

(i) The MTC nexus standard is based on the three factors in the standard apportionment formula of the Uniform Division of Income for Tax Purposes Act ("UDITPA"): property, payroll, and sales.

(ii) A state would be able to impose a business activity tax on any business whose factors in a state exceed certain thresholds; the thresholds are $50,000 in property, $50,000 in payroll, or $500,000 in sales.

c. Because P.L. 86-272 currently protects certain businesses that merely have customers or certain payroll (i.e., salespersons working from their homes) in a state, the MTC has also endorsed the repeal of P.L. 86-272 for those states that enact its factor-based nexus standard.

9. Economic nexus legislation.

a. New York.

(i) A bank is deemed to be doing business in New York if it has issued credit cards to 1000 or more people with New York mailing addresses, it has merchant customer contracts for 1000 or more New York locations, it has receipts of $1,000,000 or more from New York customers or from New York merchant locations, or certain combinations of the above requirement are met.

(ii) The New York State Department of Taxation and Finance has proposed legislation adopting economic nexus generally.

b. Connecticut.

(i) A corporation has income tax nexus if it has a "substantial economic presence" in Connecticut as evidenced by a "purposeful direction of business" in the state, without regard to physical presence.

(ii) Effective for years starting after 2009.

c. Effective June 1, 2010, Washington State has adopted economic nexus rules. Generally, nexus will be established if sales to Washington buyers exceed $250,000 or are at least 25% of the taxpayer's worldwide sales.

C. Attributional Nexus Developments.

1. *Union Tank Car Company v. Department of Revenue*, Dkt. No. 2050652 (Ala. Ct. Civ. App. April 13, 2007).

The Appellate Court affirmed the Circuit Court holding that an Illinois-based company engaged in manufacturing and leasing railcars is not "doing business in Alabama or deriving income from sources within Alabama" and, therefore, is not subject to Alabama corporate income tax. The statutory threshold for imposing the tax was not met because all of the lease agreements were negotiated and executed in Illinois; the amount of

the lease payments was fixed and received in Illinois and the manufacturer/lessor exercised no control over where the leased railcars were used.

2. *Lanzi v. Alabama Department of Revenue*, 2006 Ala. Civ. App. LEXIS 406 (June 2006).

   a. Alabama Civil Court of Appeals determined that the ownership of an interest in a limited liability pass-through entity by a non-resident, by itself, is not sufficient to create nexus with the state in which the entity conducts business.

3. *Prince v. Ala Dep't of Rev.*, ______ So.2d ___ (Ala. Civ. App. 2010).

   a. Nonresident S corporation shareholder was held to have nexus in Alabama because the corporation did business there.

   b. The court expressed disagreement with the decision in *Lanzi*. It said that the Due Process requirement that there be "some definite link, some minimum connection" between the state and the company was met.

   c. A dissent argued that *Lanzi* was indistinguishable and should be followed.

4. *BIS LP, Inc. v. Division of Taxation,* 25 N.J. Tax 88 (New Jersey Tax Court 2009), aff'd (New Jersey App. Div. 2011).

   a. BIS was a wholly-owned subsidiary of BISYS. BIS and BISYS formed Solutions, a limited partnership. BISYS was the general partner of Solutions and owned a 1% interest. BIS was the limited partner of Solutions and owned a 99% interest. Solutions did business in New Jersey; BIS did not.

   b. The Tax Court held that BIS was not subject to New Jersey's Corporation Business Tax.

      (i) BIS's 99% interest in Solutions did not create nexus. BIS was only a limited partner and not a general partner and BIS did not control Solutions.

      (ii) BIS was only a passive investor in Solutions and, hence, they were not engaged in a unitary business.

5. *UTELCOM, Inc. v. La. Dep't of Rev.* (La. Ct. App. (2011).

   a. Passive ownership of a limited partnership interest in a partnership that did business in Louisiana did not subject a foreign corporation to tax.

   b. A regulation that held to the contrary impermissibly expanded the statute and was invalid.

6. *Revenue Cabinet (Kentucky) v. Ashworth Corp.*, 2009 Ky. App. LEXIS 229 (Ky. Ct. App. 2009).

   a. A 99% limited partner was held to have taxable nexus because of the partnership's activities in Kentucky.

   b. Unlike the situation in *BIS LP*, here the statute provided that partners in a partnership that did business in the state were taxable there. The court held that this was not unconstitutional under the Commerce and Due Process Clauses.

7. *Ruling of Commissioner, P.D. 05-90*, Virginia Department of Taxation (June 9, 2005).

   a. Nexus with Virginia found where out-of-state holding company's officers conduct the company's affairs from wholly owned subsidiary's office located in Virginia.

   b. Holding company was required to join in the combined income tax return that the affiliated companies file.

8. *Decision of the Texas Comptroller of Public Accounts, Hearing No. 44,735* (April 6, 2005).

   a. A direct sales and network marketing company that sold a variety of products and services to marketing professionals had substantial nexus with Texas under the Texas franchise tax.

   b. The company sold memberships that allowed Texas customers to purchase products and become affiliate independent contractors who solicited sales of company memberships, goods, and services in Texas.

   c. Substantial nexus was found because the activities of the affiliates exceeded the mere solicitation of orders for tangible goods.

9. *Dillard National Bank, N.A., v. Johnson*, Tennessee Chancery Court, 20th Jud. Dist., Davidson County, No. 96-545-III (June 22, 2004).

   a. Dillard National Bank ("DNB"), an out-of-state bank, issued credit cards for the Dillard chain of department stores in Tennessee.

   b. The Dillard department stores and their employees performed several activities on behalf of DNB, including placing advertisements in newspapers around stores, soliciting credit card applications from customers in stores, taking credit card applications in stores, answering questions in stores for customers regarding their credit card accounts, and accepting credit card payments in stores.

   c. DNB occasionally sent three or four of its employees into Tennessee to solicit new credit card customers at store openings

(the court noted that this alone would probably not be sufficient to create nexus).

d. DNB hired a college credit card company to solicit credit card applications on college campuses.

e. The chancery court determined that these activities constituted a continuous and targeted solicitation within Tennessee to establish and maintain a market with Tennessee residents.

f. The chancery court granted summary judgment to the Commissioner of Revenue on the basis that DNB had substantial nexus with Tennessee and, thus, was subject to Tennessee franchise and corporate excise (income) tax because of the activities conducted on behalf of DNB by the Dillard department stores and department store employees as well as the activities of the college credit card company and DNB's own employees

10. *W.L. Gore & Associates Inc. v. Comptroller of the Treasury*. (Md.Tax Ct. 2010).

    a. Out-of-state holding companies were held to have nexus with Maryland because of the Maryland activities of their parent corporation. The holding companies and the parent were engaged in a unitary business.

    b. In the alternative, the court held that the holding companies lacked economic substance.

11. The cases holding that the holder of a controlling interest in an LLC does not have nexus in a state where the LLC does business do not involve single member LLCs that are disregarded for income tax purposes. Even *BIS LP, Inc.* involved an LLC that was treated as a partnership and that was not disregarded, although the taxpayer owned a 99% interest and the other 1% was owned by an affiliate. Would the result be different if the LLC, instead of being taxes as a partnership, was disregarded for income tax purposes?

    a. One can argue that for nexus purposes the answer should be the same. The sole shareholder of a corporation is not taxable in states in which the corporation does business and the sole member of a limited liability entity such as an LLC should be treated the same.

    b. On the other hand one can argue that electing a flow-through tax regime in which the LLC is disregarded involves a consent to be taxed.

    c. The California approach.

        (i) The Franchise Tax Board has ruled that the activities of a disregarded LLC will be viewed as if they were conducted

by its owner for nexus purposes *Legal Ruling No. 2011-01* (2011); *General Rules for Doing Business in California* (2011).

(ii) The sole member of a SMLLC must sign a statement on the LLC's income tax return consenting to personal jurisdiction in California for purposes of income tax collection. If it does not do so, the LLC must pay tax on the owner's share of its income at the highest marginal tax rate. Rev. and Tax Code section 18633.5 (i).

D. Sufficiency of contacts with state.

1. *Lamtec Corp. v. Department of Revenue of the State of Washington*, 2009 Wash. App. LEXIS 1956 (Wash. Ct. App. 2009), cert. den. (2011).

a. A New Jersey corporation was held subject to the Washington Business and Occupation Tax.

b. The taxpayer had no employees or property in Washington, but it shipped goods to customers in Washington. Its employees visited Washington customers 2 or 3 times a year. They did not solicit orders, but they enhanced the taxpayer's market by providing information about products, listening to concerns and answering questions, participating in calls that the customer placed to get technical support, and maintaining client relations.

c. The court accepted the proposition that a company's contacts with a taxing state needed to be directed toward creating or enhancing a market to establish nexus, citing *Tyler Pipe Indus., Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987).

d. The court said that activities could be market-enhancing even if they did not involve soliciting sales.

2. *Telebright Corporation, Inc. v. Director, Division of Taxation*, 25 N.J. Tax 333 (N.J. Tax Ct. 2010).

a. A corporation was held taxable in New Jersey because of the presence of a single telecommuting employee, even though her work had nothing to do with New Jersey.

b. The result might have been different if she had been an independent contractor and not an employee.

IV. PASSIVE INVESTMENT COMPANIES.

A. *Geoffrey, Inc. v. South Carolina State Tax Commission*, 313 S.C. 15 (1993), *cert. den.*, 510 U.S. 992 (1993).

1. Geoffrey, Inc. was a wholly-owned Delaware corporation and a second-tier subsidiary of Toys R Us to which several valuable trademarks and trade names were transferred. Geoffrey licensed intangibles to Toys R Us in exchange for a royalty of one percent of the net sales revenues. Toys R Us deducted the amount of the royalty payments from income in computing the amount of its tax obligation in South Carolina. South Carolina then took the position that Geoffrey was taxable in the state.

2. The South Carolina Supreme Court upheld the Tax Commission's decision that the state may constitutionally impose corporate income tax on royalty income derived by an out-of-state intellectual property company under a licensing agreement that based the royalty on sales generated within the state. By licensing intangibles for use in South Carolina and receiving income in exchange for their use, the court found that the taxpayer purposely directed its activities toward state residents and had the necessary connection required by due process.

