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INTRODUCTION TO COURSE

This course will cover the major areas of concern to taxpayers with regard to their taxability and liability for income taxes, or taxes measured by income, in the several states. A question of primary importance for a company doing business in more than one state is the determination of liability for tax in a given state. Once the question of jurisdiction (i.e., nexus) is settled for purposes of a particular type of tax, the company may devote significant resources to the attempt to identify the extent of its liability. This process entails a working familiarity with numerous complex state tax issues and sub-issues, the most critical of which are discussed in detail throughout the course of this outline. Moreover, corporate tax planners will also attempt to identify opportunities to streamline compliance and minimize tax liabilities through a variety of methods.

The complexities that exist in this area provide many opportunities and pitfalls to taxpayers and their advisors. The study and practice of the multistate tax area requires an acceptance of the fact that precise and uniform rules and procedures are often lacking. Even when the U.S. Supreme Court has ruled on an issue of constitutional import, state tax professionals often discover that additional questions remain unanswered, or that the Court's decision engenders new uncertainties. Nevertheless, a company may achieve substantial proactive benefits through careful consideration and creative application of the topics presented herein.

<u>LIMITS ON THE STATES' POWERS TO TAX: NEXUS</u>

IN GENERAL

As stated above, the first issue a multistate business must confront is related to jurisdiction, both the right to tax the company and the right to impose indirect tax burdens on it (e.g., to collect and remit sales/use taxes, or to file information returns). Generally, a company will be liable for tax in a given state if sufficient "nexus" is established with that state.

A company operating in more than one state has the burden of addressing this question with regard to each of the taxes imposed by each of the states in which it operates. The level of activity creating "sufficient nexus" will vary with the type of tax (e.g., income, sales and use, franchise). For example, in a given state the company may be liable for sales and use taxes but not for income taxes. In addition, the laws, both legislative and judicial, as well as the application of the laws will vary from state to state.

The question whether nexus exists may be difficult to resolve, even in situations where the company's facts and circumstances are established to a high degree of certainty. Moreover, once answered, the nexus question may arise again for any number of reasons such as: a change in the level of activity in a state, a change in state law, or the acquisition or disposition of assets, etc.

The concept of nexus is important with respect to all types of taxes. However, this chapter will focus on nexus as it relates to income taxes and franchise taxes based on income.

<u>CRITICAL NEXUS U.S. SUPREME COURT HOLDINGS</u>

Although the general subject of constitutional limits on the states' powers to tax will be addressed in a separate segment of this course, it is helpful to outline some of the major U.S. Supreme Court nexus decisions, and the propositions for which they are frequently cited, as they relate to income and franchise taxes.

***Northwestern States Portland Cement Co. v. Minnesota/ T.V. Williams v. Stockham Valves and Fittings, Inc*., 358 U.S. 450 (1959)**

In these combined cases, the Court held that where the taxpayers' activities consisted of a regular and systematic course of solicitation of orders for the sale of its products, the imposition of a net income tax would not violate the Due Process or Commerce Clauses, so long as the tax met the following criteria: (1) it was non-discriminatory; (2) it was fairly apportioned to the state; and (3) the local activities in the taxing state formed sufficient nexus to support it.

***Brown-Forman Distillers Corp. v. Collector of Revenue,* 234 La. 651, 101 So.2d 70 (1958), *appeal dism'd and cert. denied*, 359 U.S. 28 (1959)**

In *Brown-Forman*, the Louisiana Supreme Court held that the imposition of the Louisiana net income tax upon a Kentucky distiller did not hinder interstate commerce, even though the corporation's only activity in Louisiana was the presence of "missionary men" who called on wholesalers but did not solicit orders. As indicated in the above citation, the U.S. Supreme Court refused to hear the case.

***Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977)**

Although *Complete Auto* did not deal with an income tax, it is considered a seminal case in the area of a state's right to tax transactions in interstate commerce. The Court made it clear that the decision applies equally to income, franchise or transaction taxes. In *Complete Auto*, the Court established a four-part test for state taxes under the Commerce Clause (where foreign commerce is not involved). Under *Complete Auto*, a state tax does not violate the Commerce Clause where the tax (1) is applied to an activity with a substantial nexus with the taxing State; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State.

***Quill Corp. v. North Dakota,* 504 U.S. 278 (1992)**

Quill, like *Complete Auto*, is not an income tax case, but the U.S. Supreme Court's decision may have an effect on jurisdictional nexus for all businesses involved in activities other than the sale of tangible personal property. In *Quill,* the Supreme Court stated for the first time that the nexus requirements imposed by the Due Process and Commerce Clauses were not equivalent, and that a tax scheme may violate the Commerce Clause, but not offend Due Process. The Supreme Court held that a seller without physical presence in the state could not be compelled to collect and remit the state's sales or use tax, on Commerce Clause grounds. The Court held, however, that Due Process considerations would not prohibit the states from enforcing such collection and remittance responsibilities. Based on these holdings, the Court overruled the portion of its *National Bellas Hess* decision related to Due Process while sustaining its holding regarding the Commerce Clause violation. Consequently, the Court has removed the impediment previously in place against Congress enacting legislation on the proper state tax treatment of mail order sellers.

The Court stated that a Due Process nexus analysis is based on "the fundamental fairness of governmental activity" as related to an individual or entity with minimum contacts and involves a consideration as to whether the taxpayer was given "notice or fair warning." The Commerce Clause, in contrast, "limit[s] the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." Because two different analyses are required, the Court found that a corporation may have the minimum contacts that satisfy the Due Process Clause, but not have the "substantial nexus" that would satisfy the Commerce Clause. The Court stated that previous comments made by it to the effect that a tax that passed the four-pronged *Complete Auto* test would be found valid under Due Process requirements did not imply that the converse would be true; that is, a tax that is found valid under Due Process would not necessarily be found valid under the Commerce Clause.

When the two analyses were applied to the facts in *Quill,* the Court indicated that a corporation that conducts a substantial amount of business by mail or wire communications across state lines clearly has fair warning that its activity may subject it to the jurisdiction of a foreign state. Since "fair warning" meets the test of Due Process, North Dakota could impose use tax collection responsibilities on Quill without violating the Due Process Clause. The Commerce Clause test, however, reflects concerns about the national economy, and under that test, the Court found that the North Dakota law requiring every vendor who advertises in the State three times in a single year or who makes three phone calls soliciting sales in the State to collect tax unduly burdens interstate commerce. Further, the Court found that the fact that Quill held title to a minimal amount of software present in North Dakota did not rise above the "merest presence" standard rejected by the Court in *National Geographic*. The Court noted that the fact that over 6,000 taxing jurisdictions could impose the same requirement as that imposed by North Dakota added to the significance of the burden placed on mail order sellers. Consequently, the Court found the tax to be unconstitutional under the Commerce Clause.

The Court made two further comments on its *Bellas Hess* decision: (1) the physical presence test enunciated in that case constituted a "bright-line" test that firmly established "the boundaries of legitimate state authority to impose a duty to collect sales and use taxes;" and, (2) the physical presence test "created a safe harbor" and demarcated "a discrete realm of commercial activity that is free from interstate taxation."

While *Quill* is still the standard for nexus under the Supreme Court, it may come under challenge in the near future. In an unusual concurring opinion to the U.S. Supreme Court's unanimous decision in *Direct Mktg. Ass'n v. Brohl*, 135 S.Ct. 1124 (2015), Justice Kennedy suggested that the physical presence requirements under *Quill* may be outdated and ripe for challenge. Kennedy went so far as to invite current cases challenging the long standing physical presence requirements. These comments were unrelated to the key issues of the case, but time will tell if the invited cases rise before the Court. In response, states have already begun challenging *Quill* through economic nexus statutes and cases. South Dakota is challenging *Quill* in *South Dakota v. Wayfair, Inc*. Wyoming recently passed H.B. 19, an economic nexus statute inviting a *Quill* challenge.

PUBLIC LAW 86-272

Genesis and Constitutionality

As a result of the concern expressed by the business community over the Court's decisions in *Northwestern States/Stockham Valves* and its dismissal of *Brown-Forman* and *International Shoe*, 231 La. 279, 107 So.2d 640 (La. 1958), a Louisiana case holding solicitation of orders was sufficient to allow imposition of an income tax, Congress in 1959 enacted Public Law ("P.L.") 86-272. P.L. 86-272 provides federal legislation that prohibits a state from imposing an income tax (direct or indirect) upon a taxpayer whose only activity carried on within the state is "solicitation" of orders for the sale of tangible personal property, where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

P.L. 86-272 is applicable only to state income taxes (direct or indirect), and only to businesses that derive their income from the sale of tangible personal property. For example, consider a company incorporated in State A with two divisions in two completely different lines of business. The corporation does business in State B. One division engages in activities protected by P.L. 86-272 and the other in activities not so protected, e.g., the sale of services within State B. Result: the income of both of the company's divisions may be subject to income tax in State B.

The following state decisions have upheld the Constitutionality of P.L. 86-272:

- *International Shoe Co. v. Cocreham*, 246 La. 244, 164 So.2d 314 (La. 1964)
- *CIBA Pharmaceutical Products, Inc. v. State Tax Commission*, 382 S.W.2d 645 (Mo. 1964)

The *International Shoe* decision deemed P.L. 86-272 a valid enactment by Congress. The court held that the company was not taxable in the State of Louisiana since the activities carried on within the State were protected by P.L. 86-272. In this case, the only business activities carried on within the State by the company were the use of travelling salesmen in the State for the "solicitation" of orders that were forwarded to the home office and when accepted, were filled with merchandise shipped from outside the State.

The *CIBA Pharmaceutical* case held that a state may not burden interstate commerce and tax a foreign, as opposed to domestic, corporation whose only activities (solicitation of orders) did not exceed the protection afforded under P.L. 86-272.

Therefore, it is reasonable to assume that P.L. 86-272 is a constitutionally valid exercise of Congress' power to regulate interstate commerce.

General Definition of Solicitation

P.L. 86-272 does not define the term "solicitation." The initial belief was that the term "solicitation" included the normal activities performed by salesmen in the ordinary course of business. However, state court decisions interpreting and applying P.L. 86-272 have placed differing definitions on the term "solicitation," ranging from very restrictive to quite broad. The U.S. Supreme Court has now addressed this question and both taxpayers and the states have been attempting to determine how the definition applies to specific activities conducted in the state.

The U.S. Supreme Court, in *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.* 505 U.S. 214 (1992), held the taxpayer's activities in the State exceeded the protection of P.L.86-272. In order to determine whether Wrigley's activities fell within or without the protection of P.L. 86-272, the Court had first to determine the answers to two questions: "(1) what is the scope of the crucial term `solicitation of orders'; and (2) whether there is a *de minimis* exception to the activity."

The Court defined the term "solicitation of orders" as any explicit verbal requests for orders and any speech or conduct that implicitly invites an order. The Court rejected Wisconsin's argument that solicitation must be construed narrowly; i.e., only the actual requests for purchases or actions absolutely essential to making those requests would be immune activities. It also rejected the taxpayer's argument that a broad construction be given to the term; i.e., any activities accompanying the solicitation process that are routinely associated with it or that are customarily performed by salesmen would be immune. The Court found the first construction so narrow as to make the protection of P.L. 86-272 a nullity, and the second construction so broad as to render the limitation of the law "toothless." The concept that activities are properly immune from taxation based on whether they occurred before or after the sale, was also rejected by the Court as "hopelessly unworkable."

The Court then determined that the proper standard is to afford immunity to activities that are "entirely ancillary to requests for purchases - those that serve no independent business function apart from their connection to the soliciting of orders." The Court distinguished such activities from those in which the corporation would engage even if it had no sales force in the taxing state. It cited the provision of a car and a stock of free samples to salesmen as examples of entirely ancillary activities, and product repair or servicing, even when performed by salesmen, as examples of activities not ancillary to solicitation.

The Court then turned to the question of whether a *de minimis* rule should apply to activities that may exceed solicitation. It found that while P. L. 86-272 used the word "only" in describing which activities would receive immunity, longstanding legal principles permit exceptions for "trifles." The Court found that it would be especially egregious to abandon the *de minimis* principle in the context of P.L. 86-272, a law that operates in an "all or nothing" fashion; a corporation is either totally immune or taxable on its entire net income. The standard established by the Court for determining whether activities other than solicitation of orders are sufficiently *de minimis* to avoid loss of immunity is whether that activity establishes a "nontrivial additional connection" with the state.

Applying these standards to the facts in *Wrigley*, the Court analyzed each of the taxpayer's six in-state activities that the State claimed went beyond solicitation. The Court found the replacement of stale gum was not ancillary to solicitation because Wrigley would replace spoiled product even if it had no in-State sales force; in this instance, the Court stated that "it is not enough that the activity facilitates sales; it must facilitate the <u>requesting of sales</u>." Providing gum to retailers through "agency stock checks" in connection with furnishing display racks (in itself a protected activity) was not immune, because Wrigley charged the retailer for the gum.

The storage of gum in the State was not protected, because almost all of the gum so stored was used in connection with the replacement activities found not to be immune. The in-State recruitment, training and evaluation of sales representatives that took place in rented hotel rooms and the private homes of Wrigley employees was, in contrast, found by the Court to be immune, since these activities "served no purpose apart from their role in facilitating solicitation." The Court also found the function of mediating credit disputes engaged in by the regional sales manager was immune since its purpose was to "ingratiate the salesman with the customer, thereby facilitating requests for purchases."

The Court then determined that the non-immune activities did not meet its standards for a *de minimis* exception. The Court looked at the activities in the aggregate and found that although their relative magnitude was not large in comparison with the totality of Wrigley's Wisconsin activities, the activities constituted more than nontrivial additional connections with the State. Finding that Wrigley had engaged in activities that exceeded solicitation of orders and that were not *de minimis*, the Court held the immunity contained in P.L. 86-272 not to apply.

P.L. 86-272 Developments Post-*Wrigley*

<u>Multistate Tax Commission Position on P.L. 86-272</u>

Responding to *Wrigley*, the Multistate Tax Commission ("MTC") on January 22, 1993, issued revisions to its *Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272* (Phase I Statement). The Phase I Statement generally reflects the U.S. Supreme Court's *Wrigley* decision. The Phase I Statement contains a provision authorizing the adopting states to take a narrow interpretation of the Public Law in those instances where reasonable differences of opinion exist as to whether a particular activity or set of activities is protected. The Phase I Statement identifies the following unprotected activities: (1) making repairs or providing maintenance or service to the property sold or to be sold; (2) collecting current or delinquent accounts, whether directly or by third parties, through assignment or otherwise; (3) installation or supervision of installation at or after shipment or delivery; (4) the maintenance of a place of business of any kind, which may be evidenced by the advertisement of a telephone listing within the state indicating a specific place of contact; (5) entering into franchising or licensing agreements; (6) the shipment of goods into the state by means of a private vehicle, rail, water, air, or other carrier, irrespective of whether a shipment or delivery fee or other charge is made.

On March 21, 1994, the MTC released a revised version of the *Statement of Information MTC Concerning Practices of the Multistate Tax Commission and Signatory States Under Public Law 86-272* (Phase II Statement). The Phase II Statement listed five protected sales activities.

Seven years later, the MTC released, a revised version of the *Statement of Information MTC Concerning Practices of the Multistate Tax Commission and Signatory States Under Public Law 86-272* (Phase III Statement).

Under the Phase III Statement the MTC lists thirteen protected activities: (1) the soliciting orders for sales by any type of advertising; (2) the soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office; (3) carrying samples and promotional materials only for display or distribution without charge or other consideration; (4) the furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration; (5) providing automobiles to sales personnel for their use in conducting protected activities; (6) passing orders, inquiries and complaints on to the home office; (7) missionary sales activities (i.e., the solicitation of indirect customers for the company's goods); (8) coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order; (9) checking of customers' inventories without a charge therefor (for re-order, but not for other purposes such as quality control); (10) maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year; (11) recruiting, training or evaluating sales personnel, including occasionally using home, hotels or similar places for meetings with sales personnel; (12) mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders; and (13) owning, leasing, using or maintaining personal property for use in the employee or representative's "in-home" office or automobile that is solely limited to the conducting of protected activities (the use of personal property such as a cellular telephone, facsimile machine, duplicating equipment, personal computer and computer software that is limited to the carrying on of protected solicitation and activity entirely ancillary to such solicitation or permitted by this statement remove the protection under this statement).

On July 27, 2001, the MTC adopted a resolution that deletes the shipment or delivery of goods into the state by means of a private and contract carrier from the list of activities not protected by P.L. 86-272 under MTC Reg. IV.A.20.

However, on October 17, 2002, the MTC adopted a factor presence nexus standard (see below) and urged Congress to enact a provision that relieves a state of the application of P.L. 86-272 if the state has enacted the factor presence nexus standards.

State P.L. 86-272 Developments—Post-*Wrigley*

Following *Wrigley,* state courts and revenue departments continue to examine whether specific activities of taxpayers qualify for P.L. 86-272 protection. The issues revolve around whether certain in-state activities, such as delivery, storage, and business registration, for example, are protected solicitation activities, "ancillary" to solicitation (and therefore protected), or are *de minimis* activities. Courts have also addressed whether the in-state activities conducted by an entity other than the out-of-state seller can somehow cause the seller to lose its P.L. 86-272 protection.

In two cases involving the same taxpayer, *The Kelly-Springfield Tire Company et al. v. Bajorski*, 635 A.2d 771 (Conn.) 12/21/93 and the *Massachusetts Commissioner of Revenue v. The Kelly Springfield Tire Company,* 643 N.E.2d 458 (Mass.) 12/23/94, the mere qualification to do business in a state was held not to constitute a sufficient business activity to deprive a corporation of the protection of P. L. 86-272. **Note.** Mere registration was also held to not establish nexus, based on constitutional considerations, in *Rylander v. Bandag Licensing Corporation*, 18 S.W. 3d 296 (Tex. Ct. App. 2000).

In contrast to the cases where registration did not constitute a sufficient business activity to do away with protection under P.L. 86-272, in 2013 Illinois determined that sales tax registration with the state was sufficient to establish nexus. In *Department of Revenue v. ABC Company*, No. IT 13-05 (8/2/13), an Illinois Administrative Law Judge found that an out-of-state company had Illinois income tax nexus due to the in-state activities of third-parties and its sales tax registration with the state. The judge determined that when ABC Company registered with the state, they agreed to submit ABC Company to the taxing and regulatory authority of the state of Illinois. The ALJ also determined that the third parties – distributors -- were 'representatives' of Taxpayer for purposes of P.L. 86-272 and that their Illinois activities exceeded mere solicitation of sales:

In *Tyson Foods, Inc. v. Department of Revenue*, 735 N.E.2d 12 (Ill. Ct. App. Dec. 28, 1999), the Illinois Appellate Court ruled that a rented, unstaffed office used solely as a means of registering a fleet of trucks under interstate transportation laws creates a "taxable presence" and cannot be deemed ancillary to solicitation.

In *TSB-A-98(25)C,* 12/2/98, the New York Department of Taxation and Finance ruled that the storage of goods in a New York warehouse and regular visits into the State by an out-of-state corporation's marketing team did not create an Article 9-A franchise tax filing requirement. However, in TSB-A-02(7)C, 06/03/02, the Department ruled that the solicitation of advertising space by a foreign corporate publisher's in-state sales force is not a protected activity under P.L. 86-272**.** In TSB-A-06(3)(C), 7/25/06, the Department ruled that an out-of-state company with no activity in New York other than the solicitation of orders for sales of tangible personal property would not be subject to New York franchise tax merely because it hired a sales employee that worked out of her New York home. The current activities of the company and the proposed activities of the company after hiring the New York employee would all fit within the scope of "solicitation of orders" pursuant to P.L. 86-272, the Department noted. Regarding the employee's home office, the Department found it significant that the company would not represent itself to the public as having an office at its employee's home address in New York.

In *Schering-Plough Healthcare Products Sales Corporation v. Commonwealth of Pennsylvania,* 805 A.2d 1284 (Pa.Cmwlth. Aug. 28, 2002) where the taxpayer was an out-of-state subsidiary sales corporation whose activities in Pennsylvania are limited to the solicitation of orders for its corporate parent's products, the Pennsylvania Commonwealth Court ruled that ownership of tangible personal property sold to an in-state consumer is not a prerequisite for P.L. 86-272 protection. The Pennsylvania Supreme Court affirmed the decision in a one page order on October 20, 2004.

Chester A. Asher Inc. v. Director, Division of Taxation, No. 004061-2003 (N.J. Tax Ct., 1/5/06), held that a Pennsylvania corporation was subject to corporate tax in New Jersey because the activities of its drivers who delivered its goods to New Jersey exceeded the protections of P.L. 86-272. In this case, the drivers picked up and replaced damaged or returned goods and collected current and delinquent accounts. The court found that the activities of the corporation's salesmen and its independent sale agents in New Jersey were clearly within the protected solicitation activities covered by P.L. 86-272. However, the other activities were performed in the state by the corporation's agents (the drivers) who did not directly solicit sales, take orders or otherwise sell the corporation's products, and therefore, the activities were not protected by P.L. 86-272. Instead, the activities existed independently of any sales activity. The activities may have helped facilitate sales by providing better service to customers, but they did not help facilitate the requesting of sales, the standard established by the U.S. Supreme Court in *Wrigley.*

The New Jersey Tax Court distinguished the taxable presence of two out-of-state sellers of computer software programs from out-of-state intangible holding companies and declined to adopt a significant economic presence test. *See Accuzip, Inc. v. Director, Division of Taxation; Quark Inc. v. Director, Division of Taxation,* N.J. Tax Ct., Dkt. No. 005744-2003, 08/13/2009. The Tax Court set aside the tax assessments against the out-of-state sellers because one seller was not doing business in the state and lacked substantial nexus and the other's activities were protected by P.L. 86-272. See discussion on economic nexus *supra.* However, Quark, one of the taxpayers, was doing business in the state, based on the presence of its in-state sales representative. Having already determined that the software being sold was tangible personal property, the question turned to whether Quark's activities were protected from taxation under P.L. 86-272. The court explained that all of the activities of the Quark representative were pre-sale in nature, served no purpose outside of the solicitation of orders, and did not serve an independent business function. Thus, Quark was protected from the CBT by operation of P.L. 86-272, but was subject to the state's minimum tax for the years it employed a representative in the state.

The timing of in-state activities is also a consideration in determining whether P.L. 86-272 applies. In *Alcoa Building Products, Inc. v. Commissioner of Revenue,* 797 N.E.2d 357 (Mass. 2003), the Massachusetts Supreme Judicial Court ruled that after-sale warranty activities performed by in-state sales representatives serve an independent business function apart from the solicitation of sales and cause an out-of-state seller to lose immunity under P.L. 86-272.

The activities served the independent purpose of increased sales and the enhancement of the taxpayer's reputation. In P.D. Ruling 99-278, 10/14/99, the Virginia Department of Taxation concluded that warranty services carried on in Virginia are not an activity protected by P.L. 86-272. However, in P.D. Ruling 08-184, 10/17/08, the Department said the performance of warranty services by distributors, retailers, and contractors on behalf of the seller in Virginia are purchases of services by the seller and do not exceed to protection afforded under P.L. 86-272. Also, in *TSB-A-03(13)C,* 12/24/03, the New York Department of Taxation and Finance explained that the after-sale activities of delivery personnel to collect payments and damaged products from in-state customers are not *de minimis* and establish more than a nontrivial additional connection with the state.

A decision by a hearing office for the New Mexico Department of Taxation addressed the question of determining whether a person is an "independent contractor" with regard to determining the limits of P.L. 86-272. In *In re Dart Industries, Inc.* N.M. Taxn. and Rev. Dept., No. 04-03, 2/26/04, the officer rejected the arguments of a Florida-based Tupperware manufacturer ("Dart") that its New Mexico distributor operated as an independent contractor acting on her own behalf. Dart benefited from the activities of its distributors and was totally dependent on its distributors' activities to establish, maintain, and protect the market for

Tupperware products. For purposes of P. L. 86-272, the definition of an "independent contractor" is limited to someone who sells products for more than one principal, whereas a "representative" is someone who sells for only one principal. Thus, the officer concluded that the Dart's characterization of the distributor as "an independent wholesaler acting solely on her own behalf simply does not correspond to the facts." Rather, the distributor, who was contractually prohibited from selling competing products, was a Dart representative. Dart also retained substantial control over the distributor's Albuquerque office, a fact which gave Dart a clear advantage over out-of-state vendors who had no physical presence in the state. Thus, the distributor's activities--imputed to Dart--exceed the protections of P.L. 86-272. Furthermore, in-state activities conducted by Dart employees to help set up the in-state distributorship and the semi-annual visits by company vice-presidents went beyond the scope of exempt activities; these activities served to protect the reputation and value of Dart's trademarks and franchise system and cannot be characterized as "entirely ancillary" to the solicitation of orders, the officer explained. The officer also explained that, under the franchise agreement, Dart was engaged in licensing its distributors to use the Tupperware trademarks. This constitutes a business activity "separate and apart" from the sale of Tupperware products. (**Note:** California also examined the nature of an independent contractor in *The Reader's Digest Association, Inc. v. FTB,* discussed below).

Tennessee Letter Ruling 11-66, held that P.L. 86-272 protection is lost when a taxpayer directs a vendor to fill an order and the vendor does so by shipping the product from a location inside the state. The Department noted that protection is lost even though the taxpayer never takes title to the product as P.L. 86-272 contains no such exception for intrastate deliveries.

More recently, in *Skagen Designs, Ltd. v. Commissioner of Revenue*, Minn. Tax Court., Dkt. No. 8168-R, 4/23/12, the Minnesota Tax Court held that the in-state activities of an out-of-state corporation's merchandisers exceeded the protected solicitation activities thereby disqualifying the corporation from immunity under P.L. 86-272. Such unprotected activities including the provision of weekly reports, the completion and maintenance of detailed floor maps, and the conduct of training sessions combined to exceed the "de minimis" standard set from in the public law.

Where a state's corporate tax includes a non-income component, the rules regarding P.L. 86-272 do not apply. For example, in *Bantam Doubleday Dell Publishing v. Department of Treasury,* No. 243672, 2/24/04, the Michigan Court of Appeals ruled that the presence of two field sales representative employees in Michigan to solicit orders of books from wholesalers and retailers subjected an out-of-state publisher to the single business tax ("SBT"); the court refused to revisit its decision in *Gillette v. Michigan Dep't of Treasury,* 497 N.W.2d 595 (1993), holding that P. L. 86-272 does not apply to the SBT. The legislation that replaced the SBT with the Michigan Business Tax ("MBT") specifically states that the business income base is subject to P.L. 86-272 limitations. As explained by the Department of Treasury in Revenue Administrative Bulletin 2008-4 (10/21/2008), P.L. 86-272 protections do not apply to the gross receipts tax base of the MBT.

The 2006 legislation that replaced the Texas tax on earned surplus (income) and taxable capital with the Texas Margin Tax, based on modified gross receipts, specifically provides that the

Margin Tax is not an income tax, and, therefore, the provisions of P. L. 86-272 do not apply to limit imposition of the tax. (H.B. 3, Sec. 21.)

California Application and Interpretation of P.L. 86-272

The California Franchise Tax Board ("FTB") issued "Application and Interpretation of Public Law 86-272" (FTB Form 1050) that provides a good summary of California's position on P. L. 86-272. Highlights of FTB 1050 include:

(1) Nature of Property Being Sold: Only the sale of tangible personal property is afforded immunity under P.L. 86-272. Therefore, the selling or providing of services, and the selling, leasing, renting, licensing or other disposition of real estate, personal property, intangibles or any other type of property are not immune from taxation by reason of P.L. 86-272.

(2) Solicitation of Orders: For the in-state activity to be immune, it must be limited solely to solicitation (except for certain activity conducted by independent contractors as explained in FTB 1050). If there is any other activity unrelated to solicitation, the immunity is lost. FTB 1050 sets forth examples of activities presently treated by California and the other signatory states (unless otherwise stated as an exception or addition) as either non-immune or immune.

(3) Independent Contractors: P.L. 86-272 provides immunity to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the taxpayer directly. Independent contractors may engage in the following limited activities in California without the taxpayer's loss of immunity: (a) soliciting sales; (b) making sales; (c) maintaining a sales office. Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as employees. Maintenance of a stock of goods in California by the independent contractor under consignment or any other type of arrangement with the principal removes the immunity.

(4) Miscellaneous Practices: In order for there to be immunity under P.L. 86-272, the only activity in California must be in interstate commerce. If there is any other activity other than solicitation or that which is incidental to solicitation, then immunity is lost. Approval of the sales must be made outside California, except for sales by independent contractors. Deliveries must be made from a point outside California. In addition, the immunity afforded by P.L. 86-272 does not apply to any corporation incorporated within California. Finally, if a sale consists of a mixture of tangible personal property and services (e.g., photographic development), the immunity is lost.

While FTB 1050 provides general rules for the application of P.L. 86-272, it is not intended to cover all possible situations. "Each case must be judged on its own facts, with particular emphasis placed on the totality of the taxpayer's activities within the state." (*Appeal of Aqua Aerobic Systems, Inc*., Cal. St. Bd. of Equal., Nov. 6, 1985.) The following decisions are illustrative of the general application of P.L. 86-272 in California:

- In *Appeal of Dresser Industries*, No. 82-SBE-307 (Cal. St. Bd. of Equal., June 29, 1982), the California State Board of Equalization ("SBE") held that the provisions of P.L. 86-272 do not apply to foreign commerce. Export sales of pumps, whether made directly by the taxpayer or through its sales subsidiaries, were consummated by the direct shipment of pumps from California to foreign customers. The FTB applied the "throwback rule" to pump shipments to foreign countries on the theory that if P.L. 86-272 were applicable to foreign commerce, these countries would not have jurisdiction to tax the taxpayer's income. The SBE held that the FTB erred in concluding the jurisdictional limitations of P.L. 86-272 must be considered in determining whether the foreign countries in question had jurisdiction to tax the taxpayer under United States jurisdiction principles. Accordingly, the question in the area of foreign commerce is not whether 82-272 applies, but whether the foreign country lacks Constitutional nexus to tax under the Due Process Clause, which imposes two requirements: (1) a minimal connection or nexus between the interstate activities and the taxing (foreign) jurisdiction and (2) a rational relationship between the income attributed to the (foreign) jurisdiction and the intrastate values of the enterprise. (See also, Jacques, "Sales Throwbacks From Foreign-Nation Jurisdictions: California's *Dresser Industries* Decision," 3 *Journal of State Taxation* 179 (1984).)

- The California FTB issued *Legal Ruling 99-1* (Mar. 3, 1999) addressing the application of P. L. 86-272 to commerce between California and Puerto Rico.

  Corporation A, a California manufacturer, sold its products into Puerto Rico and shipped them via common carrier. Corporation A was subject to tax in Puerto Rico under U.S. Constitutional principles, but its activities were limited to solicitation of orders for the sale of tangible personal property. At issue before the FTB was whether Corporation A's sales into Puerto Rico were California sales for apportionment factor purposes. California law provides that sales of tangible personal property are assigned to California if the property is shipped from the State to another state and the seller is not taxable in the destination state. If a seller is protected from taxation in the destination state by 86-272, it is not considered taxable in that state.

  The FTB reviewed the language of 86-272 and stated that if commerce between the 50 states and Puerto Rico is considered interstate commerce, and if Puerto Rico is considered a state, the sales in question would satisfy the conditions for protection under the public law. The FTB noted that commerce with Puerto Rico ceased being foreign commerce upon ratification of the Treaty of Paris in 1899. In addition, Congress has continued to regulate commerce between the states and Puerto Rico under the interstate portion of the Commerce Clause. Thus, the FTB ruled commerce between the 50 states and Puerto Rico is interstate commerce for purposes of 86-272.

  Turning to the issue of whether Puerto Rico is a state, the FTB again pointed to congressional regulation of commerce with Puerto Rico under the Interstate Commerce

Clause, and also noted that the federal courts' consistently treat Puerto Rico as a state under federal law. Thus, the FTB ruled Puerto Rico should be considered a state for purposes of California throwback.

Consequently, the FTB found Corporation A's Puerto Rico destination sales should be assigned to California for apportionment purposes. The FTB further stated that this ruling will have no effect on analysis of the taxability of income derived from commerce with other possessions or territories of the U.S. (For further discussion of 86-272 in relation to commerce with non-US jurisdictions, see *Dresser Industries*.)

<u>California May Hold That Agency Analysis Supersedes P.L. 86-272 Protection, When Selling Agent Is Affiliate of the Seller</u>

In *The Reader's Digest Association, Inc. v. FTB*, (2001) 115 Cal Rptr 2d 53, the California Court of Appeals ruled that an out-of-state magazine corporation that was neither physically present nor directly engaged in any business activity in California, was, in actuality, doing business in-state through its wholly-owned, unitary business subsidiary; the parent company was, therefore, subject to tax. The subsidiary maintained two offices in-state and sold/solicited sales of advertising pages for the non-present parent company; based upon the exclusive sales-agent relationship that the two affiliates enjoyed, the court concluded that the subsidiary was not an independent contractor. As a result, the parent company could not claim P.L. 86-272 protection with respect to the solicitation activities of an independent contractor, despite the fact that in all other respects, the seller's and selling agents' actions were in accordance with P.L. 86-272 (e.g., all orders for the parent's publication were accepted, rejected, and shipped from out-of-state).

In Chief Counsel Ruling 2012-7, the FTB concluded that an entity, whose activities within California included training distributors and retailers and providing customer support, was engaged in transactions for the purpose of financial or pecuniary gain or profit and thus, was doing business in California under CRTC section 23101. The FTB also concluded that the entity could not rely on P.L. 86-272 because such activities were found to be neither essential nor ancillary to the solicitation of orders for tangible personal property that are filled out of state and were not afforded protection under P.L. 86-272.

It is important to note that the conclusion relating to the doing business standard in Chief Counsel Ruling 2012-7 may be different under the new economic nexus standards set forth under CRTC section 23101, which are applicable starting tax years on or after January 1, 2012. However, the FTB's analysis relating to P.L. 86-272 protection would likely remain the same under the new nexus standard.

<u>ATTRIBUTIONAL/AFFILIATE/AGENCY NEXUS</u>

The law is clear that activities performed in a state on behalf of a taxpayer may, in many cases, establish nexus to tax. There are two leading U.S. Supreme Court cases on the issue - *Scripto Inc. v. Carson,* 362 U.S. 207 (1960) and *Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue,* 483 U.S. 232 (1987). There are several state cases that also deal with the issue of attributional nexus and while not all of these cases deal with income taxes, the constitutional issues raised affect all corporations not protected under P.L. 86-272.

The U.S. Supreme Court's 1960 decision in *Scripto* established two important agency principles. First, it established there is no Constitutional significance to the label placed upon the agent, because it is the local function of the agent, not his title, which is controlling. The Court expressly found that "(t)he formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida." Second, *Scripto* held that from a Constitutional standpoint, it is unimportant whether the agent worked for several principals.

The Court's 1987 decision in *Tyler Pipe* affirmed the principles established over 25 years earlier in *Scripto* that labelling a taxpayer's representative as an independent contractor instead of as an agent cannot defeat nexus. The Court looked with approval to the analysis of the Washington Supreme Court that "the crucial factor governing nexus is whether the *activities performed in this state on behalf of the taxpayer* are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." (emphasis added).

It is clear that the affiliate relationship, in and of itself, is insufficient to establish nexus for the out-of-state entity. Pennsylvania, Connecticut, Ohio and California courts have all rejected the notion of affiliate nexus. (*See SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220, 585 A.2d 666 (Conn. 1991), *cert. denied*, 501 U.S. 1223 (1991) that held nexus does not arise merely because a parent or other affiliated corporation operates retail stores in the taxing state; *Bloomingdale's By Mail Ltd. v. Pennsylvania Dept. of Revenue*, 567 A.2d 1047 (Pa. 1991), *cert. denied*, 112 S. Ct. 2299 (1992) held the same; *Current, Inc. v. California State Board of Equalization*, 29 C.Rptr. 2d 407 (Ct. App. 1st Dist. 1994) also held the same; and *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Oh. 1995) that held an out-of-state mail order seller does not have nexus based solely upon in-state presence of its parent company, that is engaged in a distinct line of business and does not act as subsidiary's representative.)

However, it should be noted that an entity may act in a representative capacity for its affiliate (e.g., through intercompany services agreements). In such cases, it is possible for *attributional* nexus – as contrasted with *affiliate* nexus – to be established by virtue of the in-state presence of the affiliate-acting-as-representative.

As noted above in the discussion of P.L. 86-272, the New Mexico Department of Taxation held that the activities of an in-state representative were attributable to an out-of-state manufacturer in *In re Dart Industries, Inc.* N.M. Taxn. and Rev. Dept., No. 04-03, 2/26/04. In *Western Acceptance Co. v. Department of Revenue,* (1985) 572 So.2d. 497, the Florida Court of Appeals held that an out-of-state financing subsidiary of a parent corporation authorized to do business in Florida was doing business in Florida even though it had no officers, employees or property, other than cash and receivables, in the state. The court found persuasive the stipulated fact that the receivable purchase agreements between Acceptance and its parent corporation provided that the parent was to act as an agent for Acceptance in Florida and elsewhere in collecting monies owed on contracts purchased by Acceptance. Similarly, the New Jersey Supreme Court, in *Avco*

*Consumer Services Consumer Discount Co. One, Inc. v. Director, Div. of Taxation***,** 100 N.J. 27, 494 A.2d 788 (N. J. 1985), determined that a corporation with minimal connection in the State but that had an active affiliate with nexus in the State, could be subject to a tax on its net income. (Note: As part of sweeping corporate business tax overhaul legislation (A2501, enacted 07/02/02), New Jersey asserts nexus on corporations deriving receipts from sources within New Jersey or engaging in contacts with the state.)

The Maryland Supreme Court in *Comptroller of the Treasury v. Armco Export Sales Corp., et al.*, 82 Md. App. 429, 572 A.2d 562 (1990), found that a "phantom corporation," a DISC with no property and no payroll, could be considered taxable in the State because its parent corporation had sufficient operations in Maryland to be taxable. However, in *MCI International Telecommunications Corporation v. Maryland Comptroller of the Treasury*, Md. Cir. Ct., No. 24-C-99-002387, 3/17/00 the Maryland Circuit Court for Baltimore City ruled that the activities of an in-state operating company may not be attributed to an out-of-state affiliate where the affiliate is not a phantom entity.

In *America Online, Inc. v. Johnson,* Tenn. Ct. App. No. M2001-00927-COA-R3-CV (July 30, 2002), the Tennessee Court of Appeals recently reversed the lower court's summary judgment and remanded this case for review of the issue of attributional nexus. The lower court had issued summary judgment that no nexus existed, based on the earlier *J.C. Penney National Bank* (*JCPNB*) decision. However, the appellate court appears to believe that the activities of AOL's affiliates on its behalf in Tennessee were not adequately reviewed from the standpoint of attributional nexus principles, and it is possible that the result in this case might be the opposite of that in *JCPNB*, if this analysis provides grounds for distinguishing the result in *JCPNB* (where the court held that no such representative acts had been performed in Tennessee by any entity – affiliate or third party – on JCPNB's behalf).

In reversing the summary judgment, the court of appeals concluded that, considering the record as a whole, the question of whether AOL's nexus with Tennessee satisfies the "substantial nexus" test under *Complete Auto Transit* remains open. In so finding, the court stated that the interpretation by the chancery court of *J.C. Penney* that nexus requires a bright-line physical presence would incorrectly substitute "physical presence" for "nexus" under the *Complete Auto* test. "Perhaps it would have been more accurate to say the [U.S.] Supreme Court had rejected state taxes on interstate commerce where no activities had been carried on in the taxing state *on the taxpayer's behalf*," the court explained. The court then went on to note that the U.S. Supreme Court has "made no distinction between regular employees and independent contractors for the purpose of finding a nexus," citing *Scripto*.

Attributional nexus was the justification for taxing an out-of-state credit card bank based on the in-state activities conducted by its affiliate that operated a department store in the state. In *Dillard Nat'l Bank, N.A. v. Johnson,* Tenn. Ch. Ct., No. 96-545-III, 6/22/04, the chancery court explained that the physical presence requirement of substantial nexus may be established by activities carried on within the state by affiliates and independent contractors acting on the taxpayer's behalf, and that the crucial factor when examining the activities is whether the contacts are significantly associated with the taxpayer's ability to establish and maintain a market in the taxing state.

On May 28, 2015, a California Court of Appeals, in *Harley-Davidson, Inc., et al. v. Franchise Tax Board,* No. 37-2011-00100846-CU-MC-CTL (5/28/15), concluded that two special purpose entities which acquired and securitized loans made to Harley-Davidson customers, despite no in-state physical presence, had substantial nexus with California due to the activities of in-state agents. The corporations were established as bankruptcy remote special purpose entities and were engaged in securing loans for their parent and affiliated corporations that did business in California. The court found that a California affiliate was an agent of the entities. The court's conclusion that the agency relationship created California nexus for the entities satisfied both Due Process and Commerce Clause concerns.

Also in 2015, *In re ConAgra Brands, Inc.,* Maryland Circuit Court, Case No.: C-02-CV-15-993, the court found that an out-of-state intangible holding company had nexus with the state because the holding company had no "real economic substance as a business separate from" its in-state affiliates. The Court found the facts of ConAgra substantially similar to *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, Md. Ct. App., No 36 (March 24, 2014), stating the similarities included: a subsidiary created by the parent company to hold and manage patents and trademarks, the parent company holding the majority of stock in the subsidiary, shared employees, and the patent portfolios held by the intangible holding companies were obtained from the respective parent companies.

Multistate Tax Commission

The Multistate Tax Commission (MTC) issued *Nexus Program Bulletin 95-1* (last updated Sept. 10, 1996) addressing the nexus consequences under the U.S. Constitution and P. L. 86-272 to companies selling computers through direct marketing and offering repair services in the customer's state through the seller's warranty. The Bulletin utilizes the following example for purposes of its analysis:

- An out-of-state retailer selling computer equipment with a warranty requiring the customer to contact the seller if a problem arises. If repair services are authorized by the seller, then the seller, or the customer, contacts a third party repair service provider who repairs the computer in the customer's state. (Emphasis added) The Bulletin does not state that the customer is required to use a specific third party service provider to perform the repairs.

Based upon its analysis of U.S. Supreme Court nexus jurisprudence, the MTC Bulletin states that the industry practice of providing in-state warranty service through third party repair service providers creates Constitutional nexus for the imposition of use, income, franchise, and other comparable tax liabilities (e.g., gross receipts excise tax) in the taxing state where the warranty services are performed. Citing *Scripto*, the MTC noted that the U.S. Supreme Court "has uniformly found that the in-state presence of a representative of an out-of-state seller who conducts regular or systematic activities in furtherance of the seller's business, such as solicitation of sales or provision of services, creates nexus." Accordingly, the MTC stated, presence of representatives of a direct marketing computer company (no matter how they are characterized, i.e., employee or independent contractor) providing repair services in the customer's State will generate Constitutional nexus. Because the repair services are regular or systematic, and in furtherance of the seller's business, the MTC ruled they do not constitute *de minimis* or trivial activities. In addition, since these activities exceed mere solicitation, and such activities are not ancillary to solicitation, the MTC ruled P. L. 86-272 would not protect an out-of-state direct marketing computer company.

It should be noted that the Bulletin has been criticized by practitioners, trade associations, and the business community as not properly reflecting Constitutional nexus standards, and as abrogating the MTC Uniformity Process. While the MTC has stated that the Bulletin represented the position of 26 states, the SBE voted to rescind its approval.

Note: The Minnesota Department of Revenue (Department) issued *Revenue Notice 96-16* (Nov. 4, 1996), addressing and essentially reproducing in bulk, the Multistate Tax Commission's Bulletin *95-1* relating to the provision of in-state repair services of computers and whether such services create jurisdiction to tax mail order computer companies. The Revenue Notice merely states that the MTC Nexus Bulletin is "consistent with the Minnesota Department of Revenue's position with regard to such activities occurring within the State of Minnesota."

ECONOMIC NEXUS

Much of the recent activity concerning nexus deals with economic nexus—states trying to assert jurisdiction over the income of businesses that do not have a tangible physical presence in the state. For example, states are taxing the income of out-of-state intangible holding companies (IHCs) that lease intangibles (*i.e.,* trademarks, trade names) to in-state affiliates, taxing out-of-state companies whose contact with the state is limited to holding an interest in an in-state entity. Notably, state courts and revenue departments, which could assert nexus in these instances based on an affiliate relationship have chosen to assert nexus based on an economic nexus theory. These decisions and rulings therefore potentially impact all out-of-state taxpayers that direct economic activity into a state, regardless of whether such taxpayers are represented in the state by an affiliate.