B. *A & F Trademark, Inc. v. Tolson,* 167 N.C. App. 150, 605 S.E.2d 187 (2004), *cert. denied*, 126 S. Ct. 353 (2005).

1. The North Carolina Court of Appeals affirmed the decision of the Superior Court of Wake County, which had summarily affirmed the decision of the North Carolina Tax Review Board holding that several Delaware holding companies that licensed trademarks to affiliates operating in the state were subject to the corporate income tax.

2. The Court of Appeals determined that the holding companies were doing business in North Carolina and must pay North Carolina corporate income tax on the income earned from the use of their trademarks.

3. In its decision, the Tax Review Board had found that, although the holding companies had no physical presence in the state, they could be subject to tax under the relevant "doing business" statute since constitutional issues were beyond its authority.

4. The Board had found that the holding companies were "doing business" in the state because they:

   a. Owned intangible property with a business situs in the state;

   b. Rented property to in-state businesses; and

   c. Operated a business enterprise in the state.

C. *Lanco, Inc. v. Dir., Div. of Taxation,* 188 N.J. 380, 980 A.2d 176 (2006*),* cert. denied, 551 U.S. 1131 (2007).

1. Lanco is a Delaware corporation that owns and licenses intangible property (trademarks, trade names, and service marks) to its affiliate, Lane Bryant Inc., for use in its New Jersey retail business. Lanco had no officers, employees, or real or tangible personal property in New Jersey.

2. The New Jersey Tax Court held that New Jersey's corporation business tax ("CBT") does not apply to an out-of-state corporation that does not have a physical presence in New Jersey but that has New Jersey-source income from a licensing agreement with a New Jersey retail business.

3. The New Jersey Tax Court determined that the Commerce Clause requires substantial nexus, which is not satisfied unless the business has a physical presence in the state. Citing *Quill Corp. v. North Dakota* (1992) and reviewing cases in other states that addressed the issue, the court determined that the difference between use tax liabilities and income tax liabilities is not significant enough to justify a different rule for physical presence and that U.S. Supreme Court decisions decided before *Quill* strongly suggested that physical presence was a necessary element of nexus for taxing income.

4. Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill's* physical presence nexus requirement does not apply to income tax and that the CBT may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey.

5. On appeal, the Director of Taxation argued that the Commerce Clause does not require a corporation's physical presence to justify state taxation, provided that the state can establish that the corporation derives significant benefits from continued and deliberate in-state economic activity.

6. The Director also argued that, unlike the vendors in *Quill* (whose only connection with customers was by common carrier or the U.S. mail), Lanco had a long-term contractual relationship with a related corporation that operated outlets throughout New Jersey and Lanco and Lane Bryant enjoyed numerous benefits provided by New Jersey, including judicial protection, highway maintenance, and police and fire protection.

7. In reversing the Tax Court, the Appellate Division looked to recent state cases adopting the holding of the South Carolina Supreme Court in *Geoffrey*, namely North Carolina in its *A&F Trademark* decision and Louisiana in its *Gap (Apparel)* decision) (see below). After examining these cases, the Appellate Division was "satisfied" that the physical presence requirement applicable to sales and use taxes does not apply to income tax. As a result, it concluded that the New Jersey CBT may constitutionally be applied to income derived by Lanco from licensing fees attributable to New Jersey.

8. The New Jersey Supreme Court affirmed in a brief opinion.

D. *Accuzip, Inc. v. Director, Division of Taxation*, 2009 N.J. Tax LEXIS 21 (New Jersey Tax Court 2009).

1. The taxpayer was deemed to be selling tangible personal property in the State (prewritten computer software) and, hence, was protected from tax by Public Law 86-272.

2. The Tax Court said that *Lanco* applied only to taxpayers that had intangible property in the State and did not stand for the broader economic nexus principle that the mere presence of customers in the State established nexus. *See*, Peter L. Faber, "Economic Nexus: Right or Wrong," 87 Taxes: The Tax Magazine 99, 106 (2009).

E. *Va. Dep't of Tax'n, Ruling of Comm'r, P.D. 05-100* (June 28, 2005) & Va. Dep't of Tax'n, Ruling of Comm'r, P.D. 05-139 (Aug. 23, 2005).

1. In these two cases, the Virginia Department of Taxation ruled that the taxpayer and its subsidiaries were required to file on a consolidated basis because the transactions between the taxpayer and its subsidiaries were found to lack economic substance and were not made at arm's length.

2. In P.D. 05-100, the department rejected the taxpayer's argument that the transactions had economic substance because the taxpayer pays arm's length fees to the IHC to manage the taxpayer's patents and trademarks even though the IHC has no employees or place of business.

3. In P.D. 05-139, the department rejected the taxpayer's argument that the department was consolidating subsidiaries not directly owned by the taxpayer, noting that the "degree of interlocking management" allows the taxpayer to control the activities of the subsidiaries.

4. In finding a lack of economic substance in both cases, the department noted that the Virginia Supreme Court in *Commonwealth v. General Electric Company*, 372. S.E.2d 599 (Va. 1988), sustained the department's authority to equitably adjust the tax of a corporation "where two or more commonly owned corporations structure an arrangement in such a manner as to reflect improperly, inaccurately, or incorrectly the business done in Virginia or the Virginia taxable income."

F. *Bridges v. Autozone Properties*, 900 So.2d 784 (La. 2005).

1. The Louisiana Department of Revenue attempted to tax dividends received by a Nevada corporation from a real estate investment trust that earned rental income from subsidiary retail stores, some of which were located in Louisiana.

2. The REIT was subject to Louisiana tax but paid no tax as a result of the dividends paid deduction, while the stores received a deduction for rental expense.

3. The Louisiana appellate court held that the Department could not assert jurisdiction over an out-of-state holding company, because the corporation's contacts with the state were insufficient to satisfy the nexus requirements of the Due Process Clause.

4. The Louisiana Supreme Court reversed and remanded the lower court's decision and held that Louisiana had personal jurisdiction under the Due Process Clause over the Nevada corporation because Louisiana provided the benefits, opportunities, and protections that helped to create the state-based income.

5. The Court determined that the state's assertion of its taxing power survived Due Process scrutiny where the state had asserted its power in relationship to the opportunities that it had given, the protections that it had afforded under its police power, and the benefits that it had conferred by creating an orderly, safe climate in which to conduct business and earn income (*i.e.,* police protection, fire protection, street sanitation, etc.).

6. The REIT owned 68 parcels of rental producing real property in Louisiana and the shareholder had received all of the approximately $10 million of rent-based dividends from the REIT as a beneficial owner.

7. The Louisiana Supreme Court did not address the issue of whether the Nevada corporation had substantial nexus with Louisiana as required by the Commerce Clause because that issue was deemed abandoned:

> "We note that the Commerce Clause issue has not been raised on appeal in this case. Since the parties did not argue this issue in brief, we will treat the issue as abandoned. Thus, our singular focus is the Due Process Clause of the 14th Amendment."

G. Draft Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses, Multistate Tax Commission (Feb. 17, 2005).

1. The MTC Executive Committee has proposed a draft model add-back statute that is currently the subject of a public hearing process.

2. The draft model legislation would disallow deductions for certain interest and intangible expenses paid to related entities.

3. Some states have enacted provisions requiring addback of certain interest and/or "intangible" expenses, such as Alabama, Arkansas, Connecticut, Georgia, Illinois, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, and Virginia. *See, e.g.,* Ala. Code § 40-18-35(b); Ark. Code § 25-51-423(g)(1); Conn. Gen. Stat. § 12-218c; Ga. Code § 48-7-28.3; 35 Ill. Comp. Stat. 5/203(b)(2); Ky. Rev. Stat. § 141.205; Md. Code § 10-306.1; Md. Code § 10-306.1; Mass. Ch. 63, G.L. §§ 31I, 31J, 31K; Miss. Code § 27-7-17; N.J.S.A. § 54:10A-4; N.Y. Tax Law § 208(9)(o); N.C. Gen. Stat. § 105-130.7A; Ohio Rev. Code § 5733.042; and Va. Code § 58.1-402B.

4. In May 2006 the MTC Executive Committee voted to refer the proposed model statute to the Full Commission, with amendments recommended by the hearing officer. It was adopted at the August 17, 2006 meeting.

H. *Va. Dep't of Tax'n, Ruling of Comm'r, P.D. 04-188 (Oct. 8, 2004).*

1. The taxpayer holding company filed a Virginia consolidated corporate income tax return with six out-of-state subsidiaries that had reported net operating losses.

2. The taxpayer included the subsidiaries in its consolidated return on the basis that the subsidiaries had nexus with Virginia because each subsidiary had entered into leases for in-state storage of tangible personal property.

3. The Virginia Tax Commissioner determined that the six out-of-state subsidiaries and their losses should be eliminated from a consolidated return filing as distortive because the required nexus for consolidation was "artificially" created through year-end transactions with in-state affiliates.

I. *Department of Revenue v. Gap (Apparel), Inc.,* 886 So. 2d 459 (La. Ct. App., 1st Cir. 2004).

1. A Louisiana appellate court held that an out-of-state trademark licensing company was subject to Louisiana corporate income tax.

2. The court determined that the company satisfied the Due Process Clause nexus requirements of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), because the licensed intellectual property became an integral part of the licensee's business in the state and thus acquired a business situs in Louisiana.

3. The court cited *Quill* for the proposition that a physical presence is not necessary to establish nexus for purposes of the Due Process Clause.

4. It should be noted that the court did not address the issue of nexus under the Commerce Clause because the taxpayer did not raise substantial nexus under the Commerce Clause as an issue.

J. *Kevin Associates, LLC v. Crawford,* No. 03-C-0211 (Jan. 30, 2004).

1. The Louisiana Supreme Court held that an out-of-state holding company was subject to Louisiana corporate income and franchise taxes.

2. Kevin Associates (the successor-in-interest to Yendis) is a subsidiary of K&B, Inc. that was established to hold the stock of subsidiaries that owned real estate leased to K&B drugstores owned and operated by its affiliates.

3. Kevin Associates had no physical presence in Louisiana.

4. Kevin Associates made loans to an affiliate that held the stock of the group's operating companies, including a Louisiana affiliate; the loans

were funded by the dividends that Kevin Associates received from its subsidiaries that leased the property to the operating companies.

5. The appellate court held that the company did not have nexus, noting that the company followed all the required formalities for establishing and maintaining a passive investment company. *Kevin Associates LLC v. Crawford*, La. Ct. App., 1st Cir., No. 2001 CA 2652 (Nov. 8, 2002).

6. Reversing the appellate court, the Louisiana Supreme Court held that Kevin Associates was subject to Louisiana corporate income and franchise taxes because the company was commercially domiciled in Louisiana because it was managed from Louisiana, and its Delaware presence was merely a paper domicile. The court reached this conclusion because:

   a. The company was part of a closely held group of corporations, and all of its directors, except the Delaware-based nexus provider, were Louisiana residents.

   b. The company earned dividends from subsidiaries located in Louisiana and other states and received interest from an intercompany loan to an affiliated Louisiana corporation.

7. The court also concluded that the company had a physical presence in Louisiana because its principal place of business was in the state, and it was managed from there.

V. TELECOMMUTERS.

A. Convenience of the employer rule.

   1. Under this rule, a non-resident may claim an allowance for work performed outside of the state only if the work was required to be performed outside of the state by the employer and not if it was done merely for the convenience of the employee. Therefore, if a non-resident is working from outside of the state merely for his own convenience, then the employee may not apportion any income to his resident state for state income tax purposes.

   2. Currently, New York, New Jersey, Pennsylvania and Nebraska have a version of the convenience of the employer rule.

B. *Huckaby v. New York State Division of Tax Appeals,* 4 N.Y.3d 427 (N.Y. 2005), cert. denied, 126 S. Ct. 546 (U.S. 2005).

   1. The New York Court of Appeals by a 4-3 vote upheld New York's convenience of the employer test as it was applied to a Tennessee resident who worked for a New York employer but had only been present in New York for 25 percent of his working time. Specifically, the Court held that the test as applied to Huckaby, which resulted in a tax on 100 percent of his income, did not violate the Commerce Clause nor the Due Process

Clause nor the Equal Protection Clause of the Fourteenth Amendment of the U.S. Constitution.

2. New York's "convenience of the employer test" states that when a nonresident is employed by a New York employer, income derived from work at his home in another state is taxable by New York unless the work is performed out of state for the necessity of the employer.

3. Mr. Huckaby, a Tennessee resident, worked for a New York based organization primarily from his home in Tennessee and only traveled to the New York office as needed. For the years in question, it was established that Mr. Huckaby had only spent 25 percent of his working time in New York. However, the Court upheld the application of the rule to Mr. Huckaby despite the fact that it would result in taxing 100 percent of his income earned during that time.

4. Mr. Huckaby argued that the rule violated due process because he was taxed out of all proportion to the benefits he receives from New York. The Court, however, held that the amount of time the petitioner spent working in New York – approximately 25% - was "significant enough to satisfy any rough proportionality requirement called for by due process."

5. The Court also focused on the "host of tangible and intangible protections, benefits and value" New York State provided to the taxpayer and his employer that were provided every day regardless of whether the taxpayer chose to absent himself from New York.

6. The Court distinguished Mr. Huckaby's situation from the case where a non-resident employee must perform work out of state for the employer's necessity. In this latter scenario, the Court noted that nexus is created between the employer and the foreign state and therefore, New York properly did not tax in only those situations.

7. This rule had been upheld in a similar case where it was applied to a professor who taught in New York but lived out of state. *See Zelinsky v. Tax Appeals Tribunal*, 1 N.Y.3d 85 (N.Y. 2003). The U.S. Supreme Court also declined the opportunity to review this decision on April 26, 2004.

C. Federal legislation.

1. On March 6, 2007, legislation, entitled "the Telecommuter Tax Fairness Act" was introduced in both houses of Congress. (H.R. 1360 and S.785). This legislation is a direct response to the convenience of the employer rule and, if passed, would prohibit a state from imposing a personal income tax on the salary of a nonresident individual with respect to any period of time when the individual is physically present in another state. Specifically, this legislation would prevent a state from deeming a non-resident individual to be present in the state because that individual is working at home for his or her own convenience.

2. Other legislation has been introduced that would prevent a state from taxing the wages of anyone except residents and those taxpayers "physically present performing duties" in the state for at least specified periods (e.g., 30 days, 60 days).

D. *Telebright Corporation, Inc. v. Director, Division of Taxation*, 25 N.J. Tax 333 (N.J. Tax Ct. 2010).

1. A corporation was held taxable in New Jersey because of the presence of a single telecommuting employee, even though her work had nothing to do with New Jersey.

2. The result might have been different if she had been an independent contractor and not an employee.

VI. Miscellaneous Apportionment Developments.

A. Discretionary adjustments.

1. Most statutory schemes provide the Tax Department with discretionary authority to adjust an apportionment formula under certain circumstances for a particular taxpayer. *See, e.g.,* UDITPA Section 18.

a. For example, many statutes provide authority to exclude one or more of the factors or to include additional factors if the apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state.

b. These statutory adjustment powers typically also provide the options of using separate accounting or any other method that will effectuate an equitable apportionment of the tax base.

2. *U.S. Bancorp v. Dep't of Revenue*, 103 P.3d 85 (Or. 2004), *cert. denied*, 126 S. Ct. 48 (U.S. 2005).

a. The U.S. Supreme Court declined to review an Oregon Supreme Court decision that held that the Oregon Department of Revenue had the authority to depart from the standard three-factor apportionment formula for financial organizations to require the inclusion of intangible personal property in the property factor of its apportionment formula for tax years 1984 through 1992.

3. *Irving Pulp & Paper, Ltd., v. State Tax Assessor*, 879 A.2d 15 (Me. 2005).

a. Irving Pulp & Paper, a Canadian corporation engaged in forestry with timberland preserves in Maine but no payroll in the state or anywhere else in the U.S., attempted to use worldwide property, payroll, and sales in the denominators of the apportionment factors.

b. Finding the relevant statute ambiguous, the Supreme Judicial Court of Maine looked beyond the plain language of the statute and adopted the Assessor's interpretation of the terms "all" and "everywhere" to be understood contextually as all and everywhere in the United States.

c. The appellate court determined that the figures used were properly limited to property, payroll, and sales within the United States.

4. *Microsoft Corp. v. Franchise Tax Bd.,* Dkt. No. 5133343 (Ca. Sup. Ct. Aug. 17, 2006), *aff'g Microsoft Corp. v. Franchise Tax Bd.*, No.A105312 (Ca. 1st App. Dist. 2005), *rev. granted*, No. S133343 (Ca. S.Ct. June 8, 2005).

   a. The California Supreme Court recently affirmed the decision by the Court of Appeals for the First District, which had determined that the California Franchise Tax Board did not abuse its discretionary authority by employing an equitable apportionment method to omit the returned principal from the gross receipts element of the sales factor.

   b. The court determined that the standard apportionment formula did not fairly represent the extent of the corporation's business activity in California.

   c. The stipulated facts established beyond question that including returned principal in the corporation's gross receipts seriously distorted the representation of its worldwide business activity, including its California business activity.

5. *General Mills, Inc. v. Franchise Tax Board* (Ca. Super. Ct., San Francisco County 2010).

   a. The use of gross receipts for hedging transactions was held to be distortive.

   b. The FTB was reasonable in concluding that the taxpayer's hedging transactions were qualitatively different from its principal business and had to be treated separately.

6. *Miami Corp. v. Department of Revenue,* 2005 Ore. Tax LEXIS 23 (Or. Tax Court, Magistrate Div. Feb. 17, 2005).

   a. The Oregon Tax Court determined that a Delaware corporation that owned a tree farm in Oregon was subject to the Oregon excise tax apportionment formula because the taxpayer was a unitary business.

b. The taxpayer conducted business in four states.

(i) Its real estate department managed timberland in Florida, a tree farm in Oregon, and land and associated oil and gas reserves in Louisiana.

(ii) Its securities department managed its securities portfolio from the corporate head office in Illinois. The securities portfolio managed in Illinois and the oil and gas reserves in Louisiana represented the greatest part of the taxpayer's income-producing assets.

c. The court determined that the property factor of the apportionment formula should be adjusted to include intangibles for one of the tax years because application of the statutory formula produced an unfair result.

d. The court also determined that the sales factor should be modified for all the relevant tax years to include the gross receipts, rather than net gain, from the taxpayer's sale of intangibles, including securities, because these receipts were derived from the taxpayer's primary business activity.

7. *Matter of Barclays Group, Inc. (USA) & Affiliates*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 818789 (Jan. 27, 2005).

a. The Tax Appeals Tribunal upheld the determination of the Administrative Law Judge that Barclays improperly amended its returns to report, on a net basis, the assets of a wholly-owned subsidiary/member of its combined group that was engaged in business as a primary dealer of U.S. securities, for purposes of the state tax on assets of financial corporations.

b. Barclays claimed that calculating taxable assets in accordance with N.Y. Tax Law § 1455(b)(1) distorted the subsidiary's asset picture because its business of purchasing long positions in securities increased the subsidiary's taxable assets with each transaction but did not increase its wealth or otherwise improve its financial condition.

c. The taxpayer argued that netting of the subsidiary's assets would result in a better measure of the subsidiary's taxable assets within the state.

d. The Commissioner of Taxation and Finance declined to make this discretionary adjustment because the group's assets were neither inaccurately nor improperly reflected on the combined returns as originally filed.

e. The Tax Appeals Tribunal also upheld the ALJ's determination that the Commissioner properly declined to exercise the discretion

to make the proposed adjustment because the taxpayer's assets were neither inaccurately nor improperly reflected on the combined returns as originally filed.