Geoffrey, Inc. v. South Carolina Tax Commission, **437 S.E.2d 13 (S.C. July 6, 1993)**, ***cert. denied*****, 510 U.S. 992 (1993)**

The Due Process "minimum connection" requirement and the Commerce Clause "substantial nexus" requirement were the subject of this South Carolina income tax case. The South Carolina Supreme Court in *Geoffrey* found the company to be subject to South Carolina's income tax and business license fees on its royalty income derived from the use of trademarks and trade names in the State. Geoffrey was a wholly-owned second tier subsidiary of Toys R Us and owned the trademarks and trade names licensed to its ultimate parent for use in all but five states. The license also granted Toys R Us the right to use its "know-how" in the areas of merchandising and promotion of products covered by the agreement. In return, Geoffrey received royalties based on a percentage of net sales made by Toys R Us and its affiliated companies. Geoffrey had no employees or offices in South Carolina and owned no tangible property in the State. The South

Carolina Tax Commission argued that Geoffrey was subject to both the State income tax and corporate license fee. Geoffrey contended it did not do business in the State under South Carolina statutes and did not have sufficient nexus under the Due Process and Commerce Clauses of the U.S. Constitution.

The court found that under the broad South Carolina statute defining "doing business" as "the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain," the company was statutorily subject to tax, but construed the statute to extend only to Constitutional limits. The court therefore looked first to the Due Process Clause to determine if South Carolina had Constitutional jurisdiction to impose a tax on Geoffrey. Based mainly on the U.S. Supreme Court's discussion of Due Process jurisdiction in *Quill*, the South Carolina court found that physical presence was not required if the corporation "purposefully directed its activity at the state's economic forum." Dismissing Geoffrey's assertion that it had not directed its activity at the State since Toys R Us was not present in South Carolina at the time the licensing agreement was signed, the court found that the company's failure to prohibit the use of the trademarks and trade names in the State amounted to an election to purposely seek the benefit of economic contact with the State. On this basis, the court found Geoffrey to have the "minimum connection" required by the Due Process Clause.

The court also found that sales made by Toys R Us in South Carolina created an account receivable for Geoffrey and that its agreement to allow Toys R Us to use its trademarks and trade name resulted in the creation of a franchise. Citing prior U.S. Supreme Court cases, the South Carolina court found that the presence in the State of both intangible property and a franchisee was sufficient to meet the Due Process "minimum connection" requirement. The court countered Geoffrey's argument that the situs of its intangibles was its corporate headquarters by citing U.S. Supreme Court cases stating that the apportionment of income from intangibles was as reasonable as the allocation of such income to a single headquarters situs.

The court found that the second prong of the Due Process test - "the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state" - was met as a result of the benefits conferred by South Carolina on Toys R Us. Reasoning that the income received by Geoffrey resulted not from a "paper agreement," but from the purchases by customers of the retail outlet, the court found that Geoffrey had received "protection, benefits and opportunities" from South Carolina that allowed the company to earn the income it received from the State. Because the State would tax only such income generated within its borders, the court found a rational relationship to exist.

In relation to the Commerce Clause, the court tacitly recognized the fact that the U.S. Supreme Court's decision in *Quill* made it necessary to address the issue of "substantial nexus." (The lower court had merely stated that meeting the Due Process standards resulted in meeting the nexus requirement of the Commerce Clause.) The South Carolina court construed the U.S. Supreme Court's decision on the requirement of physical presence to apply only to sales and use taxation. Based on its determination that Geoffrey had intangible property in the State and had exploited the markets of the State, the court held that by licensing intangibles for use in the State, and deriving income from such use, Geoffrey had substantial nexus with South Carolina.

Finally, the court stated that Geoffrey was incorrect in stating that even if it were found to be subject to tax, all royalty income would be allocated or apportioned out of the State under South Carolina statutes. The Court found that Geoffrey was not subject to these apportionment and allocation provisions, as they were only applicable to companies primarily engaged in activities related to tangible personal property, or to companies that received gains or losses from the sale of intangible personal property not connected with their regular business.

Based on its findings, the court held Geoffrey taxable under both South Carolina statutes and the provisions of the U.S. Constitution.

In its request for U.S. Supreme Court review, the taxpayer/petitioner's brief presented the question as "[w]hether the 'substantial nexus' requirement of the Commerce Clause or the 'minimum contacts' requirement of the Due Process Clause precludes a state from imposing an income tax upon a corporation with no physical presence in the state but whose trademarks are used in the state by a licensee." The brief then outlined two substantive reasons for granting the petition:

(1) This Court should resolve the question whether *Quill's* "bright-line, physical-presence" standard applies to state corporate income taxes.

(2) The state court's ruling that a licensee's use of a trademark in a state confers jurisdiction to tax an out-of-state licensor raises a substantial due process question warranting this court's review (involving whether a trademark licensor "purposefully" establishes "minimum contacts" with a state by virtue of the licensee's use of the trademark in that state).

The brief did not, in either its original question or its reasons, raise the issue of what, outside of "physical presence," constitutes substantial nexus for Commerce Clause purposes.

The U.S. Supreme Court subsequently rejected review of *Geoffrey*. While the Court did not issue a statement outlining the Court or Justices' reasons for declining to review the case, it must be remembered that the Court's refusal is not tantamount to an endorsement of the state court's decision. It merely means that based on the question presented in the petition for *certiorari*, the Court did not choose to address the issues presented either affirmatively or negatively. As it has been known to do in the past, the Court may wait for a case that raises the specific question that needs answering. The Court may have believed the *Quill* decision answered the "physical presence" question as well as the Due Process question. However, it became apparent that several state tax administrators viewed the denial of *cert.* as an implicit approval of the concepts espoused by the South Carolina Supreme Court (see, e.g., Arkansas Department of Revenue's administrative position).

STATE DEVELOPMENTS POST-*GEOFFREY*

California

California has adopted new economic nexus standards. Under California Revenue and Taxation Code ("CRTC") Section 23101(b), the FTB will consider a corporation to be "doing business" within California if its California sales for the applicable tax year exceed the lesser of $500,000 or 25% of the taxpayer's total sales, its California property for the applicable tax year exceed the lesser of $50,000 or 25% of the taxpayer's total property, or its California compensation for the applicable tax year exceed the lesser of $50,000 or 25% of the taxpayer's total compensation. This new standard applies for taxable years beginning on or after January 1, 2011, and may affect whether an entity has nexus with California (see discussion on "doing business" section *supra*.) Note: the new economic nexus standard does not supersede protections afforded by P.L. 86-272.

On November 12, 2011, the FTB issued FTB Notice 2011-06, *Chief Counsel Rulings for "Doing Business"*, which provides guidance that when a taxpayer does not meet one or more of those standards enumerated in CRTC Section 23101(b), it still must determine whether it was "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit" under the general rule for "doing business" found within CRTC Section 23101(a). The notice states that when a taxpayer is unsure whether its activities constitute "doing business" in California under section 23101(a), the FTB will accept requests for written advice on that issue, but will not provide written advice on whether the taxpayer meets the specific factual threshold tests under section 23101(b) because, according to the FTB, the answer to such question will depend "principally upon factual issues".

For the purposes of determining whether a taxpayer has met the California economic nexus standard, a taxpayer is required to determine the amount of its California sales using the sourcing rules found in CRTC sections 25135 and 25136(b). (See Sales Factor section below.) The FTB reiterated this requirement in Chief Counsel Ruling 2012-3 by requiring a taxpayer to apply the market approach for sourcing receipts from sales of property other than tangible personal property under CRTC section 25136(b) (see discussion below regarding market sourcing) for the purposes of determining whether the amount taxpayer's sales met the economic nexus threshold under CRTC section 23101.

Colorado

On January 27, 2017, a Colorado trial court found that an intangible property company with no physical presence in the state was subject to Colorado's corporate income tax. The court concluded that Colorado's 'doing business' requirement was not defined by regulation with respect to licensors of intangible property. The court found that the company was doing business in Colorado for because it: chose to license its IP for use by Target in Colorado; chose to base the royalties it would receive under that license on Target's sales both in Colorado and nationwide; and received hundreds of millions of dollars in income related to the use of its IP in Colorado.

The court determined that physical presence is not required to create substantial nexus for state income tax purposes for two primary reasons: (1) the physical presence test from *Bellas Hess* and *Quill* was specific to the facts and concerns in those cases (i.e., the mail-order industry's substantial reliance on the test) and (2) there are material differences between sales and use taxes and income taxes that support a different nexus standard (e.g., a sales tax requires a retailer to serve as the state's collections agent, sales taxes can be due more often than once a year to many taxing jurisdictions within a state at varying rates, and (at the time of Quill), there were over 6,000 potential sales and use tax jurisdictions).

<u>Connecticut</u>

A taxpayer is deemed to have substantial economic presence in Connecticut if it generates receipts of $500,000 or more attributable to the purposeful direction of business activities towards the state, the Connecticut Department of Revenue Services stated in Connecticut Informational Publication 2010 (29), 9/23/10. The notice provides that a taxpayer does not need to consider income arising from passive investment activities in determining whether the $500,000 level of receipts has been met, and that if a "bright line" economic presence is established, a taxpayer does not need to include in gross income amounts related to interest and intangible expenses added back by a related member in computing Connecticut income. The notice clarifies the economic nexus provision enacted in 2009 and is effective for tax years beginning on or after January 1, 2010.

Legislation enacted in 2009 and commonly referred to as the Economic Nexus Legislation provides that any company, partnership or S corporation is subject to tax in Connecticut if it has a *substantial economic presence* within Connecticut. As enacted, the statute provides that existence of a substantial economic presence may be determined based on an evaluation of a taxpayer's purposeful direction of business toward the state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, without regard to physical presence, to the extent permitted by the United States Constitution. The expanded nexus provisions apply to tax years beginning on or after January 1, 2010.

The enacting legislation does not provide guidance regarding the meaning of the terms "purposeful direction," "frequency," "quantity," "systematic nature" or "economic contacts." Accordingly, the department notice is intended to provide guidance in implementing the statute. In an attempt to define "purposeful direction" the notice provides a series of examples of where a taxpayer's activities create an economic nexus in the state. The examples include an out-of-state bank that engages in active solicitation and that has significant receipts; an out-of-state entity that provides online financial services and that generates significant receipts; and an out-of-state car loan company that generates substantial interest and other income attributable to Connecticut customers.

The notice provides that an out-of-state company, partnership, or S corporation will be deemed not to have economic nexus for a taxable year, if the frequency, quantity and systematic nature of its economic contacts with the state are such that its receipts from business activities in the state are less than $500,000 for the taxable year. The "bright line" threshold applies on an entity level, even where the taxpayer is a pass through entity. Importantly, the notice provides that the bright line threshold does not preclude the Commissioner from contending that a company, partnership or S corporation has an obligation to file a return or pay a tax as a matter of law other than attributable to economic nexus.

The notice sets forth a three-part test for use in determining whether the licensing of intangible property rights will be considered a significant economic presence in the state. Specifically, the notice provides that the in-state ownership and use of intangible property by an entity in Connecticut would create economic nexus when:

the intangible property generates gross receipts within the state,

the activity through which the entity obtains such gross receipts from its intangible property is purposeful, and

the entity's presence within the state, as indicated by its intangible property and its activities with respect to that property, generate receipts of $500,000 or more in a tax year.

Income arising from passive investment activity will not be considered as the basis for finding that an entity has nexus in the state, the notice provides. For example, an out-of-state corporation that does not otherwise have nexus in the state will not be deemed to have a filing obligation merely because it derives $500,000 from a bank account and or other investment account at a Connecticut-based financial institution,

The notice makes clear that Federal Public Law 86-272 will continue to restrict Connecticut from imposing an income tax on income derived within its borders from interstate commerce if the only business activity of the business within Connecticut consists of the solicitation of orders for sales of tangible personal property, which orders are to be sent outside Connecticut for acceptance or rejection, and, if accepted, are filled by shipment or delivery from a point outside Connecticut. P.L. 86-272 protection is not afforded to transactions other than sales of tangible personal property.

The notice provides that in general, except for the licensing of intangible property, transactions between related members will not create economic nexus. For example, an out-of-state headquarters corporation, not otherwise subject to Connecticut income taxation, that provides legal and accounting services to its wholly owned subsidiary located in Connecticut, will not be subject to Connecticut corporation business tax because the provision of such services does not constitute the conduct of "business" under the economic nexus legislation.

On June 21, 2011, Connecticut enacted legislation, which provides that economic presence nexus does not apply to a foreign corporation that under the IRC has no income effectively connected with a U.S. trade or business. To the extent a foreign corporation has income effectively connected with a U.S. trade or business and has nexus, its gross income is limited to effectively connected income. Tax is imposed on a company that derives income from the state *and* has a substantial economic presence with the state.

Florida

An out-of-state corporation without any in-state physical presence nevertheless has nexus for corporate income tax purposes based on the presence of unrelated in-state retailers that process sales for the corporation and on the corporation's purposeful direction towards the in-state market, the Florida Department of Revenue explained in TAA 07C-001, 10/17/07. The Department took the position that physical presence in the state is not required to impose Florida’s corporate income tax. "This position is evident," the Department explained, by r. 12C-1.011(1)(p), which provides that selling or licensing the use of intangible property in Florida for taxable years beginning on or after January 1, 1994, creates a taxable presence. For example, licensing the use of a trade name or trademark or patent to a business entity located in Florida will subject a corporation to the corporate income tax, under the regulation.

Illinois

In September 2015, an Illinois Circuit Court ruled on summary judgment that the proper test for income tax substantial nexus is whether a 'significant economic presence' exists in the state. The test, adopted in *West Virginia Tax Commissioner v. MBNA*, incorporates a 'purposeful direction' inquiry similar to a Due Process Clause analysis, coupled with an examination of "the frequency, quantity, and systematic nature of a taxpayer's economic contacts with a state.
The court found the taxpayer had a significant economic presence in Illinois because it: (1) collected millions of dollars in fees and interest from Illinois residents, (2) systematically and continuously solicited Illinois customers to apply for credit, (3) used the Illinois courts to recover debts, (4) filed and enforced judgment liens in the state.

This is the first court ruling in Illinois addressing an income tax economic nexus standard and appears to follow a trend of income tax nexus determinations based solely on economic factors.

Indiana

Indiana is now taking a *Geoffrey* position when examining the activities of intangible holding companies (IHC's) in the state. In Letter of Findings No. 95-0401, issued on March 19, 2002, the Department of Revenue cited *Geoffrey, Inc. v. South Carolina Tax Commission* in concluding that an IHC licensing intangibles to an in-state manufacturer has "substantial nexus" with the state and therefore is subject to Indiana's adjusted gross income tax and supplemental net income tax.

Indiana is also taking a *Geoffrey* position when examining the activities of a financial institution. In *MBNA America Bank, N.A. & Affiliates* v. *Dep't of State Revenue*, Indiana Tax Court, Cause No. 49T10-0506-TA-53 (10/20/08), the Indiana Tax Court held that the Commerce Clause does not require taxpayers to have a physical presence in the state to be subject to the Financial Institutions Tax. Accordingly, an entity that limited its in-state activities to issuing credit cards to customers in the state through telephone and mail solicitation is subject to tax on interest and fees received with respect to cards held by in-state customers. The fact that the taxpayer did not maintain a place of business in Indiana, nor did it have any employees in the state is of no consequence in determining "substantial nexus" under the Commerce Clause as noted in *Quill,* which has "left the door open" for courts to determine whether an economic presence can satisfy the substantial nexus requirement for taxes other than sales and use taxes. The Indiana court agreed with, and adopted, the West Virginia court's reasoning in a matter dealing with the same taxpayer that economic presence is sufficient to establish substantial nexus. Because MBNA regularly solicited business from more than a *"de minimis* " number of Indiana customers and received interest and fees from those customers representing "significant gross receipts" for MBNA, the court held that MBNA maintained an economic presence in the state for purposes of the FIT. In a footnote, the court also noted that MNBA had, during the years at issue, more than a "*de minimis* " number of debt collection cases pending in the Indiana court system.

<u>Iowa</u>

An out-of-state franchisor with no in-state property or payroll is subject to Iowa income tax because physical presence is not required to establish income tax nexus and the income at issue is directly connected to the state. *KFC Corporation, Appellant v. Iowa Department of Revenue, Appellee.* 09-1032, 12/30/2010; *Cert, denied*, U.S. Sup. Ct., Dkt. No, 10-1340, 10/3/11

The Iowa Supreme Court analyzed the history of U.S. Supreme Court cases and state cases and concluded that the Commerce Clause "is not offended by the imposition of Iowa income tax on KFC's royalties earned from the use of its intangibles within the State of Iowa because physical presence is not required to establish substantial nexus when a state imposes an income tax." The Court states that the U.S. Supreme Court "would likely find intangibles owned by KFC," but utilized in Iowa, to "be regarded as having a sufficient connection to Iowa amount to the functional equivalent of 'physical presence' under *Quill*. Furthermore, the fact that the transactions that produced the revenue were based upon the use of the intangibles in Iowa also provides a sufficient basis to support the tax under the Commerce Clause."

The Court added that the taxation of the KFC royalty income is consistent "with the now prevailing substance-over-form approach" embraced by the Supreme Court. "When a company earns hundreds of thousands of dollars from sales to Iowa customers arising from the licensing of intangibles associated with the fast-food business, we conclude that the Supreme Court would engage in a realistic substance-over-form assessment that would allow a state legislature to require the payment of the company's fair share of taxes without violating the dormant Commerce Clause," the Court stated.

<u>Louisiana</u>

In *Bridges v. AutoZone Properties, Inc.,* La. No. 2004-C-0814, 03/25/05, the Louisiana Supreme Court ruled that Louisiana has personal jurisdiction over a Nevada corporation with no contacts with the state except for its ownership of shares in a corporate real estate investment trust doing business in the state, the Louisiana Supreme Court concluded. The protections afforded to the REIT in the state establish nexus, which is not broken by the pass-through nature of a REIT, the court explained. The Louisiana Court looked at *International Harvester Co. v. Wisconsin Dep't of Taxation,* 322 U.S. 435 (1944), where the U.S. Supreme Court upheld the right of the State of Wisconsin to tax the dividend income distributed to nonresident shareholders, although the dividend income was declared and distributed outside of Wisconsin. According to the court "*International Harvester* stands for the proposition that a state may tax a nonresident shareholder's investment income based on its investment in a separate corporation engaging in business activities in the taxing state, when the benefits, opportunities, and protections contributed to the profitability of the in-state activities. As Louisiana helped create the income, it should not be prevented from assessing the tax, the court concluded. **Note**: In response to an application for rehearing, the Chief Justice of the court said on May 13, 2005, that the court may have incorrectly decided the case. However, because the rehearing application was untimely, the judgment was final. The justice noted that the possibly incorrect decision "potentially exposes untold numbers of out-of-state corporate shareholders to suits in Louisiana, regardless of whether those shareholders possess sufficient minimum contacts to support personal jurisdiction, contrary to a long line of state and federal jurisprudential authority." The justice also noted that any attempt to correct the problem presented by the law must be corrected by the legislature.

In 2011, a similar issue rose through the courts. In *UTELCOM Inc., and UCOM, Inc. v. Department of Revenue*, La. Ct. of App., Dkt. No. 533, 407, 9/12/11, the Louisiana Court of Appeals held that mere passive ownership of an interest in a limited partnership that conducts business in Louisiana, by itself, was not sufficient to subject the foreign corporate limited partner to Louisiana franchise tax. The invalidated LAC 61:I.301(D), which states that the mere ownership of property with the state, or an interest in property within the state, whether owned directly or through a partnership or joint venture or otherwise, renders the corporation subject to franchise tax in Louisiana since a portion of its capital is employed in the state. The Department appealed to the Louisiana Supreme Court on November 29, 2011. However, the Court declined to hear the case.

Maryland

In *Maryland Comptroller of the Treasury v. SYL Inc., Maryland Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware) Inc.,* 825 A.2d 399 (2003), cert. denied U.S. Dkt. 03-566, 12/15/03, the Maryland Court of Appeals ruled that Maryland may tax income earned by an intellectual property holding company based on the Maryland business activity of its parent corporation where the company is unitary with its parent, the company lacks economic substance, and the company was formed predominantly for sheltering income from state taxation, the Maryland Court of Appeals ruled. In addition, the Maryland Comptroller of the Treasury is not required to promulgate an administrative regulation as a condition precedent to taxing the income earned by an intellectual property holding company where the income involved is taxable under the United States Commerce Clause and the principles of due process.

In 2010, the Maryland Court of Special Appeals rejected a taxpayer's attempt to distinguish its facts from those in the *SYL* case specifically that the Court of Appeals had applied the "sham transaction" doctrine in subjecting an intangible holding company to tax. *The Classics Chicago, Inc. et al. v. Comptroller of the Treasury*, No. 2047, Md. Ct. Spec. App. (1/4/10). The taxpayer contended that the reasons behind its formation were not motivated by state tax consequences and that, therefore, the lower courts improperly applied the sham transaction analysis in upholding the imposition of tax. The court denied the taxpayer's claim that *SYL* adopted a sham transaction doctrine that required an analysis of the motivation behind the transaction, but, "consistent with the trend in case law, looked to the economic substance, in terms of the practical effect of the transactions in question." Melding the principles of economic substance and substantial nexus together, the court concluded: "the basis of a nexus sufficient to justify taxation [in the cases cited] was the economic reality of the fact that the parent's business in the taxing state was what produced the income of the subsidiary."

Massachusetts

In *Capital One Bank et al. v. Commissioner of Revenue*, Mass., No. SJC-10105,(M.A. 2009), *cert. denied,* U.S. Dkt. 08-1169, 6/22/09; *Geoffrey Inc. v. Commissioner of Revenue*, Mass., No. SJC-10106, (M.A. 2009), *cert. denied,* U.S, Dkt. 08-1207, 6/22/09; the Massachusetts Supreme Judicial Court upheld the imposition of the financial institutions excise tax ("FIET") and corporate excise tax despite the fact that the taxpayers involved did not have physical presence in the state.

In *Capital One,* the court agreed with the West Virginia Supreme Court of Appeals' opinion in *Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 640 S.E. 2d 226 (W.V. 2006), *cert. denied,* U.S., No. 06-1228, 6/18/07 (discussed *infra)*, in which the West Virginia court concluded that "*Quill's* physical presence requirement for showing a substantial Commerce Clause nexus applie[d] only to use and sales taxes and not to business franchise and corporation net income taxes," such as the FIET. Turning to the facts of the case, the court held that because the banks were soliciting and conducting significant credit card business in the state "with hundreds of thousands of Massachusetts residents, generating millions of dollars of income," the banks had substantial nexus with the state. The court went on to explain that the banks were providing "valuable financial services" to state customers, for which the banks were compensated in the form of interest payments, interchange fees, and finance charges. Without the Massachusetts banking and credit facilities, in addition to the state's court system, the banks could not have provided such services, the court held. As a result, the court concluded the assessment of FIET on the banks comported with the Commerce Clause. On March 19, 2009, Capital One filed a petition for writ of certiorari with the U.S. Supreme Court. However, that petition was denied.

In *Geoffrey,* which concerned the nexus of an out-of-state intangible holding company whose trademarks were used in the state, the court first noted that its holding in *Capital One* is controlling with respect to Geoffrey's constitutional claim regarding physical presence. Substantial nexus, the court then held, "can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer." Turning to Geoffrey, the court held that Geoffrey's business activities in the state constituted substantial nexus. Specifically, the court found that Geoffrey entered into licensing agreements with an affiliated Massachusetts retailer (TRUMI) for use of its trademarks. Geoffrey encouraged Massachusetts customers to shop at TRUMI stores and relied on TRUMI employees to maintain a positive retail environment. The court also found that Geoffrey reviewed licensed products and materials to ensure high standards. All of this, the court said, generated continued business and substantial profits. Geoffrey's annual royalty income from stores in Massachusetts for the tax year ending February 1, 1997 was $5,928,567, and it increased to $7,423,420 by the tax year ending February 3, 2001. Based on these facts, the court held that assessment of corporate excise taxes was proper.

In *Allied Domecq Spirits and Wines USA Inc. v. Commissioner of Revenue,* Mass. App. Ct. No 2013-P-0984, 6/18/14 (cert denied), , the Massachusetts Appeals court disregarded the transfer of Allied USA employees to Allied Domecq North America Corporation (ADNAC), which created a physical presence in Massachusetts for ADNAC. Accordingly, Allied USA included ADNAC in its Massachusetts combined reporting group, and applied ADNAC's losses against the income of other members of the group, significantly reducing Massachusetts income tax liability. The Massachusetts Appeals Court affirmed the Appellate Tax Board's decision that, pursuant to the sham transaction doctrine, the transfers had no valid business purpose other than tax avoidance and therefore the parent was not included in the nexus combined return.

Michigan

The new Michigan Corporate Income Tax is imposed on every taxpayer, defined as a corporation, with "business activity" in the state or ownership interest in a flow-through entity that has business activity in the state, unless immune from tax pursuant to P.L. 86-272. Business activity means a transfer of legal or equitable title to or rental of property (real, personal, or mixed, tangible or intangible), the performance of services (or combination thereof), "made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but does not include the services rendered by an employee to his or her employer or services as a director of a corporation."

Substantial nexus is established if the taxpayer has physical presence in the state for a period of more than one day during the tax year, if the taxpayer "actively solicits" sales in the state and has gross receipts of $350,000 or more that are sourced to the state, or of the taxpayer has an ownership interest or a beneficial interest in a flow-through entity (directly or indirectly through one or more other flow-through entities) that has substantial nexus in the state. Physical presence means any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity; it does not include the activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in the state. These standards were in place under the repealed Michigan Business Tax.

New Jersey

The New Jersey Supreme Court held that the *Quill* physical presence requirement does not apply to taxes other than sales and use taxes, and that New Jersey may impose corporation business tax on an out-of-state corporation that limits its New Jersey activities to licensing intangibles to an in-state retail affiliate, in *Lanco, Inc. v. Director, Division of Taxation,* No. A-89-05 (N.J. 10/12/06), *cert. denied,* U.S., No. 06-1236, 6/18/07.

Lanco Inc., a Delaware corporation, holds certain intangible property, including trademarks, trade names, and services marks, that it licenses to Lane Bryant, an affiliated corporation, pursuant to an agreement that allows Lane Bryant to use the property in its retail operations. Lane Bryant has retail operations in New Jersey, but Lanco has no offices, employees, or real or tangible property in the state. The Division of Taxation assessed corporation business tax against Lanco, asserting that Lane Bryant's activity under the licensing agreement subjected Lanco to taxation.

The tax court held that Lanco's income was not subject to New Jersey tax, concluding that physical presence is "a necessary element of Commerce Clause nexus for taxation" and the physical presence requirement set out in *Quill* is not limited to use tax nexus determinations. The New Jersey Superior Court, Appellate Division reversed, instead holding that the *Quill* physical presence requirement does not apply to taxes other than sales and use taxes, and New Jersey could constitutionally impose a tax on Lanco's income. The state supreme court affirmed the appellate division's decision, noting that the *Quill* court did not attempt to equate the substantial nexus requirement with a universal physical presence requirement. Instead, the court limited its discussion to sales and use taxes. On June 18, 2007, the U.S. Supreme Court declined to consider the case.

The New Jersey Supreme Court recently held that for tax years prior to adoption of a regulatory example specifically addressing the licensing of intangible property, an out-of-state intangible holding company had corporate business tax nexus, as its licensing activities constituted doing business under the statute in *Praxair Technology Inc. v. Director, Division of Taxation,* N.J., A-91/92, 12/15/09.

Praxair Technology, Inc. ("Praxair") is an out-of-state company that owned various intangibles (patents, trade secrets, and technology) that it licensed, for a fee, to its parent for use throughout the United States, including New Jersey. Praxair received a portion of the profits from the use of the intangibles and a portion of any fee paid to its parent as part of third-party re-licensing. Praxair had no employees or other physical presence in New Jersey. During the tax years involved, 1994 through 1999, Praxair did not file New Jersey corporate business tax returns or pay the tax. In 2002, the Division of Taxation issued an assessment, which Praxair protested. After the Division issued its final determination affirming the assessment and imposing penalties, Praxair appealed the matter to the New Jersey Tax Court, which ruled in favor of the Division. Praxair's appeal to the Superior Court was successful, which lead to the Division's appeal to the New Jersey Supreme Court.

The Court noted that all relevant times, the statute (Sec. 54:10A-2) provided that "[e]very domestic or foreign corporation . . . shall pay an annual franchise tax . . . for the privilege of doing business, [or] employing or owning capital or property . . . in this State." The question, the Court said, was whether, even before the regulation was changed to add the example, Praxair's activities gave rise to a corporate business tax liability. The Court concluded that it did. The tax court's conclusion that "the statute itself exposes the plaintiff to taxation" is "unassailable," the Court explained. The tax court said that "the use of intangible property for income-producing purposes in New Jersey renders that property's owner subject to taxation either as one who is "doing business, [or] employing or owning capital or property . . . in this State." "From a straightforward plain language standpoint, no other conclusion is sensible," the Court said. This result would be the same even if the regulation prior to the added example is considered, the Court added. The pre-1996 regulation defined in "broad strokes" what constitutes doing business in New Jersey, and application of that regulation also "leads…to the conclusion that plaintiff was doing business in New Jersey."

The Court remanded to the appellate division for consideration of Praxair's challenge to the imposition of late filing and post-amnesty penalties, as this challenge was not considered by the appellate division due to its finding for the taxpayer on the underlying merits.

As discussed above, the New Jersey Tax Court recently distinguished the taxable presence of two out-of-state sellers of computer software programs from out-of-state intangible holding companies and declined to adopt a significant economic presence test. *Accuzip, Inc. v. Director, Division of Taxation; Quark Inc. v. Director, Division of Taxation,* N.J. Tax Ct., Dkt. No. 005744-2003, 08/13/2009. The Tax Court set aside the tax assessments against the out-of-state sellers because one seller was not doing business in the state and lacked substantial nexus and the other's activities were protected by P.L. 86-272. Based upon the ruling in *Lanco, Inc. v. Director, Div. of Taxation,* 188 N.J. 380 (2006), *cert. denied,* U.S., No. 06-1236, 6/18/07, the court explained that New Jersey may tax income generated in the state by intangible property where the assessed corporation lacks an in-state physical presence. Agreeing with the taxpayers, the Tax Court first established that for sales and use tax purposes, prewritten computer software is considered tangible personal property, even when delivered electronically. Additionally, federal regulations also treat the sale of prewritten software as tangible personal property even where the parties characterize the transaction as a license. The court disagreed with the Director's claim that since the software was sold together with license agreements that precluded the end users from modifying, and otherwise limited the use of, the software, that the taxpayers retained title to the property and, therefore, owned property in the state. The license agreements indicated that the taxpayers are not selling ownership of their intellectual property and that the buyers receive ownership of the physical property containing the intellectual property for their own use. To conclude that the taxpayers own property in the state "would lead to illogical results," the court said.

The court declined to follow the Director's suggestion and follow the lead of the West Virginia Supreme Court in *Tax Comm'r v. MBNA Am. Bank, N.A.,* 640 S.E.2d 226, 234 (2006)*, cert denied,* U.S., No. 06-1228*,* (06/18/07), and adopted a significant economic presence test to determine whether substantial nexus exists for Commerce Clause purposes. New Jersey has a sufficient body of law to address this issue, the court explained.

Following the decisions in *Lanco* and *MBNA* (WV), the New Jersey Division of Taxation released TAM-6 on January 10, 2011. The TAX cites nexus standards enacted in 2002 and explains that all corporations, including financial corporations, that solicit business within New Jersey or derive receipts from sources within the state, must file corporate business tax returns and pay the applicable tax to the state. N.J.A.C. 18:7-1.8, effective 8/15/11, adopts the language of the TAM.

New Mexico

In *Kmart Properties, Inc. v. Taxation and Revenue Dep't,* No. 27,269 (N.M., 12/29/05), the New Mexico Supreme Court declined to revisit a 2001 decision by the state appeals court (No. 21,140, 11/27/01) that a license by a Michigan corporation of trademarks, trade names, and service marks to Kmart Corp. for use in Kmart's New Mexico retail stores supports the imposition of income and gross receipts taxes on the Michigan corporation's royalty income.

The appeals court found that the licensing agreement "ties KPI to New Mexico" because the agreement grants to Kmart the exclusive right to use the marks in the United States and, at the time KPI signed the agreement, Kmart owned and operated approximately 22 stores in New

Mexico. By allowing its marks to be used in New Mexico, KPI purposefully availed itself of the benefits of an economic market in the state, the court found, citing *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992). The court concluded the bright-line physical presence Commerce Clause standard under *Quill* does not apply to the imposition of a state income tax and said that the U.S. Supreme Court in *Quill* repeatedly emphasized a narrow focus on sales and use taxes and the need to retain a bright-line physical presence test for the benefit of the interstate mail-order industry that had relied upon such a test for sales and use taxes.

Note. The New Mexico Supreme Court ruled on the gross receipts tax issue and concluded that intangible property licensed for use in New Mexico is not subject to gross receipts tax when all activities related to the underlying license agreement take place outside the state.

New York

.Effective January 1, 2015, taxable corporations include corporations that derive receipts, based on a $1 million threshold, from activity in New York. For purposes of the state's combined reporting provisions, a corporation that has less than $1 million, but more than $10,000 of New York receipts is deemed to satisfy the receipts threshold if the in-state receipts of all members of the combined group that separately exceed $10,000 meet the $1 million threshold in the aggregate.

The franchise tax is also imposed on any banking corporation "doing business" in the state, which is defined to include:

(1) Having issued credit cards to 1,000 or more customers who have a mailing address within New York State as of the last day of its taxable year.

(2) Having merchant customer contracts with merchants and the total number of locations covered by those contracts equals 1,000 or more locations in New York State to whom the banking corporation remitted payments for credit card transactions during the taxable year.

(3) Having receipts of $1,000,000 or more in the taxable year from its customers who have been issued credit cards by the banking corporation and have a mailing address within New York State.

(4) Having receipts of $1,000,000 or more in the taxable year arising from merchant customer contracts with merchants relating to locations in New York State.

(5) For the taxable year, the sum of the number of customers described in criteria (1) plus the number of locations covered by its contracts described in criteria (2) equals 1,000 or more, or the total amount of its receipts described in criteria (3) and criteria (4) equals $1,000,000 or more.

These provisions were part of the state's bank franchise tax which was repealed effective 2015 , and are now part of the state's general corporate franchise tax.

North Carolina

In *A&F Trademark, Inc. v. Tolson,* 605 S.E.2d 187 (N.C. Ct. App. 2004), *rev. den.* (N.C. 2005), *rev. den.* (U.S. 2005), the North Carolina Court of Appeals ruled that out-of-state companies that licensed trademarks to in-state retail affiliates were subject to North Carolina income and franchise taxes because they were doing business in the state and had substantial nexus as required by the Commerce Clause. The court found that it "is beyond dispute that North Carolina has provided privileges and benefits that fostered and promoted the related retail companies. By affording these benefits to the related retail companies, additional benefits have inured to the taxpayers." The court also rejected the taxpayers' contention that North Carolina lacked jurisdiction to impose its income/franchise taxes because the taxpayers had no physical presence within the state as required by the Commerce Clause. The court found that the U.S. Supreme Court, in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), twice expressed that the "bright-line, physical-presence requirement" in *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753 (1967) has not been adopted in other forms of taxation. The court found that *Quill* provided an "equivocal reaffirmation" of the physical presence test for sales and use taxes that does not make the expansion of the standard to other types of taxes "self evident," and that "the physical-presence requirement has never been established by judicial precedent for other forms of taxation[.]"

After determining that *Quill* did not apply to the instant case, the court concluded: "we hold under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause." Although the court did not further provide reasoning as to why the licensing of trademarks to related entities who use the marks in state creates substantial nexus, it did cite *Geoffrey's* conclusion that "by licensing intangibles... for use in [South Carolina] and deriving income from their use [t]here, Geoffrey ha[d] a 'substantial nexus' with South Carolina[.]"

Note. On March 3, 2005, the North Carolina Supreme Court denied a petition for discretionary review filed by the taxpayers

Ohio

Under the Commercial Activity Tax ("CAT"), nexus exists if a taxpayer establishes a "bright-line presence." "Bright-line presence" is defined as having any of the following in Ohio: (1) greater than $50,000 of property; (2) greater than $50,000 of payroll; (3) greater than $500,000 of taxable gross receipts; (4) 25 percent of total property, payroll, or sales in Ohio; or (4) domicile for corporate, commercial, or other business purposes. . The Ohio DOR said *Quill's* physical presence requirement does not explicitly apply to a business privilege tax such as the CAT. Furthermore, on the basis of the Court's comments in *Quill*, there is every reason to suspect that the Court would not require physical presence for the CAT. (Ohio Rev. Code Ann § 5751.01; Ohio Tax Information Release No. CAT 2005-02, 09/01/2005.)

On August 10, 2010, the Ohio Tax Commissioner issued a final determination in *Petition of L.L. Bean, Inc.,* upholding the constitutionality of the CAT nexus standard and emphasizing that the

Quill physical presence standard does not apply to the CAT. The taxpayer, L.L. Bean, Inc., sought to cancel several CAT assessments on the grounds that it did not have substantial nexus with Ohio regardless of meeting the receipts threshold under the bright-line test. In his final determination, the Commissioner concluded that "[t]he petitioner's continuous, systematic, and significant solicitation and economic exploitation of the economic marketplace in Ohio is sufficient" to establish substantial nexus under the Commerce Clause. The Commissioner noted that the taxpayer sent thousands of catalogs into the state, engaged in various forms of advertising, and had gross receipts for the assessment periods in excess of $100 million. This level of activity, the Commissioner said, is "clearly substantial."

In November 2016, the Ohio Supreme Court held that the state's commercial activity tax (CAT) economic threshold created substantial nexus for an online retailer The Court ruled that physical presence is not a necessary condition for imposing the CAT because the statutory $500,000 sales-receipts threshold is an adequate quantitative standard that satisfies the dormant Commerce Clause's substantial nexus requirement. In addition, the Court ruled that the burdens imposed by the CAT on interstate commerce are not clearly excessive in relation to fair taxation for both in-state and out-of-state sellers.

Oklahoma

The Oklahoma Court of Civil Appeals found that the state has jurisdiction to tax an out-of-state subsidiary's income from the license of trademarks to its parent for use in the parent's in-state retail stores in *Geoffrey, Inc. v. Oklahoma Tax Commission,* No. 99,938 (Okla. Civ. App. 12/23/05). The court further found that the subsidiary's royalty income should be apportioned based on sales rather than allocated to its state of commercial domicile (Delaware).

In so ruling, the court rejected the subsidiary's contention that, because it lacked a "physical presence" in Oklahoma, it lacked substantial nexus with the state for Commerce Clause purposes. The court analyzed *Quill* and concluded that the case did not extend "the *Bellas* Hess bright-line, physical presence requirement for use and sales taxes to *all* types of taxes." The court also rejected the subsidiary's Due Process Clause argument, in which it argued that it did not "purposefully direct" its activities at Oklahoma residents. Instead, the court found that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, the subsidiary had the 'minimum connection' with South Carolina that is required by due process.

Note. On March 20, 2006, the Oklahoma Supreme Court declined to hear Geoffrey's appeal.

This decision needs to be contrasted with *Scioto Ins. Co. v. Oklahoma Tax Comm'n*, 2012 OK 41 (5/1/12), in which the Oklahoma Supreme Court concluded that an out-of-state insurance company, Scioto Ins. Co., was not liable for Oklahoma income tax on payments it indirectly received for the use of intellectual property by restaurants operating in the state.

Scioto Insurance Company (Scioto) is a Vermont company that was established by Wendy's International Inc. (Wendy's) to insure various risks of Wendy's and its affiliates. In establishing Scioto, Wendy's transferred intellectual property to Oldemark, a disregarded single member limited liability company wholly owned by Scioto. Pursuant to a license agreement, Oldemark granted Wendy's the right to use and sublicense its intellectual property to related and unrelated franchisee restaurants. In return, Wendy's paid Oldemark a license fee equal to 3% of restaurant gross sales. Wendy's sublicensed the intellectual property rights to franchisees for a fee equal to 4% of the franchisee's gross sales. The Oklahoma Tax Commission assessed Scioto corporate income taxes based on payments it indirectly received from Oklahoma franchisees for the in-state use of Scioto's intangible property.

The court summarized its decision as follows: ***due process is offended*** by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . who has a bona fide obligation to do so under a contract not made in Oklahoma. (emphasis added). The court found that Oklahoma has no connection to, or power to regulate, the license agreement between Scioto and Wendy's. The court offered several facts that may have influenced its decision, including:

- The license between Scioto and Wendy's was not made in Oklahoma;
- No part of the license was to be performed in Oklahoma;
- The sub-license of intangibles with restaurants in Oklahoma was the ***legal act and sole responsibility of Wendy's***, not Scioto; and
- Wendy's obligation to pay Scioto was not dependent on the franchisees actually paying Wendy's.

South Carolina

The South Carolina Department of Revenue issued *Revenue Ruling 98-3* (Jan. 21, 1998) addressing some of the common questions that have arisen relating to the *Geoffrey* decision.

The Department ruled maintaining bank accounts in South Carolina, negotiating and obtaining loans from South Carolina banks, visiting for two days twice a year to discuss business with South Carolina banks, and loaning money to South Carolina residents do not create nexus with the State.

An out-of-state manufacturing company selling tangible personal property with a trademark or trade name it owns on the product will not have nexus in South Carolina if its only activity in the State is the solicitation of orders, which are sent outside the State for acceptance, and if accepted, are filled by shipment or delivery from a point outside South Carolina. The Department ruled the Company will not have nexus with South Carolina although the trademark or trade name is used by retailers advertising in the State, and accounts receivable are created with South Carolina residents. The Department stated that *Geoffrey* does not remove the company's protection under P. L. 86-272, but that the Public Law will not protect a company that only licenses trademarks and trade names.

Tennessee

The Tennessee Court of Appeals issued a decision differing sharply from *Geoffrey*. A national banking association that limits its activities to engaging in credit card lending activities with

Tennessee residents is not subject to excise tax because it has not established a taxable presence in the state under the Commerce Clause, the Tennessee Court of Appeals ruled in *J.C. Penney National Bank v. Johnson,* 19 S.W.3d 831 (1999), *cert. denied,* Dkt. No. 00-205, 10/11/00.

J.C. Penney National Bank (National Bank) is a federally chartered national banking association incorporated in Delaware with its principal place of business and commercial domicile in Delaware. However, its Delaware office, National Bank, engages in credit card lending activities through the issuance of Visa and MasterCard credit cards. National Bank has no offices or employees in Tennessee.

Reasoning that National Bank exercised a substantial privilege by doing business in the state through its credit card activities in Tennessee, the appeals court found that the tax assessment does not violate the Due Process Clause. No Supreme Court decision has ever found substantial nexus to exist under the Commerce Clause without the taxpayer having some physical presence in the state, the appeals court said. Noting that the commissioner was unable to present a valid reason why the physical presence requirement outlined in *Quill* should not apply to income/ franchise taxes, the appeals court dismissed the commissioner's assertion.

Note. In *Dillard Nat'l Bank, N.A. v. Johnson,* Tenn. Ch. Ct., No. 96-545-III, 6/22/04, attributional nexus was the justification for taxing an out-of-state credit card bank based on the in-state activities conducted by its affiliate that operated a department store in the state. Unlike in *J.C. Penny*, the credit cards issued by Dillard National Bank could only be used at its affiliate's stores, some of which were in Tennessee, and customers could apply for credit card accounts and make payments at in-state stores. (See above.)

<u>Texas</u>

According to Rule Sec 3.586, an entity is subject to the Margin Tax when it has sufficient contacts with the state so that it can be taxed without violating the United States Constitution. The rule's list of nexus-creating activities includes: entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which (1) the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor and (2) the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate.

<u>Washington</u>

In *Lamtec Corp. v. Washington Department of Revenue,* Wash. S. Ct., Dkt. No. 83579-9, 1/20/11, the Washington Supreme Court concluded that an out-of-state- manufacturer with no physical presence in Washington was subject to the business and occupation ("B&O") tax because its employees' occasional visits to in-state customers established and maintained a sales market in the state, thereby creating substantial nexus.

Lamtec Corporation, a New Jersey company, has no permanent facilities, office, address, phone number, or employees in Washington. It sells its products wholesale to customers who place orders by telephone. Washington customers ordered over $9 million worth of Lamtec's products from 1997 to 2003. In an effort to maintain its existing customer base, three Lamtec employees visited the company's Washington customers approximately two or three times per year. During the visits, the employees did not solicit or accept orders, but rather provided information, listened to concerns and answered questions regarding Lamtec's products, participated in telephone calls between the customers and Lamtec's service department in New Jersey, and maintained general client relations.