8. *Union Pacific Corp. v. Idaho State Tax Comm'n*, 83 P.3d 116 (Idaho 2004).

   a. The taxpayer included in its sales factor both receipts from freight sales and the money received from the sale of the freight sale accounts receivable. The state tax department asserted that this double-counted the receipts and sought to include only the freight sales in the apportionment formula.

   b. The Idaho Supreme Court found that both transactions were "sales" under the statute and thus ordinarily includable in the sales factor.

   c. However, the court determined that, because of the "unusual" accounting practice of using an accrual method for the freight sales and a cash method for the sale of accounts receivable, it was appropriate to use an alternative apportionment formula to more accurately reflect the taxpayer's income in the state.

   d. The court also found that the statute was clear as to what the rules were for imposing an alternative formula and that there was no need to include the higher federal constitutional standard of "gross distortion"/"out of all appropriate proportion."

9. *In the Matter of Magella Healthcare Corporation*, Alaska Office of Tax Appeals No. OTA-2003-01 (Jan. 2, 2004) (appeal pending).

   a. The Alaska Office of Tax Appeals held that an out-of-state parent corporation of an in-state neonatal medical care provider was entitled to relief from the statutory three-factor apportionment formula and a refund of tax paid on a combined reporting basis. The parent was not required to prove an unconstitutional distortion in apportioned income to obtain factor relief.

   b. The Office determined that the taxpayer had met its burden of proof by showing that the standard formula resulted in a substantial distortion in the income of its Alaska subsidiary by failing to include the payroll and property factors of out-of-state non-subsidiary medical practices, which the corporation controlled through practice management agreements and which generated most of the total income of the multi-state business.

   c. Because the out-of-state corporation met its statutory requirements and burden of proof, the denial of the factor relief under the discretionary adjustment was unreasonable and arbitrary.

10. *Infosys Technologies Limited,* Dkt. No. 820669, N.Y. Div. of Tax Appeals (Feb. 2007).

    a. Having determined that Infosys was required to include foreign source income in its computation of its entire net income for purposes of the New York State corporation franchise tax, the ALJ further determined that equity requires an adjustment to the payroll factor to reflect the vast wage differences between employees working in New York and those working in India. He supported his ruling by showing that the payroll factor as computed by the auditor did not properly reflect the amount of business done within New York.

B. Cost of performance.

1. *General Motors Corporation v. Department of Taxation*, 602 S.E.2d 123 (Va. 2004).

    a. The taxpayer successfully included in the apportionment formula denominator amounts the taxpayer had paid to independent contractors, based strictly on the language of the state statute.

    b. The Virginia Supreme Court reversed a lower court opinion and held that General Motors Acceptance Corporation could include amounts paid to third parties in computing its "cost of performance" ratio for apportionment purposes.

    c. For "financial corporations," the Virginia statute provides that Virginia taxable income "shall be apportioned within and without this Commonwealth in the ratio that the business within this Commonwealth is to the total business of the corporation. Business within this Commonwealth shall be based on cost of performance in the Commonwealth over cost of performance everywhere." Va. Code §58.1-418(A).

    d. The Department of Taxation had promulgated a regulation restricting the costs to be included to only the "cost of all activities *directly* performed by the taxpayer for the ultimate purpose of obtaining gains or profit." 23 V.A.C. §10-120-250 (emphasis added). The regulation further provided that the "directly" requirement in the regulation meant that costs of "activities performed on behalf of a taxpayer, such as those performed on its behalf by an independent contractor," could not be included. *Id.*

    e. Notwithstanding the lower court's decision upholding the regulation and its acknowledgment that Virginia regulations must be sustained unless they are unreasonable or plainly inconsistent with the statute, the Virginia Supreme Court struck the "directly" requirement of the regulation as inconsistent with the statutory provision.

f. The court found that nothing in the language of the statute "limits cost of performance to direct costs or suggests that the Department may exclude costs incurred for activities performed on behalf of a taxpayer by a third party."

g. The court rejected the Department's argument that exclusion of third-party costs was necessary because of the difficulty of obtaining information or cooperation from third party contractors in the course of auditing a taxpayer.

2. *Ameritech Publishing, Inc. v. Wis. Dep't of Rev.*, 788 N.W.2d 383 (Wis. Ct. App. 2010).

   a. The taxpayer sold advertising in telephone directories to customers in Wisconsin and elsewhere. All of its activities occurred outside of Wisconsin.

   b. Although the statute said that the receipts factor was based on cost of performance, the court concluded that "the income-producing activity… was access to a Wisconsin audience." The receipts from sales to Wisconsin customers were sourced to Wisconsin.

   c. Although the court purported to apply a cost-of-performance statute; it effectively interpreted it to provide for market-based sourcing.

3. *Bellsouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009).

   a. The facts were essentially the same as in *Ameritech*.

   b. Although the statute based the receipts factor on cost-of-performance, the court approved the Commissioner's use of discretionary alternative apportionment to source receipts from sales to Tennessee customers to Tennessee.

   c. Here, too, the effect of the decision was to reject the Legislature's decision to use cost-of-performance in favor of market-based sourcing.

4. *AT&T Corp v. Comm'r of Rev.* (Mass. App. Tax Bd. 2011).

   a. The Board accepted the taxpayer's argument that cost of performance should be based on its overall income-producing activity, which was operating a national integrated telecommunications network based in New Jersey.

   b. The Board rejected the Commissioner's transactional approach that compared the costs of providing calls for Massachusetts customers to the costs of providing calls for other customers.

c. The operational approach had been approved by the Supreme Judicial Court in *Boston Professional Hockey Ass'n, Inc. v. Comm'r of Rev.*, 443 Mass. 276 (2005) (income producing activity was operating a NHL franchise and not each game; operational approach was advocated by the Commissioner, contrary to her approach in the *AT&T* case).

C. Throwout and throwback issues.

1. Growing concern - more expansive rules?

a. West Virginia: Classic Throwout

(i) West Virginia employs a classic throwout rule that kicks out of the denominator of the West Virginia receipts fraction any receipts from sales destined to states in which the taxpayer is not taxed.

(ii) In order to be taxable in another state, the statute requires that "the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax," or "that the destination state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, that state does or does not subject the taxpayer to the tax."

b. New Jersey: seeking all wayward receipts

(i) Unlike West Virginia, the throwout rule enacted by New Jersey in 2002 was not limited to sales of tangible personal property and was not even limited to sales that originate in New Jersey. The rule was repealed by the Legislature, effective for years starting after June 30, 2010.

(ii) Furthermore, unlike West Virginia, New Jersey threw out receipts even if New Jersey was neither the state of origination nor the state of destination.

(iii) A sale into a state that does not impose an income tax increased New Jersey's share of the corporation's income, even if not attributable to activities in New Jersey.

(iv) The New Jersey Supreme Court held that he rule was not facially unconstitutional in *Whirlpool Properties, Inc. v. Director, Division of Taxation*, _____ N.J. ____ (2011). However, it interpreted the law not to apply to sales into states that did not impose an income tax.

2. Taxable in another state?

a. *Morton International, Inc. v. Illinois Department of Revenue*, Illinois Circuit Court, Cook County, No. 01 L 50752 (July 8, 2004).

(i) Sales of tangible personal property shipped from an Illinois facility to buyers in foreign countries were excluded from the sales factor and not subject to the "throwback" rule when apportioning income for Illinois corporate income tax purposes because, although the taxpayer did not pay tax on the sales at issue, it was subject to income tax on unrelated income.

(ii) The Illinois Circuit Court, Cook County, held that the statute clearly and unambiguously stated that the throwback rule applies if a person is not taxable in the state of the purchaser.

(iii) Since the taxpayer in this case paid a net income tax on income not related to the foreign sales, it was taxable in another state and the sales could not be thrown back to Illinois.

(iv) The court rejected the Illinois Department of Revenue's argument that the Illinois Appellate Court has interpreted "taxable" to mean that the tax must be paid on the particular sales at issue.

(v) Finally, while the court recognized that its decision would result in "nowhere sales" and that there was a strong policy in avoiding nowhere sales, the court also noted that the policy was not enough to allow it to alter the plain meaning of the statute.

b. *Magnetek Controls, Inc. v. Michigan Department of Revenue*, 562 N.W.2d 219 (Mich. Ct. App. 1997).

(i) The Michigan Court of Appeals determined that the taxpayer did not have to throw sales back to Michigan because the taxpayer had established "more than the slightest presence" in states into which it shipped products by virtue of the continuous activities of independent sales representatives and regular travel by the taxpayer's general manager and product line sales managers to meet with the independent sales representatives.

c. *Indiana Dep't State Rev. Letter of Findings 02-20100173* (2011).

(i) Throwback was held inapplicable because the taxpayer proved that its activities in other states exceeded

"solicitation" so that Public Law 86-272 did not prevent it from being taxed in those states.

(ii) There is no indication as to whether the taxpayer in fact filed returns and paid tax in the other states. The Indiana rule literally provides that throwback is not permitted if the other state has "jurisdiction to impose a net income tax" on the corporation.

3. Constitutional issues?

a. *Home Interiors & Gifts, Inc. v. Strayhorn*, 2005 Tex. App. LEXIS 5908 (Tex. App. 2005)

(i) The Texas Court of Appeals for the Third District reversed the district court's grant of summary judgment to the Comptroller.

(ii) The primary issue in the case was whether the throwback provision of the earned surplus component of the Texas franchise tax unconstitutionally burdens interstate commerce as a result of unfairly apportioning the tax base.

(iii) The earned surplus throwback provision provides that, if a taxpayer is not subject to a net income tax in another state, gross receipts from sales of tangible personal property shipped from Texas into other states are "thrown back" to Texas for purposes of apportioning apportion net taxable earned surplus.

(iv) Employing the internal consistency test, the court reviewed the hypothetical scenario that every state imposed a franchise tax identical to the Texas franchise tax (i.e., a tax on two alternative bases and a sales factor throwback provision). The court compared the burden the Texas franchise tax imposed on a strictly intrastate corporation to that of an interstate corporation under this hypothetical analysis

(v) The Court of Appeals concluded that the interplay of the earned surplus and taxable capital components of the franchise tax, coupled with the workings of P.L. 86-272, resulted in a hypothetical risk of constitutionally impermissible multiple taxation because sales to another state might be included in Texas receipts if the taxpayer is not subject to an income-based tax in the other state due to P.L. 86-272, but was still subject to a tax on its capital in the other state.

(vi) Accordingly, the Court held that the earned surplus throwback provision was internally inconsistent and, thus, violated the fair apportionment requirements of the Commerce Clause.

D. Single factor apportionment formulas.

1. An increasing number of states are employing a single-factor apportionment formula based on sales (either for all corporations or just certain industries). For example, New York, Georgia and Minnesota have recently enacted phased-in single factor formulas. *See* N.Y. 2005 Budget Bill, Georgia H.B. 191 (2005), Minnesota H.F. 138 (2005).

2. Is it Constitutional?

a. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 277 (1978)

(i) Although many would point to the Supreme Court's 1978 decision in Moorman as authority for using a single-factor receipts-based apportionment formula, the Court's decision to uphold the formula largely turned on the taxpayer's failure to develop an adequate record.

(ii) Moorman was a manufacturing corporation that had over 500 salesmen and six warehouses in Iowa; it could not deny that it had a significant level of business activity within Iowa's borders.

(iii) Moorman attacked Iowa's single-factor receipts-based formula on the grounds that it caused duplicative taxation when viewed together with Illinois taxes.

(iv) The Supreme Court expressly couched its rejection of this argument on Moorman's failure to make its record: "[s]ince the record does not reveal the sources of appellant's profits, its Commerce Clause claim cannot rest on the premise that profits earned in Illinois were included in its Iowa taxable income and therefore the Iowa formula was at fault for whatever overlap may have existed."

(v) Furthermore, in the time since *Moorman*, the standards for fair apportionment and discrimination have been further developed by court decisions (such as the internal and external consistency tests of *Container Corp*). The Supreme Court's *Moorman* decision did not, because it could not, address the internal or external consistency of a single-factor receipts-based formula.

b. Due Process issues - "out of all appropriate proportion"

(i) *Norfolk & Western R. Co. v. Missouri*, 390 U.S. 317 (1968) (testing for a grossly distorted result); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

(a) The income attributed to a state by that state's apportionment formula must be rationally related to the values connected with the taxing state.

(ii) *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).

(a) The Supreme Court found that the use of a single-factor property formula to tax 83% of the income of a taxpayer that only had 17% of its income sourced to the state (based on its manufacturing activities there) was out of all appropriate proportion to the business transacted in the state and violated the Due Process Clause.

(b) The Court explained, however, that unless the apportionment formula is "intrinsically arbitrary," the method will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases.

c. Commerce Clause external consistency issues

(i) *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983)

(a) "The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

(b) Since *Container Corp.*, the Supreme Court has been reluctant to strike down taxes on the grounds of external inconsistency.

(ii) *Oklahoma Tax Comm'n v. Jefferson L*ines, 514 U.S. 175 (1995)

(a) Oklahoma's imposition of tax on both intrastate and interstate portions of bus tickets was externally consistent, although tax on interstate portion of tickets presented a risk of double taxation, but using rationale of taxing goods in the state of delivery was reasonable to apply to taxation of services.

(iii) *Goldberg v. Sweet*, 488 U.S. 252 (1989)

(a) Illinois tax on interstate telecommunications imposed based on calls originated or terminated in Illinois and charged to an Illinois service address was externally consistent.

E. Subcontractor's/nontaxpayer affiliates' factors.

1. *Matter of Disney Enterprises*, N.Y.S. Div. of Tax. App., ALJ Unit, DTA No. 818378 (Feb. 12, 2004), *aff'd*, N.Y.S. Div. of Tax. App., Tax. App. Trib. (Oct 12, 2005).

a. The New York State Tax Appeals Tribunal affirmed the ALJ's determination that receipts of a nexus-protected member of a unitary group are properly includable in the numerator of the sales factor in calculating combined income.

b. The ALJ had determined that P.L. 86-272 did not prohibit such treatment because in this instance it could not be concluded that the only business activities conducted within New York by the subsidiaries at issue or on behalf of those entities was the solicitation of orders for sales of tangible personal property.

c. Further, the ALJ determined that protections afforded to non-taxpayer corporations by the Commerce Clause did not prohibit such treatment where the company's activities were part of a unitary business that had sufficient nexus with the state.

2. *UPS Worldwide Forwarding v. Commonwealth*, 843 A.2d 438 (Pa. Commw. Ct. 2004).

a. The Pennsylvania Commonwealth Court held that a taxpayer could not include a payroll factor in its apportionment formula for corporate net income or franchise tax purposes where all business of the taxpayer was conducted by employees of affiliated companies and independent contractors.

b. The taxpayer recorded payroll expenses related to employees furnished by an affiliated corporation; however, it had no written employment agreement with the corporation.

c. Furthermore, the taxpayer had stipulated that it had "no employees." The court noted that "compensation" is defined for payroll factor purposes as amounts paid to "employees."

d. Because the taxpayer stipulated that it had no employees, it had no compensation and thus had a zero payroll factor denominator (i.e., no payroll factor).

e. The court distinguished a Pennsylvania Supreme Court decision with a similar fact pattern in which furnished personnel were found

to be employees. In that case, there was a written employment agreement between the affiliates and the taxpayer controlled the employees.

3. *Matter of Alpharma*, N.Y.S. Div. of Tax App., Tax. App. Trib. DTA No. 817895 (Aug. 5, 2004).

   a. The New York State Tax Appeals Tribunal affirmed the decision of an Administrative Law Judge (though on other grounds) to include receipts of a nexus-protected member of a unitary group in the numerator of the sales factor in computing the combined apportionment formula.

   b. The Tax Appeals Tribunal determined that an apportionment formula is only a formula for dividing income and it does not determine nexus or tax. Thus, nexus protection is not relevant to the apportionment numerator calculation.

F. Turnover of assets

1. Issue: Should "return of principal" in a securities transaction be included in gross receipts for purposes of the California sales factor?

2. California cases.

   a. There are two cases that have recently been decided by the California Supreme Court: *Microsoft* (appealed from the 1st District).and *General Motors* (appealed from the 2nd District) In *Microsoft* and *General Motors* the Supreme Court affirmed judgments by the Court of Appeal. In *Microsoft*, the court held that the entire redemption price of a marketable security is includable as gross receipts in the sales factor. In *General Motors*, the court held that only the interest from repurchases should be treated as gross receipts. In both cases the court upheld the Franchise Tax Board's alternative method of calculation under the relief clause of UDIPTA § 25137 to achieve an equitable result. *See Microsoft v. Franchise Tax Board*, Dkt. No. 5133343 (Ca. Sup. Ct. Aug. 17, 2006) and *General Motors Corp. v. Franchise Tax Bd.*, Dkt. No. S127086 (Ca. Sup. Ct. Aug. 17, 2006).

   b. Two other cases have recently been decided at the Court of Appeals level: *Toys "R" Us* (3rd District) and *The Limited* (1st District). In *Toys "R" Us*, the Court of Appeal affirmed the trial court's judgment that inclusion of the return of principal from short-term investments in the sales factor distorted the apportionment formula and affirmed the Franchise Tax Board's allowing only inclusion of interest in the sales factor under the relief clause of UDIPTA § 25137. In *The Limited*, the Court of Appeals affirmed the trial court's judgment that the returns of principal from debt instruments held to maturity are not "sales"

within the meaning of the pertinent UDIPTA provisions and therefore are not includable in the apportionment formula that defines "sales" as including "all gross receipts." *See Toys "R" Us, Inc. v. Franchise Tax Board*, 41 Cal. Rptr. 3d 285 (2006); *The Limited Stores, Inc. v. Franchise Tax Board*, Dkt. No. A102915 (Cal. App. 5th 2005).

c. There are two other cases pending at the California Superior Court level: *Montgomery Ward LLP v. FTB*, San Diego Co. Sup. Court No. GIC-802767; *Colgate-Palmolive Co. etc. v. FTB*, Sacramento Co. Sup. Court No. 03AS00707. Both taxpayers lost before the SBE.

3. *General Motors Corp. v. Franchise Tax Board*, Dkt. No. S127086 (Ca. Sup. Ct. Aug. 17, 2006) *aff'g* in part and *rev'g* in part 120 Cal. App. 4th 114 (2004).

a. Considering this case as a companion case to the *Microsoft* decision delivered the same day, in an unpublished opinion the Supreme Court of California ruled that in line with its holding in *Microsoft*, the entire redemption price of a marketable security is includable as gross receipts in the sales factor. Thus, the Court of Appeal erred to the extent it excluded the full price of securities from gross receipts.

(i) Securities repurchase agreements are analogous to secured loans for UDIPTA purposes and thus for repurchase agreements only the interest received should be treated asgross receipts.

(ii) Because the full proceeds from General Motors' redemptions should have been treated as gross receipts, the Supreme Court remanded for further proceedings to allow the Board to make its section 25137 case in accordance with the principles set out in *Microsoft*.

(iii) Affirmed that only the specific member of a unitary group that earned research credits was allowed to use such credits to reduce its tax.

b. The California Court of Appeal, 2nd Appellate District ruled that

(i) The FTB properly excluded gross receipts from sales of securities from the denominator of the sales factor,

(ii) Only the specific member of a unitary group that earned research credits was allowed to use such credits to reduce its tax.

c. Denominator issue:

(i) General Motors had a treasury department in New York that invested excess cash of related entities, primarily in repurchase transactions.

(ii) The California FTB reclassified the treasury department income as business income and included only the net proceeds in the sales factor, which resulted in a fifty percent increase in GM's California taxable income.

(iii) The appeals court determined that the return of principal from the securities transactions should not be defined as a "gross receipt" and thus should not be included in the sales factor because it was not part of a "sales transaction."

d. Credit issue:

(i) California allows an R&D credit similar to the federal credit.

(ii) A member of GM's unitary group incurred substantial R&D expenses resulting in a significant tax credit.

(iii) This tax credit exceeded its own California tax attributed to it as part of GM's combined group.

(iv) GM sought to use the excess credit to offset the tax of the combined group as a whole.

(v) The issue rested on whether the taxpayer was the combined group or the individual company. The court found that because the credit is to be used only against the actual tax imposed, and the actual tax imposed is only on the specific member of the group, only that member may take the credit.