The Appeals Court concluded that Lamtec's activities as a wholesaler did not preclude it from the imposition of the B&O tax so long as its customers received the goods in Washington and it had nexus with the state. The court explained that the B&O tax is a gross receipts tax "for the act or privilege of engaging in business activities" on "every person that has a substantial nexus with this state." Concluding that physical presence was only required to establish substantial nexus for sales and use taxes, the court concluded that Lamtec's activities established substantial nexus with the state.

The Washington Supreme Court reiterated the reasoning of the Court of Appeals, stating that extensive language in *Quill* "suggests the physical presence requirement should be restricted to sales and use taxes." Further, the Washington Supreme Court refused Lamtec's invitation to extend the bright line standard to the B&O tax and stated that "[a] physical presence in the taxing jurisdiction for purposes of the B&O tax can be based on periodic visits."

The Washington Supreme Court found that this case was "largely controlled" by its previous decision in *Tyler Pipe Industries v. Department of Revenue*, 105 Wn.2d 318, 715 P.2d 123 (1986), *vacated in part,* 483 U.S. 232., in which the U.S. Supreme Court affirmed that for purposes of the B&O tax, taxpayers are deemed to have adequate nexus to support Washington's jurisdiction to tax if they engage in business activities that establish and maintain a sales market in the state. In addition, "to the extent there is a physical presence requirement, it can be satisfied by the presence of activities within the state. It does not require a 'presence' in the sense of having a brick and mortar address within the state," the court concluded. The court held that Lamtec's practice of sending sales representatives to meet with its customers in the state was "significantly associated" with its ability to create and maintain its market, which established sufficient nexus with the state.

Under Wash. Rev. Code § 82.04.067, "minimum nexus standards" apply to taxpayers under the 'service and other' and royalties B&O tax classifications. For these taxpayers, substantial nexus will be deemed to exist if in a tax year the taxpayer satisfies one of the following thresholds:

- More than $50,000 of property in the state;
- More than $50,000 of payroll in the state;
- More than $250,000 of receipts in the state; or
- At least 25 percent of the taxpayer's total property, payroll, or receipts in the state.

A taxpayer who has substantial nexus with the state in a tax year by applying one of the above thresholds in a tax year would also be deemed to have substantial nexus for the following tax year. The legislation provides rules for determining property, payroll, and receipts for purposes of applying these thresholds.

Other taxpayers will be deemed to have substantial nexus with the state if the taxpayer has a physical presence in the state, "which need only be demonstrably more than a slightest presence." Under the legislation, a person has a physical presence in the state if the person has property or employees in the state, or if the person, either directly or through an agent or other representative, engages in activities in Washington that are significantly associated with the person's ability to establish or maintain an in-state market for its products.

<u>West Virginia</u>

The “physical presence” test for substantial nexus under the Commerce Clause, as articulated by the U.S. Supreme Court in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), applies only to state sales and use taxes and not to state business franchise and corporation net income taxes, the West Virginia Supreme Court of Appeals held in *West Virginia Tax Commissioner v. MBNA America Bank, N.A.,* No. 33049 (W.Va. 11/21/06); U.S., No. 06-1228, *cert. petition denied,* 6/18/07. Instead, the court quoted a law review article in adopting a “significant economic presence” test that incorporates a “purposeful direction” inquiry similar to a Due Process Clause analysis, coupled with an examination of “the frequency, quantity, and systematic nature of a taxpayer’s economic contacts with a state.” Justice Brent D. Benjamin filed a dissenting opinion on January 2, 2007, arguing that the majority’s decision had “no precedential support whatsoever for [its] conclusions” and that the imposition of the taxes on an out-of-state financial organization with no employees or property -- tangible or intangible -- located in the state violates the Commerce Clause.

In *Griffith v. ConAgra Brands, Inc.*, West Virginia Supreme Court of Appeals, Dkt. No. 11-0252 (5/24/12), the Court ruled that ConAgra, an out-of-state corporation, was not liable for corporation net income tax or business franchise tax on royalties earned from the licensing of trademarks and trade names used on food products sold by licensees throughout the United States, including West Virginia. The Court ruled that the assessments against the taxpayer did not satisfy either Due Process or the Commerce Clause because (1) ConAgra had no physical presence in West Virginia; (2) ConAgra did not sell or distribute products or provide services in West Virginia; (3) all products bearing the trademarks and trade names were manufactured solely by unrelated or affiliated licensees of ConAgra outside of West Virginia; (4) ConAgra did not direct or dictate how its licensees distributed the products; and (5) the licensees operated no retail stores in West Virginia and their sales into West Virginia were made only to wholesalers and retailers.

Further, the Court distinguished this case from *MBNA*, noting that the facts which supported a finding of significant economic presence in *MBNA* were absent in the case at hand. Specifically, "MBNA continuously and systematically engaged in direct mail and telephone solicitation in West Virginia" such that physical presence was not a requirement, for Commerce Clause purposes, in upholding the corporation net income and business franchise tax assessments against MBNA. In this case, the Court noted that ConAgra did not engage in the solicitation of its business to the degree found in *MBNA*.

MTC ADOPTS FACTOR PRESENCE NEXUS STANDARDS

On October 17, 2002, the MTC voted to adopt a "factor presence nexus standard" for the imposition of business activity taxes. Under the standard, a taxpayer would be presumed to have substantial nexus with a state and, therefore, be subject to a filing requirement and potential tax liability if any one of the factors in the state exceeded the following thresholds during a tax period:

- $50,000 of property or 25% of the denominator of the property factor
- $50,000 of payroll or 25% of the denominator of the payroll factor
- $500,000 of sales or 25% of the denominator of the sales factor

In addition, the standards require commonly owned entities to aggregate their individual factor components, to the extent such components exceed certain alternative stated thresholds, to determine if the entities taken as a whole meet the general nexus thresholds stated above. As adopted, if any one of the factor components of an individual member exceeds $5,000 during the tax period, that member's factor components must be aggregated with the factor components of all other members whose factor components exceed $5,000. To the extent the aggregated amounts exceed any one of the thresholds specified in the general nexus guidelines, then each unitary member is deemed to have nexus on a stand-alone basis. While the definition of commonly owned entity is not clear, an MTC spokesperson indicated that the term includes corporations and flow-through entities such as partnerships, S corporations, and LLCs, owned directly or indirectly 50% or more.

The proposal also states that factor presence for pass-through entities would be determined at the entity level. Accordingly, once any of the general nexus thresholds is met, the partners, shareholders, or members of the pass-through entity would be subject to a filing requirement and potential tax liability on their distributive share of income earned in the state and passed through to them.

Note: The factor presence standard must be adopted by state legislatures to take effect and must be applied by such states in conformity with federal law (P. L. 86-272) and the U.S. Constitution. California has adopted these standards for its franchise tax (see below). Colorado, Ohio (commercial activity tax) and Washington (business and occupation tax for certain industries) have also adopted factor presence nexus standards.

CONGRESS CONSIDERS BUSINESS ACTIVITY TAX LEGISLATION

On August 2, 2013, Wisconsin Congressman Jim Sensebrenner introduced H.R. 2992 the "Business Activity Tax Simplification Act of 2013" (BATSA) in the House of Representatives. BATSA would expand Public Law 86-272 protection; codify the physical presence standard, including a 15-day *de minimis* period; and require an apportionment factor *Joyce* standard. This bill was replaced with a substantially similar bill on June 1, 2015: H.R. 2584, The Business Activity Tax Simplification Act of 2015.

The proposed legislation would "modernize" P.L. 86-272 by applying the restrictions of the Public Law to all "business activity taxes," defined as any tax "in the nature of a net income tax or tax measured by the amount of, or economic results of, business or related activity conducted in the State." Transaction taxes (*e.g.,* sales and use taxes) are excluded from the definition. The legislation would also extend protection from the "solicitation of orders *or customers,*" extend protection to include tangible personal property and "all other forms of property, services, and other transactions."

P. L. 86-272 would also be amended to protect certain other "business activities" from the imposition of state and local business activity taxes, including the furnishing of information to customers or affiliated in the state, coverage of events, or other gathering of information in the state as long as the information is distributed from a point outside the state, and business activities directly related to the taxpayer's potential or actual purchase of goods or services within the state if the final decision to purchase is made outside the state.

"Physical Presence" Standard Codified. Further, the legislation provides that a state can only impose state and local net income taxes and other business activity taxes only when the "physical presence" requirement has been met in the taxable period. H.R. 2992 provides that the term "physical presence" does not include presence for fewer than 15 days in a taxable year or "presence in a State to conduct limited or transient business activity." No definition is given with respect to "limited" or "transient" for purposes of this exclusion.

A person is deemed to have a physical presence only if such person's business activities in the state include (1) being an individual physically in the state, or assigning one or more employees to be in the state; (2) using the services of an agent (excluding an employee) to establish or maintain the market in the state, but only if the agent does not perform business services in the state for any other person during the taxable year; or (3) leasing or owning tangible personal property or real property in the state. Engaging in any of these activities counts against the 15-day threshold noted above.

BATSA was introduced on August 2, 2013, and a hearing was held on February 26, 2014 in the House Judiciary Subcommittee on Regulatory Reform. The bill did not move beyond the committee hearing.

DOING BUSINESS UNDER A CORPORATION FRANCHISE TAX

General Distinction Between Income and Franchise Taxes

Even tax professionals have a tendency to use the terms "income tax" and "franchise tax" interchangeably, particularly in the context of nexus. The resulting confusion is exacerbated by state labels: for instance, California denotes its corporate-level tax as a "franchise tax," when in many respects (though see discussion below of the "doing business" nexus standard) it operates in an analogous manner to the corporate net income taxes that 45 other states impose. Likewise, Texas used to impose a "franchise tax" that included a net income tax component. For purposes of distinguishing these types of tax as a general matter, "income taxes" are often referred to as taxes that are imposed on, or measured by, net income attributed to the state. State corporate income taxes also can easily be identified by reference to their broad conformity to the federal corporate income tax. [All states except Arkansas, Alabama, California, and Mississippi use federal taxable income as the starting point for calculation of state corporate income tax liability.]

In contrast, a "franchise tax" is often referred to as a tax imposed on, or measured by, the corporation's capital stock and/or net worth. Both forms of tax, however, are "direct taxes," in that they are levied on and collected from corporations and other enumerated entities, and are not intended to be passed through to customers (albeit such tax expenses are routinely included in the cost recovery calculation that influences a company's pricing of goods or services).

Income taxes and franchise taxes are not only imposed on different tax bases; they are also triggered by different *taxable events*. With respect to foreign corporations, the corporate income tax is generally predicated upon the *act* of doing/carrying on a business, trade or profession within the taxing state. Note that in such cases, the tax is imposed only on such income as is derived from those sources/acts.

In contrast, the franchise tax is generally predicated upon the grant of the *privilege of existing* (as a domestic corporation) or the *privilege to do business in the state* (as a foreign corporation – e.g., through registration to do business with the Secretary of State's office, or Department of Revenue). When the tax is so structured, such a privilege is almost universally regarded by the states as taxable, whether or not the taxpayer actually exercises such privilege through the active conduct of a business, trade or profession within the state.

As a result of these important structural differences, it is at least arguable that the two taxes are subject to different nexus standards as well.

"Doing Business" Defined for California Purposes

A small number of states, including California, impose a franchise tax based on income, either instead of, or in conjunction with, a direct income tax. In general, a franchise tax is imposed upon the privilege of doing business. Prior to January 1, 2000, the California franchise tax was generally measured by the income of the preceding year (the "income year") for the privilege of doing business in the following year (the "taxable year"). For years beginning on or after January 1, 2000, California eliminated the concept of an "income year" and began to measure the tax by the income of the taxable year. This section will deal exclusively with the California "doing business" standard.

“Doing business” is defined in CRTC section 23101(a) to mean “actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.” That standard has been explained as follows:

> The doing of business, however, does not necessarily mean a regular course of business..., for by its plain terms a corporation is doing business if it actively engages in any transaction for pecuniary gain or profit. Defendant would identify “doing business” with ‘carrying on a trade or business.” A series of transactions regularly engaged in may be necessary to establish the “carrying on of a trade or business” but the Legislature made it clear that it had no such concept in mind when it referred to transaction in the singular as “any transaction.” The word “actively” must therefore be interpreted as the opposite of passively or inactively. (*Golden State T. & R. Corp. v. Johnson*, 21 Cal.2d 493 496 (1943).)

The California Supreme Court soon after this decision was rendered, ruled that whether or not profit is made is not the controlling factor in the definition of doing business, “rather the criterion is whether or not the goal or aim is financial or pecuniary gain.” It is sufficient “[I]f the aim was pecuniary gain.” (*Hise v. McColgan*, 24 Cal.2d 147 (1944).)

The “doing business” concept is an elusive one in application, as illustrated by the following decisions:

- A corporation was doing business when it made a purchase of bonds in one year, a sale of bonds in the following year, twelve purchases and sales of stock in the year thereafter and two such transactions in the last year that was considered. From the standpoint of “actively” engaging in a transaction, the act of buying or selling is in marked contrast with merely receiving proceeds. (*Carson Estate Co. v. McColgan,* 21 Cal.2d 516 (1943).)

- A corporation was doing business in California when, in the process of liquidation, it perfected title to properties in order to sell them and collected interest on notes. (*Appeal of Sugar Creek Pine Company*, Cal. St. Bd. of Equal., March 30, 1955.)

- The receipt of interest on the buyer’s note and casualty insurance proceeds did not constitute doing business where the taxpayer had sold its assets and ceased conducting its department store business. (*Appeal of the Blanc Corporation, Assumer for Sponberg’s, Inc*., Cal. St. Bd. of Equal., Feb. 18, 1964.)

- Pre-incorporation activities are irrelevant in determining the date business commenced when those activities are not ratified at the first board of directors’ meeting. Such activities as opening a bank account, searching for business premises, and soliciting future clientele are acts preparatory to doing business. (*Appeal of Caprices De Femme, Inc*., Cal. St. Bd. of Equal., Mar. 8, 1976.)

For taxable years beginning January 1, 2011, CRTC Section 23101(b) expanded the definition of "doing business" to include any taxpayer:

- whose sales in the state for the taxable year exceed the lesser of $500,000 or 25% of the taxpayer's total sales (sales of the taxpayer include sales by an agent or independent contractor of the taxpayer);
- having real property and tangible personal property in the state exceeding $50,000, or 25% of the taxpayer's total real and tangible personal property; or
- paying compensation in the state in excess of $50,000, or 25% of the total compensation paid by the taxpayer.

Doing Business Through Limited Interests in Pass-Through Entities

The 1996 State Board of Equalization decision *Amman & Schmid* established that out-of-state corporations whose only California contacts were as limited partners in limited partnerships were not doing business in the state. The decision noted that limited partners had no interest in specific limited partnership property, no right to participate in partnership management, and were powerless to bind the partnership. (*Appeal of Amman & Schmid Finanz AG*, Cal. St. Bd. Of Equal., April 11, 1996.) It should be noted that the corporation was nonetheless subject to the California corporate income tax upon the California source income flowing from the partnership, but not the $800 minimum franchise tax.

In July 2014, the FTB issued Legal Ruling 2014-01, formalizing their longstanding position that the conclusion in *Amman & Schmid* does not apply to out of state members in LLCs which are conducting business in California. The FTB asserted that an LLC electing to be taxed as a partnership is essentially electing to treat all of its members as general partners.

In *Swart Enterprises, Inc. v. California Franchise Tax Board*, the California Court of Appeals found that an Iowa corporation with no business activities or physical presence in California, and a 0.2% investment interest in a manager-managed California LLC, was not doing business in California. The manager of the LLC had exclusive and complete authority in the management and control of the LLC. Other members, including Swart, were prohibited from taking part in the control or operation of the LLC. The court agreed with the trial courts' decision that the doing business standard in *Amman & Schmid* rests on whether the corporate member has the right to manage or control the decision-making process of the entity. The court likened the non-managing members to limited partners in a limited partnership and ruled that limited partnership law governed. The FTB has declined to appeal the decision, but limited its application to factually similar cases in FTB Notice 2017-01. (*Swart Enterprises, Inc. v. FTB*, Cal. App. 5th 497).

General Observations on the "Doing Business" Standard in California

Several general observations can be made on the "doing business" issue. First, Section 23101 by its terms is extremely broad and requires but a single ("any") transaction. A continuous course of conduct or a series of transactions is not required under the statute. Second, pre-incorporation activities, without more, generally will not constitute “doing business.” Third, Section 23101 in all likelihood, will be interpreted by the FTB as being commensurate with the minimum Constitutional nexus requirements for California to assert its jurisdiction to tax. This means that as a practical matter, the issue in controversy will not be whether the Section 23101 statutory definition of “doing business” has been satisfied, but whether California has the Constitutional ability to tax. Fourth, P.L. 86-272 acts as a federal, preemptive, limitation on the “doing business” standard, but that limitation is applicable only to sales of tangible personal property.

THE TAX BASE

IN GENERAL

Federal Taxable Income: In general, most states begin their determination of the income subject to tax with federal taxable income. Depending on state law, this may be taxable income before or after special deductions (i.e., Line 28 or 30 of the federal Form 1120). Many state income tax laws are tied to the federal Internal Revenue Code ("IRC"). However, significant variations exist with regard to effective dates and specific provisions.

On April 12, 2010, SB 401, the Conformity Act of 2010 was passed. The Act changes California’s conformity date to the IRC from January 1, 2005, to January 1, 2009. California’s conformity results in numerous substantive changes to both the Personal Income Tax Law and the Corporation Tax Law with respect to those areas of pre-existing conformity that are subject to changes under federal laws enacted after January 1, 2005. The act is operative for taxable years beginning on or after January 1, 2010, except as otherwise noted.

Alternative Bases and Modifications: There are several states whose laws are not tied to the IRC, and therefore, technically they do not start from federal taxable income. While in most cases their laws are similar to the IRC, variations can occur that must be taken into consideration. Various modifications are made to federal taxable income to arrive at a corporation’s state tax base. A corporation liable for income tax in 12 different states very likely could have 12 different state tax bases.

New York, for example, uses entire net income as a base rather than federal taxable income. New York Courts have ruled that for purposes of calculating the New York State tax base, entire net income encompasses foreign source income, but does not include income, gains or losses from subsidiary capital.

- For a corporation organized under the laws of a foreign (non-U.S.) jurisdiction and paying federal income tax only on “effectively connected” income, the difference between the New York tax base and the federal tax base can be significant. In *Reuters, Ltd. v. Tax Appeals Tribunal,* 623 N.E.2d 1145 (N.Y. Oct. 12, 1993), the Court of Appeal of New York upheld the decisions of the New York Tax Appeals Tribunal and the New York Supreme Court, Appellate Division and found that the U.S.-U.K. Tax

Treaty establishing the lesser tax base for federal income tax purposes does not cover political sub-divisions and, since the U.K. has no counterpart to state taxation, no contravention of the Treaty was involved. *Reuters* was appealed to the U.S. Supreme Court, which declined review. The court also found that the fact pattern in *Reuters* was similar to that in *Bass, Ratcliff and Gretton, Ltd*., 266 U.S. 271 (1924), in which the Court held that a foreign corporation with a branch in New York was conducting a single, unitary enterprise and, therefore, the State was entitled to apply its tax to the entire net income of the enterprise.

- The New York Division of Tax Appeals reached a similar conclusion in *Matter of Schlumberger Limited*, No. 811620 (N.Y. Div. Tax App. Apr. 13, 2000), finding that taxable entire net income of an alien corporation includes foreign source income otherwise excluded from federal taxable income.

The entire net income base in New York is replaced with a tax based on business income, defined as entire net income minus investment income and other exempt income, effective in 2015.

<u>State Gross Receipts Taxes:</u>

Recently, Ohio, Texas and Michigan, replaced their existing corporate tax structures with a tax based wholly or partly on gross receipts. The key difference between a gross receipts tax and traditional income tax is the base. As noted above, the state corporate income tax base generally starts on line 28 or 30 of a taxpayer's federal return. Gross receipts taxes are different: The measure of the Texas tax on gross receipts, called the Margin Tax, starts with line 1c. Michigan and Ohio specifically define what is included in gross receipts. Michigan's tax on gross receipts, called the Michigan Business Tax, was repealed in favor of a more traditional corporate income tax. A brief explanation of the Ohio and Texas tax bases follows:

Under the Ohio Commercial Activity Tax, gross receipts are broadly defined as the total amount realized by a person, without deduction for the cost of goods sold or most other expenses incurred. Gross receipts include the fair market value of property or services received, and any debt transferred or forgiven as consideration. Gross receipts also include amounts realized from: the sale, exchange, or other disposition of property; the performance of any services for another; and the rental, lease, or other use or possession of the taxpayer's property or capital by another (e.g., rental receipts, royalties, etc.). Deductions are provided for cash discounts allowed and taken, returns and allowances, and bad debts previously included in taxable gross receipts. In addition, the statute provides several exclusions from the definition of gross receipts.

In Texas, taxable margin equals the lesser of: 70% of a taxable entity's total revenue; or 100% of the entity's total revenue less, at the election of the taxpayer: cost of goods sold as specifically defined, or compensation as specifically defined. Total revenue is generally determined by adding and/or subtracting amounts reportable on the taxpayer's federal tax return (either Form 1120 or 1065) filed for the year at issue. Among the amounts included, for 1120 filers, are gross receipts or sales, less returns and allowances from line 1c of the 1120. The statute provides many other inclusions and subtractions. The cost of goods sold deduction against taxable margin is generally limited to taxpayers who produce or manufacture tangible personal property that is sold in the ordinary course of business and includes all direct costs of acquiring or producing the goods. Notably, COGS for Margin Tax purposes is not the same as it is for federal tax purposes.

MODIFICATIONS

All states imposing an income tax apply modifications to the starting point to arrive at the tax base. Although each state has its own additions and subtractions, several are common to most states. Following are some of the more common modifications found currently in state law:

Additions

- State income taxes
- Foreign income taxes
- Local income taxes
- Interest from state obligations
- Excess ACRS depreciation
- Excess depletion
- Federal N.O.L. C/O
- Federal capital loss C/O
- Federal contribution C/O
- Federal bonus depreciation (several states do not conform to the federal bonus depreciation)
- Excluded DISC/FSC income
- Payments to Related Entities
- Federal deduction for domestic production activities
- Dividends from Captive REITs/RICs
- Discharge of Indebtedness - IRC Section 108 deferral

Subtractions

- Dividends (General)
- Dividends controlled corporations
- Federal jobs credit wages
- Interest - U.S. obligations
- State income tax refunds
- Current year capital loss
- Subpart F income
- Capital gain from years before state law enacted
- Federal income tax
- Partial capital gain deduction

Federal IRC §385 Regulations

On October 13, 2016, the Treasury Department and Internal Revenue Service released final and temporary regulations under Section 385 ("Section 385 regulations"), which address whether certain instruments between related parties are treated as debt or equity. The Section 385 regulations were effective as of October 21, 2016 and apply to taxable years ending on or after the date 90 days after the publication date, which will be January 19, 2017. States may enact legislation or impose regulations that adopt, modify, or decouple from the federal regulations, resulting in different federal and state income tax treatment of intercompany financing arrangements. In addition, the implications in separate company states could be significant, as transactions between companies that would not have separate federal 385 implications (due to being part of a consolidated group) could have implications in the state. Further, the consolidated group exception may not apply in all combined reporting states, leaving open questions for how intercompany transactions should be treated. The federal one-corporation exception is discussed in the "Analysis of Issues and Opportunities in Combined and Consolidated Returns in Selected States" section.

Dividends

The states differ in their treatment of dividend income. However, there are some common rules. Some examples are:

- Dividends received are reduced in conformity with the dividends received percentage allowed on the federal return.
- Dividends received are reduced by an arbitrary percentage fixed by state law.
- The IRC Section 78 deemed-paid gross-up on foreign (country) dividends are usually excluded from dividend income.
- Subpart F income may or may not be treated as dividends.

U.S. Supreme Court: Domestic Versus Foreign Dividend Treatment

The states have also accorded different treatment to foreign dividends in relation to domestic dividends. The U.S. Supreme Court held in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance,* 505 U.S. 71 (1992), that Iowa's taxation of dividends violated the Foreign Commerce Clause. Iowa used federal taxable income as the starting point for the computation of Iowa taxable income. No adjustment for dividends was written into the statute and, as a result, corporations were entitled to deduct domestic dividends to the extent they were deductible under federal provisions, but were taxed on foreign dividends taxable under the IRC.

The Court found it "indisputable" that foreign dividends were treated less favorably than were domestic dividends, and also found that this treatment affected foreign commerce. The Court stated that through the "interplay of the federal and Iowa tax statutes," the only dividend payments taxed by Iowa were those reflecting a foreign business activity.

Having found that the issue did involve foreign commerce, the Court turned to the question of discrimination. While agreeing with the State that Iowa subsidiaries were not favored over subsidiaries located elsewhere, the Court found such favoritism not to be an essential element in a foreign commerce context stating, "the absence of local benefit does not eliminate the international implications of the discrimination." The Court found the Iowa tax to impose a burden on foreign subsidiaries not imposed on domestic subsidiaries and thus to discriminate against such subsidiaries.

It is important to note the Court's footnote with regard to its ruling relative to a state employing unitary combined apportionment (Footnote 23). Footnote 23 speaks to the possibility that a state that imposes its tax on the taxpayer's income including its foreign dividend income, and also on the income of a domestic subsidiary doing business in its borders, may well not be discriminating in violation of the Foreign Commerce Clause. It further states, however, that the comparison which is most apt is between corporations whose subsidiaries do not do business in the taxing state. Various states have attempted to use this footnote to justify their taxation of foreign dividends under a domestic combined reporting provision.

Important State Decisions - Dividends

California

In *Farmer Brothers Co. v. Franchise Tax Board*, 108 Cal.App.4th 976 (2003), U.S. Supreme Ct., Docket No. 03-776, ("Farmer") petition for cert. denied 02/23/04, the California Court of Appeals ruled that statutory provisions that tie the general corporation dividends received deduction to the payor's level of California in-state activity create an unconstitutional burden on interstate commerce and are invalid.

Farmer applied for a partial refund of corporate franchise taxes levied on dividends received from corporations that conducted no business in California. The FTB denied the refund claim, citing CRTC section 24402, which provides a deduction for dividends from corporations taxed by California. However, section 24402 does not allow a deduction for dividends from corporations that do not conduct business in the state.

The court concluded that Section 24402 is discriminatory on its face because it favors dividend-paying corporations doing business in and paying taxes to California over dividend-paying corporations that do not do business in and pay no taxes to California. In addition, the court dismissed the FTB's assertion that Section 24402 does not violate the internal consistency doctrine, explaining that the imposition of Section 24402 by every state would favor intrastate commerce over interstate commerce by giving a greater tax benefit to taxpayers investing in their home state corporations as opposed to out-of-state corporations or corporations engaged in multistate businesses. The court also ruled that the statute is not a valid compensatory tax, which would otherwise allow a facially discriminatory statute to survive a Commerce Clause challenge.

Connecticut

In *Eastman Kodak Company v. Connecticut Commissioner of Revenue Services*, 27 Conn. L. Rptr. 273 (2000), the Connecticut Superior Court ruled that a department policy disallowing a portion of the deduction for commissions paid to a foreign sales corporation arbitrarily treats the commissions as nondeductible expenses related to dividend income, and is nothing more than a vehicle to allow the state to indirectly tax income that it is prohibited from taxing directly. In preparing its federal return for the years at issue, Eastman Kodak claimed a deduction for the full amount of commissions paid to a subsidiary FSC as allowed under the federal code. However, in computing Connecticut taxable income, Eastman Kodak added back 8/23rds of the commissions as expenses related to dividends. Generally, Connecticut allows for a dividends received deduction, but it must be less related expenses.

Following a ruling by the Connecticut Supreme Court in *SLI International Corp. v. Crystal*, 671

A.2d 813 (1996), in which the court upheld a deduction for commissions paid to sister corporation that qualified as a Foreign Sales Corporation ("FSC"), Eastman Kodak filed a claim for refund of the previously disallowed commissions. The commissioner denied Eastman Kodak's refund claim based on a policy in effect since the late 1980s to disallow 8/23rds of the commissions paid by a corporation to a FSC as an expense related to dividend income.

The court ruled that this policy lacks a statutory basis, and is a clear attempt by the commissioner to indirectly tax income it is prohibited from taxing directly, the court said. There is no statutory authority allowing the commissioner to tax income earned by the FSC by disallowing a portion of the commissions Eastman Kodak paid to the FSC.

Idaho

A taxpayer was entitled to an additional exclusion for certain foreign dividends after making an election under IRC Section 965, the Idaho State Tax Commission ruled in, Decision No. 21032, March 11, 2009, received July 15, 2009.

The Idaho State Tax Commission's Income Tax Audit Bureau disallowed the taxpayer's additional exclusion for certain foreign dividends in calculating its Idaho taxable income coupled with the taxpayer's election to take a temporary dividends received deduction ("DRD") under IRC Section 965. The taxpayer filed a protest and petition for redetermination. The taxpayer made an election under IRC Section 965 to take an 85% deduction in arriving at federal taxable income for eligible dividends from foreign subsidiaries. In calculating Idaho taxable income, starting with federal taxable income, Idaho law requires the addback of DRDs under IRC Sections 243, 244, 245, and 246A, but does not require that the IRC Section 965 DRD be added back. Idaho also allows its own DRD under Idaho Code Ann. Sec. 63-3027C, and the taxpayer utilized the Idaho DRD in addition to the IRC Section 965 DRD in determining its Idaho taxable income. The Bureau argued that the taxpayer had "already been allowed an 85 percent exclusion of foreign dividends, as allowed in the computation of federal taxable income. . . [and] no further exclusion is allowed under the Idaho statutes." However, the Commission disagreed, stating that since income is subject to apportionment "to the extent taxable" and the remaining 15% of dividends after application of IRC Section 965 indeed was taxable, the taxpayer was correct in applying the state-specific DRD exclusion under Idaho Code Ann. Sec. 63-3027(c)(3) to that remaining 15%.

Indiana

In *Indiana Department of State Revenue v. Caterpillar, Inc.,* No. 49S10-1402-TA-79 (8/25/14), the Indiana Supreme Court held that Caterpillar may not deduct foreign source dividends it received from its foreign subsidiaries when calculating Indiana NOLs. Indiana's NOL statute is separate from its foreign source dividend deduction statute. Indiana law provides that a taxpayer's adjusted gross income includes a deduction for foreign source dividends. A separate statute provides, an Indiana NOL is defined by reference to a taxpayer's federal NOL with certain state adjustments, none of which specifically reference a foreign source dividend deduction. The Court determined that the NOL statute is unambiguous, and does not include a step to deduct foreign source dividends. Accordingly, Caterpillar could not include foreign source dividends in its Indiana NOL calculation.

Kansas

In *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. Dec. 10, 1993) the Kansas Supreme Court held the taxation of dividends from unitary foreign subsidiaries and the use of domestic combined reporting did not violate Constitutional principles. Because Kansas, like Iowa, excluded domestic dividends from taxation while taxing foreign dividends, the taxpayer argued that the inclusion of foreign dividends in its taxable base violated the Foreign Commerce Clause of the U.S. Constitution.

The court found the Iowa and Kansas taxing schemes differed. The court pointed out the fact that in Kraft, the U.S. Supreme Court stated that "Iowa is not a State that taxes an apportioned share of the entire income of a unitary business, without regard for formal corporate lines." Kansas, in contrast, requires domestic unitary businesses to file a combined report. Because of this difference, the issue before the Kansas court was whether Footnote 23 of the Kraft decision could be interpreted as allowing the taxation of foreign but not domestic dividends under a domestic combination taxing methodology.

Footnote 23 speaks to the possibility that a state that imposes its tax on the taxpayer's income including its foreign dividend income, and also on the income of a domestic subsidiary doing business in its borders, may well not be discriminating in violation of the Foreign Commerce Clause. It further states, however, that the comparison that is most apt is between corporations whose subsidiaries do not do business in the taxing state.

The Kansas court found that Footnote 23 should be read as stating that, "the appropriate measure of discrimination is comparison of similar circumstances," and found the taxpayer's comparison to be faulty. The court found Morton Thiokol had postulated a "hypothetical" situation that went beyond the U.S. Supreme Court's definition of an "appropriate" comparison, and stated that an inappropriate comparison cannot be used to determine the presence or absence of discrimination. Because the hypothesized example bore "little, if any, resemblance to the actual circumstances of the taxpayer in the present case," the court concluded that a state employing domestic combination was not discriminating under the holding in Kraft, and did not violate the Foreign Commerce Clause of the U.S. Constitution.

Maine

In reliance on *Morton Thiokol*, the Maine Supreme Judicial Court in *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. Apr. 9, 1996) ruled that the inclusion of foreign source dividends in the computation of taxable income is Constitutional. The court noted that unlike the single entity reporting system used in Iowa, Maine utilizes a combined method of reporting. Thus, the court stated, Iowa taxed neither the income nor the dividends of a domestic subsidiary if the subsidiary did not do business within the State. In contrast, the court remarked, the combined reporting method "by definition includes within the amount apportioned to Maine part of the income earned by the unitary business's domestic subsidiaries . . . effectively captur[ing] some of the value of the business activity of the domestic subsidiaries by directly taxing an apportioned part of the domestic subsidiary's income."

The court ruled Maine's use of the water's edge combined reporting provided "a type of 'taxing symmetry' that is not present under the single entity system." The court reasoned that although dividends paid to parent corporations with domestic subsidiaries are not taxed, the apportioned income of the domestic subsidiaries is subject to tax. Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine, the court found that the inclusion of dividends paid by foreign subsidiaries did not constitute the kind of discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft*.

Maryland

The Maryland Tax Court, *Kraft General Foods, Inc. v. Comptroller of the Treasury,* Md. Tax Ct., No. 98-IN-OO-0353, 06/08/01, ruled that a comptroller's policy prohibiting a taxpayer from claiming a statutorily authorized deduction for foreign source dividends, in a year when such a deduction will increase the taxpayer's federal net operating loss carryforward, violates the Commerce Clause of the U.S. Constitution.

Maryland taxable income begins with federal taxable income and makes certain addition and subtraction modifications, the court explained. Subtraction modifications include a deduction for foreign source dividends—allowed as a response of the disparate treatment of domestic and foreign source dividends at the federal level; *i.e.,* domestic source dividends are excluded from federal taxable income while foreign source dividends are included in federal taxable income. (See *Kraft General Foods, Inc., v. Iowa Department of Revenue,* 505 U.S. 71 (1992).) By adopting federal taxable income as a starting point in computing Maryland taxable income, the state allows taxpayers to claim a deduction for domestic source dividends, even if the deduction for domestic source dividends creates a net operating loss, the court noted. In contrast, a taxpayer may not claim a deduction for foreign source dividends to the extent the deduction increases a federal net operating loss. Accordingly, a taxpayer will always get the benefit of the federal deduction for domestic source dividends received in a loss year, while the Maryland subtraction modification for foreign source dividends received in a loss year will be lost. As a result, the comptroller's policy exposes foreign commerce to burdens that domestic commerce is not required to bear. Such a taxing scheme fails to meet Commerce Clause requirements and is invalid, the court said.

Mississippi

Mississippi law permits a recipient of intercompany dividends to exclude such dividends from its calculation of gross income if the distributing corporation is doing business in Mississippi in the year of the distribution and files a Mississippi income tax return for that year. Accordingly, taxpayers may not exclude dividends received from an affiliate that does not do business in the state.

In the case of *AT&T Corp. v. Mississippi Dep't. of Revenue*, the taxpayer claimed a deduction for dividends received from affiliated corporations in computing its taxable income. On audit, the state adjusted the taxpayer's income and disallowed deductions for dividends received from affiliates that did not do business and file returns in Mississippi.

The Mississippi Supreme Court ruled that the state's dividends received deduction, which applies only to dividends received from affiliates doing business and filing state income tax returns in Mississippi, unconstitutionally discriminates against interstate commerce. By striking the offensive limitation, the taxpayer could exempt from taxation income from dividends that have already been taxed in Mississippi or in any other state.

New Hampshire

The New Hampshire Supreme Court held that a statute that allows a parent to take a business profits tax deduction for dividends received from subsidiaries that do business in the state but not for dividends received from subsidiaries that do not business in the state does not facially discriminate against foreign commerce, in *General Electric Company, Inc. v. New Hampshire Dep't of Revenue Admin.,* N.H., No. 2005-668, 12/5/06. In so ruling, the court looked at the state's taxing system as a whole and the aggregate taxes assessed against unitary business in New Hampshire and concluded that there was no improper discriminatory treatment. By allowing a deduction for dividends received from a foreign subsidiary that does business in the state (and is already taxed in the state), the statute prevents double taxation. However, a foreign subsidiary that does not conduct business in New Hampshire is not directly subject to New Hampshire tax, and as such, it is not necessary to protect against double taxation and allow a parent to take a deduction for dividends received from such subsidiaries.

New Mexico

The New Mexico Supreme Court in the consolidated cases *of Conoco, Inc. and Intel Corporation v. New Mexico Taxation and Revenue Dept.,* 931 P.2d 730 (N.M. Nov. 26, 1996), reversed the State Court of Appeals and held New Mexico's scheme of exempting domestic dividends while taxing foreign dividends under the Detroit formula to violate the Foreign Commerce Clause of the U.S. Constitution.

New Mexico permits taxpayers to elect one of four methods of filing for income tax purposes: (1) separate accounting, (2) separate corporate entity reporting, (3) combination of unitary corporations, or (4) filing as a federal consolidated group. Both Conoco and Intel had elected separate entity reporting. Because New Mexico uses federal taxable income including the dividend received deduction for domestic dividends as the tax base under the separate entity option, the State's scheme mirrors that of Iowa, a scheme found unconstitutional by the U.S. Supreme Court in *Kraft*. The New Mexico Department of Revenue (Department) argued that the use of the Detroit formula remedied the differential treatment of domestic and foreign dividends by reducing the amount of taxes paid. Under the formula, a portion of the property, payroll and sales of dividend-producing foreign subsidiaries is added to the parent's denominators. The portion is determined by dividing the net dividends the parent receives by the subsidiaries' total net profit. The addition of these factors to the denominator tends to lower the apportionment percentage and thus the amount of tax owed. The court found, however, that the formula does not always eliminate the tax paid on dividends from foreign subsidiaries. Most particularly, both

Conoco and Intel were liable for more tax under the Detroit formula than they would have been had the foreign dividends been excluded. Finding *Kraft* clearly to require that domestic and foreign commerce be treated equally, the court held the Detroit formula did not cure the unconstitutional discrimination.

The Department argued that the taxpayers were not entitled to relief because the discrimination they may have suffered was due to their election to file on a separate entity basis. Citing Footnote 23 from the *Kraft* decision, the Department stated that the taxpayers could have chosen domestic combined reporting, an option, according to the Department, which would have been Constitutional. The court found that even if the U.S. Supreme Court had "implicitly approved domestic combined reporting, an interpretation we are not inclined to accept and do not adopt in this opinion, the existence of Constitutional options should not preclude taxpayer relief from the unconstitutional aspects of the option exercised by the taxpayer." Consequently, the court found the fact that other reporting options existed was not relevant to the issue.

More recently, in *In re Xerox Corporation,* No. 03-22, 12/3/03, a hearing officer for the New Mexico Taxation and Revenue Department ruled that a corporate income tax scheme that taxes a combined filer on dividend and Subpart F income received from foreign affiliates that are part of the taxpayer's unitary group, but that excludes from tax income received from domestic affiliates that are not part of the unitary group does not impermissibly discriminate against foreign commerce.

The hearing office explained that the taxpayer cannot rely on the findings of *Conoco,* and said that Xerox's attempt to compare the tax treatment of dividends from non-unitary domestic subsidiaries with the tax treatment of dividends from unitary foreign subsidiaries is like comparing "apples and oranges," the hearing officer said. During the years at issue, the exclusion of dividends from domestic subsidiaries was based on the non-unitary relationship of those subsidiaries. If Xerox had received dividend income from non-unitary foreign subsidiaries, the income would have been similarly excluded. The differential treatment is not based on whether the subsidiary is foreign or domestic, but on whether the subsidiary's activities were unitary or non-unitary with the business income of the parent. Based on that, the different tax treatment of the domestic and foreign dividends for the years at issue does not violate the Foreign Commerce Clause, and Xerox may not deduct the income it received from its unitary foreign subsidiaries when filing corporate income tax returns using the combined reporting method, the hearings officer found.

North Dakota

In *D.D.I, Inc. v. North Dakota,* 657 N.W.2d 228 (N.D., 2003), the North Dakota Supreme Court ruled that statutory provisions that limit the dividends received deduction based on the payor's level of North Dakota taxable income impermissibly discriminate against interstate commerce and are not defensible as a "compensatory tax" structure. The ruling enjoins the state from collecting income taxes from the taxpayers at issue on dividend income received from payor corporations that conduct business either wholly or primarily outside of North Dakota. The court determined, and the commissioner conceded, that the state's dividends received deduction facially discriminates against interstate commerce. As such, the court found, the commissioner must establish that the tax structure is a valid "compensatory" tax that requires interstate commerce to bear a burden already borne by intrastate commerce. The court rejected the commissioner's argument that the tax scheme attempts to compensate for the imposition of the North Dakota corporate income tax on in-state corporations. The commissioner argued that if $10 of corporate income tax is imposed on $100 of an in-state corporation's profits, it is equitable to 1) allow a 100 percent deduction to the recipient of a $100 dividend from that corporation and 2) impose $10 of tax on the same $100 dividend paid by a corporation not subject to the corporate income tax. This taxing scheme imposes the same tax on the same amount of corporate profit and avoids the double taxation of an in-state corporation’s profits as a dividend, the commissioner claimed. The commissioner's argument ignores the corporate income tax that an out-of-state corporation's state might impose on the out-of-state corporation's profits, which effectively imposes a double layer of tax on the out-of-state income but not on in-state income, the court found.

Oregon

In *Stancorp Financial Group v. Department of Revenue,* Or. Tax Ct., TC-MD 070881B, 8/22/11, the Court held that a corporation could not eliminate dividends received from its wholly-owned subsidiary, in insurance company, because the insurance subsidiary was excluded from the parent's consolidated Oregon corporation excise tax return. Under Oregon law, if an entity is required to use a different apportionment formula than a corporation with which it is affiliated, the entity is not permitted to be included in the same Oregon consolidated return. In this case, because the insurance subsidiary was required to use an industry-specific apportionment formula and file a separate Oregon return, the dividends it paid to its parent may not be eliminated from the parent's Oregon consolidated return.

Subpart F Dividends

The states differ on the treatment of federal Subpart F dividends. For example, California does not recognize Subpart F dividends as income. Some states, such as Kansas, do tax Subpart F dividends as income.

California

California does not include deemed dividends as taxable income in a worldwide combined report until the dividends are actually distributed. Thus, in a worldwide combined report setting, any Subpart F income is eliminated as a state to federal adjustment to be removed as income. However, under a water's edge filing method, Subpart F income is treated differently. In *Amdahl Corp. v. Franchise Tax Bd.,* Cal. Ct. App., No. A101101, 7/7/04, the California Court of Appeal, First District held that dividends paid from one controlled foreign corporation ("CFC") to its parent CFC are eliminated in determining the amount of CFC income to be included in the income of the unitary group, to the extent that the lower-tier CFC paid the dividends out of income that was included in combined income. In addition, where part of a CFC's income is Subpart F income and thus included in the unitary group's tax return, dividends paid by the CFC to the unitary group should be deemed paid *first* out of included income and thus eliminated.

A water's edge combined report includes the income and apportionment factors of U.S. affiliates, as well as a portion of the income and apportionment factors of a CFC if all or part of the CFC's income is "Subpart F income." Pursuant to CRTC section 25110(a)(6), the pre-apportionment tax base of the water's edge group includes a portion of the CFC's income determined by the ratio of its Subpart F income to its earnings and profits ("E&P") for the year (the "inclusion ratio"). For federal purposes, dividends paid from one CFC to its parent CFC are eliminated in determining the amount of CFC income to be included in the consolidated return pursuant to IRC Section 959(b). However, the California FTB disputed the application of the federal rule for purposes of determining the proper CFC inclusion ratio. The appellate court found not one but two separate rationales to support the taxpayer's (Amdahl's) position. Relying on the express terms of the statute, the court adopted the superior court's reasoning that, under CRTC section 25106, dividends paid out of the unitary income of a lower tier subsidiary must be eliminated from the income of the recipient and "shall not be taken into account .... in any other manner."

Despite the court's disposition of the matter in favor of Amdahl, the court noted that it disagreed with the superior court's conclusion that California had not adopted IRC Section 959(b) or its principles. "[A]bsent clear language in the [California] statute or in administrative regulations refusing to do so, we may assume California has adopted into its definition of Subpart F income the federal exclusions, including 'distributions of previously taxed income under [IRC] Sec. 959(b)'" (quoting from the Treasury regulations). The court further concluded that, "[i]t is clear that California has chosen to measure Subpart F income by incorporating the federal definition -- a standard that implies California's willingness to follow the federal lead."