G. IRC § 338(h)(10) deemed asset sales.

1. *Canteen Corp. v. Commonwealth*, 854 A.2d 440 (Pa. 2004).

a. In a *per curium* decision, the Pennsylvania Supreme Court affirmed the *en banc* decision of the Pennsylvania Commonwealth Court that had reversed a decision of a three-judge panel of the Court Commonwealth Court and held that a target company's gain on the deemed sale of its assets in a transaction subject to I.R.C. § 338(h)(10) of the Internal Revenue Code was nonbusiness income.

b. The Commonwealth Court held that the fictional construct of I.R.C. § 338(h)(10), in which a corporation the stock of which is sold to another corporation is deemed to have sold its assets and

liquidated into its selling parent corporation, should be respected for Pennsylvania tax purposes.

c. In reaching its decision, the court applied prior Pennsylvania case law that uses both the functional and the transactional tests in determining whether gain on the sale of assets produces business or non-business income but provides that the gain on the sale of assets that are used in the business is nonbusiness income if the sale proceeds are distributed to the shareholders of the selling corporation and are not reinvested in the seller's business.

d. The court then held that the fictional sale and liquidation hypothesized by I.R.C. § 338(h)(10) should be taxed in the same way as is an actual sale and liquidation.

2. *ABB C-E Nuclear Power, Inc. v. Director of Revenue,* Missouri Administrative Hearing Commission, No. 04-0189 RI (June 23, 2005).

a. The Missouri Administration Hearing Commission granted the taxpayer's motion for summary determination, thereby holding that gain from a deemed sale of the assets under IRC § 338(h)(10) is nonbusiness income of the subsidiary and therefore, is not apportionable to Missouri for corporate income tax purposes.

b. The Commission determined that, because the sale of assets under IRC § 338 was not in the regular course of the subsidiary's trade or business, it was properly categorized as nonbusiness income allocable to Connecticut, the subsidiary's state of domicile.

c. In addition, the Commission determined that the subsidiary did not receive any proceeds from the sale of its assets; rather, another subsidiary that did not have nexus with Missouri received the proceeds.

3. *CenturyTel, Inc. v. Department of Revenue* (Oregon Tax Ct. 2010).

a. The Oregon Tax Court did not acknowledge that there was a liquidation exception to the functional test but it said that even if there was it would not apply to the facts before it because the selling parent used the sale proceeds in a business that was unitary with the business conducted by the subsidiary the stock of which was sold.

b. This is the first case that focused on the use of the sale proceeds by the seller. *See*, Peter L. Faber, "Oregon Court Adds New Test for Nonbusiness Income in Liquidating Sale," State Tax Notes (September 13, 2010).

H. Other business vs. nonbusiness income cases.

1. *MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008), reversing 371 Ill. App. 108 (App. Ct. Ill., 1st Dist., 6th Div. (2007)).

   a. Mead sold the assets of its Lexis/Nexis subsidiary in a taxable transaction.

   b. Mead treated its gain attributable to the subsidiary's goodwill as nonbusiness income.

   c. The Illinois court held that the goodwill served an operational function for Mead, not an investment function, and that the gain was business income. It did not address the question of whether the businesses were unitary.

      (i) There was virtually no discussion of the details of the operational concept.

      (ii) Cases involving minority interests in other corporations were distinguished.

   d. The U.S. Supreme Court reversed. It explained that the operational function in *Allied Signal* was not intended to add an additional ground for apportionability. It only meant that an asset that served an operational function could be part of a taxpayer's unitary business even if there was no unitary relationship between the payor and the payee.

2. *Jim Beam Brands Co. v. Franchise Tax Bd.*, 133 Cal. App. 4th 514 (Cal. Ct. App. 2005).

   a. The California Court of Appeal affirmed the State Board of Equalization's decision to treat gain from the sale of stock in a unitary subsidiary as business income under the functional test.

   b. Under the functional test, income is "business income" if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business.

   c. The court stated that the functional test does not examine the use of the proceeds of the disposition or focus on the reasons for the transaction. Instead, the test examines whether the taxpayer controls and uses the property to contribute materially to its production of business income so that the property becomes interwoven into and inseparable from the taxpayer's business.

   d. The court declined to find an exception under the functional test for a partial liquidation, noting that under California law, the focus is on the relationship between the assets sold and the taxpayer's

regular trade or business operations and not on the nature of the transaction.

3. *Legal Ruling 2005-02*, California Franchise Tax Board (July 8, 2005).

   a. The California Franchise Tax Board has issued a ruling stating that I.R.C. § 965 (the 85 percent foreign dividends received deduction) affects the business characterization of income in California only to the extent that dividends are not immediately reinvested and generate income while waiting to be reinvested. In that case, the earmarking of the I.R.C. § 965 dividends for a particular purpose controls the characterization of income arising from those dividends.

   b. If the funds are earmarked for a unitary business purpose, any income earned on those funds would constitute business income apportionable to the unitary trade or business.

   c. If the repatriated funds are earmarked for a nonbusiness function, or are earmarked for a line of business separate from the taxpayer's unitary trade or business, any income earned on those funds would not constitute business income apportionable to the unitary trade or business.

4. *General Electric Co. v. Iowa State Bd. of Tax Review*, 702 N.W.2d 485 (Iowa 2005).

   a. The Iowa Supreme Court affirmed the lower court's decision to hold that Iowa's nonbusiness allocation rule did not apply to a capital gain completely offset at the federal level and excluded from state net income.

   b. In 1993, General Electric realized a capital gain which was classified as "nonbusiness" for Iowa tax purposes and was not taxed in Iowa due to allocation to another state. GE later applied for a refund on its 1993 Iowa income tax based on a carryback of a capital loss sustained in 1995.

   c. The court found that Iowa's nonbusiness allocation rules only applied to items of income contained in the taxpayer's Iowa net income. Because the 1993 capital gain was completely offset at the federal level, none of that gain was included in the taxpayer's Iowa net income. Thus, the taxpayer could not allocate gain that was not included in the first instance. Allowing allocation of such items would amount to a double deduction.

5. *J.R. Simplot Co. v. Missouri Director of Revenue*, No. 03-1990RF (May 13, 2005).

   a. The Missouri Hearing Commission found that an Idaho company's long-term capital gain from the sale of another firm's stock

resulted in nonbusiness income that was not apportionable to Missouri.

b. The ruling was based on the fact that the two firms did not comprise a unitary business and that the funds from the gain were not used for operational purposes.

6. *Final Agency Decision No. 09 REV 5669* (N.C. Dep't of Rev. 2011).

a. Gain on the sale of limited partnership interest was not apportionable because the taxpayer was a passive investor in the partnership and was not unitary with it, even though the partnership was closely held and operated a series of related businesses.

b. The fact that the taxpayer had reported income from the partnership as apportionable business income was irrelevant.

VII. SALES AND USE TAX NEXUS.

A. *Louisiana v. Dell International, Inc.,* No. 2004 Ca 1702 (La. App. Ct., 1st Cir. Feb. 15, 2006), rev'g, State of Louisiana and Secretary of the Department of Revenue and *Taxation v. Dell Catalog Sales, L.P.,* Dkt. No. 456,807 (La. 19th Jud. Dist. Ct., Parish of East Baton Rouge, May 25, 2004).

1. The Louisiana Appellate Court reversed and remanded the opinion of the 19th Judicial Circuit, which had granted summary judgment to Dell on the basis that the sales of optional services contracts administered by BancTec in Louisiana were not sufficient to subject Dell to a Louisiana use tax collection responsibility.

a. The trial court had first determined that Dell did not have a physical presence in Louisiana and that Dell was not performing services in Louisiana.

b. The trial court had also determined that BancTec was not performing services on behalf of Dell but on behalf of Dell's customers and, thus, its activities did not create nexus for Dell.

2. Dell, a remote catalog vendor, sold optional computer repair service contracts to its computer customers. Dell contracted with BancTec, an independent contractor, to perform the computer repairs under the service contracts.

3. The Louisiana Department of Revenue sought to impose a sales and use tax collection obligation on Dell based on BancTec's activities in Louisiana.

4. The appellate court determined that computer repair services provided to an out-of-state computer retailer's customers in Louisiana by an on-site

repair company raised a genuine issue of fact as to whether the computer retailer had sufficient nexus with Louisiana to require it to remit use tax.

5. The appellate court looked to the extent and the nature of the services provided by BancTec to Dell's Louisiana customers as well as the impact of this service on Dell's ability to establish and maintain a lucrative market in this state. Based on the record, the court concluded that Dell did not prove that there was no factual support for the claim that BancTec provided computer repair services in Louisiana to Dell customers on behalf of Dell. Accordingly, the trial court had erred in granting summary judgment for the computer retailer because Dell failed to establish its entitlement to summary judgment in its favor as a matter of law.

B. *Dell Catalog Sales v. Commissioner of Revenue Services*, 48 Conn. Supp. 170, 830 A.2d 812 (Ct. Superior Ct. 2003).

1. Dell, a remote catalog vendor, sold computer repair service contracts to its computer customers. Dell contracted with BancTec, an independent contractor, to perform the computer repairs under the service contracts.

2. The Connecticut Department of Revenue Services sought to impose a sales and use tax collection obligation on Dell based on BancTec's activities in Connecticut.

3. The court noted that, because Dell was a retailer and not a manufacturer, it did not provide any implicit warranties about the product.

4. All repairs were initially arranged through Dell; in appropriate circumstances, Dell referred the customers to BancTec for an on-site visit.

5. The court did not reject outright the notion that the activities of BancTec could create nexus for Dell but nevertheless determined that there was insufficient evidence demonstrating the extent of BancTec's actual activities in Connecticut.

C. *Kmart Corp. v. New Mexico Taxation and Revenue Dept.*, N.M. Sup. Ct. Docket No. 27,269 (Dec. 29, 2005).

1. The New Mexico Supreme Court unanimously held that New Mexico's gross receipts tax does not apply to receipts from granting a license to use intangible personal property when the grant occurs outside New Mexico. However, the court declined to rule on the constitutional nexus and corporate income tax issues. Instead, the court quashed its writ of certiorari on these issues and ordered that the Court of Appeals' decision be published, making the appeals court's holdings the current law of New Mexico.