Note: Following the *Amdahl* decision, on March 4, 2005, the FTB issued a discussion draft in which it proposed amending Regulation Sec. 24411(e) to specifically provide that, if a dividend is paid out of the E&P of a given year, and the dividend is not sufficient to exhaust the total E&P of that year, "the dividend shall be considered a dividend eligible for treatment under Revenue and Taxation Code sections 24402, 24410, 24411, or 25106 (or any other section of the Revenue and Taxation Code that would provide that the dividend is not included in net income), respectively, on a pro rata basis, based on the ratio of earnings and profits drawn from that year to the total earnings and profits originally available to be drawn from that year."

Note: *Amdahl* was acquired by Fujitsu IT Holdings prior to the conclusion of the Amdahl appeal, as such it was renamed Fujitsu IT Holdings. While Amdahl provided guidance with respect to a distribution paid from current tax year E&P, it did not address the situation where a distribution is paid from current and prior year E&P layers. In this situation, California's position was that a distribution was classified between CRTC section 25106 (100% DRD or intercompany elimination) or section 24411 (75% DRD) based on the current year E&P, and then you looked to the most recent prior year and then to the next prior year, on a last-in-last-out ("LIFO") basis to determine the classification. You look to the extent the paying CFC had been included in that water's-edge tax year (the CRTC section 25106 portion) or the excluded portion (the CRTC section 24411 portion). A different position taken was that the distribution that exceeded the current E&P layer could be applied against the accumulated CRTC 25106 layers, before application of the accumulated CRTC 24411 layers. This is the issue that was resolved by the *Appeal of Apple Computer.*

In *Appeal of Apple Computer Inc.,* No. 152016 (Cal. State Bd. of Equal. 11/20/06), the SBE held that pursuant to the LIFO ordering provisions, dividends from the accumulated earnings of a partially included CFC of a water's-edge filer must be treated as coming from the current year's E&P until exhausted and then from the most recent year's E&P without regard to whether the E&P represent included or excluded income. Further, dividends received from a CFC must be prorated between income included in and excluded from the combined report. In so ruling, the "preferential ordering" method of drawing the dividend first from included income until fully exhausted and then from excluded income as outlined in *Fujitsu IT Holdings v. Franchise Tax Board,* 120 Cal. App.4th 459 (2004) was rejected.

In determining how to allocate dividends paid from accumulated earnings among the various years, the parties agreed that the relevant law requires LIFO ordering, but disagreed as to the mechanics. The taxpayer argued that LIFO ordering requires that dividends be allocated from included income, starting with the current year, then to most recent year's included income and so on, until all of the accumulated included income is exhausted with only the excess remaining deemed to come from excluded income. The FTB countered that LIFO requires that dividends be allocated in a way that exhausts each year's earnings in turn, without regard to whether the income is included or excluded. The SBE agreed with the FTB, explaining that the applicable LIFO provisions do not differentiate between included income or excluded income, but state that dividends are deemed distributed from more recent earnings before older earnings.

The SBE explained that, after application of the LIFO ordering rules, one must determine "the allocation of dividends paid from a year in which the underlying income was partially included in the combined report." Preferential ordering -- the allocation method advanced by the taxpayer and endorsed in *Fujitsu* -- would deem the dividends to be paid first from included income, with any excess paid from excluded income, the SBE noted. This method would subject a greater portion of the dividends to elimination under Section 25106. Proration -- the allocation method advanced by the FTB -- would deem dividends to be paid in part from excluded income and in part from included income, in the ratio that included and excluded income bear to total income. Proration would subject a greater portion of the dividends to deduction under Section 24402**.**

The taxpayer argued that Section 25106 and *Fujitsu* require "preferential ordering" of dividends. The taxpayer emphasized that *Fujitsu* was not based merely on "regulatory interpretation," but relied on Sec. 25106 and the legislative intent behind the statute. The taxpayer noted that "the *Fujitsu* court did not simply require that dividends be deemed paid first from included income; the court also emphasized that the plain language and purpose of Sec. 25106 allows members of a unitary group to move dividends among themselves without taxation, and stated that only its method of allocating dividends would effectuate that purpose." The state responded that Cal. Code Regs. tit. 18, Sec. 24411 requires proration, and the clear language of IRC section 316(a), which California generally adopts, does not differentiate between kinds of income. In addition, the FTB submitted that the taxpayer's reliance on *Fujitsu* was improper and that the holding in *Fujitsu* referred only to "current year earnings" and was silent as to the treatment of accumulated E&P. Therefore**,** *Fujitsu* provides no guidance on the ordering of dividends, the FTB argued. The FTB asserted that the taxpayer's "interpretation of LIFO ordering would defeat the original purpose of LIFO, which is to prevent the corporation from choosing which year's earnings it wants to distribute for tax purposes." Finally, the FTB argued that the reasoning in *Fujitsu* was erroneous, and that the SBE should treat *Fujitsu* with limited deference because the *Fujitsu* court relied on and incorrectly interpreted inapplicable statutes.

The SBE agreed with the state's proration method. The SBE concluded that when "dividends are paid from income with mixed character," the state has required the proration method since the 1940's. In addition, the SBE cited *Safeway Stores v. Franchise Tax Board,* 3 Cal. 3rd 745 (1970). In *Safeway,* the court held that a dividend proration method must be used to bifurcate dividends partially sourced to California. The SBE also stated that Sec. 24402 and Sec. 24411 explicitly requires proration. "After careful consideration, we hold that dividends paid from a mix of included and excluded earnings should be prorated," the SBE stated. The SBE found that *Safeway* was decided in a higher court then *Fujistu,* and thus carries more weight.

The California Superior Court in the *Appeal of Apple* reached the same conclusion as the SBE on the issue of the LIFO ordering rule under IRC Sec. 316(a), treating distributions first as coming from current year's earnings until exhausted and then from the most recent years' earnings without regard to whether the earnings represent included or excluded income. With respect to the SBE's interpretation of Fujitsu and its decision on the proration method however, the court noted the holding of the distribution ordering method at issue in Fujitsu is "expressly limited" to "current year earnings." Expanding Fujitsu's interpretation of Sec. 25106 to multiple years would conflict with the LIFO ordering rule for dividends in former CRTC section 22495, operative in the year at issue, and IRC Sec. 316(a). The court established a middle ground and stated that "the best way of reconciling Fujitsu's interpretation of Sec. 25106 with IRC Sec. 316(a) is to hold that a distribution is deemed paid entirely from included income of a CFC's most recent year's earnings until exhausted. Then the remainder of the distribution is deemed drawn from the excluded income of the most recent year. When that source is exhausted, the remainder is deemed paid from the included income of the previous year and so on until the entire amount of the distribution is accounted for," the court concluded. [*Appeal of Apple Computer, Inc.*, Cal. Sup. Ct., County of San Francisco, CGC-08-471129, 1/26/10]

The court in *Apple* also discussed the interest expense deduction under CRTC section 24425, which disallows deductions for any amounts "allocable" to untaxed income. The court pointed out that Sec. 24425 "however, does not disallow interest expense deductions for borrowings that have some economic connection to the generation of deductable income." Apple showed that it used its borrowings to fund working capital needs and none of the money flowed to Apple's foreign subsidiaries. In addition, the court held that FTB's "fungibility of money concept" has not been adopted in Sec. 24425 and "FTB's interpretation of Sec. 24425 " stretches the meaning of "allocable" beyond a reasonable construction."

The court relied on the SBE's decision in Appeal *of Zenith National Insurance Corp*., Cal. State Bd. Of Equal. Jan. 8, 1998 , which held that the ultimate test for determining whether borrowing is "allocable" to a source of income is the taxpayer's "dominant purpose" in incurring and continuing the indebtedness. Furthermore, *Zenith* ruled that a taxpayer can establish the dominant purpose of its borrowing either through direct tracing to a particular investment or by consideration of the totality of facts and circumstances establishing a sufficiently direct relationship borrowing and the investment.

Apple showed that during the years at issue, several of its foreign subsidiaries held a substantial portion of Apple's cash reserves, providing sufficient evidence that those foreign subsidiaries were cash rich and did not need funds from Apple U.S. Furthermore, Apple had no long term debt during the years at issue and there were no intercompany loans or any other flow of funds from Apple to any of those foreign subsidiaries holding the majority of those cash reserves, proving Apple did not borrow to fund its foreign operations. The court concluded, that based on the undisputed evidence, Apple's interest expenses were allocable to its taxed domestic earnings and not to the untaxed dividends from its subsidiaries.

Note. On March 15, 2011, the FTB issued Technical Advice Memorandum ("TAM") 2011-02 to provide guidance on the LIFO and proration approaches to ordering dividend distributions from CFCs that are partially included in the water's edge combined report. In the TAM, the FTB provided that the FTB would continue to follow LIFO ordering to determine the order of the years from which dividend distributions are made, starting with the current year. With respect to ordering of distributions within a given year, the FTB abandoned its prior proportional method and stated that it would deem that dividends are first paid out of E&P that was included in the unitary group's combined report, making the dividends eligible for complete elimination under Section 25106. When that pool of E&P is exhausted, then the dividends are deemed paid from other earnings eligible for elimination under other provisions of the Corporation Tax law, until those earnings are depleted.

On September 12, 2011, the California Court of Appeal affirmed the *Apple* court's decision on foreign dividends and interest expense allocation, concluding that the dividends from the accumulated earnings of a partially included CFC of a water's edge filer are governed by the LIFO ordering provisions and must be treated as coming from current year earnings until exhausted and then from the most recent years' earnings, without regard to whether the earnings represent previously taxed income. This is consistent with the treatment provided for in FTB's TAM 2011-02. Also, the appeals court affirmed the trial court's holding that interest expense attributable to funds proven to have some economic connection to the generation of California taxable income qualify for deduction. The California Supreme Court subsequently denied review of the appellate court decision on January 4, 2012. [*Apple Inc. v. Franchise Tax Board*, 199 Cal. App. 4th 1 (Cal. Ct. App., 1st Dist., Sept. 12, 2011), petition for review denied, Cal. Supreme Court (S197381, Jan. 4, 2012).]

Net Operating Losses

The state provisions relating to net operating losses vary greatly. Few states allow the same amount of net operating loss claimed on the federal return. However, most states allow a deduction for some portion of net operating loss ("NOL") carryover, if specific conditions are met.

In a case where a company joins in the filing of a federal consolidated return, but files a separate return for state purposes, NOL carryovers for state purposes are determined "as if" the company had filed separate federal income tax returns for all the years involved. Most state laws provide that a company must have been subject to tax in that state in the year a loss is incurred, in order to avail itself of a NOL carryover in the present year.

The federal stimulus legislation signed into law March 9, 2002, by President Bush ("The Job Creation and Workers Assistance Act of 2002," P.L. 107-147) extended the carryback period for NOLs arising in tax years ending in 2001 and 2002 to five years from two years. Some states decoupled from automatic conformity to the IRC, or specifically disallowed the extended carryback period, as a way to limit the impact of the federal legislation. Other states already disallow or otherwise restrict NOL carry backs.

In California, for tax years beginning after January 1, 2002 and before January 1, 2004, use of the NOL deduction was suspended and the carryover period was extended. For tax years beginning after January 1, 2008 and before January 1, 2010, again the use of the NOL deduction was suspended and the carryover period was extended for each year the NOL is barred. Per CRTC section 24416.9(d), this NOL suspension does not apply to taxpayers that have taxable income below $500,000. This exception applies on an entity-by-entity basis. The NOL deduction was again suspended and the carryover period was extended for tax years beginning on or after January 1, 2010, and before January 1, 2012. However, this suspension does not apply to taxpayers with pre-apportioned income of less than $300,000 for the taxable year. Prior to 2011, California had no provision for NOL carry backs. However, for 2011, 50% of an NOL can be carried back for 2 years; for 2012, 75% of any NOL can be carried back for 2 years; and for 2013, 100% of any NOL can be carried back for 2 years. No NOL carry back will be allowed for any tax year beginning before January 1, 2009. In September of 2011, the FTB issued Legal Ruling 2011-04 in order to answer questions about the calculation of a taxpayer's remaining NOL carryover period when the NOL deduction is suspended under California Law. Legal Ruling 2011-04 clarified that if even a portion of an NOL generated in a particular year is denied, the carryover period for the entire NOL generated in that year is extended, and if none of the NOL carryover would have been used during the suspension period, then the carryover life of that NOL is not extended.

The California Legislature did not extend the suspension of NOL deductions during the 2012 legislative session. Therefore, Taxpayers may deduct NOL's in taxable years beginning on or after January 1, 2012.

Important State Developments

Connecticut

In *Grade A Market*, *Inc. v. Commissioner of Rev. Srvs*., 709 A.2d 61 (Conn. Super. Tax Jan. 5, 1996), the Connecticut Superior Court held that pre-merger net operating losses may be utilized by a surviving entity. However, the court required the surviving entity to continue the business operations of the non-surviving merged corporation. The court held that under the "continuity of business" theory, the deduction of a merged corporation's loss carryover will be permitted if (1) the surviving corporation retains the same corporate identity of the pre-merged corporation; (2) the business enterprise that produced the loss is continued by the surviving corporation; (3) there is no substantial change in ownership of the surviving corporation; and (4) the income producing business of the surviving corporation is not altered, enlarged, or materially affected by the merger.

The state tax treatment of NOLs in a post-merger/acquisition situation may also differ from the rules of IRC Secs. 382. For example, in *Ruling No. 93-23*, the Connecticut Department of Revenue Services (DOR) discussed the application of IRC Secs. 382 to the net operating loss carryover provisions of the Connecticut corporate business tax. The DOR analyzed the Connecticut statute relevant to NOLs and found it did not incorporate the loss limitations of IRC Secs. 382 and that such limitations were not a factor in analyzing whether pre-merger NOL carryovers could be deducted against post-merger income. Accordingly, the DOR ruled where the surviving corporation in a merger has pre-merger NOL carryovers apportioned to Connecticut, such losses are not diminished by reason of the merger, and may be deducted under Connecticut law without regard to the NOL limitations under IRC Secs. 382.

Indiana

A taxpayer could not carry back consolidated net operating losses to its previously-filed separate returns because it could not be considered the common parent of the consolidated group, the Indiana Department of Revenue ruled in LOF 06-0441 (9/17/2007). In 1999, the taxpayer created a new holding company ("HC"), and subsequently executed a reverse acquisition of HC. In subsequent years, two additional corporations were added to the affiliated group, and in 2001 a consolidated Indiana income tax return was filed. In 2001, the taxpayer also filed amended returns carrying back a consolidated net operating loss ("CNOL") sustained by the group to HC's 1999 and 2000 income tax returns. After the federal government extended the NOL carryback period to five years, the taxpayer re-amended its returns to carry back the CNOL to its own 1996 and 1997 separate returns.

The Department explained that under the federal rules, if the group did not file a consolidated return during the carryback period, the loss may only be carried back to the separate return year of the common parent of the consolidated group. Accordingly, only the common parent of consolidated groups may benefit from CNOL carrybacks to its separate return years, the Department reasoned. Since neither the taxpayer nor HC were members of consolidated groups prior to the formation and reverse acquisition of HC, and after the reverse acquisition HC became the common parent of the consolidated group, the taxpayer could never benefit from the CNOL carrybacks because it was never a common parent, the Department ruled.

Massachusetts

Net Operating Loss Carried Forward on Separate Entity Basis

The Massachusetts Court of Appeals (Court) held in *Farrell Enterprises, Inc. v. Commissioner of Revenue*, 707 N.E.2d 1088 (Mass. App. Ct. Mar. 30, 1999), that the net operating losses of three subsidiary corporations could not be used to offset the income of profitable subsidiaries in the combined group.

Farrell Enterprises, Inc. (Farrell) and its subsidiaries filed federal consolidated income tax returns and Massachusetts combined excise tax returns since 1975. One hundred percent of the income of each of the Farrell corporations was Massachusetts source income. Three of Farrell's subsidiaries had no taxable income for the 1991 tax year. However, each of these subsidiaries had a net operating loss carryforward attributable to the 1989 and 1990 tax years. On an amended 1991 Massachusetts combined excise return, Farrell applied the unused NOLs of its three subsidiaries to offset the income of the profitable subsidiaries in the combined group.

The Court noted that Massachusetts law provides that "[i]f two or more domestic business corporations or foreign corporations participated in the filing of a consolidated return of income to the federal government, the net income measure of their excises . . . may, at their option, be assessed upon their combined net income . . . determined as follows: (a) the taxable net income of each such corporation apportioned to this commonwealth . . . shall first be separately determined; and (b) the taxable net income of each such corporation, as so determined, shall then be added together and shall constitute their combined net income taxable under this chapter."

According to the court, the calculation of combined taxable net income "requires a simple mathematical addition of the apportioned taxable net incomes of the individual members." Consequently, the court held that the NOL carry forwards were unavailable to the group's combined tax return.

Missouri

Net operating losses generated by a predecessor corporation in a year that the predecessor corporation was not subject to tax may be deducted in computing the Missouri taxable income of a successor corporation provided the losses are deductible for federal income tax purposes, the Missouri Administrative Hearing Commission ruled in *Cooper Industries Inc. v. Missouri Director of Revenue*, Mo. Admin. Hearing Comm., No. 98-2920 RI, 8/9/00. Missouri Rev. Stat. Secs. 143.431.1 provides that a corporation's federal taxable income as reflected on line 30 of its federal tax return must be used as the starting point in computing its Missouri taxable income. There are no separate net operating loss provisions requiring an adjustment to the computation of state taxable income. Based on Cooper's showing that predecessor losses are deductible in computing its federal taxable income, such losses are deductible in computing its federal taxable income.

Regulation Sec. 10-2.165 was amended to provide that net operating losses from a year when a loss company was not subject to Missouri tax are deductible in determining Missouri taxable income. The amendment eliminates Sec. 10-2.165(3), which prohibits a deduction for net operating losses from a year when the loss company was not subject to taxation by Missouri. Elimination of this provision conforms to the decision of an administrative law judge in *Cooper Industries Inc.*

New Jersey

In *Richard's Auto City*, *Inc. v. Director, Division of Taxn*., 140 N.J., June 21, 1995, the New Jersey Supreme Court held that net operating losses may only be carried over by the actual corporation that sustained the loss. Net operating losses incurred by the non-surviving corporation in a statutory merger are not permitted to be carried over to offset the income of the survivor. This decision was cited by the New Jersey Tax Court in *A.H. Robins Co. Inc. v. New Jersey Director, Division of Taxation,* N.J. Tax Ct., No. 005682-92, 2/21/02, in which the court ruled that statutory provisions prohibiting a successor corporation from claiming net operating losses of a predecessor corporation subsequent to merger are not preempted by the federal bankruptcy code. Without elaboration, the New Jersey Supreme Court affirmed this decision. (No. A-96-2003, 12/07/04).

In *Ronson Corp. v. Director, Division of Taxation,* N.J. App. Div., No. A-6776-03T2, 11/21/05, the New Jersey Superior Court, Appellate Division ruled that a taxpayer could not carry forward net operating losses that were created when a taxpayer both excluded dividend income and deducted an NOL carryover from income during the calculation process. The court also rejected the taxpayer's attempt to reuse the previously-taken NOL, dismissing the taxpayer's argument that it had a sufficiently large dividend exclusion to offset all of its income for that tax year.

New York

Net operating losses incurred by a subsidiary and reattributed to its parent pursuant to a proper election under federal consolidated return regulations cannot be claimed by the parent on its separate state return, the New York Tax Appeals Tribunal concluded in *In the Matter of the Petition of Univisa,* N.Y. Tax Appeals Tribunal, No. 820289 (9/20/07).

The taxpayer, Univisa, Inc., filed federal consolidated returns with its affiliates, including Univisa Sports Holding Inc. ("USHI"), a wholly-owned subsidiary. For federal purposes, Univisa timely elected to reattribute to itself USHI's NOLs. For New York corporate franchise tax purposes, both Univisa and USHI filed separate tax returns. Univisa utilized the reattributed USHI NOLs to offset income on its New York corporate franchise tax return. The Department of Taxation disallowed the use of the USHI NOLs and issued an assessment. The Department of Taxation claimed, and the Tribunal agreed, that corporations filing separately have to determine their NOLs without reattribution, which is only allowed in a federal consolidated context.

The New York Tax Appeals tribunal concluded that entire net income, inclusive of applicable net operating losses, be computed whether or not tax is actually paid on the base of net income. [*In the Matter of the Petition of TD Holdings II, Inc.*, State of New York Tax Appeals Tribunal, No. 825329, 4/7/16]

For 2005 to 2007, the bank tax was imposed on one of four alternative bases. In 2005, TD Holdings generated an NOL on its income base. In 2006, TD Holdings' non-income base was the largest of its four bases and did not apply its 2005 NOL carryover to its 2006 net income.

In January 2015, the administrative law judge found that TD Holdings was not required to use a net operating loss deduction to reduce its entire net income for New York bank franchise tax purposes in a year when the tax was not based on entire net income. The ALJ concluded that although state law provides that the state NOL cannot exceed a federal NOL, it does not bar the state NOL from being less than the federal deduction when the banking franchise tax is paid on an alternative base.

In April 2016, The New York Tax Appeals Tribunal reversed the ALJ's determination and found that a taxpayer was required to utilize a NOL deduction to reduce its entire net income for New York bank franchise tax purposes in a year when the tax was measured on a base other than entire net income.

The Tribunal explained that an NOL carryover is a kind of a tax exemption or deduction that "'must clearly appear, and the party claiming it must be able to point to some provision of law plainly giving the exemption." The Tribunal asserted that there is no language in the statute that requires, permits, or prohibits an offset of entire net income if entire net income plays no role in determining its tax liability. The Tribunal explained that because the statute is silent, it does not plainly allow limiting NOL application in this manner, thus taxable net income must be computed inclusive of NOLs even if tax is paid on an alternative tax base.

The Tribunal also stated that TD was required, under New York law, to compute its entire net income for 2006 whether or not it ultimately paid tax on that base. TD had positive entire net income before the application of any New York NOL deduction. "Such a requirement plainly contemplates that entire net income be computed inclusive of any applicable NOL deductions."

Oregon

In a case of first impression, the Oregon Tax Court held that net operating losses incurred by a unitary group member that departs the group mid-year may be taken into account by the remaining group members, but only to the extent those losses were incurred on or before the departure date. *US West, Inc., et. al. v. Department of Revenue*, Oregon Tax Court TC 4896; TC 4897, 8/20/11.

US West, Inc. and Qwest Dex Holdings, Inc. (collectively, USW) are the parents of two different unitary groups, each of which file separate Oregon consolidated tax returns. The two unitary groups, together with their comment parent, Media One (MO), are members of an affiliated group that files a federal consolidated tax return.

On June 12, 1998, MO distributed all of its USW's shares to its shareholders, thereby departing from USW's federal consolidated group. For federal tax purposes for the tax year ending December 31, 1998, MO filed a consolidated return for the full year, reflecting a single 12-month period and including in that return tax items of USW only for the period January 1, 1998 through June 12, 1998. USW was required to divide its 1998 tax year into two filing periods for federal and Oregon purposes - first for the period January 1, 1998 to and including June 12, 1998 (pre-spin) and second for the period June 13, 1998 through December 31, 1998 (post-spin). MO generated significant tax losses throughout the year while USW generated taxable income in both pre-spin and post-spin periods.

On USW's originally filed Oregon consolidated tax return for the post-spin tax period ending December 31, 1998, it deducted NOL carryforwards from the pre-spin period computed by combining USW's pre-spin year income with MO's pre-spin year losses. In an amended filing, USW recomputed available NOL carryforwards arising from the pre-spin period by increasing them to include the effect of MO's full-year loss, including the loss for the post-spin year.

The Department of Revenue argued, and the Oregon Tax court agreed, "that the loss of MO that may be taken into account in computing the loss carryover for USW is only the loss of MO for the period from January 1, 1998, to and through June 12, 1998." The court considered a "closing of the books" method for determining items of income and loss for the pre-spin period, but ultimately concluded that the time ratio approach proposed by the Department was a reasonable method by which to compute the NOL carryforward available to USW.

The Department applied a time-based allocation method, determining the amount of the loss assigned to USW by first multiplying MO's full 1998 tax year loss by a fraction, the numerator of which is the number of days in the pre-spin period and the denominator of which is 365. USW's pre-spin period income was subtracted from this amount to determine the net operating loss allocable to the pre-spin year. The amount of the pre-spin net operating loss was then subject to apportionment to determine how much of the loss was assigned to USW as carryover for use in the post-spin and subsequent years.

In support of finding that the time-based allocation method is reasonable, the Court noted that the same method is used to calculate the results of individual members filing a consolidated tax return and "[t]he direction of the legislature is to follow the federal consolidated return regulations that touch on separate company determinations."

Tennessee

A successor corporation may not use net operating losses generated by a predecessor corporation in computing a franchise and excise tax liability in years following a merger, the Tennessee Court of Appeals concluded in *AT&T Corp. v. Johnson,* Tenn. Ct. App., No. M2003-00148-COA-R3-CV, 04/08/04.

Tennessee Law (Tenn. Code Ann. Sec. 67-4-805) allows a net operating loss carryover in the next succeeding taxable year in which the *taxpayer* has net income. A department regulation provides that, in the case of mergers, *no loss carryovers incurred by the predecessor corporation will be allowed as a deduction from net earnings on the tax returns of the successor corporation* (emphasis added).

AT&T argued that the regulation exceeds the department's rule-making authority and places an unreasonable and arbitrary restriction on the use of an NOL. The court upheld the department's decision and cited *Little Six Corp. v. Johnson* No. 01-A-01-9806-CH-00285, 5/28/99, where the Tennessee Court of Appeals held that the surviving entity of a merger was not entitled to any net operating loss carryover deductions earned prior to the merger by the non-surviving entity. Specifically, in *Little Six,* the court found that the department acted within its authority in adopting the Rule and that the carryover statute's use of the phrase "in the next succeeding year or years in which the taxpayer has net income" indicates the Legislature's intent that any benefit flowing from an operating loss must be enjoyed by the entity that suffered the loss. AT&T appealed the matter to the Tennessee Court of Appeals, where it urged the court to reconsider the *Little Six* decision or, alternatively, that the facts in *Little Six* are distinguished from the present case. The court found little distinction between the rulings and dismissed AT&T's assertions. In addition, the court dismissed AT&T's assertion that because Information Systems was formed to merely comply with a Federal Communication Commission order that required AT&T to spin off certain enhanced services to separate entities, AT&T was the actual taxpayer that incurred the losses. Such an argument "ignores the well settled rule that a corporation is an entity separate and apart from the persons or corporations who own the stock," the court said. In addition, it presumes that a merger statute delineating the powers possessed by a survivor corporation apply for tax purpose. Such an assertion is not supported by the wording of the statute, and the losses are properly denied, the court said.

Depreciation and Depletion

Various states disallow part of the federal deduction for depreciation and depletion because of differences between federal and state laws. The original reason for the differences was the enactment of the IRC ACRS provisions in 1981. Certain of the differences relate to the location of the property subject to depreciation.

The Jobs Creation and Workers Assistance Act of 2002 (H.R. 3090) enacted IRC Sec. 168(k), which allowed taxpayers to claim a 30 percent bonus depreciation for property placed in service after September 10, 2001, and before January 1, 2005. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) amended Sec. 168(k) and allowed taxpayers to claim a 50% bonus depreciation deduction for property placed in service after May 5, 2003, and before January 1, 2005. In addition, the 2003 Act allowed taxpayers to claim a $100,000 asset expense deduction under Sec. 179 for property placed in service in tax years beginning in 2003, 2004, and 2005. The bonus depreciation provisions were expected to exacerbate the budget problems already felt by a number of states and were of particular concern in those states that conform state taxable income to the IRC. Thus, many states have decoupled from automatic conformity to the IRC (IRC) as a way to limit the impact of the federal legislation. A majority of states do not conform to all or some of the federal bonus depreciation provisions. The decoupling may be accomplished in the form of a change from automatic to specific-date IRC conformity, or by requiring an addback of the bonus depreciation when computing state taxable income.

The Economic Stimulus Act of 2008 generally modifies the existing bonus depreciation rules of section 168(k) by changing the effective dates to January 1, 2008, and December 31, 2008. Under the final bill, property must be placed in service on or after January 1, 2008, and on or before December 31, 2008. Property subject to a binding written contract before January 1, 2008, will not be eligible for bonus depreciation, and property acquired (or self-constructed property for which construction began) before January 1, 2008, will not be eligible for bonus depreciation. An extended placed in service date of December 31, 2009, is available for long production period property (property with an estimated production period exceeding one year and estimated cost exceeding $1 million), certain transportation property, and certain aircraft. States that previously decoupled from Sec. 168(k) will not have to act further to decouple from modified bonus depreciation. Other states may achieve decoupling as they have done before: a change from automatic to specific-date IRC conformity, or by a requiring an addback of the bonus depreciation when computing state taxable income.

The American Recovery and Reinvestment Act of 2009, enacted February 12, 2009, extends the temporary benefits for capital expenditures under IRC Secs. 168(k) and 179 included in the Economic Stimulus of 2008. As enacted, the ARRA allows taxpayers to claim a 50 percent bonus depreciation deduction under Sec. 168(k) for qualifying property expenditures incurred in 2009. In addition, the ARRA allows qualifying small business taxpayers to claim an increased Sec. 179 deduction equal to $250,000 for qualifying property expenditures incurred in 2009.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, enacted December 17, 2010, extends 100 percent bonus depreciation through 2011 and 50 percent bonus depreciation for 2012. As enacted, this law allows taxpayers to boosts 50 percent bonus depreciation to 100 percent for qualified investments made after Sept. 8, 2010 and before Jan. 1, 2012, and makes 50 percent bonus depreciation available for qualified property placed in service after Dec. 31, 2011 and before Jan. 1, 2013. It also increased the IRC Sec. 179 dollar and investment limits to $500,000 and $2 million respectively, for tax years beginning in 2010 and 2011 and allows expensing at a level of $125,000 for 2012.

The American Taxpayer Relief Act of 2012, enacted on January 2, 2013, extends 50 percent bonus depreciation for qualified property through the end of 2013, and decouples bonus depreciation from the Section 460 percentage of completion method of accounting for assets with a depreciable life of seven years or less that are placed in service in 2013. The legislation also allows taxpayers to elect to accelerate some alternative minimum tax credits in lieu of bonus depreciation.

Important State Decisions

Delaware

In *CNA Holdings, Inc. v. Delaware Dir. of Rev.,* 818 A. 2d 953 (2003), the Delaware Supreme Court ruled that statutory provisions that require a taxpayer to allocate gains attributable to depreciation recapture entirely to the state where the property is located, rather than to apportion such gains using the statutory income apportionment formula, are clear and unambiguous and do not produce an unreasonable result.

Under Delaware's apportionment statute, a corporation suffers double taxation when it sells Delaware property, the court explained. However, the issue is not whether a particular item is overtaxed; the issue is whether the statute unambiguously provides that the state tax 100 percent of the gain from the sale of Delaware property, and if it does, whether the statute leads to a grossly distorted result. In determining whether the statute leads to unreasonable results, one must review the statute in its entirely, not its individual parts, the supreme court said. In so doing, one sees that while Delaware taxed $25 million in gains on the sale of Delaware property, it did not tax $5.7 billion in gains on property located outside the state, the court noted. In addition, comparing the tax benefit generated in all states from the depreciation deduction with the tax cost of allocating 100 percent of the gain to Delaware indicates that CNA received a net tax benefit over the years during which depreciation was claimed.

Illinois

No exception to the bonus depreciation add-back requirement exists for a taxpayer that does not receive the benefit of passive losses due to the federal passive loss rules, the Illinois Department of Revenue explained in ruling IT 04-0049-GIL, 11/17/04.

Due to federal passive loss rules, which prohibit passive deductions in excess of passive income in the year the losses were incurred, a portion of a taxpayer's passive losses were disallowed for federal purposes. Federally, the taxpayer was allowed to claim a bonus depreciation deduction, which is disallowed for Illinois tax purposes. Following an audit of the taxpayer's Illinois corporate income tax return, in which the department disallowed the taxpayer's "other subtractions" that the taxpayer used to account for its inability to use the bonus depreciation to offset disallowed passive losses, the taxpayer argued that if it were required to add back the net amount of bonus depreciation that was claimed for federal purposes, equity requires that it be allowed to offset that additional income with other passive deductions (out of the federal disallowed amount) that it incurred during the tax year. Alternatively, if its "other subtraction" is disallowed, it should not be required to add back the federal bonus depreciation, the taxpayer argued. The department disagreed. Illinois law requires taxpayers to add back the entire amount of bonus depreciation taken on its federal income tax return. However, "there is no exception for taxpayers who do not receive the full benefit of its bonus depreciation and other deductions because they have incurred a federal loss during the year or because passive activity loss rules or similar rules limit the benefits of losses incurred," the department explained. In addition, there is no statutory provision that would allow the taxpayer the subtraction claimed on its return.

Wisconsin

One example of a state that had different depreciation methods based on the location of the property was Wisconsin. However, a taxpayer successfully challenged the Constitutionality of the Wisconsin tax scheme in *Beatrice Cheese, Inc. v. Wisconsin Department of Revenue*, Nos. 91-I-100, 101, 102 (Wis. Tax App. Comm. Feb. 24, 1993).

The Wisconsin statute permitted a deduction for accelerated depreciation only for property located in the State. The taxpayer claimed the statute discriminated against interstate commerce in violation of the Commerce Clause of the U.S. Constitution. The Wisconsin Tax Appeals Commission (Commission) found the clear language of the statute established differential treatment of taxpayers depending on the location of their property. The result of this facial discrimination, according to the Commission, was to impose a higher Wisconsin franchise tax burden on businesses that located some or all of their property in states other than Wisconsin. Citing numerous U.S. Supreme Court cases, the Commission found the statute to be "clearly designed to have discriminatory economic effects on corporations locating depreciable property outside the state." The Commission also found that the economic effect of this provision exerted "inexorable pressure" on taxpayers to locate their property in the State and, therefore, impermissibly burdened interstate commerce. The Wisconsin Department of Revenue did not appeal this decision.

New York City

New York City has also ruled that different depreciation methods based on the location of property were unconstitutional. In *R.J. Reynolds Tobacco Co. v. City of New York Dept. of Finance*, 257 A.D.2d 6 (N.Y. A.D. Dec. 9, 1997), *appeal dismissed,* 694 N.E.2d 865 (N.Y. Apr. 7, 1998), the New York Supreme Court held the City ordinances treating in-State property differently than out-of-state property violated the Commerce Clause and were, therefore, invalid.

The New York Department of Taxation and Finance announced, in *TSB-M-99(1)(I), 02/16/1999,* that the *R.J. Reynolds* decision would be followed for New York State purposes.

New Jersey

In *Toyota Motor Credit Corp. v. Director, Division of Taxation,* No. 002021-2010, (8/1/14). Toyota operated a vehicle leasing business whereby it leased vehicles to consumers and sold the used vehicles after the lease period ended. During tax year 2003 and 2004, Toyota had federal NOL carryforwards that included depreciation deductions (for federal tax purposes, Toyota disposed of vehicles and recognized depreciation recovery gain which was attributable to the excess depreciation deductions which provided no benefit to Toyota for New Jersey CBT purposes).

New Jersey had suspended NOL carryforwards for the 2003 and 2004 tax year and, therefore, Toyota was unable to benefit under New Jersey law for depreciation deductions available under federal law. Toyota disposed of vehicles in the years at issue, and the Divisions of Taxation required that the basis of these vehicles be adjusted down to account for the depreciation deduction.

The court found that these depreciation deductions provided Toyota no benefit for New Jersey CBT purposes. Therefore, the basis of Toyota's vehicles should not be reduced by the amount of depreciation deduction.

Interest on Federal Obligations

The states are prohibited from taxing federal obligation income under the intergovernmental immunity doctrine. However, this doctrine only applies to state taxes imposed directly on net income as opposed to those taxes measured by net income. States imposing a direct net income tax are required to provide for a subtraction modification for U.S. interest. States levying franchise taxes measured by net income generally tax such income.

It is important to note that not all income relating to federal obligations is considered exempt nor is it always clear whether an entity is exempt as a federal instrumentality. In *Nebraska Dept. of Rev. v. Lowenstein*, 513 U.S. 123 (1994), the U.S. Supreme Court unanimously held a state may tax income from repurchase agreements (repos) without violating either the Supremacy Clause of the U.S. Constitution, or 31 U.S.C. Secs. 3124(a) that, in relevant part, exempts from state taxation interest on "obligations of the United States Government." The Court found that income derived from repos does not constitute interest on federal securities; rather, such income may be characterized as interest on loans, with the securities merely serving as collateral. The Supremacy Clause is not violated since Nebraska does not differentiate between state and federal repos in the context of taxation. Further, the Court found no evidence that the taxation of this income causes "obvious and appreciable injury to the Government's borrowing power."

Important State Decisions

Illinois

The Illinois Court of Appeals held in *Bell Federal Savings & Loan Association v. Wagner,* 675 N.E.2d 135 (Ill. Ct. App. Dec. 13, 1996) that interest paid by the Federal Home Loan Bank (FHLB) was not exempt from State taxation.

The FHLB was created by the Federal Home Loan Bank Act of 1932 (Act) to provide a reliable source of funds to homebuyers. There are 12 regional FHLBs, each of which has the power to accept deposits, borrow and give security and to pay interest thereon, and to issue debentures, bonds, or other obligations. The Act provides that "[a]ny and all notes, debentures, bonds, and other such obligations issued by any bank, and consolidated Federal Home Loan Bank bonds and debentures, shall be exempt both as to principal and interest from all taxation . . ."

Bell Federal Savings and Loan Association (Bell) earned interest on a deposit account with the FHLB known as a daily investment deposit account (DID). Bell paid taxes under protest on the interest earned on this account. At issue before the Court of Appeals was whether the Act precluded the State of Illinois from taxing the interest earned on this account. Bell argued that its DID account fell within the "other such obligations" language of the Act.

The court turned to the doctrine of *ejusdem generis*, which provides that a specific provision, when followed by a general provision, is read to control the general when both relate to the same subject matter, and found Bell's DID account did not share characteristics in common with the debt instruments explicitly exempted from taxation by Congress (i.e., notes, debentures, and bonds). The court noted that the DID account was not a debt instrument issued by the FHLB because it was not an executed writing that contained a promise to pay specified amounts at specified times. As a result, the court held the interest paid by the FHLB on Bell's DID accounts was not exempt from State taxation.

Maryland

Maryland requires an addback modification for federal government bond interest in computing Maryland modified income. However, Maryland law provides a subtraction modification for "interest attributable to an obligation of the United States." The Maryland Comptroller's policy is to allow a subtraction for federal government bond interest up to the point that it creates or increases a net operating loss. Maryland does not require an addback modification for Maryland government bond interest.

In August, 2016 the Maryland tax court held that The Maryland Comptroller's policy of limiting the subtraction for federal government bond interest such that it cannot create a loss carryover (i.e., the policy does not allow the subtraction to reduce a taxpayer's taxable income below zero or increase a net operating loss) violates the US Supremacy Clause, state law, and federal law. The policy creates a greater burden on holders of federal obligations by allowing holders of Maryland obligations to carry forward the entirety of their loss but not allowing the same for holders of federal obligations.

In granting the taxpayer's refund claim, the Tax Court allowed the taxpayer a subtraction modification measured by its federal government bond interest that was left unsubtracted in prior years, effectively allowing a 'federal interest subtraction carryforward.'

New York

The New York Supreme Court, in *In the Matter of Sumitomo Trust and Banking Company v. Commissioner of Taxation*, 720 N.Y.S. 2d. (2001), held that interest income earned on certificates guaranteed by the U.S. Small Business Administration is not deductible in determining corporate franchise tax because such certificates are not U.S. government obligations. The certificates were not obligations of the United States because the binding promise by the U.S. government is not a fixed and certain obligation, but a secondary and contingent one, the court noted. The original lenders continue to service the loan pools and, on the last business day of each month, are required to forward to the fiscal and transfer agent the pro rata share of the principal and interest due and paid by the borrowers. The court found it significant that the Federal government received none of the proceeds of the certificates. Absent a showing that that obligation would impose a burden on the borrowing power of the United States, the interest income is not deductible, the court said.

Charitable Contributions

Some states apply a percentage limitation based on "net" or "taxable" income.

Municipal Interest

Many states require federal taxable income to be increased by the amount of interest received on state and municipal obligations that are exempt from U.S. tax. Any related expenses that were not allowed as deductions for federal purposes may reduce this income. Some states, which require this modification, exclude interest received on their own bonds or on bonds issued by their political subdivisions from this provision.

U.S. Supreme Court

On May 19, 2008, the U.S. Supreme Court overturned a decision of the Kentucky Court of Appeals that held that the state's tax on interest income derived from bonds issued by states other than Kentucky is facially discriminatory in violation of the Commerce Clause. *Department of Revenue of Kentucky v. Davis,* No 06-666, 5/19/08.

The case concerned Kentucky's allowance to claim an income tax deduction for interest earned on bonds issued by Kentucky. However, the state does not allow a deduction for interest income earned on out-of-state bonds. Two individuals challenged the state's tax treatment of interest from out-of-state bonds claiming that it violates the U.S. Constitution's Commerce Clause and Equal Protection Clause. The court of appeals found that Kentucky's bond taxation system "is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds."

However, the U.S. Supreme Court explained that an exception to the facially discriminatory analysis exists in situations, like here, where a state acts as a market participant, rather than as a market regulator. "The logic that a government function is not susceptible to standard dormant Commerce Clause scrutiny because it is likely motivated by legitimate objectives distinct from simple economic protectionism applies with even greater force to laws favoring a State's municipal bonds, since issuing debt securities to pay for public projects is a quintessentially public function, with a venerable history." The Court added that there is no discrimination because, as a public entity, Kentucky does not to treat itself as being substantially similar to other bond issuers in the market.

State and Local Taxes on Income

Most states do not allow a deduction for their own income tax. Many states disallow a deduction for all state and local income taxes. The laws of those states requiring an addback of other states' income taxes must be reviewed to determine which taxes fall within the modification provisions (i.e., income taxes versus franchise taxes based on income). A direct income tax is imposed on net income derived from sources within a state, whereas a tax based on or measured by income is usually imposed for the privilege of doing business in a state.

California

For many years, California FTB Notice 90-2 required taxpayers to bifurcate the SBT into deductible and nondeductible portions based on the same reasoning as Kentucky in the *General Motors* case. However, in *Dayton Hudson Corporation,* 94-SBE-003 (Cal. St. Bd. of Equal. Feb. 3, 1994) the SBE found the Michigan tax base included an element of cost of goods sold and, therefore, the tax was not measured by income. Since the tax was not on or measured by income, the SBE found the tax deductible. The FTB argued the SBT base did not include all costs of goods sold and, therefore, was not fully deductible as a pure gross receipts tax. The FTB referred to FTB Notice 90-2, but the SBE found no authority for the FTB notice and, citing the U.S. Supreme Court's opinion in *Trinova*, found the SBT to be an "indivisible" tax upon the value added activity of the business that could not be bifurcated into deductible and nondeductible portions. The SBE revisited the SBT again in *Appeal of Kelly Service Inc*., 97-SBE-010 (Cal. St. Bd. of Equal. May 8, 1997). In that case, the FTB had argued that the SBT was nondeductible to a service organization that did not have any costs of goods sold. The SBE again held against the FTB, finding that the SBT was not applied differently depending upon the activities of the taxpayer and, therefore, the SBT should be deductible regardless of the components in the taxpayer's tax base. Accordingly, the Michigan SBT should be fully deductible in California.

In 2017, the Franchise Tax Board released Legal Ruling 2017-01 discussing the analysis for whether a state or local tax was (1) a "net income tax" and creditable under the other state tax credit, (2) "an income tax" and not creditable or deductible, or (3) a "tax not measured by income" and deductible under California Revenue and Taxation Code section 17201. The ruling analyzed a variety of taxes, deciding that each tax must be analyzed separately.

The Legal ruling determined that the Texas franchise tax was not an income tax. Accordingly, it could not be creditable under the California Other State Tax Credit, but could be deducted by a business against business income.

Of additional interest is that despite being an interpretation of current law, the Legal Ruling was given an effective date, stating that "this ruling will be applied for taxable years beginning on or after January 1, 2016."

Federal Income Tax

A few states allow a deduction or partial deduction for federal income taxes paid. When a corporation seeking to obtain the deduction files on a federal consolidated basis, the computation of the deduction can be complicated.

Alabama

An Alabama corporation was entitled to a full deduction for its federal tax due on a recapture of LIFO deductions upon its conversion to an S corporation, even though the corporation only paid a portion of the total federal liability in the tax year at issue, the Administrative Law Division ruled in *CC Dickson Company v. Alabama Department of Revenue,* Ala. Admin. Law Div., Docket No. BIT 09-238, 6/9/09.

Taxpayer was a C corporation that converted to an S corporation. As a result of the conversion, on its final federal C corporation tax return, the taxpayer was required to recapture $16 million of LIFO deductions taken in previous years. Federal law permitted the taxpayer to pay the resulting additional tax liability in four equal installments, beginning with the final federal C corporation return. For Alabama income tax purposes, however, the taxpayer deducted the entire federal tax liability resulting from the LIFO recapture on its final Alabama C corporation return. The Department disallowed the part of the deduction that was not paid on the final federal C corporation return and issued an assessment. The taxpayer appealed the assessment to the Administrative Law Division ("ALD").

For purposes of computing Alabama income tax, Ala. Code Sec. 40-18-35(a)(2) allows corporations a deduction for all federal income tax "paid or accrued" during the tax year. Although Alabama law does not define "accrued," the ALD explained that accrued is generally defined as "[t]o come into existence as a claim that is legally enforceable." Thus, the tax liability accrues when the taxpayer becomes legally liable to pay the tax, even if the due date is in the future. Therefore, the ALD concluded that because the taxpayer became legally liable for the entire tax amount resulting from the LIFO recapture in the year of its final federal C corporation return, the federal tax liability accrued in that year. As such, based on the plain language of the statute, the taxpayer was entitled to a full deduction on its final Alabama C corporation return even though the taxpayer only paid a portion of the liability.

Arizona

Arizona, under prior law, allowed a deduction for federal income taxes paid or accrued for the tax year. In *State of Arizona, ex rel., Arizona Department of Revenue v. Arizona Sand and Rock Company*, 155 Ariz. 58, 745 P.2d 116 (Ariz. 1987), the Supreme Court of Arizona determined that the statute must be construed literally, i.e., the deduction must be based on taxes actually paid rather than those calculated by use of a pro-forma or hypothetical return. A formula based on a net-to-net ratio was generally required in order to ascertain the portion of the loss attributable to the Arizona taxpayer.

North Dakota

At issue before the North Dakota District Court in *Kinney Shoe Corporation v. State*, 552 N.W.2d 788 (N.D. Sept. 3, 1996) was whether Kinney Shoe Corporation's (Kinney) federal tax deduction should have been limited to its share of the consolidated tax liability actually paid by its parent, F.W. Woolworth Company (Woolworth). Kinney filed federal income tax returns as part of a consolidated group with Woolworth, and other Woolworth subsidiaries for the fiscal years ended January 31, 1982 through January 31, 1985. To determine the federal income tax deduction available for each member of the Woolworth consolidated group, the federal consolidated tax liability was allocated using a ratio of the tax of each profit member computed on a separate return basis to the total amount of the taxes for all profit members. Kinney filed separate company North Dakota corporate income tax returns based on pro forma federal income tax returns. During the years involved, the sum of the tax allocations exceeded Kinney's share of the amount of tax actually paid by Woolworth to the federal government.

The Tax Commissioner determined Kinney's federal tax deduction was limited to its share of the amount of tax actually paid by Woolworth to the federal government.

During the years at issue, North Dakota law provided a deduction from federal taxable income "by the amount of federal income taxes, paid or accrued . . . to the extent that such taxes were paid or accrued upon income that becomes a part of the North Dakota taxable income."The Tax Commissioner (Commissioner) asserted that the words "to the extent that such taxes were paid or accrued" meant paid or accrued to the federal government, and did not include transfers of money between related corporations. Since Kinney elected to file separate North Dakota returns, the court found, it should not be permitted to receive the benefit from operating losses that reduced consolidated federal taxable income. Consequently, Kinney's federal income tax deduction was limited to its share of the consolidated tax liability actually paid by its parent to the federal government.

Payments to Related Entities

The ability to claim deductions for intercompany interest and intangible costs and expenses paid to a related entity has been the focus of much recent state case law and legislation. In response to judicial and administrative decisions allowing such deductions and to growing budget deficits, states, with Louisiana being the most recent, have enacted legislation limiting these deductions and expanding the taxing authority's ability to deny such deductions upon a determination that the payments and their related transactions fail to meet certain federal tax principles such as the business purpose or economic substance doctrines. Oregon enacted legislation (H.B. 3069) which repeals the addback of intangible expenses and costs paid to related members repealed, effective for tax years beginning on or after January 1, 2013. Virginia enacted legislation which sets limitations on the state's subject to tax and unrelated party addback exceptions. The subject to tax exception is generally limited to the "portion of income" received by the related member. The unrelated party exception is generally limited to the "portion of income" derived from license agreements that are comparable to third party agreements. Both limitations are retroactive to taxable years beginning on and after January 1, 2004.

State Decisions and Rulings

Alabama

The Alabama Court of Civil Appeals has reversed a Circuit Court holding that the state's "addback statute" for certain intercompany intangible and interest expenses resulted in an "unreasonable" denial of deductions for legitimate business expenses in *Alabama Dep't of Revenue v. VFJ Ventures, Inc.,* Ala. Civ. App., No. 2060478, 2/8/08. In so holding, the appeals court also rejected other challenges to the addback statute that were not ruled on by the circuit court, including the so-called "subject-to-tax" exception to the addback statute and several constitutional challenges. As explained by the court, the statute provides that the addback is required "unless the corporation established that the adjustments are unreasonable[.]" The court noted that the term "unreasonable" is not defined in the Alabama Code Article concerning income taxation, and therefore the general rule of statutory interpretation applies: that the commonly accepted definition of the term should be used. The court noted that testimony at trial established that the Department had applied the unreasonableness exception to those situations where a corporation's tax would be "out of proportion with what could reasonably be said to be attributed to the State". Further, the court explained that ",the Department has consistently interpreted the unreasonable exception as not being determined by business purpose or economic substance." This "is consistent with the commonly accepted definition of the term 'unreasonable,' i.e., exceeding reasonable limits or clearly excessive." The court concluded: "The Department has interpreted the unreasonableness exception as being concerned with whether the add-back statute results in taxation that is out of proportion to the corporation's activities in Alabama. That interpretation, which was later formalized in the add-back regulation, is consistent with the common-usage definitions of the term 'unreasonable'...".

The court then examined the "subject-to-tax exception," whereby the addback does not apply to the extent that the corresponding item of income was in the same taxable year "subject to a tax based on or measured by the related member's net income in Alabama or any other state[.]" The phase "subject to tax based on or measured by the related member's net income" is defined in the statute to mean "that the receipt of the payment by the recipient related member is reported and included in income for purpose of a tax on net income[.]" The court said, "[w]e hold that for purposes of the subject-to-tax exception, the term 'included in income for the purposes of a tax on net income' means that the income at issue is actually taxed as part of a tax on net income. Stated another way, we interpret the subject-to-tax exception set forth in subsection (b)(1) of Alabama's add-back statute to apply on a post-apportionment, rather than on a pre-apportionment, basis." The court agreed with testimony received during trial that interpreting the exception to apply on a pre-apportionment basis "would effectively negate the operation of the add-back statute" by allowing a corporation to "easily avoid the application of an add-back... by paying corporate income tax in a state in which its apportionment factor is relative[ly] insignificant."

The Alabama Supreme Court on September 19, 2008 affirmed the decision. Without further comment, the Court stated that it: agreed with the views expressed by the appellate court's thorough and well reasoned opinion, would not explicate further, and adopted that opinion in its entirety. On January 21, 2009, a petition for writ of certiorari was filed with the U.S. Supreme Court. [*Ex parte VFJ Ventures Inc*., U.S., No. 08-916, cert petition filed 1/21/09., *petition denied,* April 27, 2009]]

Connecticut

In *Carpenter Technology Corp. v. Commissioner of Revenue Services*, 772 A. 2d. 593 (2001), the Connecticut Supreme Court held that a corporate taxpayer properly deducted the interest it paid on a loan made to its wholly-owned subsidiary because the subsidiary had economic substance and a business purpose, and the relationship and transactions between the two entities were legitimate business arrangements. Carpenter formed a wholly-owned subsidiary under Delaware law to hold certain assets, including its investment in foreign business operations. The subsidiary was incorporated with approximately $300 million in cash in 1989 and within days of its formation, the subsidiary loaned back to Carpenter almost all of money received on incorporation pursuant to a commercial loan. The loan required Carpenter to make periodic interest rate payments at an interest rate of two percent over prime. The Connecticut Commissioner of Revenue Services disallowed the deductions on the basis that the subsidiary was a sham corporation and that the entities were a single entity for tax purposes. In upholding Carpenter's interest expense deductions under the lending agreement, the court upheld the trial court's findings that the subsidiary was a separate and viable corporation and that Carpenter consistently paid its obligation under the debt agreement.

Indiana

In LOF 03-0406, 08/01/04, the Indiana Department of Revenue rejected a protest of the disallowance of a royalty expense paid to a wholly-owned subsidiary for the license of intellectual property, finding that both the transfer of the intellectual property to the subsidiary and the resulting payment of royalties was "devoid of economic substance." "Although the information provided by taxpayer does give evidence of the fact that [the subsidiary] performed a legitimate function by protecting the integrity of the patents and intellectual property, both the transfer of those properties to [the subsidiary] and the resulting payment of substantial royalties are devoid of economic substance," the department concluded. The department cited several factors supporting its conclusion: (1) there was no indication of any determination of the value of the intellectual property prior to the transfer of ownership of the property to the subsidiary; (2) there was no indication that the subsidiary gave consideration in return for receiving ownership of the intellectual property; (3) the subsidiary "was never a disinterested third-party" at the time of the intellectual property transfer or license; (4) the amount of royalties paid to the subsidiary "seems wildly disproportionate to the services expected" to be performed by the subsidiary; and (5) the taxpayer and the subsidiary entered into a revolving credit agreement allowing the taxpayer to borrow "the same money it paid in royalties." The department also concluded that the audit would also have been justified in disallowing the deduction on the ground that the royalty expenses were incurred as a result of a "sham transaction."

Massachusetts

A Massachusetts taxpayer's deduction for royalty and interest expenses was properly disallowed because the transactions giving rise to such expenses lacked economic substance and had no practical effect aside from the tax benefits, the Massachusetts Court of Appeals held in *The TJX Companies, Inc. v. Commissioner of Revenue,* Mass. App. Ct. 07-P-1570, 4/3/09.

The court explained that for a business reorganization that results in tax advantages to be respected, the taxpayer "bears the burden of showing that the structuring of a business is legitimate and not just 'form without substance'; it must show that the entity was formed for a substantive business purpose or was engaged in substantive business activity." Referring to the Board's decision, the court noted the following characteristics of the transactions: the primary benefit of owning the intangibles was lost on the subsidiary since the income was loaned back to TJX; while technically free to license the intangibles to other companies, the subsidiaries did not do so; TJX continued to maintain and protect the intangibles after the transfer; and the stated business purposes were not credible. Thus, based on the evidence, the court affirmed the Board's decision, holding the transactions lacked economic substance and had no practical effect, other than the creation of tax benefits.

Further, the court reaffirmed the Board's decision to disallow the interest expense deduction on the grounds that the loans between the Nevada subsidiaries and TJX were not bona fide loans. The court noted that based on the record before it, it could not determine whether or not reattribution of income generated by the subsidiaries from sources other than the licensing agreements was proper. As such, the court remanded the case to the board for the sole purpose of addressing whether such reattribution was appropriate. Although the court remanded for further findings on this issue, it noted that "while the fruits of a sham transaction are appropriately disregarded and reapportioned to the parent… any income independently earned by the subsidiary is more properly taxable only to that subsidiary[.]"

In another case, *The Talbots, Inc., v. Commissioner of Revenue*, App. Tax Board, Docket Nos. C266698, C271840, C276882, 9/29/09, the Massachusetts Appellate Tax Board affirmed an assessment issued by the Commissioner against a taxpayer, finding that intercompany royalty transactions constituted sham transactions because the taxpayer's subsidiary, an intangible holding company, lacked economic substance and was created for tax avoidance purposes. As such, the Commissioner's adjustments to the taxpayer's taxable income were proper.

Following an audit, the Massachusetts Commissioner of Revenue ("Commissioner"), asserting that the royalty transactions between Talbots and its intangible holding company (Classics) constituted sham transactions, adjusted Talbots' taxable income by disallowing the royalty expense deduction paid to Classics, reattributing all of the royalty and interest income earned by Classics to Talbots, and allowing Talbots a deduction for amortization and other expenses related to the trademarks. Talbots appealed to the Massachusetts Appellate Tax Board ("Board").

The Board explained that based on the Massachusetts Supreme Court decision in *Sherwin-Williams*, the "sham transaction doctrine" gives the Commissioner the authority to "disregard, for taxing purposes, transactions that have no economic substance or business purpose other than tax avoidance." Additionally, based on previous Supreme Court decisions, transactions involving royalties and trademarks were deemed to have economic substance, and thus not constitute sham transactions, when (1) the subsidiaries entered into agreements or obligations with unrelated third parties for use of the trademarks; (2) the subsidiaries receive royalties, which are invested with unrelated third parties to earn additional income for their businesses; and (3) the subsidiaries incur and pay substantial liabilities to maintain, manage, and defend the trademarks.

Turning to the characteristics of the Talbots' royalty transactions, the Board noted the following: the license agreement was "de facto" exclusive to Talbots and its subsidiaries because Classics did not license the Talbots trademarks to any other third parties; Classics lacked the leverage to renegotiate the license agreement on terms more favorable to Classics; two of the three members serving on Classic's board of directors were Talbots' executives; the vast amount of the royalties were returned to Talbots tax-free in the form of principal and interest payments on the loan, dividends, payments for Classic's share of federal income tax, and an undocumented loan; the royalty receipts received by Classics were invested in short-term overnight investments of cash, pursuant to guidelines established by Talbots, such that the royalties could be returned to Talbots as quickly as possible and with the least amount of risk; and Talbots, not Classics was the entity that bore the expenses of hiring outside legal and advertising firms. As a result, the Board found that because the trademarks were not licensed to third parties, the trademarks and royalties were controlled by Talbots, and Classics did not incur or pay substantial liabilities to manage, maintain, or defend the trademarks, the transactions did not satisfy any of the three characteristics of economic substance set forth under *Sherwin Williams*, and thus lacked economic substance. Additionally, as tax avoidance was deemed to be the sole motivation behind the transactions and the transactions lacked economic substance, the Board concluded that the transactions constituted sham transactions.

In *Cambridge Brands, Inc. v. Commissioner of Revenue,* Mass. App., No. 03-P-1447, 1/7/05, the Massachusetts Appeals Court affirmed a Massachusetts Appellate Tax Board ruling that allowed a deduction for royalty payments made by a manufacturer to an affiliate. The Board found that the license that generated the royalty payments had both a valid business purpose and economic substance, explaining that the license “had very real practical economic benefits beyond the creation of income tax benefits.” The Board emphasized that the manufacturer never possessed control over or had responsibility for the intellectual property because the manufacturer's parent purchased the intellectual property separately from a third party at the time that the manufacturer purchased the real and tangible personal property used to manufacture the products bearing the marks. On appeal, the court, determined that "[t]here was sufficient evidence to establish that the arrangement has a business purpose..” The court also found that the ATB's findings that the trademark licensing expenses were deductible and "ordinary and necessary" business expenses under Mass. Gen. Laws ch. 63, Sec. 30(4) and IRC Sec. 162 were "amply supported by the evidence.” Finally, the court found that while Mass. Gen. Laws ch. 63, Sec. 39A provides that the Commissioner shall determine the "net income of a foreign corporation which is a subsidiary of another corporation" by "eliminating all payments to the parent corporation of affiliated corporations, in excess of fair value," the ATB's findings that the licensing arrangement was bona fide and that royalty rate was not in excess of fair value was supported by substantial evidence.

In *Massachusetts Mutual Life Insurance Co. v. Massachusetts Commissioner of Revenue,* Massachusetts Appellate Tax Board, Nos. C305276, C305277, June 12, 2015, addressed whether certain intercompany advances made by Massachusetts Mutual Life Insurance Company ("MMLIC") to its wholly-owned subsidiary, MMH, constituted bona fide debt for Massachusetts tax purposes. The Board found and ruled that: (1) the amounts advanced to MMH were used for the valid business purposes of funding and expanding the operations of its subsidiaries; (2) in advancing the funds in the form of loans instead of equity, MMLIC was motivated by regulatory concerns, not by a desire to avoid tax; and (3) the MMH Notes constituted bona fide indebtedness with economic substance. Accordingly, the Board found and ruled that the interest paid pursuant to the MMH Notes was fully deductible for Massachusetts tax purposes. Additionally, as the Board found and ruled that income of MMH was improperly adjusted, the Board found and ruled the NOL carryover of MML was similarly improperly adjusted and should have been fully available for use in the tax year ended December 31, 2005.

In June 2016, the Massachusetts Appeals Court (Court) ruled that deferred subscription arrangements (DSAs) did not qualify as bona fide debt because the DSAs did not require payments to satisfy the obligations. Accordingly, the entity subscribing for shares could neither deduct the interest expense component of its payments pursuant to the DSAs in determining its taxable net income nor deduct as liabilities the book value of the DSAs in determining its taxable net worth. In a separate opinion issued the same day, the Court ruled that the Commissioner was not bound by an IRS closing agreement that allowed a federal deduction for a portion of the amount claimed as interest on the DSAs.

These cases illustrate that the state is continuing to re-characterize debt as equity, which results in the disallowance of both interest and balance sheet deductions. Taxpayers should take care that their debt instruments satisfy state requirements for bona fide debt.

New Jersey

In *Beneficial New Jersey, Inc. v. Director, Division of Taxation,* N.J. Tax Ct., No. 009886-2007, 8/31/2010, the New Jersey Tax Court reversed an assessment based on related party interest expense addback, finding that the "unreasonableness" exception applied based on a "totality" of factors including economic substance and business purpose. The court rejected the state's limited reading of this exception to instances of "double taxation" and as applied to centralized cash management systems, finding that this narrow reading was itself an unreasonable application of the statute.

During the taxable years at issue (2002–2004), HSBC Finance Corp. ("HSBC"), was the parent of operating subsidiaries providing consumer finance to customers in the United States. One of these subsidiaries -- Beneficial New Jersey, Inc. ("BNJ") -- held a New Jersey lender license for making consumer and mortgage loans to New Jersey customers. To finance the loans it made to its customers, BNJ borrowed money from HSBC. HSBC in turn borrowed funds from unrelated third parties and loaned those funds to its subsidiaries, including BNJ. HSBC charged its subsidiaries interest on the loans pursuant to funding arrangements with the subsidiaries. "BNJ's rate was the maximum Applicable Federal Rate [*sic*], pursuant to Treasury Regulation § 1.482-2(a)(2)(iii)."

BNJ deducted the interest payments allocable to its loans from HSBC in arriving at its taxable income for the 2002–2004 taxable years. After auditing BNJ for these years, the Director, Division of Taxation disallowed the deductions under the state's addback provisions for interest paid, accrued, or incurred to a related member. The Director issued a final determination, assessing additional corporation business tax, interest, and penalties. BNJ filed a complaint in Tax Court, and sought summary judgment on the basis that it met three statutory exceptions to the addback provisions (only one need be met): the "three percent" exception, the "guarantee" exception, and the "unreasonable" exception, as well as that the assessments were unconstitutional (the Tax Court did not reach the constitutional claims). Based on satisfying the "unreasonable" exception, the court granted summary judgment in favor of BNJ.

The court sided with BNJ on the issue of whether the exception applied where the taxpayer establishes by clear and convincing evidence, as determined by the Director, that the disallowance of a deduction is "unreasonable." The court noted that the Director offered only two scenarios in which the "unreasonable" exception would apply: (1) where the taxpayer can demonstrate double taxation in New Jersey with the related party to which it pays interest, and (2) where the taxpayer's corporate group has a centralized cash management system. However, "while these situations are perhaps unreasonable, they are not the 'alpha and omega' of unreasonable situations," the court found. "Had the Legislature intended for such strict circumstances, it would not have drafted the statute as it did. . . . The Director's overly narrow interpretation of the statute, in this matter, at least, goes beyond reasonable limits, calling into question the reasonableness of the methodology."

The court found that BNJ's loans from HSBC had economic substance, as the court found "credible BNJ's proffered reasons for this plan -- HSBC receives more favorable interest rates than can its subsidiaries." In addition, the court noted that HSBC "pays taxes" in other jurisdictions on the interest income it earns from BNJ. (In a footnote, the court ceded that "due to income apportionment, the effective tax rates for HSBC [are] virtually always lower than the corresponding flat tax rates. However, the court feels the numerosity of jurisdictions bolsters the economic substance and business purpose behind the transactions.") The court concluded that "the totality of these circumstances present the kind of situation contemplated by the drafters of the unreasonable exception."

The court cautioned, however, that its decision to apply the "unreasonable" exception in this case "in no way creates a general rule of applicability. It is a case-by-case determination, and only the totality of BNJ's circumstances was such to trigger its application here."

Two recent, consolidated New Jersey Tax Court cases held that the former Section 114 extraterritorial income (ETI) exclusion is not added back for corporate business (CBT) purposes. In *International Business Machines Corporation v. Director, Division of Taxation,* N.J. Tax Court No. 011630-2008, 1/26/11, and *Creston Electronics Corporation v. Director, Division of Taxation,* N.J. Tax Court No. 011795-2009, 1/26/11, the New Jersey Tax Court held that taxpayers cannot be required to add back the extraterritorial income (ETI) exclusion for corporation business tax purposes because such income is not enumerated among the statutory exceptions to federal taxable income, the New Jersey Tax Court recently concluded. In so finding, the court determined that the Division of Taxation could not rely on the introductory sentence of the definitional statute of entire net income, while ignoring what comes after, and that the regulation does not require the addback of the extraterritorial income exclusion.

As explained by the court, under N.J.S.A. Sec. 54:10A-4(k), "[e]ntire net income "means" total net income from all sources, whether within or without the United States. . . ." This definition is limited by the next sentence of the statute, which provides that "the amount of a taxpayer's entire net income shall be deemed prima facie to be equal in amount to the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report . . . to the United States Treasury Department for the purpose of computing its federal income tax." This couples entire net income under the CBT with line 28 of the federal income tax return. Following these definitional sentences, the statute lists numerous exceptions (additions and subtractions) to federal taxable income that taxpayers must take into account when determining entire net income. The federal exclusion for ETI is not listed among these adjustments. Thus, the court said "[e]xtraterritorial income, excluded from federal taxable income by federal law, is, therefore, excluded from entire net income for CBT purposes. There is nothing ambiguous about the language of Sec. 54:10A- 4(k)."

The Division argued that the ETI exclusion is included in the calculation of entire net income because the first sentence of the statute provides that entire net income means "income from all sources, whether within or without the United States." The court said that if this sentence was the entire statute, the Division would prevail. However, as noted, this sentence is followed by detailed provisions governing how entire net income is calculated -- provisions that include several exceptions to the federal tax scheme. The sentence relied upon by the Division is introductory in nature and must be read in conjunction with the provisions that follow, the court explained. If the introductory sentence is read in isolation, the rest of the statute would be rendered meaningless. The court found this interpretation of Sec. 54:10A-4(k) to be "unacceptable."

The court noted that in 2004 Congress phased out the ETI exclusion and replaced it with the deduction under Section 199 for "qualified production activities income" from federal taxable income. The next year, New Jersey limited this deduction for CBT purposes. Specifically the state disallowed any deduction under Section 199, except for amounts "that are exclusively based upon domestic production gross receipts of the taxpayer which are derived only from any lease, rental, license, sale, exchange, or other disposition of qualifying production property which the taxpayer demonstrates to the satisfaction of the director was manufactured or produced by the taxpayer in whole or in significant part within the United States. . . ." Thus, the legislature can create an exception to an exclusion from federal taxable income when it decides to, and if the first sentence of Sec. 54:10A-4(k) includes all foreign source income in entire net income, the Section 199 modification enacted by the state would be unnecessary, the court explained.

The court dismissed the Division's claim that because the ETI exclusion is considered a federal exclusion, as opposed to a deduction, that income is included in determining entire net income under the CBT. The plain language of the statute "does not vest any significance in the distinction drawn in federal tax law between exclusions and deductions."

The court also found the Division's reliance on regulation N.J.A.C. Sec. 18:7-5.2(a)(1)(xi) to be "unavailing." The regulation provided that "[a]ll income from sources outside the United States which has not been included in computing Federal taxable income less all allowable deductions to the extent that such allowable deductions were not taken into account in computing Federal taxable income" must be added to federal taxable income when computing CBT entire net income. The regulation does not apply to the taxpayers' ETI exclusion because they first reported their ETI on line 1 of their federal returns and then excluded such amounts to arrive at taxable income before the net operating loss deduction and special deductions. "Extraterritorial income was, therefore, 'included in computing Federal taxable income' and does not fall within the ambit of N.J.A.C. 18:7-5.2(a)(1)(xi)," explained the court. Even if ETI fell within the regulation, a requirement that federally excluded ETI be added back for CBT purposes "contradicts the statute and would extend the CBT Act to income not expressly taxed by the Legislature," the court stated. The court granted the motions for partial summary judgment to the taxpayers.
In *Kraft Foods Global Inc. v. Div. of Taxation*, N.J. Tax Court, No. 017974-2009, April 25, 2016, The New Jersey Tax Court upheld the Division of Taxation's determination that a corporation's interest paid to a related party did not satisfy the 'unreasonable exception' of New Jersey's addback. Taxpayer had debt 'pushed down' to it from its parent and paid interest at a rate comparable to the rate the parent paid on debt owed to third parties.

The Court found that the 'unreasonable exception' did not apply because Taxpayer produced no document suggesting that it was ultimately responsible for its parent's debt to third parties. The existence of facts supporting that a taxpayer is ultimately responsible for its parent's debt to third parties could assist a taxpayer in establishing the 'clear and convincing evidence' necessary to support the Unreasonable Exception in situations where it is paying interest on debt that is ultimately paid to third parties.

Ohio

A taxpayer could not adjust its royalty expense addback for amounts paid to a related party because the licensor could have filed a combined report or consolidated return with other related entities in states where the corresponding income was subject to tax, the Ohio Board of Tax

Appeals ruled in *Family Dollar Stores of Ohio v. William W. Watkins, Tax Commissioner of Ohio*, No. 2005-V-469 (Ohio Bd. of Tax App. 1/4/2008) Ohio Revised Code Sec. 5733.024 requires taxpayers to add back intangible expenses paid to related corporations when reporting Ohio net income amounts. However, section 5733.055(A)(2)(b) allows taxpayers to make favorable adjustments to net income for a "related member's net intangible income actually allocated or apportioned to other states that impose a tax on or measured by income." However, for purposes of Sec. 5733.055(A)(2)(b), "other states" does not include those states under whose laws the taxpayer or the related corporation filed or could have elected to file a combined or consolidated tax return. The Board found the statutory language unambiguous, and determined that the commissioner's amended return rejection was proper because the taxpayer's related licensor had the option of filing combined returns in both South Carolina and Massachusetts. The Board reached this conclusion even though South Carolina and Massachusetts combined returns would not eliminate the potential for "double taxation" of the royalty income because the states use separate legal entity reporting, where members of the combined reporting group merely report their separately computed taxable incomes and liabilities together without eliminating intercompany transactions.

State Legislative Responses

Multistate Tax Commission

On August 17, 2007, the Multistate Tax Commission adopted a two-part model expense addback statute. The first part requires the addback of otherwise deductible intangible expense directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members, and the second requiring a similar addback for interest expense (not limited to interest related to intangibles). The two parts were enacted in such a way that an adopting state may choose to require the addback of intangible expense without the broader addback of interest expense.

Under the statute, taxpayers would be allowed a credit where the related member is "subject to tax" in the enacting state, another state or a foreign nation "or a combination thereof on a tax base that included the intangible [or interest] expense paid, accrued, or incurred by the taxpayer[.]" The credit would be equal to the higher of the tax paid by the related member on such portion, or the tax that would have been paid if that portion of income had not been offset by expenses or losses or the resulting tax liability had not been offset by a credit or credits. The credit must be multiplied, however, by the apportionment factor of the taxpayer in the enacting state (the state granting the credit). Further, the credit is capped at the taxpayer's total tax liability attributable to the addback in the enacting state.

The statute also contains a "conduit" exception to the intangible expense addback requirement, whereby the addback (and the credit mechanism described above) do not apply, if the taxpayer establishes by clear and convincing evidence that 1) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member; and 2) the transaction giving rise to the intangible expense between the taxpayer and the related member was undertaken for a valid business purpose.

Further, the statute contains an exception, applicable to the interest expense addback only, where the addback (and the credit mechanism) would not apply if the taxpayer establishes by clear and convincing evidence that 1) the transaction giving rise to the interest expense between the taxpayer and the related member was undertaken for a valid business purpose; and 2) the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.

In addition, the intangible or interest expense addback, and credit mechanism, would not apply in either of the following instances:

> I. The taxpayer establishes by clear and convincing evidence that a) the related member was subject to tax on its net income in the enacting state or another state or U.S. possession or some combination thereof; b) the tax base for such tax included the intangible expense or interest expense paid, accrued or incurred by the taxpayer; and c) the aggregate "effective rate of tax" applied to the related member is not less than [an unspecified] percentage [the statutory rate of tax applied to the taxpayer in the enacting state minus an unspecified number of percentage points].
>
> II. The taxpayer establishes by clear and convincing evidence that a) the intangible or interest expense was paid, accrued or incurred to a related member organized under the laws of another country; b) the related member's income from the transaction was subject to a comprehensive income tax treaty with the United States; c) the related member's income from the transaction was taxed in such country at a tax rate at least equal to that imposed by the enacting state; and d) the intangible expense was paid, accrued, or incurred pursuant to a transaction that was undertaken for a "valid business purpose" and using terms that reflect an arm's length relationship.

State Addback Legislation

Following is a list of states that have enacted add-back legislation as of April 2017, with their respective effective dates:

State	Year legislation went into effect
Alabama	Tax years beginning after 12/31/2000
Arkansas	Tax years beginning after 1/1/2004
Connecticut	Tax years beginning on or after 1/1/1999, interest provision effective tax years beginning 1/1/2003
Georgia	Tax years beginning on or after 1/1/2006
Illinois	80/20 companies – Tax years ending on or after Dec. 31, 2004
Indiana	Tax years beginning after 6/30/2006

Kentucky	Tax years beginning on or after 1/1/2005
Louisiana	Tax years beginning on or after 1/1/2016
Maryland	Tax years beginning after 12/31/2003
Massachusetts	Tax years beginning on or after 1/1/2002
Michigan (CIT)	Tax years beginning on or after 1/1/2012
Mississippi	Tax years beginning after 12/31/2000
New Jersey	Tax years beginning on or after 1/1/2002
New York	Tax years beginning on or after 1/1/2003 for royalties only, not interest. Effective for tax years beginning on or after January 1, 2013, New York adopts the provisions of the Multistate Tax Commission's model addback statute.
North Carolina	Tax years beginning on or after 1/1/2001
Ohio	Originally 1991, As amended, 1/1999
Oregon	Repealed effective for tax years beginning on or after January 1, 2013
Pennsylvania	Tax years beginning on or after 12/31/2014
Rhode Island	Repealed effective for tax years beginning on or after January 1, 2015
South Carolina	Tax years beginning after 2005 (for payments accrued but not paid)
Tennessee	In most cases, taxpayers are required to obtain pre-approval from the Department of Revenue before claiming the intangible expense deduction, effective for tax years ending on or after July 1, 2012.
Virginia	Tax years beginning on or after 1/1/2004
Wisconsin	Tax years beginning on or after 1/1/2009
Washington DC	Unclear on legislation enacted 8/2/2004

Typical Safe Harbors:

- Economic substance/ arm's length rates & terms for transactions
- Purpose other than state income tax avoidance
- Payment of income tax by royalty recipient
- Royalty recipient not "primarily engaged" in maintenance and management of intangibles
- Ultimate pass through of expense to unrelated party
- The related party is subject to an income tax or like tax by a foreign nation that has entered into a comprehensive tax treaty with the United States.

Federal Deduction for Domestic Production Activities

The IRC Sec. 199 deduction for Domestic Production Activities ("DPA") is one of the most significant parts of the American Jobs Creation Act of 2004. The overall purpose of the DPA deduction is to counterbalance the tax impact of the phase-out of the Extraterritorial Tax Income ("ETI") regime. However, while the ETI regime benefited exporters, the DPA deduction is designed to provide tax benefits more broadly to domestic production activity, regardless of whether the resulting goods are exported. As a result of the breadth of its scope, the annual federal tax "cost" of the DPA deduction, when fully phased-in was initially estimated to total $10.7 billion. The annual reduction in state tax revenue based on full adoption was estimated to be $1.3 billion. Twenty states have taken action to decouple from or require the addback of the federal DPA deduction.

Complexities in determining the allowable Sec. 199 deduction at the state level may arise when the state employs a different filing method (e.g. separate or unitary vs. federal consolidated) than that used by taxpayers at the federal level. Issues may also arise regarding pass-through entities, where at the federal level, the deduction passes through to the owners or members; whereas some states tax impose a tax directly on the entity.

State Activity

Alabama

In *The Sherwin-Williams Co. v. Dep't of Revenue;* Docket No. BIT. 13-359; Docket No. BIT. 11-741 (11/30/16), the Alabama Tax Tribunal held that the domestic production activities deduction limitation (DPAD), which is calculated on a consolidated basis for federal income tax purposes, should be calculated for Alabama purposes based on the amount of federal taxable income as determined by the proforma separate federal tax return required by Alabama law, before any state modifications. Therefore, the DPAD limitation should be based on proforma separate federal taxable income, and not Alabama taxable income.

The Alabama calculation for the DPAD should essentially mirror what the federal deduction would be if the company filed a separate return for federal purposes. By not taking into account state modifications in the calculation of the limitation, Alabama appears to be strictly conforming to the federal calculation of the deduction.

New Jersey

New Jersey law (L. 2005, A.B. 4294) disallows any deduction under IRC Sec. 199, except for amounts "that are exclusively based upon domestic production gross receipts of the taxpayer which are derived only from any lease, rental, license, sale, exchange, or other disposition of qualifying production property which the taxpayer demonstrates to the satisfaction of the director was manufactured or produced by the taxpayer in whole or in significant part within the United States[.]" Such allowable gross receipts do not include qualified production property that was grown or extracted by the taxpayer. For purposes of allowable gross receipts, the term "manufactured or produced" is limited to operations with the object of placing items of tangible personal property "in a form, composition, or character different from that in which they were acquired." The legislation further provides that "[t]he change in form, composition, or character shall be a substantial change, and result in a transformation of property into a different or substantially more usable product."

Louisiana

In Revenue Ruling 06-003, issued 5/10/06, the Louisiana Department of Revenue explained that all members of an expanded affiliated group are treated as a single corporation for Sec. 199 purposes. An "expanded affiliated group" is an affiliated group as defined in the IRC consolidated return provisions except the "80 percent" rule is replaced by a "50 percent" rule. The Sec. 199 deduction is computed for the entire group, then allocated among the group's members based on each member's respective amount of qualified production activities income. The ruling explains that once a member's deduction is allocated for federal purposes, the taxpayer must then determine how much of the deduction is attributable to: (a) apportionable Louisiana income; (b) allocable Louisiana income; and (c) income not taxable by Louisiana. The amount of the federal deduction attributed to each class of income is based on the percentage of QPAI attributable to each class

Deductions from Captive REITs and RICs

With ever increasing frequency states have enacted legislation that would require the addback of dividends paid by captive real estate investment trusts (REITs) and regulated investment companies to their parents. On July 31, 2008, the MTC approved a model statute addressing the state taxation of captive REITS, defined as a federal REIT, the shares or beneficial interests of which are not regularly traded on an established securities market and more than fifty percent of the voting power or value of the beneficial interests or shares of which are owned or controlled (directly or indirectly, or constructively) by a single entity treated as a corporation at the federal level and not tax-exempt under IRC Sec. 501(a). The model statute disallows the federal dividends paid deduction and requires that the deduction be added back in computing state tax. An exception in the case of "Listed Australian Property Trusts" and certain other "Qualified Foreign Entities" that own REITs was lauded by a representative of Australian investors in U.S. real estate, who urged the MTC members to adopt this exception in conjunction with the REIT addback in their respective states.

As of July 27, 2011, the MTC adopted a model statute that would require taxpayers to addback all expenses and costs directly or indirectly paid, accrued, or incurred to a REIT that is a related member.

Minnesota

In *HMN Financial, Inc. and Affiliates v. Commissioner of Revenue*, No. 7911-R, 5/27/09, the Minnesota Tax Court has determined that the Commissioner of Revenue properly disregarded intercompany transactions between a taxpayer and two subsidiaries under a captive real estate investment trust (REIT) structure because they lacked economic substance and were undertaken solely to avoid Minnesota corporate franchise taxes.

Under the sham transaction or economic substance doctrine, a transaction that lacks practical, economic effects beyond the creation of tax benefits may be disallowed for tax purposes, the court found. Minnesota courts have long applied the economic substance doctrine to test whether a taxpayer's challenged arrangements undermine Minnesota's tax policy. The court noted that some state courts have not set aside transactions under a captive REIT structure, but in those instances the REIT or intermediary corporation had actual business operations and transactions with third parties. HF REIT had no activity except to own the loan participations from HF Bank, and HF Holding had no activity other than owning HF REIT. There were no dealings or business done with third parties.

HMN maintained that evidence showed there were legitimate business purposes other than avoidance of tax and that the transaction had economic substance, stating the business purposes included "helping the bank to meet or exceed performance goals, compete with other banks, create a structure that could be used to raise capital…, and enhance employee retention," along with tracking and monitoring of loans. However, the Commissioner argued, and the court agreed, that when the REIT transactions are viewed as a whole, "the only genuine reason for the captive REIT transactions was to avoid Minnesota tax." The court emphasized that "of all of the purported business reasons asserted for establishing the captive REIT, the only one that was carried out was to avoid tax." The court found that HMN did not raise capital, track loans, effectively manage its interest rate risk, or raise income through any means other than tax avoidance as a result of the transactions. Additionally, the captive REIT structure and related transactions were presented to HMN by its accountants as a state tax savings plan. There were also no discernible differences in the treatment of the loan holders after the transactions, along with no economic risk in transferring the loans. The court noted that HMN dissolved both HF REIT and HF Holding when the Minnesota legislature changed the FOC requirements by establishing payroll and property limits.

The court concluded that HF REIT and HF Holding were created solely for the purpose of avoiding Minnesota taxes, stating that the transactions at issue had "no real business purpose or economic substance, and, when looked at as a whole, were created only to avoid taxes." The court therefore affirmed the Commissioner's order.

On May 20, 2010, the Minnesota Supreme Court overturned the lower court's decision. The Supreme Court held that the Minnesota Commissioner of Revenue did not have the authority to disregard the taxpayer's captive REIT structure on the ground that the structure had the primary purpose of tax avoidance. Significantly, the Court found a lack of support for the Commissioner's assertion of the business purpose and economic substance doctrines in either Minnesota statutes or in the common law. *See HMN Financial, Inc. v. Commissioner of Revenue*, Minn. No A09-1164, 5/20/10.

Oklahoma

Capital Gains Deduction:

In *CDR Systems Corporation v. Oklahoma Tax Commission,* Okla. Sup. Ct., No 109,886 (4/22/14) CDR Systems Corporations was incorporated in California and had manufacturing facilities in Oklahoma. In 2008, CDR entered into a stock purchase agreement with Hubbell Lenoir City, Inc., whereby CDR sold all of its assets to Hubbell. Hubbell elected to treat the stock sale as an asset sale for federal purposes. CDR had owned the assets it transferred to Hubbell for more than three years before the sale.

In a 5-4 decision, the Oklahoma Supreme Court held that the Oklahoma capital gains deduction was constitutional. The capital gains deduction is generally available for gains resulting from the sale of certain property held for at least three years by an Oklahoma headquartered company or held for at least five years by a non-Oklahoma headquartered company. The sale of stock, held for more than three years, of an Oklahoma headquartered company would also qualify for the deduction. The court found that Commerce Clause concerns were not implicated because the deduction did not target a specific common market or industry. Additionally, the court generally viewed the deduction as a tax incentive to promote Oklahoma businesses. Even if the Commerce Clause applied, without a disincentive for out-of-state activities, the court found that no discrimination existed. Subsequently, on May 12, 2014, CDR filed a motion for rehearing before the Oklahoma Supreme Court, and on November 24, 2014 CDR's Petition for Rehearing was denied.

Discharge of Indebtedness - IRC Section 108 Deferral

The American Recovery and Reinvestment Act of 2009, enacted February 12, 2009, modifies federal provisions dealing with the recognition of income from the cancellation or repurchase by a taxpayer of its debt for an amount less than its adjusted issue price. In general, Sec. 108 provides that a taxpayer must recognize cancellation of debt income (CODI) in an amount equal to the excess of the old debt's adjusted issue price over the repurchase price in the year the debt is cancelled or required. However, Sec. 108(i)(1) allows certain businesses to recognize CODI over 10 years (defer tax on CODI for the first four or five years and recognize this income ratably over the following five taxable years) for specified types of business debt reacquired by the business after December 31, 2008, and before January 1, 2011. In addition, Sec. 108(i)(2) requires taxpayers to defer deductions with respect to original issue discount on certain debt obligations for periods that match those noted above.

The CODI provisions raise a number of concerns at the state level. Most notably, where a state decouples from the CODI deferral provision, either as a result of direct legislative action or lagging conformity, taxpayers will have a liability at the state level without a corresponding liability at the federal level. Other state tax concerns include determining whether CODI: 1) qualifies as apportionable or nonapportionable income, 2) is included in the sales factor, and 3) if included, how is CODI sourced. Other non-income tax concerns include the treatment of CODI for Ohio commercial activities tax, Michigan business tax, and Texas margin tax purposes, and other "unique" tax bases. Additional concerns may arise when the entity with CODI is a pass through entity subject to tax withholding requirements at the state level.

UNITARY THEORY

IN GENERAL

The theory underlying the unitary business principle has its roots in real property tax law, where the issue of apportionment first arose in the context of railroad taxation. In *Union Pacific Railway Co. v. Ryan,* 113 U.S. 516 (1884), the Court recognized that the value of a railroad line could not be measured merely by looking to the value of the property located within a specific geographic area. The Court found that a "separate mile or two of its length is almost valueless by itself," and approved the method enacted by the city of Cheyenne that taxed the value of the track within its city limits as a percentage of the value of the entire railroad line. The value attributed to Cheyenne was calculated by determining the value of the entire line and dividing this value by the total number of miles of line to generate a valuation per mile of track. In 1897, the Court expanded this concept of "unit" valuation in *Adams Export Co. v. Ohio State Auditor*, 165 U.S. 194 (1897), by recognizing that unity of use and management of a business that is scattered through several states may be considered when a state attempts to impose a tax on an apportioned basis.

The next landmark in the development of the unitary theory of state taxation was the Court's decision in *Underwood Typewriter v. Chamberlain,* 254 U.S. 113 (1920). The Court in *Underwood* approved a formula used by Connecticut to determine the amount of income from a multistate business that was attributable to Connecticut for state tax purposes. In approving for the first time the use of an apportionment formula for income tax purposes, the Court commented: "The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with the sale in other states."

The term "unitary business" itself can best be traced to the Court's decision in *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924). There, the Court held that the State of New York was justified in using formula apportionment to attribute a "just proportion of the profits earned by the company from such unitary business" that included the brewing of ale in England and its sale in New York.

On January 15, 2004, the Multistate Tax Commission adopted a resolution that sets forth principles for determining the existence of a unitary business.

UNITARY TAXATION AND NEXUS

The concepts of unitary taxation and nexus are intertwined. Chapter I discussed the concept of nexus in general terms. Two significant U.S. Supreme Court cases, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980), and *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980), deal with the concept of nexus as it relates to unitary taxation methodology. There was no question in these cases that the corporations had nexus in the taxing states; rather, the issue addressed was whether the *income* each state sought to tax had a sufficient connection to the taxing state. In each case, the Court held that there was a "substantial connection," i.e., nexus, between the overall operations and activities of the business (including subsidiaries) and the taxing state.

Mobil: Taxation of Foreign Dividends Constitutional, if Payor Is Unitary

In *Mobil*, the Court held that Vermont's corporate income tax on foreign source dividend income received by the taxpayer from subsidiaries and affiliates doing business abroad was valid. The Court found that there was sufficient nexus between Mobil and Vermont to support the tax and that neither the foreign source nature of the income nor the fact that it was received as dividends from subsidiaries and affiliates precludes its taxation. The tax did not impose a burden on interstate commerce. If New York (the taxpayer's state of commercial domicile) can tax the taxpayer's dividend income, the Court ruled there is no reason why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other states. Since the income bears a relation to state benefits and privileges received, Vermont's interest in taxing a proportionate share of the dividends is not overridden by any interest of New York.