2. The Court of Appeals had held that royalties flowing from the sale of the license could be taxed because the license was used in New Mexico through the use of the trademarks and that the affiliate could be taxed

because its relationship with the in-state operating company created the functional equivalent of physical presence.

D. *Massachusetts Department of Revenue, Letter Ruling 05-7* (Nov. 8, 2005).

1. The Commissioner of Revenue ruled that there was no sales and use tax nexus for a corporation that operates a retail store in the state and whose foreign parent corporation and other wholly owned subsidiaries sell similar tangible personal property by mail order or the Internet to in-state residents. The corporation does not conduct in-store advertising for affiliated companies and no website addresses, telephone or other contact information appear on the corporation's shopping bags, store receipts or in store displays. However, the corporation has a "repurchase" policy to repurchase or replace products they normally carry even if the item was not originally purchased at that store. Catalogs for the affiliated companies are available to customers upon request but are primarily used by store employees

2. The commissioner concluded that there must be some additional connection between related corporations beyond a related company name and similar inventory to constitutionally require an out-of-state affiliate to collect sales or use tax.

3. The corporation's "repurchase" policy was distinguished from other return policies that encourage in-store return of items bought on-line or from a catalog. The activity was not found to meaningfully benefit the affiliate companies.

4. Use of catalogs and a common gift certificate were found to only incidentally benefit the affiliated companies.

E. *Mason Shoe Mfg. Co. v. State Bd. of Equalization*, 2005 Cal. App. Unpub. LEXIS 7868 (Cal. App. Ct., 1st App. Div. Aug. 30, 2005).

1. An out of state manufacturer which has nexus with California is required to collect California use tax when it delivers goods sold by an out-of-state retailer that has no nexus with the state to a California consumer.

2. California sales and use tax law provides that, when tangible personal property is delivered by an owner or former owner thereof, or by a factor or agent of that owner, former owner, or factor to a consumer or to a person for redelivery to a consumer, pursuant to a retail sale made by a retailer not engaged in business in California, the person making the delivery shall be deemed the retailer of that property. Cal. Rev. & Tax. Code § 6007.

F. *Borders Online, LLC v. State Board of Equalization*, 129 Cal. App. 4th 1179 (Cal. Ct. App. 2005).

1. The First District Court of Appeal held that an online retailer was required to collect use tax from its California customers by virtue of its relationship

with its in-state bricks and mortar affiliate. The trial court had granted the Board of Equalization's motion for summary judgment – the issue on appeal was whether, in granting the Board's motion, the trial court properly held that there was no triable issue of material fact.

2. The Court of Appeal held that the trial court correctly determined that Borders stores acted as an agent of Borders Online by virtue of the return policy adopted by Borders Online (*i.e.*, merchandise ordered from Borders Online could be returned to Borders stores), the fact that employees in Borders stores were told to encourage customers to place orders with Borders Online, and the fact that receipts were printed with encouragement to shop at Borders Online.

3. The Court of Appeal also held that imposition of a use tax collection responsibility was consistent with the Commerce Clause. In conducting this analysis, the court generally looked to the standard articulated in *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232 (1987): "whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for sales."

4. The court found that the Borders stores assisted Borders Online with building a market in California by (1) accepting returns; (2) imprinting at least some receipts with the phrase "Visit us online at www.Borders.com; and, (3) encouraging customers in the Borders stores to shop at Borders Online. The court also noted that additional facts supported that a "cross-selling synergy" existed (*e.g.*, use of similar logos or sharing of market and financial data) that allowed Borders Online to establish and maintain a market in California.

G. *St. Tammany Parish v. Barnesandnoble.com,* Dkt. No. 05-5695, E.D. La. (Mar. 22, 2007) (appeal pending).

An Internet seller was alleged to have sales and use tax presence in Louisiana due to its affiliation with an entity owning bookstores in the state. The companies had separate management, employees and offices. However, they participated in gift card and membership programs operated by their parent, and benefited by advertising of the programs as well as certain other cross promotional activities. The brick and mortar stores also accepted returns of merchandise sold by the Internet seller, but also accepted returns of unrelated sellers' products. The Internet site listed store locations. The federal court refused to attribute tax presence from brick and mortar stores to the Internet seller. The court stated that the contacts were not "of the order of magnitude necessary to establish that" the brick and mortar stores marketed the Internet company's sales in Louisiana. The sharing of a common name, brand identity and the joint marketing described did not establish nexus. This case has been appealed.

H. *Barnesandnoble.com v. State Bd. of Equalization,* No. CGC-06-456465, (Superior Court, San Francisco County, Sept. 7, 2007).

1. An out-of-state corporation that sells books, music, and movies in the state via the Internet does not engage in business in the state, even though limited marketing was done through brick-and-mortar stores in the state.

2. The California Rev. & Tax. Cd. § 6203 definition of a retailer engaged in business in the state includes a retailer having an agent within the state. The Superior Court ruled that Barnes & Noble, which owned brick-and-mortar stores in California, was not the agent of Barnesandnoble.com when the brick-and-mortar stores inserted the online retailer's coupons into its shopping bags and printed the name of the online retailer on one side of its shopping bags.

3. The Superior Court distinguished the present case from that in the previous *Borders* case in that Barnesandnoble.com was not fully controlled by Barnes & Noble. Also, Barnes & Noble had no authority to bind Barnesandnoble.com, and Barnes & Noble owned only 40% of Barnesandnoble.com, whereas in *Borders*, the subsidiary was wholly owned by the parent.

I. *Decision, Hearing No. 39,829*, Texas Comptroller of Public Accounts (Feb. 24, 2004).

1. A debt collection service company had the requisite physical presence in Texas to create substantial nexus and thus could be required collect Texas sales and use tax on charges for its services.

2. Physical presence was established by the employment of at least six contract salesmen soliciting business in Texas.

3. Sales of debt collection services by these salesmen qualified as doing business in Texas.

4. In addition, the company had contracts to provide debt collection services in Texas, and one of those contracts required the company to provide internal staff for coordination and implementation of all client-related activities.

J. *Boat America Corp. and Boat U.S. (Advisory Opinion),* TSB-A-04(3)S, N.Y.S. Comm'r of Tax'n and Fin. (Feb. 24, 2004).

1. The New York State Department of Taxation and Finance ruled that an out-of-state non-profit membership organization with no physical presence in New York established nexus in the state through the activities of two unrelated independent contractors in the state and, therefore, must collect sales and use tax on catalog and internet sales made to New York purchasers.

2. The organization, an association for boaters, provided various services to its members, including marina membership discounts, insurance, theft protection, magazine subscription, and access to emergency towing services.

3. Four retail stores in New York owned by third parties, but which bore the organization's name, sold memberships to the organization.

4. The Department ruled that the stores served as independent representatives that established New York nexus for the organization through the sale of memberships.

5. The Department found that nexus was also established through the arrangement the organization had with local towing companies for its members to receive emergency towing services throughout the country.

K. States have adopted a number of legislative approaches aimed at requiring out-of-state Internet sellers to collect use tax. These efforts have been supported by bricks-and-mortar retailers.

1. Some states have adopted statutes providing that an out-of-state retailer has nexus, or is presumed to have nexus (subject to rebuttal), if it has in-state affiliates who provide links to the retailer's website and sales to in-state customers exceed certain levels.

   a. Examples: Arkansas, California, Connecticut, Illinois, New York, North Carolina, Rhode Island.

   b. New York law (rebuttable presumption) is being challenged in court and has been upheld. *Amazon, Inc. v. Dep't of Tax and Fin.* (N.Y. County 2009).

2. Some states have adopted statutes requiring out-of-state retailers to report in-state purchasers.

   a. Examples: Colorado, Oklahoma, South Dakota, Vermont.

   b. A federal district court has granted a preliminary injunction against enforcement of the Colorado statute on constitutional grounds. *Direct Marketing Ass'n v. Huber,* ____ F. Supp. _____ (D. Col. 2011).

3. Proposed Model Affiliate Sales Tax Nexus Proposal, Multistate Tax Commission (April 28, 2005).

   a. The MTC Executive Committee has approved a proposed attributional nexus standard for sales and use taxes. The proposal was rejected at the August 2006 Annual Meeting in Topeka, Kansas

b. The proposed standard would have provided that:

(i) An out-of-state business has nexus with a state (and a corresponding sales and use tax collection obligation) if the out-of-state business is "related to" an in-state business and:

(a) the out-of-state and the in-state businesses use "an identical or substantially similar name, tradename, trademark or goodwill to develop, promote, or maintain sales", or

(b) the in-state business "provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market."

(ii) Businesses would be "related" if they are members of the same "controlled group" for federal corporate income tax purposes, or there is a 50 percent ownership relationship between the parties (for this purpose, ownership would include direct, indirect, beneficial, or constructive ownership).

4. Attributional nexus standards have been enacted by several states, such as Alabama, Arkansas, Indiana, Kansas, Kentucky, Minnesota, and Utah. *See* Ala. Act 390 (H.B. 650) (2003) (effective Aug. 1, 2003); Ark. H.B. 1440 (2001) (effective Jan. 1, 2002); Ind. P.L. 81-2004 (H.B. 1365) (2004) (effective July 1, 2004); Kan. Laws Ch. 159 (H.B. 2416) (2003) (effective July 1, 2003); Ky. H.B. 272 (effective Aug. 1, 2005); Minn. Laws Ch. 127 (S.F. 1505) (2003) (effective Jan. 1, 2004); and Utah Laws Ch. 255 (H.B. 273 2004) (effective July 1, 2004).

VIII. MISCELLANEOUS SALES TAX DEVELOPMENTS.

A. Computer software.

1. The states generally treat the sale of pre-written and non-individualized software as a sale of tangible personal property that is subject to sales tax.

a. An argument can be made that software is inherently intangible, even though it may be preserved on a piece of tangible property (e.g., a disc), and that the proper way for a state to subject it to sales tax would be to so provide specifically in the statute.

b. Disputes often develop as to when software should be viewed as being developed to meet a customer's specific needs and is not "canned."