Exxon: Apportioned Income Taxation of Unitary Business Income is Constitutional

In *Exxon*, the Court upheld the Wisconsin Supreme Court decision that subjected the income of a unitary business to statutory apportionment as opposed to separate accounting in Wisconsin. The Court ruled that the Due Process requirement of minimal connection (nexus) between a corporation's interstate activities and the taxing state is met when a taxpayer takes advantage of the privilege of carrying on business in the state. Although the company's only activities in Wisconsin were marketing operations, the Court found that these operations were an integral part of a unitary business. Since there was a unitary stream of income, Wisconsin was not precluded from taxing, under its apportionment formula, income derived from oil and gas extraction outside Wisconsin. The Court also held that the Commerce Clause of the federal Constitution did not require Wisconsin to allocate all income from the company's exploration and production functions to the situs state rather than include it in its apportionment formula. Since Wisconsin sought to tax income, not property ownership, the tax did not subject interstate business to an unfair burden of multiple taxation. The geographic location of raw materials does not alter the fact that unitary business income of an interstate enterprise is subject to fair apportionment in all states where sufficient nexus exists.

The Court observed: "While Exxon may treat its operational departments as independent profit centers, it is ... a highly integrated business that benefits from an umbrella of centralized management and controlled interaction." In almost the same words, Mobil had been described as an "integrated petroleum enterprise" to which the State's apportionment formula could constitutionally be applied. Neither decision defined "unitary business". This lack of definition is where the confusion lay for some years thereafter.

TESTS OF UNITY

Three Unities Test

The judicial determination whether a group of controlled affiliated companies is involved in a unitary business was originally expounded in two California decisions that are cited in many other states' court decisions dealing with this issue. The first case, *Butler Brothers v. McColgan*, 17 Cal.2d 664, *aff'd*, 315 U.S. 501 (1942), sets forth the "three unities test," which describes three hallmarks of a unitary business:

- Unity of ownership - It has long been the position of the FTB that a group of companies possesses unity of ownership where affiliated corporations are owned entirely by a parent corporation or controlling shareholders. In practice, the FTB has required that there be more than 50 percent ownership of an affiliate to satisfy the ownership requirement.

- Unity of operation - Evidenced by central purchasing, advertising, accounting and management.

- Unity of use - Centralized executive force or some other asset in the general system of operation.

In *Butler Brothers*, the court held that the business in question, conducted by a single corporation both inside and outside California, was a unitary business.

Contribution or Dependency Test

The second judicial test of unitary businesses is the "contribution or dependency test" used in *Edison California Stores v. McColgan,* 183 P.2d 16 (Cal. 1947). Here, the court stated:

> If the operation of a portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate.

In this case, the court determined that the business conducted by a group of affiliated corporations in California and other states was a unitary business, and it sustained the use of the combined reporting method to determine and apportion the unitary income of the group.

Generally, if one of the following situations exists, in addition to meeting the [50% unity of] ownership requirements, California will find a unitary group to exist pursuant to the "contribution or dependency test":

- Multistate use of contiguous assets - In this case the business operates through a physical connection of tangible assets. Examples are railroads, telegraph, telephone and pipeline companies.

- Multistate use of the same assets - The business utilizes the same assets in more than one state. For example, trucks, buses, aircraft and steamships.

- Income arising from transactions in more than one state - The business derives income that arises from a series of transactions in more than one state, e.g., the manufacture of a product in one state and its sale in another state.

- Local activities contribute to net income of the entire business - The operations within the state contribute to (or are dependent upon) the earnings derived from the entire business. The necessary contribution may be established by a flow of goods, centralized purchasing, advertising, accounting or management.

The California courts in a variety of cases have applied the three unities test and the contribution or dependency test consistently. (See California Appendix for significant California cases)

“Constitutional” Tests of Unity

The United States Supreme Court has alluded to other tests of unity that, in reality, may be no more than variations on these two standard tests.

Specifically, the Court has referred to a unitary business as one that exhibits “contributions to income resulting from functional integration, centralization of management and economies of scale.” *Mobil Oil Corp.; F. W. Woolworth Co. v. Taxation and Revenue Dept. of the State of N.M.*, 458 U.S. 354, 366 (1982). In addition, the Court suggested another *indicium* of a unitary business, noting that “[t]he prerequisite to a constitutionally acceptable finding of a unitary business is a flow of **value**, not a flow of goods.” *Container Corp. of America v. Franchise Tax Bd.* 463 U.S. 159 (1983). In an alternative approach, the Court has stated that for commonly controlled activities to be nonunitary, they must be part of “unrelated business activity which constitutes a “discrete business enterprise.”” *Mobil Oil Corp.*, *ASARCO Inc. v. Idaho State Tax Comm’n*, 455 U.S. 307 (1982).

California SBE “Boilerplate” Test

By far the greatest number of unitary cases has been adjudicated in California. Before proceeding with an analysis of the specific facts and circumstances of a unitary case, it is common for the SBE to recite two standard paragraphs setting forth its view of the basic legal principles of the unitary method. [See, e.g., *Appeal of Doric Foods Corporation*, 90-SBE-014 (Cal. St. Bd. of Equal. Dec. 5, 1990)*; Appeal of Dr. Pepper Bottling Company of Southern California, et al.*, 90-SBE-015 (Cal. St. Bd. of Equal. Dec. 5, 1990)*; Appeal of Power-Line*

Sales, Inc., 90-SBE-016 (Cal. St. Bd. of Equal. Dec. 5, 1990); *Appeal of Sierra Production Service, Inc., et al*., 90-SBE-001A (Cal. St. Bd. of Equal. Sept. 12, 1990.]

The language used in *Power-Line* is typical:

> If a taxpayer derives income from sources both within and without California, its franchise tax liability is required to be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (*Edison California Stores, Inc. v. McColgan*)

DETERMINING WHETHER UNITY OF OWNERSHIP EXISTS

Whereas unity of use and unity of operation are two of the three required elements that generally lie at the heart of most unitary controversies, unity of ownership appears to be an element that ordinarily can be determined factually. However, there are a number of instances in which unity of ownership is subject to dispute. For some states unity of ownership means direct or indirect control of more than 50 percent of a corporation's voting stock. The general rule becomes more complex in the context of partnerships and joint ventures, and in situations where attributional ownership is possible.

California Unity of Ownership Definition - "Commonly Controlled Group"

Under CRTC section 25105, for combined reporting purposes, the income and factors of two or more unitary corporations are included in a combined report if the corporations are members of a "commonly controlled group." The term "commonly controlled group" includes:

1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent provided

    (a) the parent owns stock with more than 50 percent of the voting power of at least one corporation and, if applicable,
    (b) stock cumulatively representing more than 50 percent of the voting power of each corporation is owned by the parent, a corporation described in (A), or one or more corporations that satisfy the greater than 50 percent voting control requirement.

2. Any two corporations, if stock representing more than 50 percent of the voting power is owned or constructively owned by the same person.

3. Any two or more corporations that constitute "stapled" entities. Two or more interests are "stapled" interests if by reason of ownership restrictions on transfer of one of the interests, the other interest(s) are also transferred or required to be transferred.

4. Any two or more corporations, all of whose stock representing more than 50 percent of the voting power of the corporations is cumulatively owned by or for the benefit of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers, sisters, grandparents, children and grandchildren, and their respective spouses.

The statute establishes a bright-line, single entity controlling ownership test, except for family and stapled stock situations, and provides that if a corporation is eligible to be treated as a member of more than one commonly controlled group of corporations, it may elect to be treated as a member of only one commonly controlled group. The FTB may prescribe conditions of the election and the taxpayer may only revoke the election with the permission of the FTB.

These provisions give detailed definitions of various terms including the term "more than 50 percent of the voting power," which means voting power sufficient to elect a majority of the board of directors of a corporation. The provisions also provide the FTB with the ability to disregard certain transfers of voting power and treat as stock, warrants, obligations convertible into stock, options to acquire stock, and similar instruments. In addition, the FTB is given the power to prescribe regulations to carry out the purposes of the new law.

PRESUMPTION OF UNITY

Background: Weighting the Unitary Factors

It may be possible that one group of companies owned or controlled by the same interest will be engaged in several separate unitary businesses. This is possible, for instance, where management has sought to diversify and hold certain groups of companies as totally autonomous. As an example, one organization might consist of 15 controlled companies. Three of these companies may be in one combined group, such as oil drilling or oil-related products (drilling, tooling, marketing, etc.), related to the oil industry. A second group consisting of seven corporations may be in the outdoor advertising business. The remaining five companies may each be in totally unrelated businesses or industries. There are no unitary attributes other than ownership between either of the two groups or the other subsidiaries. Each of the two groups would probably be unitary, and the remaining companies would not. It must be recognized, however, that such combinations of companies are, in fact, unusual and the diverse nature of the various businesses does not preclude a finding that the businesses are unitary (*Appeal of Sierra Production Service, Inc., et al.*, 90-SBE-010 (Cal. St. Bd. of Equal. Sept. 12, 1990).

In addition, one can argue that different divisions of one corporate legal entity ought to be treated as separate unitary businesses. Consider the following example: A conglomerate operates through various divisions. One division is engaged in manufacturing aerospace products, another division is engaged in growing and marketing tobacco and related items, and the third division produces and distributes motion pictures. As long as each division operates independently, one may conclude that the taxpayer is involved in three separate unitary businesses, each of which will have its own income and own apportionment factors. It may be that no portion of one trade or business of a taxpayer is carried on within this state, so that no apportionment is applicable. On the other hand, the separate trade or business may be carried on entirely within the state so that all the income or loss is attributable to this state. The final measure of tax is the total of all the income of the separate trades or businesses apportioned to this state. This is an extremely difficult position to sustain. In this regard, see the New Jersey Supreme Court's ruling in *Silent Hoist & Crane Co. v. Director, Division of Taxation*, 494 A.2d 775 (N.J. 1985), which stated that rental income from a New Jersey commercial property unrelated to the manufacturing operation and portfolio investment income were part of the manufacturer's unitary business and were includible in apportionable income.

A question often asked is "which intercorporate connection or unitary attribute is most important?" As is usually the case with such questions, the answer is, "it depends." A review of the cases that have determined that a unitary business exists would show the two frequently recurring attributes are intercompany product flow and strong centralized management. With the exception of a few cases, the facts have shown some form of intercompany product flow or use. Similarly, integration of top level, policy-making executives and directors has consistently been considered to weigh heavily in the balance.

California Regulates the Presumption

In California, Regulation 25120 provides additional guidance and rules regarding what constitutes a unitary business. Most significantly, the regulation (1) recognizes that a single taxpayer may have more than one "trade or business"; and (2) sets forth three factors, the presence of any one of which creates a "strong presumption" that the activities of the taxpayer constitute a single trade or business. Regulation 25120 provides in pertinent part:

> "(b) Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula that takes into consideration the instate and out-of-state state factors that relate to the trade or business the income of is which is being apportioned.

* * *

The application of the Regulation 25120 presumption was discussed in depth in *Appeal of Sierra Production Service, Inc., et al.* There, the SBE made the following observations on the regulation and the presumption of unity arising out of centralized management:

> (1) "The FTB, for some time, has not been applying this presumption to taxpayers engaged in diverse lines of business. By our decision in this case today . . . we intend to leave no doubt in anyone's mind that we strongly disapprove of . . . [the FTB's] . . . failure to apply its own regulation. We believe that, fairly read in its entirety, the regulation is consistent with the applicable constitutional principles."

(2) "If, for example, a taxpayer is seeking the benefit of that presumption, the presumption will apply if the taxpayer establishes, by specific, concrete evidence that it had both 'strong central management' and 'centralized departments for such functions as financing, advertising, research or purchasing.' Once those are proven, the presumption of unity applies and the burden of going forward with the evidence shifts to . . . [the FTB] . . . , who will then be obliged to offer concrete evidence sufficient to support a finding that a single integrated economic unity did not exist. If . . . [the FTB] . . . satisfies this burden, then the presumption disappears, and the taxpayer will, as in the usual tax case, bear the ultimate burden of persuading us, by a preponderance of the evidence, that the taxpayer's position is correct."

(3) "What constitutes 'strong central management' will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the mere existence of 'common officers or directors' or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular operational role in the business activities of the various divisions or affiliates. The significance of such a managerial role, in the constitutional context, was underscored by the Supreme Court in *Container*."

(4) "There is no question that the regulation does not contain an all-inclusive list of the services which might be centralized, and which might provide evidence of unitary integration. Similarly, it should be clear that proof of a 'centralized department' requires something weightier than merely alleging, for example, that there was a 'common accountant' who kept the books for each affiliate. Other trivialities like a 'common insurance agent' will likewise be insufficient."

The SBE has only referred to Section 25120's presumption of unity once since it decided *Sierra Production*. In *Appeal of Doric Foods Corporation*, Cal. St. Bd. of Equal., Dec. 5, 1990, the SBE noted that while the taxpayer alleged there was centralized management and the taxpayer was engaged in the same line of business as the subsidiary, the taxpayer "had made no claim" that it was entitled to the presumptions of unity contained in the regulation. Under these facts, the SBE stated that, "[a]ccordingly, we do not rely on the provision of the regulation to decide this matter."

"INSTANT UNITY"

Occasionally, the issue is not whether entities are unitary, but precisely when they became unitary. This issue is illustrated by several decisions.

- *Appeal of Atlas Hotels, Inc., et al.*

  In *Appeal of Atlas Hotels, Inc., et al.*, Cal. St. Bd. of Equal., Jan. 8, 1985, the SBE found that a subsidiary became "instantly unitary" with the parent's unitary business from the date of its acquisition where there was evidence that many of the managerial and operational changes that demonstrated the subsidiary's integration with its parent not only were implemented immediately upon acquisition, but were planned or commenced well before the actual acquisition date.

- *Appeal of the Signal Companies, Inc*.

  The result in *Atlas Hotels* contrasts with the result in *Appeal of The Signal Companies, Inc*., 90-SBE-003 (Cal. St. Bd. of Equal. Jan. 24, 1990). There, the SBE concluded that the gradual exploration and institution of integrating ties between companies, which did not begin until acquisition, did not make the subsidiary unitary with its parent corporation upon the date of acquisition. As stated in *Signal*, "unity is almost never demonstrated by some single event, but is a conclusion drawn from the aggregation of connecting factors between entities."

  Accordingly, except where there is "instant unity," the precise date upon which a subsidiary subsequently becomes unitary must be determined on a case-by-case basis. The determining factor in choosing the time for a combined report is the date when sufficient unitary ties existed to support a finding of unity.

- *Appeal of Paradise Systems*

  In *Appeal of Paradise Systems*, 95A-0363 (Cal. St. Bd. of Equal. Mar. 19, 1997), the SBE ruled that Paradise was engaged in a single unitary business with its acquiring parent company from the time it was acquired. The FTB determined a unitary relationship did not exist for the seven months immediately after the date of acquisition, based upon the absence of significant unitary ties during that time frame. However, the SBE found several important unitary features were present that indicated that interdependence and contribution existed between the entities. Chief among these was an integrated executive force, operations in the same general line of business, and the existence of intercompany product flow. The SBE noted numerous high-level employees of the acquiring company were involved not only in Paradise's major policy decisions, but also participated directly in its day-to-day key operation functions. At acquisition, all Paradise directors and officers were removed and replaced with different people, including three key officers of the acquiring company. In addition, while there was a minimal transfer of goods between the two companies, there was a substantial transfer of intercompany services including both management and staff personnel support services.

- *Appeal of ARA Services*

  In *Appeal of ARA Services*, 93R-0262 96R-1013, (May 08, 1997), the SBE ruled that a service management company ("ARA") did not establish sufficient evidence that its newly acquired subsidiaries were functionally integrated with or maintained unity of use or operations with ARA during the years immediately subsequent to their acquisition.

  ARA offered a number of general factual statements in support of its unitary business claim, such as the existence of centralized banking and borrowing, administrative assistance in the areas of computer systems, security, purchasing, finance, real estate, planning, marketing, insurance, benefits, pension administration, labor relations, and tax accounting service. The SBE recognized these factors as germane to the unitary business principal in general, but stated that ARA was under an obligation to demonstrate some definitive links between members of the unitary group and the operational activities of the three subsidiaries for the income years in question. The SBE noted that both the three unities test and the contribution or dependency test focus on the operational aspects of the business, not the administrative components. While ARA maintained an extensive support structure for personnel and administrative matters, the SBE found the unique nature of the newly acquired subsidiaries operations prevented them from readily integrating the significant aspects of their operational activities with the ARA enterprise.

- *Appeal of Boston Scientific*

  In *Appeal of Boston Scientific,* No. 244315, (Cal. St. Bd. of Equal. Feb. 8, 2005), the SBE ruled that an acquired corporation did not become unitary with its new parent until approximately three months after the date of acquisition, rather than the acquisition date or as of the start of the parent's subsequent tax year. This appears to be compromise decision as the FTB argued that unity occurred upon acquisition and the taxpayer (the acquiring corporation) argued that unity occurred at the start of its next tax year. The FTB claimed that the three-unities test was satisfied upon acquisition: unity of ownership was not contested, unity of use was triggered immediately by interlocking executives and the fact that the target was in the same line of business as the acquirer, and unity of operation was evident in immediate integration the sales forces. The taxpayer countered that the target maintained its own research and development function, target's employees continued with their benefits plans until the end of the year, target became subject to the taxpayer's fixed asset capitalization and capital expenditure policies at the start of the taxpayer's next tax year, and that the internal computer and inventory systems did not become integrated until the start of the taxpayer's next tax year. The SBE reached this "compromise" without elaboration; yet the decision is instructive in showing that the SBE will not assume unity upon acquisition.

The trend of states moving to mandatory combined reporting has increased the relevance and importance of the instant unity concept. Detailed below is a brief summary of how other states have addressed the issue of instant unity. It is important to remember that the states provide separate and sometimes differing guidance regarding what may be considered significant indicia of a unitary relationship.

Massachusetts

The Massachusetts combined filing regulations specifically state that there is a presumption that the first year in which the ownership threshold is met that the acquiring and the acquired corporations are not engaged in a unitary business for the tax period of the combined group that includes the acquisition. 830 CMR 63.32B.2(3)(c). However the regulations further provide that this presumption shall not apply if the companies were previously engaged in either the same general line of business or were parts of a vertically structured business. Moreover, the regulations state that "(t)hese presumptions may be rebutted by the taxpayer or the Commissioner by the presentation of clear and cogent evidence showing that the corporations in question either are, or are not, engaged in a unitary business, as the case may be."

Texas

Texas bucks the trend of the other states that are recent to combined filing in that Texas presumes the entities are unitary on the date of acquisition or organization. Specifically, the Texas regulations provide that when a taxable entity acquires another entity, a presumption exists for finding a unitary relationship during the first reporting period. This presumption is rebuttable and, if such presumption is rebutted, then the taxable entities shall not be considered unitary as of the date of acquisition. Further, when a taxable entity forms another taxable entity, a unitary relationship exists as of the date of formation unless the business is not unitary on a longer term basis. Texas Rule §3.590(b)(6)(C).

Vermont

Vermont was the first state to pass legislation requiring combined reporting during a recent flurry of legislative activity. In doing so it also started the trend of specifically addressing the issue of instant unity in its regulations. Vermont penned the rule that was significantly adopted by both Massachusetts and Wisconsin and that provides "when a corporation acquires another corporation, a presumption exists against a finding of a unitary relationship during the first reporting period. Any party may rebut such presumption by proving that the corporations were unitary. If such presumption is rebutted, then the corporations shall be considered unitary as of the date of acquisition, unless the evidence shows that unity was established as of another date." Vt. Reg. Sec. 1.5862(d)-6(c)(4). Moreover, when a corporation forms another corporation, a presumption exists in favor of finding unity between the two corporations as of the date of formation. Any party may rebut such presumption by proving that the corporations are not unitary or became unitary at a later date. Vt. Reg. Sec. 1.5862(d)-6(c)(5).

Wisconsin

Following the trend started in Vermont, the Wisconsin combined filing regulations provide a presumption that the acquiring and acquired corporations are not engaged in a unitary business for the acquirer's taxable year that includes the acquisition. The regulations further provide that this presumption shall not apply if the acquiring and the acquired corporations were engaged in a unitary business apart from being in the same unitary group. Wis. Reg. 2.62(6)(e)(1), (2). For newly formed corporations it is presumed that the corporation is engaged in a unitary business with the forming corporation on the day of its formation. Wis. Reg. 2.62(6)(f).

DIFFERENT LINES OF BUSINESS

The California Court of Appeal in an unpublished decision has affirmed the trial court's finding in *Yellow Freight*, *Systems, Inc. v. Franchise Tax Bd*., A070143 (July 31, 1996), that an interstate trucking company doing business in California was engaged in a unitary business enterprise with its wholly-owned oil and gas exploration subsidiary.

Yellow Freight System, Inc. (Yellow) hauled freight in interstate commerce. To facilitate its plan to ensure an adequate fuel supply, Yellow incorporated Overland Energy, Inc. (OEI) as a wholly-owned subsidiary to develop oil and gas reserves in sufficient quantities to produce daily production equivalent to the energy consumption by the motor carrier operations.

The Yellow board of directors controlled every significant decision made relating to OEI's activities. Seven of OEI's twelve employees were transferred from Yellow and all of the OEI officers were officers of Yellow. From the time of its incorporation, all OEI office facilities were located at Yellows headquarters. Yellow provided to OEI personnel training services, in addition to administered OEI's benefit plans, payroll processing, accounting, legal and insurance services. Yellow controlled OEI's bank accounts. Yellow and OEI did not share a centralized research and development department, or common sales force.

The FTB argued that the existence of interlocking directors and management, and common administrative links, did not demonstrate the necessary degree of interdependence to warrant the conclusion that the two businesses were unitary. The FTB further noted that there was no flow of value between the two companies.

However, the court stated that "[b]ecause OEI's activities gave Yellow the capability of acquiring fuel for use in Yellow's interstate trucking operations in the event of a repetition of the fuel shortages of the 1970s, we conclude . . . there was some sharing or exchange of value not capable of precise identification or measurement - beyond the mere flow of funds arising out of passive investment or distinct business operation." (Citing *Container.*)

The court rejected the FTB's argument that the absence of certain integrated functions, such as research and development, advertising, technology exchanges, and sales, demonstrated a lack of unity of operations. The court noted OEI did not need this type of support and, therefore, found that the lack of these integrated functions did not undermine the degree of interdependence. The court also rejected the FTB's contention that unity of use, or the integration and control of executive functions, was lacking because Yellow's management of OEI was not based on its own operational expertise. The court found Yellow exercised control over all facets of OEI's operations, and the fact that it chose to enter into contracts that delegated the actual drilling and operations of the wells did not vitiate the fact that Yellow was involved in every business decision made by OEI.

THE "MONSANTO" ISSUE

Under the unitary business principle, it is not necessary for the activities of a taxpayer in California to be directly integrated with the activities of each other subsidiary elsewhere as long as the California activities are part of the taxpayer's overall unitary business. In *Appeal of Monsanto Company*, Cal. St. Bd. of Equal., Nov. 6, 1970, the taxpayer argued that its subsidiary, Chemstrand Corporation, was not a part of the parent's unitary business because it did not contribute to, or depend upon, the California operation and because it had no direct dealings with the California operation. The SBE rejected this argument and concluded:

> This argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separate from either Chemstrand or the California operations.

The SBE has consistently followed Monsanto. (See, e.g., *Appeal of Aimor Corporation*, Cal. St. Bd. of Equal., Oct. 26, 1983, - "[I]t is not necessary for each part of a unitary business to be directly related to each other part.")

Contrary to the decision in *Monsanto* and in a rare state tax decision by a federal appeals court, the U.S. Court of Appeals (see *Envirodyne Industries, Inc., v. Illinois Department of Revenue* v. U.S. Ct. Appeals, 7th Cir., No. 02-1632, 01/06/04) held that absent the existence of a unitary group relationship integrating the business activities of related subsidiaries, a parent corporation cannot carry forward the losses of one subsidiary to offset the income of another. Under the Illinois statute, a unitary business group is defined as a "group of persons related through common ownership whose business activities are integrated with, dependent upon, and contribute to *each other*," explained the court. Given the statutory definition, the court concluded that a unitary business did not exist in situations in which the two subsidiaries were not integrated to each other.

PARTNERSHIP INTERESTS

If a partnership and a corporation are engaged in a unitary business, California (as well as most other states) treats the corporation's share of the partnership's business income as apportionable business income and apportions that income at the corporation level by combining the corporation's share of the partnership's apportionment factors with the corporation's own factors to determine the corporation's apportionment percentage. If the partnership and the corporation are not engaged in a unitary business, then the corporation's share of the partnership's business income is treated as a separate trade or business of the corporation, i.e., the corporation's share of the partnership income is apportioned by only using the corporation's share of the partnership factors. (Regulation 25137-1)

Accordingly, except for ignoring the unity of ownership element, the issue of whether a corporation and a partnership are engaged in a unitary business is examined under the standard unitary analysis. No clear distinction is made based on whether the partner is a general or limited partner. However, there is authority to the effect that "absent unusual circumstances," it would be difficult to overcome the "inherently passive investment nature of a limited partnership interest," such that a limited partnership interest would be found to be part of a unitary business with a corporate partner. (*Appeals of Gasco Gasoline, Inc.*, *et al*., Cal. St. Bd. of Equal., June 1, 1988.)

HOLDING COMPANIES

A holding company often performs no function other than to hold ownership of the stock of another corporation. In some instances, the holding company also engages in some management or oversight functions. However, holding companies typically do not engage in activities that are generally thought of as "operational" in nature. This limited role poses unique questions in the unitary business context.

One of the first decisions highlighting the holding company issue is *Appeal of Power-Line Sales, Inc*., 91-SBE-016 (Cal. St. Bd. of Equal., Dec. 5, 1990), in which a holding company was formed to acquire all of a taxpayer's outstanding stock. The holding company had no paid employees and did not conduct any operations, but the taxpayer alleged a director/treasurer and president of the holding company, who was also a director of the taxpayer, provided management services and assisted the taxpayer in some of its investment, operational, financing and sales decisions. The SBE concluded the operations were not unitary and noted (1) the holding company had no employees and did not engage in any operations, so there were no centralized functions; (2) no exchange of operating information was possible; (3) there was no mutually beneficial exchange of information and know-how; (4) there was no product flow or intercompany loans; and (5) the management and related executive services provided by the head of the holding company to the taxpayer were not provided in any capacity other than as a director of the taxpayer.

Another California decision addressing the holding company issue *is Appeal of Insul-8 Corporation*, 92-SBE-007 (Cal. St. Bd. of Equal., Apr. 23, 1992), where the SBE ruled that Delachaux Corporation (Delachaux), the taxpayer's parent corporation, was not engaged in a unitary business with the taxpayer and the taxpayer's unitary subsidiaries. Delachaux borrowed funds to purchase assets of a division of another company. Immediately, Delachaux transferred these assets to the taxpayer. After the asset transfer, Delachaux engaged in no activities, had no employees, and provided no financing for the taxpayer or its subsidiaries. The taxpayer distributed funds from its operating profits to Delachaux that were used to make payments on the debt that Delachaux had incurred to purchase the assets. The SBE excluded Delachaux from the unitary group and, as a result, Delachaux's interest expense on the acquisition debt and deductions for taxes paid to Delaware were not able to be offset against the income of the unitary group (consisting of the taxpayer and its subsidiaries).

Nevertheless, the SBE sustained FTB's position, and found Delachaux was not part of the unitary group. The SBE rejected the taxpayer's argument for unity based on claims of centralized management because "with no operations in Delachaux to manage, it is meaningless to speak of centralized management" that, in any event, consisted of no more than the commonality of officers and directors of the two corporations. The SBE also rejected the taxpayer's argument for unity based on claims of "common services," since the services involved are of the type to be expected in any corporate common ownership situation. The SBE also rejected the taxpayer's argument for unity based on claims of intercompany financing, since the "mere use of profits from one corporation to pay the debts of another does not indicate a unitary business . . ." Finally, the SBE rejected the contention that it "should consider a passive holding company such as Delachaux to be *per se* unitary with the operating companies with which it is affiliated."

In *Appeal of PBS Building Systems, Inc., and PKH Building Systems, Inc.*, 94-SBE-008 (Cal. St. Bd. of Equal., Nov. 17, 1994) the SBE addressed whether PKH, a holding company with no offices, no employees, no income other than dividends from PBS, and no expenses other than debt service and payments related to a covenant not to compete, was engaged in a single unitary business with PBS, its wholly-owned operating company.

PKH and PBS filed combined California franchise returns during the years at issue. The FTB audited the taxpayers and separated them based on the FTB's belief that the passive holding company was not engaged in a unitary business with its operating subsidiary.

This appeal was unusual because both the taxpayers and the FTB agreed that a unitary relationship existed between PKH and PBS, however, the FTB asked the SBE to clarify its position regarding the role of holding companies in a unitary business. As a preface to its decision, the SBE made it clear that no separate unitary test existed in the holding company context, and that the standard unitary analysis (i.e., three unities test and contribution and dependency) was to be applied in determining whether a holding company and an operating company are unitary. The SBE also rejected the notion that its prior decisions (i.e., *Appeal of Insul-8* and *Appeal of Power-Line Sales, Inc.)* created a rule that pure holding companies were *per se* non-unitary and incapable of providing or receiving a flow of value to or from an operating company.

Although the SBE stated no separate test existed with respect to holding companies, it observed that one should focus on the "economic realities" of a particular corporate structure in determining whether a holding company and its operating subsidiaries were unitary, stating that factors that might be considered relatively insignificant in a case of horizontal or vertical integration took on "added importance" because they were the only factors present to consider. The SBE found the nature of benefits accruing to both the holding company and its operating subsidiaries as a result of their corporate structure such as insulation from liability, shared tax benefits, intercompany financing, loan guarantees, debt instruments or improved creditworthiness must be examined.

The SBE found the intercompany financing was a substantial unitary tie because significant funds were loaned by PKH to PBS without interest or security. The public debt issued by PKH was secured by the assets of PBS and PBS funded the costs of issuing the public debt. Further, the SBE found significant benefit to exist when PKH entered into a covenant not to compete with PepsiCo to protect PBS from competition from its former owner. Finally, the SBE cited the complete overlap of officers and directors as evidence that PHK and PBS operated a unitary business.

The SBE also used this case to address the FTB's long-standing policy of not including "pure" holding companies in combined reports and stated that this policy was <u>not</u> supported by its prior decisions. Further, the SBE stated that such a policy created a "trap for the unwary and a planning opportunity for the apprised." The SBE noted that the FTB's bright line policy created a type of "elective combination" for informed taxpayers who could manipulate the activities of a holding company to create or break unity and that it resulted in "short sighted tax policy... contrary to the policy goals of combined reporting and apportionment...."

However, the SBE differentiated this decision from its prior decisions in *Appeal of Power-Line Sales* and *Appeal of Insul-8*, and noted that in both of those prior appeals the taxpayers failed to substantiate their unitary assertions. Thus, the SBE concluded, both *Power-Line* and *Insul-8* should be viewed as "failures of proof" cases.

In *Appeal of Ashland Oil, Inc*., 88A-1376 and 89R-0276-JG (Cal. St. Bd. Equal., Jan. 5, 1994), the SBE addressed, among other issues, the unitary relationship between an *intermediary* holding company and its parent. Ashland formed a holding company, Ashland Oil Holdings, Inc. (Holdings) to hold the stock of Ashland Exploration, Inc. (Exploration) and Ashland Oil Canada, Ltd. (Canada). The stated purpose of Holdings' formation was to facilitate management's plan for the disposition of targeted affiliates and assets. During the appeal years, Exploration sold a substantial portion of its assets at a large gain, and Holdings sold its stock interest in Canada at a large gain. Ashland filed a California combined report including Holdings and Exploration but excluded Canada and reported the gains as nonbusiness income allocable to its commercial domicile, Kentucky.

Ashland contended that Holdings carried on no operations, and that as a holding company, it could not be part of a unitary business. The SBE found the use of the Ashland name, intercompany financing and the contribution or dependency supplied by Holdings to the unitary business by facilitating and effecting the management plan of disposing of certain segments of Ashland's operations were sufficient to conclude that Holdings was part of a single unitary business.

The California FTB issued *Legal Rulings 95-7* (Nov. 29, 1995) and *95-8* (Nov. 29, 1995), regarding the combination of a passive parent holding company with its unitary operating subsidiaries, and an intermediate passive holding company with its subsidiaries that operate as part of a unitary business with their parent. *Legal Ruling 95-7* addresses three separate factual patterns, all involving a passive holding company called "H." In the first fact pattern, H is the majority shareholder of Corporation S-1, an operating company engaged in a single unitary business. The second fact pattern involves H as the majority shareholder of S-1 and S-2, both operating companies engaged in a single unitary business. The third scenario describes a situation in which Corporation P, an operating company engaged in a trade or business separate and distinct from H, S-1, and S-2, owns the majority of H stock as a nonbusiness asset. H is the majority shareholder of S-1 and S-2.

Citing *PBS Building Systems*, the FTB recognized that when corporations are neither horizontally nor vertically integrated, the typical characteristics of unity may not exist. Therefore, the FTB stated that the focus should be on the economic realities of the corporate structure and, where pure or passive holding companies are involved, the inquiry should be on "the nature of the benefits accruing to both the holding company and the operating subsidiaries as a result of their corporate structure."

Using this analysis, the FTB found that "[w]hen a passive holding company holds one or more operating company subsidiaries engaged in a single unitary business, the holding company's primary function is as a conduit between the shareholders and the single unitary business that the shareholders indirectly own. The unitary business is what gives the holding company value to the shareholders. The holding company represents the unitary business and the shareholders in relationships with each other. In addition, the holding company . . . dedicates all or virtually all of its activity, however small, to the unitary operating company or group. In such circumstances, the holding company 'is an integral part of a larger and unitary system,' the parts of which contribute to and/or depend upon each other (quoting *Edison California Stores*). Separating the holding company from the unitary operating company or group for combined reporting purposes places too much emphasis on the form of corporate structure, when the substance is that the holding company and its operating company subsidiaries are engaged in but one unitary business."

Thus, in all three fact patterns, H was considered by the FTB to be unitary and includable in a combined report with its operating subsidiary or subsidiaries. In the third fact pattern, however, the FTB ruled P would not be includable in a combined report with H, S-1, and S-2.

In *Legal Ruling 95-8*, the FTB addressed two fact patterns concerning an intermediate passive holding company. In the first situation, P is a majority shareholder of H, and H, is the majority shareholder of S. P and S are engaged in a unitary business. In the second fact pattern, P is a majority shareholder of H, and H is the majority shareholder of S-1 and S-2. Corporation P, S-1, and S-2 are unitary operating companies required to file a combined report.

The FTB noted the well-established principle that there does not need to be a direct unitary relationship between each corporation in a combined report; an indirect relationship is sufficient. Thus, "[w]hen an intermediate passive holding company owns one or more operating company subsidiaries which are unitary with the holding company's parent, the holding company's primary function is as a conduit which effectuates contributions and/or dependencies between the parent and operating company subsidiary or subsidiaries. The holding company performs a unitary function for the group by holding the stock of the lower tier operating company subsidiary or subsidiaries which would be a unitary business asset of the parent corporation if it were held by the parent directly. It dedicates all or virtually all of its activity, however small, to the parent and subsidiary or subsidiaries. In such circumstances, the holding company 'is an integral part of a larger and unitary system,' the parts of which contribute to and/or depend upon each other (quoting *Edison California Stores*). To separate the holding company for combined reporting purposes places too much emphasis on the form of corporate structure, when the substance is that the holding company and its operating company parent and subsidiaries are engaged in but one unitary business. The underlying economic reality is that there is but one unitary business."

Consequently, the FTB ruled H is unitary and includable in a combined report with P and S, and, in the second scenario, with P, S-1, and S-2.

In *Appeal of Esprit de Corp.,* 48986 (Cal. St. Bd. Equal., April 18, 2001), the SBE in a letter decision concluded that interest expenses incurred to obtain funds to finance a leveraged buyout were a nonbusiness expense and that the associated LBO fees and merger costs should be prorated (16.6667 percent to business expense and 83.3333 percent to nonbusiness expense). This case involved a holding company that was created by the taxpayer to effectuate a LBO of the stock owned by one the taxpayer's principal shareholders. In doing so, the taxpayer incurred heavy debt to finance the purchase and interest expenses from the indebtedness. In this case, the taxpayer--arguing that the expense was a nonbusiness expense--took the position that the FTB did in *Power-Line* that the acquisition debt incurred in connection with the LBO should be treated as a nonbusiness expense. The LBO was an extraordinary event or transaction outside the scope of Esprit's clothing business the taxpayer argued, and the SBE agreed. (See additional discussion under business and nonbusiness income). While *Esprit* is merely a letter decision, it suggests that the status of a holding company--as either unitary or nonunitary--may not be the sole consideration in determining the deductibility of LBO-related interest expenses.

INSURANCE COMPANIES

Insurance companies present unique issues under the California Bank and Corporation Tax Law. Article XIII, Secs. 28 of the California Constitution generally provides that insurance companies doing business in California (other than companies issuing title and ocean marine insurance) must pay to the state a tax based on gross premiums. Subdivision (f) of Section 28 provides that with the exception of taxes on real estate and motor vehicles, the gross premiums tax is "in lieu of all other taxes and licenses, state, county, and municipal, upon such insurers and their property. . . ." (See also *Mutual Life Ins. Co. v. City of Los Angeles,* 50 Cal.3d 402 (1990).) FTB Legal Ruling No. 385 (Apr. 1, 1975) states that because of the constitutional limitation set forth in Article XIII, Section 28, a corporate insurer engaged in a unitary business is excluded from a California combined report.

U.S. SUPREME COURT DECISIONS APPLYING UNITARY THEORY

Several decisions by the United States Supreme Court have helped to clarify somewhat the status and reach of the states' rights to tax income of multijurisdictional corporations under the unitary business concept. In these cases, the Court has applied the unitary business principle in three separate but closely related contexts.

Single Corporation - Multiple Businesses

In the first context, a single corporate entity has alleged that its business is not a single unit, but rather consists of two or more separate businesses for tax reporting purposes. This was the argument presented before the court in *Exxon Corp. v. Department of Revenue,* 447 U.S.207 (1980). Exxon, a "vertically integrated petroleum company," had three main functional operating departments; exploration and production, refining, and marketing. Its activities within Wisconsin were confined to marketing, which division was operated at a loss based on internal separate accounting. Exxon sought to limit its taxability in Wisconsin to its marketing activities. The Court, however, found that Exxon's three operating departments were not separate unitary businesses or "discrete business enterprises." Rather, Exxon was "a highly integrated business which benefited from an umbrella of centralized management and control interaction," and as such, its business represented a single economic unit for tax reporting purposes.

Single Corporation - Taxation of Intangibles

The second context involves the issue of whether intangible income items (dividends, capital gains, royalties, etc.) received from a subsidiary are properly includable in a taxpayer's apportionable income for tax purposes. This issue is illustrated by the conflicts presented in the cases of *Mobil Oil v. Commissioner of Taxes,* 445 U.S. 425 (1980)*; ASARCO, Inc. v. Idaho State Tax Commission*, 455 U.S. 307 (1982); and *F.W. Woolworth Co. v. New Mexico Taxation and Revenue Dept.,* 458 U.S. 354 (1982).

In *Mobil*, the question before the Court was whether Vermont could properly include in the apportionable income tax base dividends of foreign subsidiaries, including those in which Mobil did not own a majority of the stock. It was more or less presumed Mobil was engaged in a unitary business, and in the Court's opinion, Mobil failed to show that its foreign activities giving rise to the dividend income were unrelated to its petroleum sales activities in Vermont. In *Mobil*, the Court stated:

> The linchpin of apportionability in the field of state income taxation is the unitary-business principle. In accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that state....In the absence of any proof of a discrete business enterprise, Vermont was entitled to conclude that the dividend income's foreign source did not destroy the requisite nexus with in-state activities. (Emphasis added.)

In other words, Mobil failed to carry its burden of proof that the foreign source dividend income was derived from an unrelated business activity that constituted a "discrete business enterprise not related to its in-state marketing activities." Due process was satisfied because the foreign dividend income possessed the requisite nexus with the services provided by the taxing state and because there was a close relationship between the income attributed to the state and the activities within the state. The Court was careful to point out, however, "Where the business activities of the payor have nothing to do with the activities of the recipient in the taxing state, due process considerations might well preclude apportionability, because there would be no underlying business."

About two years after its decision in *Mobil*, the Court heard the *ASARCO* case. Here, the state of Idaho sought to include dividends, interest, royalties, rents and capital gains earned from ASARCO's foreign affiliates in the taxpayer's apportionable business income. ASARCO, however, was able to carry its burden of proving that certain of its subsidiaries were not part of its unitary business and were "discrete business enterprises." The Court found that there was no "rational relationship between the (ASARCO dividend) income attributed to the state (Idaho) and the intrastate values of the enterprise." Both *Mobil* and *Exxon* were distinguished on the basis that, in these cases, a single unitary business was found to exist, whereas in the present case, the activities of the subsidiaries were separate and distinct from the Idaho business of ASARCO.

Idaho also promoted the argument that the purpose for which the subsidiaries were acquired to help ensure a source of raw materials and to establish a market for ASARCO products was controlling in determining whether income from the subsidiaries was business income. In other words, Idaho argued that ASARCO was engaged in a unitary business; but whether or not the subsidiaries were unitary with ASARCO was irrelevant so long as income received from the subsidiaries arose from an investment made by ASARCO for a business purpose. The Court struck down this argument, ruling that such purpose is insufficient to establish unity and it is the actual interrelationship of the various corporate entities that is controlling.

At the same time as *ASARCO*, the decision in *F. W. Woolworth* was handed down. The *Woolworth* case involved New Mexico's attempt to include dividends received from foreign subsidiaries that did no business in New Mexico as apportionable business income. Woolworth had foreign subsidiaries, all either wholly owned or majority owned, which sold the same products as the U.S. parent company, used the same name and reported financial results to their U.S. parent. There was no common purchasing or sales, and management operations were separate. Based on the record developed, the Court found Woolworth had sustained its claim that it was not conducting a unitary business with its subsidiaries. The Court applied the "three factors of profitability" test of functional integration, centralization of management, and economies of scale and found them lacking. Accordingly, taxation of a portion of dividends received from foreign subsidiaries engaged in a discrete business enterprise would violate the Due Process Clause.

It is clear from the above three cases that so long as the income from intangibles arises <u>in a unitary business setting</u>, the Court will require it to be included in the taxpayer's apportionable income provided that the resulting tax liability is not out of appropriate proportion to the business transacted in the taxing state. Additionally, it is clear that a unitary relationship cannot be predicated solely on ownership, potential for control (unexercised), and economic benefits derived.

<u>*Allied-Signal* Articulates the Operational/Investment Function Dichotomy in Unitary Analysis</u>

On June 15, 1992, the U.S. Supreme Court rendered a five-to-four decision in *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992), holding the "unitary business principle remains the appropriate device for ascertaining whether a State has transgressed its constitutional limitations," and under this principle, New Jersey did not have the power to tax income not generated in the course of the taxpayer's unitary business. The Court found both the Due Process and Commerce Clauses prohibit states from taxing value earned outside their borders unless there is "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." The Court distinguished its Due Process ruling in *Quill* from that underlying its decision in *Allied-Signal*. The Due Process issue in *Quill* was whether the State had the authority to tax the entity. In *Allied-Signal*, the question was the tax on the activity, not on the entity undertaking the activity. The Court found that when Due Process is applied to the activity, it serves to "circumscribe the reach of the State's legitimate power to tax" and must be justified by the "protection, opportunities and benefits" the State provides to the activity.

The Court rejected the argument made by New Jersey and several of the *amici curiae* that all income of a corporation doing business in a state should be considered unitary by virtue of common ownership. According to the Court, such a theory could not "be reconciled with the concept that the Constitution places limits on a State's power to tax value earned outside of its borders." The Court further stated that prior decisions should only be overturned if they were unsound in principle, unworkable in practice, and have not been relied on. The Court found the unitary principle to be sound and to be workable in practice notwithstanding the fact that different state courts have reached different results. The Court stated that variations were possible, particularly because each unitary case is fact-sensitive. Finally, the Court found that the reliance placed by the states on prior unitary decisions led them to enact taxing provisions allocating intangible nonbusiness income to domiciliary states, and that by abandoning the unitary concept the Court itself would have to either invalidate those statutes or authorize certain double taxation. The reliance of corporations that have structured their activities based on the rules would also be disturbed, and difficult questions regarding retroactivity would result.

The Court also addressed the arguments made by the Multistate Tax Commission and other *amici curiae* that the unitary principle should be modified by adopting as the Constitutional test the standards enunciated in the Uniform Division of Income for Tax Purposes Act (UDITPA), i.e., permitting apportionment of "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The Court found that "in the abstract," the UDITPA definition may be compatible with the unitary business principle, but also stated that the "business purpose test" rejected by the Court in its *ASARCO* decision, was still not an acceptable definition of a unitary relationship.

In applying the unitary principle to the facts in *Allied-Signal*, the Court turned to the question of whether the income realized by Bendix, predecessor in interest to Allied-Signal, was attributable to the taxpayer's activities within the State. Contrary to New Jersey's arguments, the Court found there to be a distinction between assets serving an investment function and those serving an operational function. The Court found the relevant unitary business inquiry to be one "which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." The Court found it is not necessary that the payor and payee be engaged in the same unitary business in order for the taxing jurisdiction to be allowed to apportion the income arising from the transaction. What is required, according to the Court, is that "the capital transaction serve an operational rather than an investment function."

The Court pointed out that an investment that constituted an interim use of idle funds accumulated for future use in a taxpayer's business operations could result in apportionable income. In the instant case, however, the Court found that stock held for two years did not meet the definition of an interim or short term use, and, therefore, the investment activity had to be analyzed in relation to the operational unity, or lack of it, between the company acquired and the unitary business of Bendix. The Court rejected the possible use that Bendix might have made of the realized gain from the sale of the stock as irrelevant to the true inquiry, the existence of a unitary relationship between Bendix and ASARCO. Based on the stipulated facts, the Court found no indicia of unity and held that New Jersey could not include the gain from the sale of the stock in Bendix's apportionable tax base.

Mead Revisits *Allied-Signal*

The Mead Corporation ("Mead"), an Ohio corporation, filed combined Illinois unitary returns with Lexis/Nexus ("LN"), its electronic publishing subsidiary/division (LN's status changed several times over the years). Mead sold LN in 1994, treated the gain from the sale as nonbusiness income, and did not include the income on its Illinois tax return. In concluding that the gain yielded business income, the court found that Mead's investment in LN served an operational purpose in that LN represented a significant business segment of Mead.

Harkening back to *Allied-Signal.,* the Illinois Court of Appeals, in *The Mead Corp. v. Illinois Dept. of Rev.,* Ill. App. Ct., No. 1-03-1160, 11/3/06, noted that a state may apportion income of a multistate nondomiciliary corporation in these circumstances only if there is a unitary relationship between the parties or if the intangible asset served an operational rather than an investment function. The appellate court did not reach the lower court's finding that the taxpayer's and its electronic publishing division were not unitary, because it found that the taxpayer's investment in the subsidiary served an operational purpose in that the subsidiary represented a significant business segment of the taxpayer

On January 24, 2007, the Illinois Supreme Court denied the taxpayer's petition for appeal. On April 20, 2007, the taxpayer filed a petition for a writ of certiorari with the U.S. Supreme Court (U.S., No. 06-1413, cert petition filed 4/20/07), which was accepted, and a decision was handed down on April 15, 2008..

In *MeadWestvaco Corp. v. Illinois Dept. of Revenue,* U.S., No. 06-1413, *vacated and remanded,* the U.S. Supreme Court vacated and remanded the appellate court's decision. In an opinion authored by Justice Alito, the U.S. Supreme Court concluded that "the state courts erred in considering whether Lexis served an 'operational purpose' in Mead's business after determining that Lexis and Mead were not unitary."

The references to "operational function" in *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment, the court found. The concept of operational function "simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'" The court noted the banking example used in *Allied-Signal,* the 'payor' was not a unitary part of the taxpayer's business, but the relevant asset was." The conclusion that the asset served an operational function "was merely instrumental to the constitutionally relevant conclusion that the *asset* was a unitary part of the business being conducted in the taxing state[.]"

In the instant case, where the asset in question is another business, "we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." While the trial court found all of these hallmarks lacking, the appellate court made no such determination, instead relying on "its operational function test," the court found. Accordingly, the court remanded the case.

The court declined to examine the case on an alternative ground raised by the state and *amici,* that because Lexis did substantial business in Illinois, Lexis' own contacts with the state justify the apportionment of Mead's capital gain. This "new ground" for the apportionment of intangibles based on the taxing state's contacts with the capital asset rather than the taxpayer was neither raised nor decided by the state courts, the court noted. "We typically will not address a question under these circumstances even if the answer would afford an alternative ground for affirmance," the court stated. Further, the Court noted that the states of Ohio and New York have both adopted this rationale for apportionment, and neither of those states have appeared as an *amicus* in the case, nor was on notice that the constitutionality of its tax scheme was at issue. "So postured, the question is best left for another day," the court concluded. [In a footnote, the court noted that remand would be required even if the state's position were accepted, as "presumably the apportioned tax base should be determined by applying the State's four-factor apportionment formula not to Mead [as was done by the state's auditor] but to Lexis."]

Justice Thomas concurred in the court's opinion, finding that the court "today faithfully applies our precedents." However, Justice Thomas took the occasion to reiterate his belief that constraints on taxation of a multistate enterprise beyond those required by due process "require us to read into the Due Process Clause yet another unenumerated, substantive right." As such, "[t]o the extent that our decisions addressing state taxation of multistate enterprises rely on the negative Commerce Clause, I would overrule them. As I have previously explained, the Court's negative Commerce Clause jurisprudence 'has no basis in the Constitution and has proved unworkable in practice.'" (quoting his concurrence in *United Haulers*) Justice Thomas noted that Congress has "undisputed authority" to resolve income apportionment issues by virtue of its power to regulate interstate commerce.

<u>Multiple Corporations - Combined Reporting (U.S. Parent)</u>

The third context in which the Court has applied the unitary business principle involves a determination as to when two or more separate corporate or business entities are engaged in a unitary business, the income of which is to be apportioned among the various jurisdictions where business is conducted. This was the central dispute in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) a major decision by the Court on combined reporting.

Container Corporation was a paperboard packaging manufacturer headquartered in Illinois and doing business in California and elsewhere. It also had several overseas subsidiaries that were incorporated in the countries in which they operated. In its California tax returns, Container treated its overseas subsidiaries as passive investments rather than as part of its unitary business and considered only its domestic operations in computing its income attributable to California under the three-factor apportionment formula. The FTB contended Container should have

included its foreign subsidiaries as part of its unitary business and computed its tax using worldwide combination.
As presented to the Court, there were three central issues to be decided:

- Whether the state court's conclusion that Container and its foreign subsidiaries were engaged in a unitary business was "within the realm of permissible judgement,"

- Whether California's use of three-factor apportionment, when applied to a multinational enterprise, violated the constitutional requirement of "fair apportionment," and

- Whether California's method of apportionment - combined reporting - was violative of the Foreign Commerce Clause.

Regarding the first issue, the Court held California's application of the unitary business principle to Container and its foreign subsidiaries was proper. In so finding, the Court appeared to endorse the state court system as the "final word" on most future combined reporting cases, stating:

> …This Court will, if reasonably possible, defer to the judgement of state courts in deciding whether a particular set of activities constitutes a 'unitary business.' ....It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a de novo adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgement was within the realm of permissible judgement.

Container was unable to prove that the state court erred in its application of existing legal standards to the factual situation presented. Accordingly, in the Court's opinion, the factors relied upon by the court in holding that the appellant and its foreign subsidiaries constituted a unitary business clearly demonstrated that the court reached a conclusion "within the realm of permissible judgement."

In its original brief, Container Corporation urged the Court to adopt a bright-line rule that would require a substantial flow of goods as a prerequisite to a finding that a mercantile or manufacturing enterprise is unitary. The Court firmly rejected any such bright-line rule, stating, "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods." Interestingly, however, the Court did little to expand on its "flow of value" concept other than to reiterate its position outlined in both *Mobil* and *Woolworth* that "a relevant question in the unitary business inquiry is whether contribution to income of the subsidiaries resulted from functional integration, centralization of management, and economies of scale." Many observers believe that *Container* sheds little new light on the question of exactly what constitutes a unitary business.

In disposing of the second issue presented for decision, the Court found that Container had not met its burden of proving that the income apportioned to California was out of all appropriate proportion to the business transacted in the state. While the Court recognized the three-factor formula for apportionment is less than perfect, it was not demonstrated that the margin of error was any greater than the margin of error inherent in separate accounting. Indeed, since Container and its subsidiaries were found to be engaged in a unitary business, the Court reasoned that in addition to the foreign payroll and materials that went into production by a foreign subsidiary, there was also California payroll, as well as other California factors, contributing - albeit more indirectly to the same production. Just because Container's accounting does not reflect this possibility "does not disturb the underlying premises of the formula apportionment method."

As to the third and final argument presented in the *Container* case, the Court ruled that California's unitary method of taxation was not violative of the Foreign Commerce Clause or the "one voice" standard espoused by *Japan Lines, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). In the Court's opinion, the risk of double taxation occasioned by California's scheme of taxation is not impermissible. In fact, California would have trouble avoiding double taxation of corporations subject to the franchise tax even if it adopted the arm's-length separate accounting approach. The Court stated:

> If California's method of formula apportionment 'inevitably' led to double taxation, that might be reason enough to render it suspect. But since it does not, it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation.

Moreover, the Court pointed out that California's method does not create an <u>automatic</u> asymmetry in international taxation, is not pre-empted by federal law, or fatally inconsistent with federal policy. In addition, the court noted that tax treaties do not cover the taxing activities of states. Accordingly, the unitary method of taxation does not implicate foreign policy issues or violate clear federal directives.

Overall, the Court in *Container* did little in the way of setting a precise standard for when taxpayers are engaged in a unitary business, choosing to leave this determination to the state courts. As such, continued disputes can be expected in this area as states and taxpayers become more aggressive in the application of the unitary method of taxation.

<u>Multiple Corporations - Combined Reporting (Foreign Parent)</u>

In the *Container* decision, the Court chose not to address the issue of apportionment with respect to foreign controlled corporations engaged in multijurisdictional operations. However, in a footnote, it was indicated that a foreign-based unitary group might require a different analysis than presented in *Container,* as indicated below:

> We recognize that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests. We need not decide here whether such a case would require us to alter our analysis.

Based on this language, foreign-based multinational corporations challenged the Constitutionality of California's worldwide combined reporting. In *Barclays Bank, PLC v. Franchise Tax Bd. of Ca.*, 512 U.S. 298 (June 20, 1994), the Court upheld the constitutionality of California's worldwide combined reporting method of apportionment where a foreign parent corporation was involved. In a companion case, *Colgate-Palmolive Co. v. Franchise Tax Bd. of Ca.*, 512 U.S. 298 (June 20, 1994), the Court considered similar issues in the context of a domestic parent and concluded that California's worldwide unitary method was constitutional as applied to a domestic parent corporation, a result not surprising in light of the Court's 1983 decision on the same issue in *Container*.

Barclays claimed that California's worldwide combined reporting requirement violated the antidiscrimination component of the Court's Commerce Clause standard because a foreign-based owner of a corporation filing a California tax return "is forced to convert its diverse financial and accounting records from around the world into the language, currency, and accounting principles of the United States at 'prohibitive' expense." Domestic-based multinationals, by contrast, need not incur such expense, because they already keep most of their records in English and in accordance with United States accounting principles. This allegedly prohibitive administrative burden created a competitive advantage for U.S.-based multinationals amounting to economic protectionism in violation of the Commerce Clause, Barclays asserted.

While acknowledging that "[c]ompliance burdens, if disproportionately imposed on out-of-jurisdiction enterprises, may indeed be inconsonant with the Commerce Clause," the Court found the factual predicate of Barclays discrimination "infirm." The Court pointed to the fact that the California FTB permitted taxpayers to use "reasonable approximations," in determining its worldwide income, thereby avoiding most of the compliance costs of which it complained. Because Barclays "has not shown that California's provision for 'reasonable approximations' systematically 'overtaxes' foreign corporations generally" or Barclays in particular, its claim of unconstitutional discrimination against foreign commerce failed.

Barclays further contended that the "reasonable approximations" standard was so vague that it invested the FTB with "standardless discretion" in violation of the Due Process Clause. The Court responded that "reasonableness" was a guide permitting effective judicial review in myriad circumstances, that the California courts had construed the law to curtail the discretion of California taxing officials, and that, given the "inescapable imprecision" in matters of international multijurisdictional income allocation, "California's scheme does not transgress constitutional limitations."

Turning to the two additional factors that must be addressed when a State tax implicates Foreign Commerce Clause concerns -- the enhanced risk of multiple taxation and the requirement that the Federal Government speak with "one voice" in international trade -- the Court addressed Barclays' contention that there was a more aggravated risk of international multiple taxation with a foreign-based than with a U.S.-based multinational (as in *Container*) because foreign-based multinationals typically have more of their operations outside the United States. Consequently, a higher proportion of their income is a subject to tax abroad with a concomitantly enhanced risk of international multiple taxation when such income is included in California's apportionable tax base.

Without questioning Barclays' premises, the Court nevertheless found that Barclays' multiple taxation argument had been answered by *Container*. The Court observed that *Container's* holding, rejecting the taxpayer's multiple taxation argument rested on two considerations. First, the multiple taxation in *Container* though "real" was not "inevitabl[e]," because it resulted from the overlap of two different methods of dividing a tax base and could as easily result in undertaxation as overtaxation. In drawing a distinction in this context between adventitious multiple taxation, which is constitutionally permissible, and "inevitable" multiple taxation, which is not, the Court recognized that its decision in *Container* "effectively modified, for purposes of income taxation, the multiple taxation inquiry described in *Japan Line*" where it declared that a property tax on instrumentalities of foreign commerce "is incompatible with the Commerce Clause if it "creates a substantial risk of international multiple taxation."" Second, the alternative method available to the taxing State (arm's-length, separate accounting) would not eliminate the risk of multiple taxation because different jurisdictions apply the arm's-length separate accounting method differently. The Court stated:

> And if, as we have held, adoption of a separate accounting system does not dispositively lessen the risk of multiple taxation of the income earned by foreign affiliates of domestic-owned corporations, we see no reason why it would do so in respect of the income earned by foreign affiliates of foreign-owned corporations. We refused in *Container* to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation. The foreign domicile of the taxpayer (or the taxpayer's parent) is a factor inadequate to warrant retraction of that position.

Finally, the Court turned to the question "ultimately and most energetically presented," namely, whether worldwide combined reporting "impair[ed] uniformity in an area where federal uniformity is essential," (quoting *Japan Line*, 441 U.S. at 448), and, in particular, whether the State's taxing regime prevented the Federal Government "from 'speaking with one voice' in international trade." The two decisions cited by the Court to "principally inform our judgment," were *Container* and *Wardair Canada, Inc. v. Florida Dep't. of Revenue*, 477 U.S. 1 (1986). In *Container*, the Court had explicitly reserved the question whether its determination that worldwide combined reporting did not violate the "one voice" doctrine as to a U.S.-based multinational would apply as well to a foreign-based multinational.

The Court now found, however, that the considerations that had led to its conclusion in *Container* likewise applied in the context of a foreign-based multinational. These considerations were that (1) California's method did not create an automatic asymmetry in international taxation; (2) the taxpayers were plainly subject to tax in California in one way or another, and the amount of tax they pay is therefore "much more the function of California's tax rate than of its allocation method"; and, most significantly, (3) there were no specific indications of congressional intent to preempt California's tax. On the contrary, the Court cited "the tax treaties into which the United States has entered . . . in none [of which] . . . does the restriction on 'non-arm's-length' methods of taxation apply to the States"; the rejection by the Senate of a treaty "that would have extended that restriction to the States"; and the fact that "Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income."

Similarly, in *Wardair*, where the Court rejected a challenge to Florida's tax on the sale of fuel to foreign airlines on the ground that it "threaten[ed] the ability of the Federal Government to speak with one voice," *Wardair*, 477 U.S. at 9, the Court found its analysis relevant to the controversy now before it. Specifically, the Court in *Wardair* had examined international agreements that barred taxation of aviation fuel at the national level, but not at the subnational level. The Court concluded that "[b]y negative implication arising out of [these international accords,] the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel."

A critical lesson that the Court drew from *Container* and *Wardair*, in which the Court addressed and rejected the "one voice" argument only after determining that the tax was otherwise constitutional under Interstate Commerce Clause criteria, was this: "Congress may more passively indicate that certain state practices do not impair federal uniformity in an area where federal uniformity is essential; it need not convey its intent with the unmistakable clarity required to permit state regulation that discriminates against interstate commerce or otherwise falls short under *Complete Auto* inspection."

Under this relaxed standard, the Court had little difficulty concluding that the "one voice" criterion was satisfied in *Barclays*. As in *Container* and *Wardair*, there were no specific indications of congressional intent to the bar the state tax in question. Like the court below, the U.S. Supreme Court found the Senate's refusal to ratify U.S-U.K. Tax Treaty without a reservation on the article that would have barred the States' use of worldwide combined reporting as reinforcing its "conclusion that Congress has implicitly permitted the State to use the worldwide combined reporting method." Moreover, the Court felt that its decision in *Container* had left the ball is Congress's court: "had Congress . . . considered nationally uniform use of separate accounting 'essential,' it could have enacted legislation prohibiting the States from taxing corporate income based on the worldwide combined reporting method. In the 11 years that have elapsed since our decision in *Container*, Congress has failed to enact such legislation."

The Court observed that over the past three decades foreign governments had made their displeasure with States' worldwide combined reporting requirements known to Congress and that Congress had considered the legislation limiting or barring such requirements on many occasions. In light of these "indicia" of Congress's willingness to tolerate States "worldwide combined reporting mandates, even when those mandates are applied to foreign corporations and domestic corporations with foreign parents." Given the Court's firm conviction that these questions are "much more the province of the Executive Branch and Congress than of this Court," (quoting *Container*, 463 U.S. at 196), the Court concluded that there was no basis for its intervention.

The Court also dismissed the contention that various statements emanating from the Executive Branch opposing States' use of worldwide combined reporting constituted a "clear federal directive" (*Container*, 463 U.S. at 194) proscribing such reporting. The Court noted that it is Congress, not the Executive, that has the constitutional power to regulate commerce with foreign nations. Consequently, Executive Branch actions such as press releases, letters, and *amicus* briefs "are merely precatory." "Executive Branch communications that express federal policy but lack the force of law cannot render unconstitutional California's otherwise valid, congressionally condoned, use of worldwide combined reporting," the Court said.

Barclays was consolidated with *Colgate Palmolive Co. v. Franchise Tax Bd.*, which involved a renewed challenge to worldwide combined reporting by a U.S.-based multinational. Colgate's case depended entirely on the Court's determination that worldwide combined reporting was unconstitutional as applied to a foreign-based multinational, although Colgate's claim still might have failed even if the Court had so held. In any event, in light of the Court's disposition of the worldwide combined reporting issue with respect to Barclays, the Colgate case had no independent significance, other than to reaffirm the Court's holding in *Container*.

The Multistate Tax Commission on January 15, 2004, adopted a resolution revising its allocation and apportionment regulation to include provisions "setting forth principles for determining the existence of a unitary business." MTC member states may adopt the recommended amendments, which are intended to guide states in consistently interpreting and applying U.S. Supreme Court cases involving unitary determinations. The MTC stated in its resolution that the guidelines for unitary determination are being included in the allocation and apportionment regulation because "determining the existence of a unitary business is central to the apportionment of income for tax purposes[.]"

Definition of Unitary Business. The resolution defines a unitary business as "a single economic enterprise" made up of separate parts of a single entity, or of a commonly owned or controlled group of entities, that "are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts." Regarding a sharing or exchange of value, the resolution states that "if the activities of one business either contribute to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business."

Under the U.S. Constitution, the resolution notes, a sharing or exchange of value requires "more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business."

Application of the "*Mobil Oil.*" The resolution states that a unitary business is characterized by significant flows of value as characterized by significant flows of value, as evidenced by the three factors described in *Mobil Oil Corp. v. Vermont,* 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. The resolution states that facts suggesting the presence of any of these factors "should be analyzed in combination for their cumulative effect and not in isolation."

Functional Integration. The resolution states that functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. While "[t]here is no specific type of functional integration that must be present," the resolution lists examples of business operations "that can support the finding of functional integration":

1. Sales, exchanges, or transfer of products, services, and/or intangibles between business activities (the resolution states that functional integration is not negated by the use of arm's length sales because such sales may present "an assured market" for the seller or source of supply for the purchaser).
2. Common marketing, including sales to a common customer, use of a common trade name, or identification to customers that the entities are members of the same enterprise (the resolution states that the use of a commonly-controlled advertising office does not establish common marketing but is relevant to determining the existence of economies of scale or centralization of management).
3. Transfer or pooling of technical information or intellectual property.
4. Common distribution system.
5. Common purchasing of substantial quantities of products, services, or intangibles from the same source, particularly where significant cost savings result or where the products are not readily available from other sources and are significant to each entity's operations.
6. Significant common or intercompany financing (but "not necessarily" lending that serves an investment purpose of the lender).

Centralization of Management. Under the resolution, centralization of management exists when directors, officers, and/or other management employees jointly participate in management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. The resolution provides that the existence of common officers and directors, while relevant, does not alone provide evidence of centralization of management. The resolution also distinguishes "stewardship" oversight, consisting of activities that any owner would take to review the performance of or safeguard an investment, such as implementing reporting requirements or mere approval of capital expenditures.

Economies of Scale. Under the resolution, economies of scale occur when an increase in operational size, resulting from a relation between business activities, produces a significant decrease in the average per unit cost of operational or administrative functions. Economies of scale may exist "from the inherent cost saving that arise from the presence of functional integration or centralization of management," the resolution states. Examples of business operations "that can support the finding of economies of scale" include centralized purchasing and centralized administrative functions.

"Inferences of a Unitary Business." While the resolution lists several "inferences of a unitary business," it is unclear whether these "inferences" create a presumption of unity and what weight such a presumption would carry:

Same Type of Business. "Business activities that are in the same general line of business generally constitute a single unitary business[.]"

Steps in a Vertical Process. "Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business." The proposed regulation cites a business engaged in exploration, development, extraction, and processing of a natural resource that also sells a product based on the extracted natural resource.

Strong Centralized Management. One unitary business may exist where there is strong centralized management, coupled with the existence of centralized departments for functions such as financing, advertising, research, or purchasing.

Common Control. The resolution states that separate corporations can only be part of a unitary business if they are members of a "commonly controlled group," generally based on ownership of stock representing more than 50 percent of the voting power of each of the corporations. The resolution provides that if a corporation is eligible to be treated as a member of more than one commonly controlled group of corporations, the corporation must elect to be treated as a member of only one group. The election may be revoked with the approval of the state's tax agency.

ALLOCATION AND APPORTIONMENT

IN GENERAL

One of the major differences between the federal system for taxing income and the system used by the states and sub-state units, is the need to divide the tax base of multistate taxpayers. As Jerome R. and Walter Hellerstein point out in their two-volume work, State Taxation, "The need to divide the tax base springs from the existence of competing claims of the jurisdictions in which businesses conduct activities, own property, or derive income, and from which they obtain the benefits and protection of the States' markets, their public services, and their legal and other institutions." It is clear that the states in which a multistate business operates have a right to tax the income of the enterprise based on the benefits and protections provided by those states. However, it is also clear that under the Commerce Clause of the U.S. Constitution, as well as under basic standards of equity and fairness, multistate businesses should not be subject to tax on more than 100 percent of their income, and should not be placed at a competitive disadvantage relative to companies operating a completely intrastate business.

The Uniform Division of Income for Tax Purposes Act, commonly known as "UDITPA," was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and approved by NCCUSL and the House of Delegates of the American Bar Association in July 1957. UDITPA deals with the allocation and apportionment of income of multistate businesses, and was designed for enactment in those states that have either net income taxes or taxes measured by net income. It defines "business income" and "nonbusiness income"; defines the three factor apportionment formula that is used to apportion business income; and provides specific rules for the allocation of nonbusiness income.

UDITPA makes two basic assumptions: that the state has jurisdiction to tax; and that the state has defined the base of the tax and the only remaining question is the amount of the base that should be assigned to the particular taxing jurisdiction. Section 2 of UDITPA exempts from its operation three major classes of taxpayers: (1) individuals, to the extent of their income for personal services; (2) financial organizations; and (3) public utilities. (See Pierce, "The Uniform Division of Income for State Tax Purposes," Taxes, Oct. 1957, p. 747.)

MTC AND THE UDITPA REGULATIONS

The Multistate Tax Commission (MTC) has enacted a major set of regulations, and many states have enacted their own regulations to interpret the provisions of UDITPA. In order to understand the development of the regulations, it is first necessary to understand the development of the Multistate Tax Compact and the MTC.

In 1959, the United States Supreme Court in *Northwestern States Portland Cement v. Minnesota,* 358 U.S. 450 (1959) suggested that a state could impose an income tax on a corporation's activities that were wholly in interstate commerce. As discussed in Chapter 1, in response to this decision and under pressure from the business community, Congress in 1959 enacted P.L. 86-272, which generally precluded the states from imposing an income tax if the only activity of a corporation within the state consisted of soliciting sales of tangible personal property. Congress also commissioned at that time a study and report on the general subject of state taxation of multistate income. The report and recommendations of the study committee, commonly known as the "Willis Committee," were published in 1964 and 1965. Among its recommendations was that all states should be required to use a federal tax base with a two-factor apportionment formula, and federal legislation was introduced for that purpose. The federal legislation was never enacted, although hearings were held.

In response to the formation of the Willis Committee and the federal legislation it spawned, state tax officials commenced work on an alternative. In 1966, the National Association of Tax Administrators, the National Association of Attorneys General and the National Legislative Council, drafted the Multistate Tax Compact (Compact). The Compact is an agreement among consenting states to facilitate the proper determination of state and local liability of multistate taxpayers. The Compact created the MTC. The Compact also incorporates UDITPA. States join the MTC by enacting the Compact.

A Regulations Committee of the National Association of Tax Administrators drafted regulations for UDITPA. In 1971, the Committee's regulations were adopted by the FTB. The Committee's regulations were also proposed for adoption by the MTC. In 1971, the MTC adopted the Committee's regulations, but with numerous revisions. In response to comments and criticism of its 1971 model regulations for UDITPA, the MTC commenced a study to make revisions. In 1973, the MTC issued its revised regulations for UDITPA.

Since 1973, numerous other changes have been made to the FTB and MTC regulations for UDITPA. However, those changes generally have not disturbed the fundamental rules for allocation and apportionment of income under UDITPA. Instead, the changes have been mainly in the area of promulgating regulations for special industries. For example, the MTC in 1981 adopted Regulation IV.18(f), which established special rules in respect to railroads. In addition, the FTB in 1987 adopted Regulation 25137-8, which established special rules with respect to motion picture and television film producers and television networks. The FTB is currently reviewing the special rules in this area and has provided additional guidance in renumbered Regulation 25137-8.1 and Regulation 25137-8.2.

The U.S. Supreme Court has afforded the states wide latitude in determining their own apportionment formulas based on its oft-reiterated statement that rough approximation rather than precision is sufficient. In finding that Iowa's single-factor apportionment formula was Constitutional, *Moorman Manufacturing v. Bair*, 437 U.S. 267 (1978), the Court stated, "The only conceivable constitutional basis for invalidating the Iowa statute would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States. If the Constitution were read to mandate such precision in interstate taxation, the consequences would extend far beyond this particular case. For some risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for division of income." Given the number of states presently mandating a double weighted or more than double weighted sales factor, it is clear that uniformity is still a goal, not a reality.

Currently, ongoing litigation in California has created some uncertainty in regard to the apportionment factor used by California taxpayers. California was a signatory state to the MTC, but later in 1993, adopted a double-weighted sales factor and the proper apportionment factor has been a continuing issue since. First, on July 24, 2012, the California Court of Appeal held that taxpayers have the option to elect an equally weighted sales, property and payroll apportionment factor as provided under the MTC, or the double-weighted sales factor under CRTC section 25128. (See *Gillette v. FTB* (2012) 147 Cal.Rptr.3d 603.) In this case the taxpayers asserted that since California was a signatory to the MTC and codified the MTC under CRTC section 38006, the MTC was a valid interstate compact binding California to the MTC provisions. The court agreed with the taxpayers and reasoned that since California entered into the MTC, California cannot, by subsequent legislation, unilaterally alter or amend its terms. Therefore, the enactment of CRTC section 25128 in 1993, which provides for a double-weighted four factor apportionment formula, did not alter the availability of the MTC apportionment formula because the state of California is bound by the MTC (unless the state withdraws from the Compact). However, most recently in late 2015, the California Supreme Court superseded the Court of Appeals decision and held that the California law precludes taxpayers from relying on the MTC's equally-weighted three-factor apportionment election provision (*The Gillette Co. v. Franchise Tax Board,* 62 Cal.4th 468 (2015)). The Court reasoned the Compact was not a binding reciprocal agreement due do to facts in *Northeast Bancorp v. Board of Governors*, FRS, 472 U.S. 159 (1985); *Gillette* relied heavily on this case in determining the binding nature of the Compact. The U.S. Supreme Court declined to take up the *Gillette* case, however as discussed below, it could review the issue if it arises from another jurisdiction.

Use of the three-factor MTC apportionment formula has also been the subject of litigation and legislation in Michigan. In May 2011, Michigan replaced the Michigan Business Tax (MBT) with the Corporate Income Tax (CIT). Contained in that legislation was a provision that, beginning January 1, 2011, taxpayers could not apportion income under the Compact for either MBT or CIT purposes. On July 14, 2014, the Michigan Supreme Court held that IBM was entitled to apportion income using the MTC election for its 2008 tax year. The court reasoned that the specific single sales apportionment formula provision in the MBT could be harmonized with the Compact's equally-weighted three factor apportionment formula. By enacting the MBT, the Michigan Legislature did not impliedly repeal the Compact's apportionment election. The court found that the May 2011 law repealing the Compact "could have – but did not – extend this retroactive repeal to the start of the [MBT]"

In September 2014, Michigan enacted S.B. 156, which retroactively repealed the state's membership in the Multistate Tax Compact effective beginning January 1, 2008.

On November 19, 2014, in compliance with the Michigan Supreme Court's July 14, 2014, decision, the Court of Claims on remand entered an order in favor of IBM. The Department filed a motion for reconsideration. On April 28, 2015, the Michigan Court of Claims ruled that IBM, which had prevailed at the Michigan Supreme Court, could not make the election because S.B. 156 retroactively repealed the Compact effective January 1, 2008.

The litigation in Michigan continued with a group of over 50 taxpayers, spearheaded again by Gillette, challenging the constitutionality of Michigan's retroactive appeal. This claim was rejected by the Michigan Court of Appeals, which held that the MTC was an advisory agreement, not a binding compact or contract, and thus, removal from the agreement was not prohibited by the Constitution. The Michigan Supreme Court declined to rule on the appeals decision, Gillette has appealed the issue to the U.S. Supreme Court.

Other states where litigation regarding the MTC election has occurred include Minnesota, Oregon, and Texas. It remains to be seen whether the US Supreme Court addresses this issue.

THE RIGHT TO APPORTION

Allocation or apportionment of income is available only if a taxpayer is entitled to do so. In that regard, Article IV.2 of the Compact is generally representative of the rules and provides that:

> Any taxpayer having income from business activity which is taxable both within and without this State, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income...

A key phrase in the above paragraph is "which is taxable both within and without this State." In other words, the right to allocate and apportion will only exist where the taxpayer is liable for tax in another state. As Article IV.3 of the Compact provides,

> For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another State if (1) in that State he 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 corporate stock tax, or (2) that State has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not.

A question arises whether a taxpayer must file tax returns in other states in order to allocate or apportion its income. The taxpayer's *activities* occurring in other jurisdictions, rather than the filing of returns, should control this issue. Two illustrative cases in this area are: (1) *Amray, Inc. v. Commissioner of Revenue*, No. 119875 (Mass. App. Tax Bd. April 17, 1986), and (2) *Technical Assistance Advisement 95(C)1-008*, Fla. Dept. of Rev., August 30, 1995.

In the *Amray, Inc*. case, the Massachusetts Appellate Tax Board held that the company was "subject to tax" in other jurisdictions due to activities of its service personnel despite its failure to file returns in the other states. Accordingly, Amray was entitled to apportion its sales within and without Massachusetts.

The Florida Department of Revenue (Department) ruled in *TAA 95(C)1-008* that a Florida corporation licensing a patent outside the State was not entitled to apportion its income within and without the State. Company L, a Florida corporation, owned a patent, which it licensed exclusively to a company based in another state. With the exception of interest income, Company L derived its income from the licensing of the patent. Company L did not file income tax returns in any other state, and the state in which it licensed the patent had not issued a formal opinion on whether the license of an intangible within the state created income tax nexus.

Florida law (F.A.C. §12C-1.015) provides that corporations may apportion their income only if they are doing business within and without the State. Taxpayers are considered doing business within and without the State if (1) another state subjects the corporation to a net income tax, franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) the state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not tax the corporation.

The Department noted that Company L was not subject to an income tax in any other state, and did not provide any evidence that another state had jurisdiction to subject it to a net income tax. Thus, the Department ruled that Company L had not met either criterion that would allow it to apportion its income. As a result, Company L was required to report all of its adjusted federal income tax to Florida.

BUSINESS/NONBUSINESS INCOME and APPORTIONABLE INCOME

Income under UDITPA is divided into two categories: business income and nonbusiness income. Business income is apportioned to a state by use of a formula while nonbusiness income is allocated to a particular state under a series of statutory rules based upon multiple rationales -- the state of the taxpayer's commercial domicile; the asset from which the income is derived is located in the state; or the asset from which the income is derived has acquired a business situs in the state. On April 28, 2005, MTC General Counsel Fred Katz advocated a move to defining business income as "all income which is apportionable under the Constitution," a move which would focus a business income inquiry "on the correct considerations and avoid the agonizing parsing of the current definition" of business income. Currently, the District of Columbia, Illinois, North Carolina, and Pennsylvania have enacted such a standard. On July 30, 2014, the MTC adopted this new language.

Multistate Tax Commission Definitions – Through June 30, 2014.

The MTC's definitions of the terms "business" and "nonbusiness" income are presented below:

Business Income

Article IV.l(a) defines business income as: "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

Regulation IV.l(a) interprets this definition as follows: "In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income..." The regulation also states: "In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of a trade or business..."

The language of the definition of business income was patterned after the definition of "unitary income" under SBE decisions predating UDITPA. As was explained in *Appeal of W.J. Voit Rubber Corp*., Cal. St. Bd. of Equal., May 12, 1964:

> "The underlying principle in these [pre-UDITPA] cases is that any income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole. And, with particular reference to assets which have been depreciated or amortized in reduction of unitary income, it is appropriate that gains upon the sale of those assets should be added to the unitary income."

The states have generally found that the UDITPA and MTC definitions provide two alternative tests to determine whether income constitutes business income. The first is the "transactional test." Under this test, the relevant inquiry is whether the transaction or activity that gave rise to the income arose in the regular course of the taxpayer's trade or business.

Under the second, or "functional test," income from property is considered business income if the acquisition, management, and disposition of the property are "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction.

If either of these two tests is met, the income will constitute business income in many states. Some state courts have held that both tests must be met in order for income to be considered business income. A handful of states apply only the transactional test.

MTC regulations provide, unequivocally, that income that satisfies *either* the transactional test or the functional test is business income.

The regulation also provides that income satisfies the transactional test even if the actual transaction or activity that gives rise to the income does not occur in [this State]. In addition, a transaction or activity does not have to be frequent in order for it to be in the regular course of a taxpayer's trade or business. The regulation states that it is sufficient to classify a transaction or activity as being in the regular course of a trade or business, "if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does."

The regulation states that, under the functional test, business income does not have to be derived from transactions or activities that occur in the regular course of the taxpayer's trade or business. Rather, it is sufficient that the property from which the income is derived is or was an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business. The regulation also provides that property that has been converted to a nonbusiness use for a sufficient period of time (the regulation states five years) or that has been removed as an operational asset and is held exclusively for investment purposes is no longer a business asset. Thus, the income derived from such property would not be considered business income.

The regulation also states that "income derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations." In addition, the regulation provides that income from intangible property is business income when such property serves an operational, rather than an investment, function, and that a business income determination is based on whether the property is or was held in furtherance of the taxpayer's trade or business.

Nonbusiness Income

Nonbusiness income, defined under UDITPA as "all income other than business income," is subject to allocation.

Multistate Tax Commission Definitions - Effective July, 1 2014

Apportionable Income

Article IV.l(a) defines "apportionable income" as:

(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:

(A) income arising from transactions and activity in the regular course of the taxpayer's trade or business, and

(B) income arising from tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer's trade or business; and

(ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

NonApportionable Income

"Non-apportionable income", defined as all income other than apportionable income.

Important State Developments

Cessation/Liquidation of Business

California

In what is arguably the first California appellate court decision addressing the “cessation of business” and “partial liquidation” exception concepts, the California Court of Appeal, First Appellate District, held in *Jim Beam Brands Co. v. Franchise Tax Bd.,* (2005) 133 Cal. App. 4th 514, that the complete sale of a subsidiary corporation engaged in a unitary business with the taxpayer resulted in business income under the functional test. The court found it irrelevant that the proceeds from the sale were distributed to the taxpayer’s non-unitary parent company, citing the California Supreme Court’s decision in *Hoechst Celanese Corp. v. Franchise Tax Bd.,* 22 P.3d 324 (Cal. 2001), in concluding that the “critical inquiry” for purposes of the functional test is the relationship between the property sold and the taxpayer’s business operations and not the taxpayer’s use of the proceeds from the disposition or the reasons behind the sale. The court also rejected the taxpayer’s alternative argument that it was entitled to reduce its gain on the stock sale by adjusting its basis to reflect certain undistributed earnings and profits.

On January 4, 2006, the California Supreme Court declined to review the court of appeal’s decision.

<u>Illinois</u>

The issue of whether a cessation or liquidation of business yields business or nonbusiness income has been litigated in Illinois more than in any other state, despite 2004 legislation (S.B. 2207), which defines "business income" as all income that may be treated as apportionable business income under the U.S. Constitution, net of all deductions allocable thereto.”

In *Texaco-Cities Service Pipeline Co. v. McGraw,* 675 N.E.2d 1004 (Ill. 1998), *rev. denied*, June 1, 1998, the Illinois Supreme Court held that gain from the disposition of a major segment of a taxpayer's business is considered business income under the functional test if the asset disposed of was used by the taxpayer in its regular trade or business operations. The functional test focuses on the role or function of the property as being integral to regular business operations, the court said. The use of a capital asset in the taxpayer's regular trade or business renders that asset an "integral part of its regular business operations.” In reaching its conclusion, the court explained that, unlike the cases the taxpayer cited, in this instance, "there was no evidence that this sale was a cessation of a separate and distinct portion of" the taxpayer's business. The court also dismissed the taxpayer's assertions that only the transactional test applied in determining the definition of business income.

In *Blessing/White, Inc., v. State of Illinois Department of Revenue,* 768 N.E.2d 332 (Ill. App. Ct, 2002), the Illinois Court of Appeals concluded "that *Texaco-Cities* tacitly recognizes the distinctive nature of corporate liquidations resulting in a discontinuation of business activity and suggests that the functional test will be met in such cases only where the property and the liquidation of assets (i.e. disposition) are essential to the taxpayer's regular trade or operations."

The court, in *Blessing/White,* ruled that gain from the sale of a corporation's assets in liquidation where the proceeds are distributed to the shareholders generates nonbusiness income because the liquidation is not integral to the corporation's regular business operations. The court noted that while the assets sold by Blessing were essential to Blessing's regular business operations, the disposition of assets was not equally important to the company. The court also found it significant that the proceeds from the disposition were not used to support any ongoing business concerns but were disbursed to the corporate shareholders. The court concluded that as the liquidation was not integral to the company's regular business operations, the gain does not qualify as business income under the functional test. Accordingly, Blessing's gain is nonbusiness income, not taxable by Illinois, the court said.

In *National Holdings Inc. v. Illinois Dept. of Rev.,* No. 4-06-0148 (Ill. App. Ct. 1/19/07), the Illinois Court of Appeals, citing *Blessing/White,* concluded that a corporation realized nonbusiness income from the sale of all of its assets in complete liquidation, where the proceeds were distributed to the shareholders and not reinvested in the business.

In *The Mead Corp. v. Illinois Dept. of Rev.,* Ill. App. Ct., No. 1-03-1160, 11/3/06, where the Illinois Court of Appeals concluded that liquidation proceeds yielded business income, a determining factor was that the taxpayer used the proceeds to fund its business operations and did not, unlike the taxpayer in *Blessing/White,* distribute the proceeds to the shareholders. The court also concluded that Mead's investment in its liquidated subsidiary served an operational function. The Illinois Supreme Court declined to review the case, but the taxpayer's appeal was accepted by the U.S. Supreme Court, which issued its decision on April 15, 2008, albeit on constitutional issues and not on the cessation of business. (See discussion following, *Allied-Signal*)

In contrast to *Mead*, in *Shakkour v. Bower,* Ill. App. Ct., No. 1-04-1646, 9/1/06, the Court reached the opposite result--and found that liquidation proceeds yielded nonbusiness income--where the proceeds were distributed to the shareholders. The Illinois Supreme Court declined to review the *Shakkour* case.

Indiana

The Indiana Tax Court held, in *May Dep't. Stores Co. v. Indiana Dep't. of State Revenue*, Ind. Tax Ct., No. 49T10-9906-TA-144, 5/7/01, that gain from the sale of assets of an entire operating division pursuant to the settlement of an antitrust suit is nonbusiness income. While the sale was planned as part of May Department Stores acquisition of Associated Dry Goods Corp., the sale was a one-time event involving the liquidation of the assets of a distinct and separate business division and, therefore, did not generate business income under the transactional test.

In its functional test analysis, the court concluded that "it is not enough that the property was used to generate business income for the taxpayer prior to its disposition." "The disposition too must be an integral part of the taxpayer's regular trade or business operations." In order to be "integral," the disposition of Horne's assets must be considered "necessary or essential" to Associated's regular trade or business operations, the court found. The disposition of Horne's assets was neither necessary nor essential to Associated's department store retailing business, the court concluded. The court noted that while Horne "was unquestionably an integral part of Associated's business operations," the terms of the settlement with Pittsburgh resulted in a sale of Horne's assets for the benefit of a competitor rather than for the benefit of Associated.

Louisiana

In *BP Products North America, Inc. v. Bridges*, La. Ct. App., First Cir., Dkt. No. 529,766. 8/10/11, the Louisiana Court of Appeals held that the sale of a Louisiana refinery was deemed to yield apportionable income over the Department's protest that the proceeds be allocated to Louisiana in their entirety. The Department argued that the sale was not in BP's regular course of business and that the sale of fixed assets should be allocated to the site of the asset. However, the sale was not only for fixed assets, but for an operating business. The Court held that the transaction was a regular practice of BP, and the sale was directly related to BP's overall business, that is, to streamline the refining to better serve the needs of all segments of the business.

North Carolina

In *Lenox Incorporated v. Offerman,* 548 S.E. 2d 513 (N.C. 2001), the North Carolina Supreme Court held that gain from a transaction that involves the complete or partial liquidation and cessation of a taxpayer's particular line of business where the proceeds are distributed to shareholders rather than reinvested in the company is nonbusiness income under the functional test because a liquidation is not an integral part of a taxpayer's regular trade or business.

The following year, the state amended the definition of "business income" to include all income that may be apportioned under the U.S. Constitution, effective for tax years beginning on or after January 1, 2002. According to the House Finance Committee fiscal note, the effect of this amendment would be to include in the tax base income from irregular events, such as the sale of a subsidiary. This amendment would effectively eliminate the holding of *Lenox Incorporated v. Offerman*.

Pennsylvania

In *Laurel Pipe Line Co. v. Board of Fin. and Revenue*, 642 A.2d 472 (Pa. 1994), the Supreme Court of Pennsylvania held the gain on the sale of an idle pipeline to be nonbusiness income. The court upheld a previous determination that the gain did not generate business income under the transactional test. In addressing the functional test, the court explained that because the pipeline had been idle for over three years prior to its sale, the disposition was, in essence, a partial liquidation and not an integral part of Laurel's regular trade or business. The court also found the fact that Laurel distributed the proceeds, rather than reinvesting them in the business, to be further evidence of a liquidation of a separate and distinct aspect of its business. Based on these findings, the court held the gain to be nonbusiness income.

L. 2001, Act 23, signed by the governor on June 22, 2001, expanded the definition of business income. Specifically, the law is intended to clarify that the term "business income" includes income from tangible and intangible property if *either* the acquisition, management, *or* disposition of property constitutes an integral part of the taxpayer's regular trade or business operations. The statute further provides that business income "includes all income which is apportionable under the Constitution of the United States." As amended, the statute treats as business income gain from the liquidation or partial liquidation of business assets, and effectively eliminates the holding of the Pennsylvania Supreme Court in *Laurel Pipe Line*.