2. Disputes are developing as to whether the provision of a service in which a customer uses the Internet to access the services provider's platform is a taxable license of the provider's software. See, e.g., *MindLenders, Inc.*, N.Y.S. Dep't of Tax. and Fin. TSB-A-09(2)S (2009), in which an interactive web-based educational and training service was held to be a taxable license of pre-written software that was taxable if the customer used it in New York, regardless of where the server was located.

B. New York's tax on information services.

1. The law.

a. Tax Law section 1105 (c)(1) imposes tax on:

"The furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons, but excluding the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons, and excluding the services of advertising or other agents, or other persons acting in a representative capacity, and information services used by newspapers, radio broadcasters and television broadcasters in the collection and dissemination of news, and excluding meteorological services."

b. Tax Law section 1105 (c)(9) extends this to information services provided by "telephony or telegraphy or telephone or telegraph services."

c. Consulting services are generally not taxable.

2. General principles.

a. Bundling.

(i) When taxable and tax-exempt tangible personal property are sold together and the price for the exempt property is not separately stated, the entire "bundle" is taxable.

(ii) The Department says that the same principle applies to bundles of taxable and tax-exempt services, although there is no comparable regulation. TSB-A-97 (82)S.

b. If the primary function or true object of a service is consulting or another non-taxable service, the entire service is not taxable even though one or more components of it, if viewed in isolation, would be taxable information services. *Matter of SSOV' 81 Ltd* (DTA 810966, 810967, 1995) (primary function of dating service was to provide dates, not information); TSB-M-10(7)S.

3. Issues that come up in analyzing information services issues in the financial services industry.

   a. What is the service's primary function or true object?

   b. Is the service "personal or individual in nature?"

   c. Is information being provided?

   d. Who is providing or buying the service?

4. In July 2010, the Department released a comprehensive TSB-M announcing its general policies in connection with information services. TSB-M-10(7)S.

   a. General principles.

      (i) The primary function or true object test was confirmed.

      (ii) The principal focus is on the nature of the information purchased and not on its use by the buyer.

   b. Examples of taxable information services include (among 25 services listed):

      (i) Investment reports and services, including stock market reports and forecasts, mutual fund rating services, and stock quotation services.

      (ii) Newsletters.

      (iii) Survey results.

   c. The TSB-M received widespread publicity. Many buyers and vendors are changing their practices to comply with it.

   d. Some of the positions set forth in the TSB-M and in other Department communications are controversial and may be challenged by taxpayers. The TSB-M represents the Department's views and not the law.

5. Selected issues of interest to the financial services industry.

   a. Is a service a taxable information service or a nontaxable consulting services?

      (i) Broker/dealers often provide investment management advice along with research and written investment reports.

      (ii) If the principal value to the client is access to the firm's investment professionals, the provision of information should be viewed as incidental to the consulting service and should not be taxable under the true object test. See *Matter of Nerac* (DTA 822568, 2010) (true object of consulting

service was analyzing and solving problems and not providing information); *Matter of Telecheck Services, Inc.*, DTA 822275, 2009) (true object was advice on whether to accept check and not credit information).

b. Soft dollar arrangements.

(i) In a soft dollar arrangement, a broker agrees to discount its commission on trades. In addition to other alternatives, the discount may be provided by purchasing research for the Client from third-party vendors, using the discounted amounts. The Client chooses the Vendor and the nature of the research. The broker does not see or use the research.

(ii) Department auditors have raised the issue in audits.

(iii) Arguments against taxability.

(a) The research is personal and individual (will depend on the facts).

(b) The Client, not the broker, is the real buyer of the services and it, not the broker, is liable for any tax that may be due.

(1) The Client selects the Vendor and the research to be purchased.

(2) The Client uses the research. The broker never sees it.

(3) The fact that the broker is liable for payment to the Vendor is irrelevant. It is merely a paying agent. See TSB-A-09(51)S.

(4) It would be helpful if unused funds in the soft dollar account reverted to the Client when the relationship ends.

c. Risk analytics services.

(i) Firms offer to Clients analytical tools to evaluate risks of investment portfolios. They measure risks presented by various events (e.g., changes in interest rates, inflation). The Client accesses proprietary software that is developed and owned by the Firm. The software uses mathematical models. Its use may be coupled with in-person advice by the Firm's economists and investment professionals.

(ii) In its comprehensive TSB-M on information services in 2010, the Department announced that it would treat risk

analytics services as taxable information services, effective September 1, 2010, reversing its prior position.

(iii) Arguments that risk analytics services are not taxable information services.

(a) The information, if any, that is provided to the Client is based on the Client's information and is personal and individual. *Matter of Standard-Poor's Compustat Service, Inc.* (DTA 808827, 1994).

(b) There is no providing of information.

(iv) A more serious argument for taxability is that the arrangement amounts to a taxable license of software.

(a) Arguably, the Client is paying for the use of the Firm's software that was not designed for the Client's use and, hence, is "canned" and not customized.

(b) Arguments against taxability.

(1) The Client does not possess or control the software.

(2) The software remains on the Firm's server and the Client does not have access to the underlying software code.

(3) The Firm can change the software or suspend its use at any time.

(4) The Firm can change the software at any time.

(5) Under the true object test, the Firm is providing an analytic service that it does using its proprietary software as a tool.

(6) Taxing the service would violate the Internet Tax Freedom Act because the service, if provided other than by the Internet, would not be taxable.

d. Bundling of commissions.

(i) If a taxable information service is provided by a broker/dealer along with securities trades and the cost is not separately stated, does the bundling concept mean that the entire fee, including the commission, is subject to sales tax?

(ii) This is a theoretical possibility, but top Department officials have indicated informally that that is not the Department's position..

IX. FUTURE TRENDS.

A. No-fault penalties.

1. In the past, penalties have generally been imposed only as punishment for bad conduct (e.g., fraud, negligence, disregard of rules and regulations).

   - Taxpayers have generally been able to avoid the imposition of penalties by showing reasonable cause (e.g., reliance on competent tax advisor) or by disclosing their positions on their tax returns.

2. Now, states are starting to impose no-fault penalties (i.e., whenever there is a deficiency, even if the taxpayer's position is reasonable and is disclosed on its tax return).

3. California Revenue Tax Code section 19138(b).

   a. Effective December 19, 2008, for taxable years starting after December 31, 2002, for which the statute of limitations had not expired as of December 19, 2008.

   b. Applies only to corporations.

   c. If the taxpayer has an understatement of tax of more than $1,000,0000, the penalty is 20% of the entire understatement (not just the amount of the understatement in excess of $1,000,000).

   d. The penalty is avoided only if:

      (i) The law changes after the earlier of the extended due date of the return or the filing date of the return or

      (ii) The taxpayer reasonably relies on a formal Franchise Tax Board Chief Counsel ruling.

   e. There is no exception for reasonable cause or disclosure.

   f. See, generally, FTB Notice 2009-03.

4. Other states have imposed an unusually high interest rate on deficiencies when taxpayers have failed to proceed under amnesty programs (e.g., New Jersey).

5. No-fault penalties are bad tax policy and should not be used.

   a. The tax laws are complex. Taxpayers and tax administrators often disagree in good faith about their meaning.

b. The tax litigation process tilts against the taxpayer.

(i) The taxpayer typically has the burden of proof with respect to factual matters.

(ii) The courts typically defer to the presumed expertise of the department of revenue on legal issues, especially when the court is one of general jurisdiction and not a special tax court.

c. A taxpayer that reasonably interprets the tax laws should not have to pay a penalty in addition to a tax deficiency and interest if the courts reject its position.

B. Mandatory combined returns.

1. More states are moving to mandatory combined reports whenever related corporations are engaged in a unitary business.

2. Tax administrators are coming to the conclusion that combined reporting is needed to prevent tax avoidance through the use of multiple entities operating in different states.

3. The states need money. Raising rates is politically unappealing. Combined reporting is a way of increasing business taxes without raising rates.

4. States that have recently moved to combined reporting: Vermont (2006), Michigan (2007), New York (2007, Massachusetts (2009), West Virginia (2009), Wisconsin (2009).

5. More states are considering moving to unitary combined reporting.

C. Retroactive legislation.

1. State legislatures have been willing to adopt retroactive tax laws.

2. Retroactive laws are unfair. A taxpayer should be able to plan a transaction in reliance on the law as written at the time.

3. The courts have generally been willing to allow retroactive tax legislation, even when it deprived taxpayers of benefits that they have relied on receiving. See, e.g., *Exelon Corp. v. Ill. Dep't of Rev.*, 917 N.E.2d 899 (Ill. 2009); *Miller v. Johnson Controls*, 296 S.W.3d 392 (Ky. 2009), cert. denied 2011 (retroactivity justified by the legitimate government purpose of preventing loss of revenue).

- The courts have relied on the U.S. Supreme Court's decision in *U.S. v. Carlton*, 512 U.S. 26 (1994), in which Congress was allowed to fix a mistake by retroactively repealing a statute that would have inadvertently allowed massive avoidance of the estate tax – a classic example of bad facts making bad law.

4. A Washington statute that reached back 24 years to deny deductions to manufacturers of bunker fuel (the deduction was limited to wholesalers and retailers) was held to be unconstitutional on Due Process grounds in *Tesoro Refining and Marketing Co. v. Wash. Dep't of Rev.*, 159 Wash. App. 104 (Wash. Ct. App. 2010).

D. Effect of regulations.

1. There is a strong presumption of favor of the validity of regulations that have been adopted by a department of revenue.

2. In *Mayo Foundation for Medical Education and Research v. US*, ___ U.S.______ (2011), the U.S. Supreme Court upheld a Treasury regulation dealing with FICA tax liabilities of medical residents, holding that it was "a reasonable interpretation" of a general statute.

3. Nevertheless, regulations will be struck down if they are inconsistent with a statute that they purport to interpret. See, e.g., *IBM Corp. v. Director, Division of Taxation*, ____ N.J. Tax ____ (2011) (regulation purporting to tax certain export income that was excluded from federal taxable income and not added back by the New Jersey statute held invalid).