***Allied-Signal* Considerations**

Maryland

In *Southland Corporation v. Comptroller of the Treasury,* Md. Ct. Special App., No. 1661, 6/13/01, the Maryland Court of Special Appeals ruled that the gain on the sale of a 50 stock percent stock interest in a corporation was not constitutionally subject to apportionment where the ownership and subsequent sale of the stock served an investment rather than an operational function.

Citing *Allied Signal,* the court noted that the U.S. Supreme Court clearly stated that where the companies involved in a transaction are not engaged in a unitary business operation, the "capital transaction" must serve an operational rather than an investment function for the income from the transaction to be taxable.

The court dismissed the comptroller's assertions that despite Southland's lack of corporate control over Citgo, various areas in agreements between Southland and Citgo support a finding that Citgo performed an operational function for Southland. Specifically, the court dismissed the comptroller's assertion that Southland's investment in Citgo, which was made to generate income to pay down debt, was an interim use of idle funds, noting that Southland held its investment in Citgo for more than six years. Southland's investment in Citgo "was clearly not a short term deposit of the type that would likewise give rise to a finding that Citgo served an operational function," the court said.

Massachusetts

The distributive share income received from a Massachusetts limited partnership by a corporate limited partner is subject to apportionment in Massachusetts when the investment serves an "operational function," as opposed to a passive investment function, the Massachusetts Appellate Tax Board found in *Sasol North America, Inc. v. Comm. of Rev.,* Mass. App. Tax Bd., No. C273084 (9/5/07).

The question of whether the distributive share income was subject to apportionment or whether it was allocated 100% to Massachusetts hinged on whether the income was determined to arise from business activities that were related or unrelated to the operations of Sasol. Pursuant to Massachusetts' definition of "related business activities", the following are related business activities notwithstanding the absence of a unitary relationship: (a) the short-term investment of capital in a non-unitary business segment or activity; and (b) any other investment of capital that serves an operational function.

The Board concluded that the "operational function" test, derived from *Allied-Signal* and various state cases, looks to (1) whether the funds used to purchase an intangible asset are characterized as "working capital," and (2) whether the investment resulted in an operational benefit to the ongoing business of the corporation, beyond a passive monetary return to the corporate treasury. The Board held that both requirements were met.

Since the "operational function" test was satisfied, the Board determined that Sasol's investment in ASMC LP served an operational function. Under *Allied-Signal,* the Board noted other jurisdictions in which Sasol conducted business were entitled to tax an apportioned share of the distributive share income received by Sasol from ASMC LP. It follows that the distributive share income is "business activity which is taxable both within and without" Massachusetts and thus is subject to apportionment.

More recently, in *W.R. Grace & Co. - Conn. vs. Commissioner of Revenue*, No. C271787, 4/6/09, the Massachusetts Appellate Tax Board concluded that a Massachusetts taxpayer was not subject to tax on interest and dividend income and generated by its non-unitary affiliates. The income arose from a series of transactions undertaken by the taxpayer to pay off amounts owed to third-party creditors.

The taxpayer had the burden of proving by "clear and cogent" evidence that the state was seeking to tax extraterritorial values. The taxpayer argued that extraterritorial values were taxed because it was not engaged in a unitary business with the affiliates (subsidiaries) at issue and that the income lacked sufficient connection with the in-state operation of the affiliates. The ATB agreed.

Guided by U.S. Supreme Court precedent, the ATB found that the taxpayer and its affiliates were not engaged in a unitary business because there was no functional integration, centralization of management, or economies of scale between the parties. In this instance, the taxpayer's supervision of its subsidiaries' finances was "more in the nature of a stewardship oversight function…", which did not rise to the standard of a unitary business. Thus, even though the affiliates had nexus with Massachusetts, the assessment of tax amounted to taxation of extraterritorial values in violation of the Due Process and Commerce Clauses of the U.S. Constitution. Citing *Allied-Signal,* the ATB also concluded that the transactions that gave rise to the income served an investment purpose, rather than an operational function.

Oregon

Income received in settlement of a tort judgment was held to be business income subject to apportionment by the Oregon Supreme Court in *Pennzoil and Subsidiaries v. Department of Revenue,* 33 P.3d 314 (Or. 2001), *petition for cert. denied,* U.S., Dkt. No. 01-964, 03/18/02.

Shortly after Pennzoil entered into a contract to purchase a large share of Getty Oil stock, Pennzoil learned that all of the Getty stock had been purchased by Texaco. In its subsequent suit against Texaco, Pennzoil based its claim for damages on the cost it would incur to find and develop one billion barrels of oil reserves. After Texaco filed for bankruptcy protection, a settlement was reached whereby Pennzoil accepted $3 billion in lieu of the $11+billion (including punitive damages) awarded to it by the court. The IRS considered $2.1 billion of the $3 billion settlement includable in Pennzoil's 1988 federal taxable income. Pennzoil treated the settlement as nonbusiness income in its 1988 return, but the Oregon Department of Revenue concluded the income was business income and assessed Getty on an apportioned share of it.

In terms of what gave rise to the income, the court looked to the question, "in lieu of what were the damages awarded," and determined that Pennzoil's request for damages based on the cost it would incur to find and develop oil reserves was an indication that the damages were awarded based on the contract. Because the contract was undertaken to acquire an interest in oil reserves, and because acquiring such interests was vital to Pennzoil's "regular business," the transactional test of the business income definition was met.

Because the income was paid in lieu of Pennzoil's right to acquire Getty or Getty's oil reserves, and such reserves were necessary for Pennzoil to carry on its Oregon operations, the court held the income served an operational function and could, therefore, be apportioned to Oregon under both Due Process and Commerce Clause standards.

Tennessee

The Tennessee Supreme Court ruled in the case of *Blue Bell Creameries, LP v. Commissioner*, Tenn., No. M2009-00255-SC-R11-CV, 1/24/11, that capital gain resulting from a one-time stock transaction between the taxpayer and its holding company was apportionable income under both the statutory "functional test" for "business earnings," and the constitutional unitary test for apprortionability.

The court found that the language 'acquisition, use management or disposition of the property' in the definition of business earnings suggests that the taxpayer must control, but not necessarily own, the property for earnings arising from the property to qualify as business earnings." The court found that property must contribute materially to the production of business income to constitute an integral part of the taxpayer's regular trade or business operations.

With respect to the holding company's stock, the stock transaction at issue was a necessary step in the reorganization of the Blue Bell business entities that profited from the production, sale, and distribution of Blue Bell ice cream, the court found.

The court next analyzed whether the capital gain satisfied the constitutional unitary test for apportionability. Citing *Allied-Signal, Inc.,* the court noted that the U.S. Supreme Court has used the "operational-function" concept to determine whether income derived from assets such as stock is part of the taxpayer's unitary business. The court noted that the U.S. Supreme Court in *MeadWestvaco Corp.,* 553 U.S. at 29, stated that "[t]he concept of operational function simply recognizes that an asset can be part of the taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'" Further, the court noted commentary that the court in *MeadWestvaco* "explicitly embraced the 'operational-function' concept as a basis for apportionability of income from *assets*" (emphasis in original; Walter Hellerstein, *MeadWestvaco and the Scope of the Unitary Business Principle,* 108 J. Tax'n 261, 263 (May 2008)).

"Applying the United States Supreme Court's distinction between operational and investment functions to the present case, we hold that the Stock Transaction served an operational function rather than an investment function for the Blue Bell ice cream business," the court concluded.

The transaction was undertaken "solely as part of the reorganization of the entities profiting from the business. The Stock Transaction neither diversified the business nor reduced risks associated with the ice cream business. To the contrary, the Stock Transaction and reorganization served to increase net gain from the ice cream business. Because the capital transaction served an operational function… income from the stock is unitary with Taxpayer's ice cream business."

Pension Reversions

California

In *Hoechst Celanese Corporation v. Franchise Tax Board*, (2001) 106 Cal.Rptr.2d 548, *cert. denied,* U.S. No. 01-265, 11/26/01, the California Supreme Court reversed a Court of Appeals decision and held that pension reversion income arising from the termination of a qualified pension plan constitutes business income under the functional test where the plan materially contributes to a taxpayer's business operations via its effect on employee retention and recruitment, regardless of the fact that the taxpayer does not have an ownership interest in or title to the property generating the income.

In analyzing the functional test, the court found that while the critical inquiry is the relationship between the income-producing property and the taxpayer's business operations, the term "property" does not imply that the taxpayer must actually own or hold legal title to the property.

While the functional test refers to the "acquisition, management, and disposition of the property," with the word "and" having a conjunctive rather than a disjunctive meaning, the terms "acquisition," "management," and "disposition" must be considered in the context of the whole statutory definition of business income. After discussing the dictionary definitions of the three terms, the court concluded that the phrase "acquisition, management, and disposition of the property" requires that the taxpayer must:

- obtain some interest in and control over the property,
- control or direct the use of the property, and
- transfer or have the power to transfer control of the property.

Therefore, the court concluded, legal ownership or title to the income-producing property is not required under the functional test.

The court also noted that Commissioners Comments to UDITPA state that income from the disposition of property is business income if the property is "used in a trade or business of the taxpayer." "In making this statement, the Commissioners clearly contemplated that the functional test would focus on the taxpayer's control and use of the property and not on legalistic formulations of property ownership," the court concluded. While Celanese did not actually own or hold legal title to the pension plan assets, the court found, it did exercise control over the plan and its assets through committees composed of its officers and employees.

In interpreting the second part of the functional test, the court found, the phrase "regular trade or business operations" requires that the taxpayer's control and use of the income-producing property be part of the taxpayer's "normal or typical business activities." The court then held that the term "integral" "requires an organic unity between the taxpayer's property and business activities" whereby the property "must be so interwoven into the fabric of the taxpayer's business operations that it becomes 'indivisible' or inseparable from the taxpayer's business activities with both 'giving value' to each other." (*Hoechst,* supra, at 532).

The court concluded that property maintained and used to retain and attract employees was integral to the taxpayer's business operations. Because the pension plan assets contributed materially to Celanese's production of business income "via their effect on Celanese's labor force," the court concluded that Celanese's acquisition, management, and disposition of the assets constituted integral parts of its business operations in satisfaction of the functional test. The pension plan assets "were interwoven into and inseparable from Celanese's employee retention and recruitment efforts - an essential part of any business operation," the court said. **Note.** Although not a UDITPA state, Massachusetts concluded that Celanese's pension reversions did not constitute earnings and profits, subject to the income measure of the corporate excise tax. The case, which also addresses sales factor issues, is discussed in more detail below.

North Carolina

Income arising from a pension plan reversion is nonbusiness income to the plan administrator under the functional test where the income is not integral to the administrator's business operations and the reversion was not part of the administrator's regular business operations, the North Carolina Supreme Court ruled in *Union Carbide Corporation v. Offerman*, N.C., 507 S.E.2d 284, 2/4/00.

Following a catastrophic gas leak in Bhopal, India, Union Carbide's stock prices plummeted. Fearing a hostile takeover, Union Carbide adopted a restructuring plan. Part of that plan consisted of "spinning-off" excess funds from an over-funded pension plan not needed to cover benefits for current employees, purchasing annuities with the spun-off assets to pay retiree benefits, and distributing the remainder to shareholders to increase stock prices. The reversion generated income to Union Carbide for federal and state income tax purposes.

Union Carbide reported the income as nonbusiness income on its North Carolina corporate tax return. On audit, the department reclassified the income as business income and tax. Union Carbide challenged the assessment.

Noting that Union Carbide merely held a contingent property right in the excess funds, the supreme court reasoned that the excess funds were not integral or essential to Union Carbide's business operations. The plan assets and the funds from those assets were not used to generate income in the regular course of Union Carbide's business operations, the court said. Rather, the funds were merely surplus investments that were not needed to meet the obligations of the pension plan. The reverted funds are not business income, but rather investment income taxable by the domicile state, the court said.

Working Capital

California

The California FTB ruled in *Legal Ruling 98-5* that interest and dividend income generated from liquid assets in excess of current and identified future business needs could not be characterized as business income solely because the assets were available for business use.

The FTB explained that income realized from liquid funds set aside or utilized as business cycle working funds is properly characterized as business income, none of the cases or other authorities suggest that funds, simply by virtue of being "available" for business use should automatically be characterized as business income. The FTB noted that cases have uniformly held that the mere potential for integration of an asset into the taxpayer's business did not give rise to business income. The FTB also noted that a broad proposition such as an "available for business use" test runs afoul of the unitary cases holding the mere potential to operate a company as part of a unitary business is not dispositive for purposes of determining the apportionability of the income of an interstate enterprise.

The FTB stated that the relevant analysis is "whether the funds are needed for the taxpayer's current business cycle needs or have been identified for future business needs . . . To the extent that funds can be identified as in excess of any business need or contingency, the functional and transactional tests of business income have not been satisfied. Thus, the income from such funds is clearly not business income."

Contrast *Legal Ruling 95-8* with the SBE's ruling that interest and dividend income earned on long-term investments is business income under the functional test when the funds invested are earmarked for a specific unitary business use in *Appeal of Consolidated Freightways Inc.*, Cal. St. Bd. of Equal., No. 98A-0499, 9/14/00. Determining whether income is business income under the functional test requires a two-pronged analysis, the board explained. The first prong, or working capital test, analyzes whether the pool of funds at issue is part of the "working capital" of the taxpayer. The second prong analyzes whether the pool of funds has been earmarked for a specific business need. Because the funds at issue were well in excess of Consolidated's working capital needs and were removed from working capital, the income is not business income under the first prong of the functional test, the board said. However, because Consolidated never wavered from its commitment to purchase an appropriate replacement candidate and at all times managed the funds so that they would be readily accessible, liquid, and available for immediate use to acquire a compatible business, the income is business income under the second prong of the functional test.

Illinois

The Appellate Court of Illinois, First District reversed and remanded the Cook County Circuit Court's holding that short-term investment income qualified as apportionable business income because it was placed into a working capital reserve account. *Home Interiors & Gifts, Inc. v. The*

Department of Revenue of the State of Illinois, 741 NE2d 998, reversed and remanded November 13, 2000, rehearing denied February 1, 2001. The Circuit Court had also held that because the income, which came from interest on stocks, bonds, and commercial paper, was available for day to day business operations, it met the definition of "business income" as defined under both the transactional test and functional test.

The court concluded that only the portion of the interest income in the short-term investment accounts that was available for use as working capital was to be apportioned as business income under the functional test. The court further concluded that Home Interiors had demonstrated that it did not use all of its funds for operational purposes meeting its burden to establish that only a portion of the income was apportionable.

IRC § 338(h)(10) Considerations

Illinois

In *American States Insurance Company v. H80068022001amer,* No. 1-03-1646, 08/27/04, the Illinois Court of Appeals concluded that gain on a deemed asset sale under IRC Sec. 338(h)(10) is nonbusiness income because the transaction must be considered as a complete liquidation and cessation of the target corporation's business. In so ruling, the court recognized the distinctive nature of corporate liquidations. On January 26, 2005, the Illinois Supreme Court declined to hear the appeal filed by the Illinois Department of Revenue.

American States Insurance Company ("ASI") reported the gain from the deemed asset sale under IRC § 338(h)(10) as nonbusiness income on its Illinois return. The department reclassified the gain as business income and assessed tax. In arguing that the gain at issue is business income, the department offered that *Blessing/White, Inc., v. State of Illinois Department of Revenue,* 768 N.E. 2d. 332 (Ill. App., 2002), which tacitly recognized the distinctive nature of corporate liquidations, was wrongly decided. The court disagreed. The court explained that the Illinois Supreme Court's decision in *Texaco-Cities Service Pipeline Co. v. McGaw,* supports the inference in *Blessing/White* that, when determining whether a transaction generates business or nonbusiness income, corporate liquidations are distinct and, in certain circumstances, yield nonbusiness income.

The court rejected the department's alternative argument that, even if *Blessing/White* was properly decided, the gain at issue is business income because a deemed liquidation under Sec. 338(h)(10) does not result in the discontinuation of business activity and the property disposed of in the deemed liquidation was essential to ASI's business operations. The court pointed out, however, that the department acknowledged that it recognizes the Sec. 338(h)(10) "fiction." Thus, as the department treats ASI as two corporations in a Sec. 338(h)(10) transaction--a liquidating corporation and a new corporation--it cannot claim that ASI continued its business, the court explained. The department must treat the transaction as a complete liquidation and cessation of business by the old ASI.

Four years later, in *Nicor Corp. v. Illinois Dep't of Revenue*, Ill. Ct. App., 1st Dst., Nos. 1-07-1359 & 1-07-1591 (12/5/08), the Illinois Appellate Court, First District, agreed with *American States* and held that the parent company of a group of affiliates properly characterized income from the sale of a subsidiary as nonbusiness income because the sale was conducted under a valid IRC Sec. 338(h)(10) election. **Note.** The court noted, however, that effective July 30, 2004, the state significantly amended, prospectively, the definition of business income, as it applied in this case. As a result, the functional test that was applied in this case no longer exists.

Missouri

Gain on a deemed asset sale under IRC Sec. 338(h)(10) is nonbusiness income, the Missouri Supreme Court held in *ABB C-E Nuclear Power, Inc. v. Director of Revenue,* No. SC87811 (Mo. 1/30/07), upholding a ruling by the Missouri Administrative Hearing Commission. The court agreed with the commission's finding that a sale of assets in complete liquidation is not a type of business transaction in which the taxpayer regularly engaged, and therefore gain from the sale is not business income under the transactional test. Further, the court agreed that such income is not business income under the functional test because the liquidation and cessation of the business is an extraordinary, one-time event, and not an integral part of the taxpayer's regular trade or business operations.

New Jersey

The Tax Court of New Jersey reached a similar conclusion to those discussed above in *McKesson Water Products Company v. Director, Division of Taxation,* N.J. Tax Court, No. 000156-2004 (8/13/07). However, rather than utilize the term "nonbusiness income", the court followed *Allied-Signal* when deciding that a deemed asset sale and liquidation under IRC Sec. 338(h)(10) yields nonoperational (nonbusiness) income, which must be allocated to the state where an out-of-state taxpayer principally conducts its business, and cannot be taxed by New Jersey.

In the context of Sec. 338(h)(10) elections, the court found other state court decisions persuasive in determining whether such gains generate operational or nonoperational income. Thus, the deemed sale of assets and liquidation of Water Products did not constitute the acquisition, management, and disposition of property as an integral part of the taxpayer's regular trade or business operations. The result of the transaction was a cessation of Water Products' business with a complete liquidation and distribution to McKesson of the proceeds of the asset sale. The gain was neither operational income nor investment income serving an operational function because no operational function of Water Products continued after the transaction, and McKesson did not invest the proceeds in a business similar to that conducted by Water Products. The income, therefore, is not allocable to New Jersey and must be assigned to the state where Water Products' principal place of business is located--California, the court explained. The court also concluded that as New Jersey explicitly recognizes Sec. 338(h)(10) elections, the Director must accept all the consequences of the election.

Oregon

In *CenturyTel, Inc. v. Department of Revenue,* Oregon Tax Court, No. 4826, 8/9/10, the Oregon

Tax Court concluded that the gain on the sale of stock treated as an asset sale pursuant to IRC Sec. 338(h)(10) was deemed to generate business income to the seller. In so ruling, the court said that even if there was a liquidation exception under the functional test for determining business income, such exception would not apply in the present situation where the seller used the proceeds to further its business operations.

The taxpayer, CenturyTel Inc., is the parent of a group of wireline and wireless telecommunications companies and is domiciled outside of Oregon. During the years at issue, the taxpayer and its subsidiaries filed consolidated Oregon returns and operated as a unitary business. Subsequently, the taxpayer sold all of the stock of its wireless subsidiary to an unrelated purchaser and elected, along with the purchaser, to treat transaction as the sale of assets under IRC Sec. 338(h)(10). The taxpayer used the proceeds of the sale to finance the purchase of additional wireline operations and to repay debt. On its Oregon tax returns for the year of the sale, the taxpayer treated the gain as nonbusiness income, with none of the gain allocated to Oregon. The Department of Revenue determined the gain was apportionable business income, ultimately resulting in the issue being litigated before the Oregon Tax Court.

The court noted that the assets deemed sold in this case were employed in a unitary business operating in Oregon. As to the underlying issue--how the gain is characterized--the court was guided by its decision in *Crystal Communications v Oregon Department of Revenue*, Oregon Tax Court, No. 4679, 7/19/10, where the court held that the gain on the disposition of an asset is business income under the functional test, even when the disposition occurred at the conclusion of a taxpayer's business operations.

The court noted that the asset disposition in *Crystal Communications* was followed by a cessation of business and a complete liquidation. However, in this instance, the taxpayer continued its business operations and used the proceeds to expand its wireline operations. The court noted that it did not recognize a liquidation exception in the *Crystal Communications* case and, even if it did, such an exception would not apply here, where the taxpayer redirected the proceeds into certain aspects of its communications business. Accordingly, the court agreed with the department's business income determination.

Pennsylvania

On July 20, 2004, the Pennsylvania Supreme Court affirmed the Commonwealth Court’s decision that gain generated from the deemed sale of assets pursuant to an IRC Sec. 338(h)(10) transaction is nonbusiness income in *Canteen Corp. v. Commonwealth of Pennsylvania,* Pa., No. 57 MAP 2003, 7/20/04; aff’g Pa. Commw. Ct., No. 856 F.R. 1997, 03/06/03. The Commonwealth Court recognized that both the deemed sale and the deemed liquidation were fictions, but found that the state could not on the one hand recognize Sec. 338(h)(10) in finding the target had a gain from the deemed sale of assets, but on the other hand, refuse to recognize the deemed liquidation. According to the court, either both transactions are fictions that must be ignored, or both must be recognized.

Other Interesting Developments

California

In *Robert Half International, Inc. v. Franchise Tax Bd.,* 78 Cal. Rptr.2d 453 (Cal. Ct. App. Sept. 21, 1998), the California Court of Appeals ruled that a company's repurchase of a warrant was an extraordinary event constituting nonbusiness income.

Pursuant to terms of a merger, Boothe Financial Corporation (Boothe), assumed the obligation to issue its own shares under a warrant held by a third party. Subsequently, Boothe paid the warrant holder $7.5 million to repurchase and cancel the warrant. Boothe deducted the entire $7.5 million payment as a nonbusiness loss on its California return. Upon audit, the FTB determined the payment was a business loss apportionable among the various states in which Boothe did business.

The court stated the issue in this matter was simply whether the loss Boothe incurred when it repurchased the warrant arose from tangible or intangible property, the acquisition, management, and disposition of which constituted an integral part of its regular trade or business operations. The court stated the answer was clearly no, because Boothe's acquisition of the warrant was not an integral part of its regular trade or business. The court noted Boothe was not in the business of acquiring warrants and that the loss Boothe incurred to negate the possibility of the warrant being exercised was an extraordinary event. As a result, the court remanded the case for proceedings consistent with its opinion.

In *Appeal of Fox,* Cal, State Bd. of Equal., No. 171248, 07/08/04, the SBE explained that, in determining whether capital gain from the disposition of a partnership interest qualifies as business income, the functional test focuses on the business operations of the corporation disposing of the partnership asset, not the business operations of the partnership itself.

Fox contended that capital gain from the sale of the partnership interest was apportionable business income because the partnership interest produced business income for Fox's separate and distinct magazine business (the partnership). The SBE rejected Fox's analysis that the focus of the business/nonbusiness determination is on whether the disposition of the partnership interest was integrally related to the *partnership* itself. The proper focus is the relationship between the partnership interest and Fox. In *Hoechst Celanese Corp. v. Franchise Tax Board* (2001) 25 Cal. 4th 508, the case relied upon by Fox, the income producing property was an integral part of the *taxpayer's* regular business, not an integral part of a separate business. Accordingly, the SBE concluded that Fox failed to prove that the FTB's recharacterization of the gain as nonbusiness income was erroneous. As Fox's commercial domicile was deemed to be in California; the nonbusiness income must be allocated to California.

In *Appeal of Pacific Bell Telephone Company and Affiliates*, Cal. State Bd. of Equal. No. 521312, 9/20/11, a recent unpublished decision, the SBE held that taxpayers properly treated income from their minority investments in foreign telecommunications companies as nonbusiness income. Appellant invested in newly privatized foreign phone systems and wireless start-up companies based on the investment's growth potential. Appellant also provided a limited number of expatriate employees to its investments and sat on the board of directors of some of its investments.

The SBE held that income from those foreign investments constituted nonbusiness income and was not subject to tax in California because the activities underlying the foreign investments did not form an integral part of appellant's domestic telecommunications business. Ultimately, the mere potential for integration was insufficient to find business income under the functional test under *Appeal of Occidental Petroleum Corp.* (1983) 83-SBE-118. The SBE reaffirmed the holding in *Hoechst Celanese v. Franchise Tax Board* (2001) 25 Cal.4th 508 that the income producing property (the foreign investments in this case) must be so interwoven into the fabric of the taxpayer's business operations that it becomes "indivisible" or inseparable from the taxpayer's business activities with both "giving value" to each other.

On August 29, 2012, the FTB issued FTB Legal Ruling 2012-1, which discusses the FTB's position on when stock sale proceeds constitute business or nonbusiness income. Specifically, the ruling discusses the treatment of a sale of stock where the Taxpayer corporation purchases the stock of another corporation with which it has pre-existing operational ties with the unfulfilled intent to integrate the acquired corporation into the Taxpayer's unitary business. The FTB then provided three specific fact patterns that are intended to provide guidance as to the types of situations where the mere potential for integration as opposed to actual integration, would lead to the generation of business or nonbusiness income.

In (*ComCon Production Services I, Inc. v. California Franchise Tax Bd.*, the California Court of Appeals determined that the receipt of a merger termination fee constituted business income because it met the transactional test. The FTB argued that the termination fee at issue constituted business income under the transactional test because it arose from an acquisition agreement, which was a type of transaction and activity that was of the same basic nature as scores of other agreements the taxpayer regularly entered into in the course of its business; and the taxpayer used the proceeds to pay down its business obligations. Additionally, the FTB asserted that the termination fee constituted business income under the functional test because the merger agreement represented intangible property rights that the taxpayer acquired, managed, and disposed of as an integral part of its regular business. The FTB also argued that the $1.5 billion fee represented lost profits that the taxpayer would have earned had the merger been completed. Because the fee for lost profits replaced profits the taxpayer would have earned in the regular course of its business, those profits constituted business income. *(ComCon Production Services I, Inc. v. California Franchise Tax Bd.*, California Court of Appeals, Second District, Case No. B259619, 12/14/2016)

The court held that the termination fee met the transactional test of business income, as Comcast frequently acquired media companies. In response, Comcast argued that the activity of entering into acquisition agreements did not produce income for the business, but rather, "income was only generated by integrating and then operating the acquired cable properties, activities that occurred well after any agreement was signed and performed." The court rejected Comcast's argument, stating that "the relevant question is not whether the corporation earns income similar to that at issue in the regular course of its trade or business, but whether the activities that produced the income occurred in the regular course of its business."

In *Appeal of ConAgra Foods, Inc.*, California State Board of Equalization, Case Nos. 597512, 785058, and 799162, 06/26/2015 (not to be cited as precedent), the Board's Summary Decision concluded that gain on the sale of publicly traded stock received in exchange for the taxpayer's chicken processing business was nonbusiness income. The SBE explained that the stock received in the earlier transaction was not an integral part of the taxpayer's regular trade or business operations at the time of the subsequent sale.

THE APPORTIONMENT FORMULA IN GENERAL

Under the model UDITPA formula, states use an equally weighted three-factor formula of property, payroll and sales to apportion business income. "Property" generally includes all real and tangible personal property owned (valued at original cost) or rented (valued at eight times the net annual rental rate) by the taxpayer. In general, "payroll" includes all forms of compensation paid to employees. "Sales" generally includes all gross receipts of the taxpayer from the sale of tangible and intangible property. The property and payroll factors were intended to emphasize the activity of the manufacturing state, while the sales factor was intended to recognize the contribution of the consumer state toward the production of the income of the business. (Pierce, "The Uniform Division of Income for State Tax Purposes," Taxes, Oct. 1957)

The amount of business income attributable to a state is determined through the use of the formula that calculates the percentage of the taxpayer's property, payroll and sales that are attributable to a state and then averages these three percentages to reach the state apportionment factor. The total business income of the taxpayer is then multiplied by the apportionment factor to determine the amount of business income apportioned to the state. Accordingly:

$$\frac{\frac{\text{In-State Prop.}}{\text{Total Property}} + \frac{\text{In-State Payroll}}{\text{Total Payroll}} + \frac{\text{In-State Sales}}{\text{Total Sales}}}{3} = \text{State Factor}$$

For example, assume a corporation doing business within and without the state has the following factors:

	In-State	Everywhere	State Portion
Property	$ 300,000	$ 3,000,000	10 percent
Payroll	100,000	400,000	25 percent
Sales	1,000,000	2,000,000	50 percent

The average of the property, payroll and sales attributable to the state is 28.33 percent ((10 + 25 + 50) / 3). Thus, if the corporation's total business income is $500,000, the business income apportionable to the state is $141,667 (500,000 x 28.33 percent).

Some states have adopted a modified three-factor formula that consists of 50 percent of the receipts factor, 25 percent of the property factor and 25 percent of the payroll factor, and certain other states have adopted a one or two-factor formula instead of the conventional three-factor formula. Some states, such as Alabama, require the elimination of a factor if its everywhere amount (i.e., the denominator) is zero.

To provide a general guideline as to the elements usually considered in determining the three factors of a typical apportionment formula, we will focus on the more important sections of the MTC rules and regulations since a large number of states are MTC members (either full or associate) and a significant number have adopted these rules and regulations. This review will also be supplemented by comments regarding apportionment factors that may not be accepted under the MTC but are recognized by other states.

Note: In order to create incentives for businesses to locate within a particular state, and perhaps in recognition of the importance of the market state in the production of income, many states have increased the weight of the sales factor, and some have shifted to a single sales factor formula. In 2010, only 16 states had a generally applicable equally weighted three factor formula. Of the remaining states that impose a corporate income tax about half have a double weighted sales factor formula and the rest have a triple or greater weighted or single sales factor formula. Further, many states impose industry-specific formulas or allow taxpayers to elect an optional formula.

Effective for taxable years beginning on or after January 1, 2011, and before January 1, 2013, California provides that any apportioning trade or business, other than an apportioning trade or business described in CRTC section 25128(b) (i.e., businesses that derive more than 50% of their gross receipts from agriculture, extractive business, savings and loans, or bank and financial activities), may make an annual irrevocable election on an original timely filed return to use a single sales factor for apportionment. This legislation was adopted under CRTC Sec. 25128. The FTB has provided additional guidance regarding the mechanics of the election in California Code of Regulations ("CCR") section 25128.5 and the sourcing of receipts other than tangible personal property in CCR section 25136-2 (as described below).

Effective for taxable years beginning on or after January 1, 2013, California eliminated the apportionment election for any apportioning trade or business, other than an apportioning trade or business described in CRTC section 25128(b) (i.e. businesses that derive more than 50% of their gross receipts from agriculture, extractive business, savings and loans, or bank and financial activities) is required to use a single sales factor for apportionment. (CRTC § 25128.7.) Qualified businesses, as described under CRTC section 25128(b), will continue to use an equally weighted three-factor formula. Proposition 39 also created CRTC section 25136.1, which provides a special carve-out rule pertaining to cable companies. Under this special carve-out rule, 50% of the company's qualified sales assigned to California will be equal to 50% of the amount of qualified sales that would be assigned to California pursuant to the sourcing rules under CRTC section 25136 but for the application of this section. The remaining 50% will not be assigned to California. (CRTC section 25136.1.)

PROPERTY FACTOR

Denominator

The denominator includes the average value of all real and tangible personal property owned or rented and used during the tax period in the regular course of the trade or business.

Inclusions in Property Factor

- Land;
- Buildings;
- Leasehold improvements;
- Machinery;
- Inventory;
- Equipment.

Exclusions from Property Factor

- Cash;
- Property or equipment under construction during the tax period except inventoriable goods in process (when this property is actually put into use in the regular course of the trade or business it is included in the factor);
- Property used in connection with the production of nonbusiness income.

Property is included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business. Property held as reserves or standby facilities or property held as a reserve source of materials is included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property used in the regular course of the trade or business remains in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally five years) during which the property is held for sale.

Example 1: Taxpayer closed its manufacturing plant in State X and held the plant for sale. The plant remained vacant until its sale one year later. The manufacturing plant is included in the property factor until the plant is sold.

Example 2: Same as above except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

Example 3: Taxpayer closed its manufacturing plant and leased the building under a five-year lease. The plant is included in the property factor until the commencement of the lease.

Numerator

The numerator includes the average value of the real and tangible personal property owned or rented by the taxpayer that is used in this state during the tax period. The term “this state” refers to whatever state happens to be under review. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller that is included by a taxpayer in its property factor denominator (in accordance with its regular accounting practices) must be included in the numerator according to the state of destination.

Valuation of Owned Property

Property owned by the taxpayer shall be valued at its original cost--that is cost before any allowance for depreciation. As a general rule “original cost” is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc.

Example: The taxpayer acquired a factory building at a cost of $500,000 and 18 months later expended $100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar year basis. Depreciation of $22,000 was claimed on the building in its return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is $600,000.

If the original cost of property is unascertainable, it is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

Inventory of goods is included in the factor in accordance with the valuation method used for federal income tax purposes. Thus, if the last in, first out (LIFO) valuation method is used for federal purposes, the same LIFO inventory values must also be used in the property factor for state purposes.

Valuation of Rented Property

Rental property is valued at eight times its net annual rental rate. The net annual rental rate is the annual rental paid less the aggregate annual subrentals paid by subtenants of the taxpayer.

Subrents are not deducted when they constitute business income because the property that produces the subrents is used in the taxpayer’s regular course of a trade or business.

Example: The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income, they are not deducted from rent paid by the taxpayer for the food market.

"Annual rental rate" is the amount paid as rental for property for a 12 month period (that is, the amount of the annual rent). Where property is rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period.

"Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, for the use of the property and includes:

- Any amount payable for the use of real or tangible personal property, or any part thereof, whether paid as a fixed sum of money or as a percentage of sales, profits or otherwise.

  Example: Under a lease agreement the taxpayer-lessee pays $1,000 per month as a base rental and at the end of the year pays the lessor one percent of its gross sales of $400,000. The annual rent is $16,000 ($12,000 plus one percent of $400,000 or $4,000).

- Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items that are required to be paid by the terms of the lease or other arrangement (not including amounts paid as service charges, such as utilities, janitor services, etc.).

  Example: The taxpayer pays the lessor $12,000 a year rent plus taxes of $2,000 and mortgage interest of $1,000. The annual rent is $15,000.

Leasehold improvements are treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements is included in the factor.

Averaging Property Values

As a general rule, the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and end of the tax period. However, the tax administrator may require or allow averaging by monthly values if such method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period.

Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or where property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

Example: The monthly value of the taxpayer's property was as follows:

January	$ 2,000
February	2,000
March	3,000
April	3,500
May	4,500
June	10,000
July	15,000
August	17,000
September	23,000
October	25,000
November	13,000
December	2,000
Total	$120,000

The average value of the taxpayer's property includable in the property factor for the year is:

$120,000/12 = $10,000

If a beginning and end of year average were used, the average value of the taxpayer's property includable in the property factor would have been $2,000, computed as follows:

$$\frac{\$2,000 + \$2,000}{2} = \$2,000$$

In this particular situation, it may be assumed that the tax administrator would require averaging by monthly values since this method more clearly reflects the average value of the taxpayer's property for the tax period.

Non-MTC Property Factors

The following examples of property factor practices differ from the MTC regulations and are used in some states:

- Net book value or Federal adjusted basis of property owned is used.
- Rents are not included in the factor or only real estate rentals are included.
- Construction in progress is included in the factor.
- Leasehold improvements are excluded from the property owned factor and their annual amortization is included in the rent factor.
- Certain inventory in transit is excluded from the factor.

State Developments Addressing the Property Factor

<u>Arizona</u>

In corporate tax ruling 01-02, issued on May 1, 2001, the Arizona Department of Revenue explained the inclusion of computer software in a corporation's property factor. The department noted that under Ariz. Rev. Stat. Sec. 43-1140, the property factor includes real and tangible personal property used in the taxpayer's business. Computer software that is treated as tangible personal property and capitalized for federal tax purposes is accorded the same treatment for Arizona tax purposes because the state conforms to the IRC in determining the value and nature of business assets, the department noted. Under ordinary circumstances, the department explained the Arizona property factor includes only software treated as tangible personal property on the federal income tax return. The value of the software is attributed to the numerators of the states in which the software is used on a reasonable basis.

California

Government Owned Property Used by Taxpayer

In *Appeal of The Proctor & Gamble Manufacturing Company, et al*., 89-SBE-028 (Cal. St. Bd. of Equal. Sept. 26, 1989), the issue was whether the taxpayer properly included in the property factor government-owned property that was used by the taxpayer in its unitary business and, if so, the amount to be included. The taxpayer through P & G Canada, a wholly owned unitary subsidiary, had executed a Forest Management Agreement with the Providence of Alberta, Canada, under which P & G Canada was granted rights to harvest timber from, and to have other extensive rights to use, 3.5 million acres of timberland to which Alberta retained title. In exchange for the rights granted, P & G Canada was obligated to cut trees on the land in approximately equal numbers each year for processing in an adjacent wood pulp manufacturing facility owned by P & G Canada. The trees that were harvested each year apparently represented, on average, production from 47,200 acres. P & G Canada also had additional obligations under the agreement, such as constructing all primary roads and bridges on the timberland, paying annually a "holding charge" of $3.00 per square mile and a "forest protection charge" of $12.80 per square mile, and maintaining public access to several recreation areas. The taxpayer in its combined report included $399 million in the denominator of the property factor, which purportedly represented the fair market value of the entire timberland in 1974, the year that the taxpayer stated the land was placed in productive use. The FTB disallowed that inclusion.

Citing its decision in *Appeal of Union Carbide*, Cal. St. Bd. of Equal., April 5, 1984, (*Union Carbide I*) the SBE concluded that under Regulation 25137, subdivision (b), an "appropriate amount" associated with the timberland must be included in the denominator of the property factor where, as here, the property owned by Alberta was used by the taxpayer at no charge (or at a nominal rate). However, the SBE found the taxpayer erred in that it must use the reasonable market rental value of the property rather than its fair market value. Finally, the SBE concluded that since the agreement did not preclude any part of the timberland from being "available for or capable of being used during the income year" (Reg. 25129), the entire area of the timberland, and not merely the 47,200 acre segment proposed by FTB, should be included in determining reasonable market rental rate. The SBE noted that FTB's proposed "reasonable market rental value" of $15.80 per square mile, computed by adding the annual "holding charge" and "forest protection charge," was no more than a "nominal rate" of rent and, thus, unacceptable under Regulation 25137, subdivision (b).

In *Appeal of Union Carbide Corporation*, 93-SBE-003 (Cal. St. Bd. of Equal. Jan. 13, 1993), the SBE rejected an attempt of the FTB “to relitigate the issue” decided in *Union Carbide I*. The FTB contended the government owned property should not be included in the taxpayer’s property factor because the taxpayer did not have a possessory interest in that property. The SBE rejected this argument and applied the holding in *Union Carbide I* to subsequent tax years.

In *Matter of Weyerhaeuser Co. and Subsidiaries,* No. 103555 (Cal. St. Bd. of Equal. Jan. 26, 2005), the SBE concluded that the taxpayer failed to attribute a reasonable value to land leased from Canadian provincial governments for purposes of including such land in its property factor denominator. For property factor purposes, property rented by the taxpayer is valued at eight times the net annual rental rate, and annual rent includes consideration paid for the use of the property whether it is a fixed sum or a percentage of sales or profits. However, annual rent does *not* include "royalties based on extraction of natural resources." Under regulation 25137,"[i]f property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property." The FTB has concluded that when a private business extensively uses government-owned property while paying no or nominal rent, regulation 25137 requires the use of a reasonable market rental rate. The taxpayer argued that it paid no rent to the provincial government, thus, the regulation requires the use of a reasonable market rental rate to represent Canadian government-owned timberland in the denominator of appellant's property factor. The taxpayer further contended that, pursuant to *Proctor & Gamble*, all of the timberland subject to the licenses should be used in determining the rental rate, not merely the land harvested in a given year. However, in rejecting the taxpayer's estimated rental value, the SBE concluded the "sheer enormity of the taxpayer's rental rates calls into question their reasonableness; even appellant concedes that the rental rates exceed the business income of its entire unitary business during two of the years at issue."

Margin Loans Applied for in State Included in Property Factor Numerator

A discount brokerage service must include margin loans in its California property factor numerator, where customers applied for the loans at local offices, the SBE ruled in *Appeal of Quick & Reilly, Inc.,* Cal. State Bd. of Equal., No. 202953, 3/9/04. The SBE did not accept the taxpayer’s argument that because all approval, billing, and monitoring of the margin accounts took place in its New York office, the inclusion of the margin loans in the California property factor numerator did not fairly represent the extent of its business activities in California.

A financial corporation must include certain intangible property in its property factor pursuant to Cal. Code Regs. tit. 18, Sec. 25137-4.1(c)(1), the SBE noted. Under the regulation, assets "in the nature of loans... shall be attributed to this state if the office of the bank or financial corporation at which the customer applied for the loan is located in this state except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located." The SBE noted that the appellant agreed that there is no "banking regulatory authority" or other regulatory authority that requires it to recognize margin loans to California customers as being made from or as assets of its New York office. "Because there is no ‘banking regulatory authority’ requiring appellant to recognize margin loans that were applied for at California offices as made from or as assets of appellant's New York office, regulation 25137-4.1 required appellant to include those margin loans in the numerator of its property factor," the SBE concluded.

Indiana

Leased Property Included in Property Factor

A taxpayer that leased gas stations back to an affiliated oil company through an intermediary trust was required to include the gas stations located in Indiana in its Indiana property factor numerator for adjusted gross income tax apportionment purposes, the Indiana Department of Revenue ruled in LOF 02-0312, 27 Ind. Reg. 1066, 12/1/03.

The Department rejected the taxpayer's assertion that the value of leased gas stations located in the state should not be included in the Indiana property factor numerator for adjusted gross income tax apportionment purposes because it did not "use" the gas stations. Under Ind. Code Sec. 6-3-2-2(c), the numerator of the property factor is the average value of the taxpayer's real and tangible personal property "owned and rented and used" in the state during the taxable year. "Clearly, taxpayer received income attributable to the Indiana gas stations locations," the Department stated. Without further addressing the taxpayer's assertion that it did not "use" the gas stations in the state, the Department found the auditor's decision to include the value of the Indiana gas stations in the property factor "entirely appropriate in order to 'fairly represent the taxpayer's income derived from sources within the state of Indiana...'" under the Department's discretionary authority under Ind. Code Sec. 6-3-2-2(l).

Massachusetts

Property factor for financial institutions

In *First Marblehead Corp. v. Comm'r of Revenue,* Mass., No. SJC-11609, 8/12/16, the taxpayer challenged the state's method of sourcing its income from securitized loans for purposes of its property apportionment factor.

In this case, a non-operating financial institution holding company held interests in trusts that in turn directly or indirectly securitized loans. The holding company had no other material assets, no payroll or tangible assets, and did not own or lease office space; however, it was subject to tax in Massachusetts because its commercial domicile was in the state.

The taxpayer argued that because it had no regular place of business or any offices that would constitute property, the property factor should have been sourced to the location of the loan servicers' offices -- which were all out of state, rendering the holding company's property factor zero.

The Massachusetts Supreme Judicial Court, however, agreed with the state and determined that the loan servicers' offices were not the taxpayer's regular place of business, and that because the taxpayer had no regular place of business, the loans should be sourced to the taxpayer's commercial domicile. That meant the company's Massachusetts property factor should be 100 percent, according to the court.

The US Supreme Court accepted review of an apportionment formula challenge under the internal consistency test. The Court vacated in the decision light of the Court's decision in *Comptroller of Maryland v. Wynne.* On August 12, 2016, upon remand, the Supreme Judicial Court of Massachusetts held that the state's financial institution excise tax satisfies the internal consistency test as provided by the US Supreme Court in *Wynne*.

First Marblehead filed a Petition for Writ of Certiorari with the US Supreme Court in December 2016, which was denied February 21, 2017

New Mexico

In a recent decision, the New Mexico Taxation and Revenue Department found that oil and gas royalty payments made by a taxpayer under the terms of several leases were "rents" for purposes of calculating the New Mexico corporate income property factor. *In the Matter of Protest of Chevron USA, Inc.*, New Mexico Taxation and Revenue Department, No. 10-20, December 15, 2010.

In deciding for the taxpayer, the Department found that New Mexico had not adopted the MTC regulation that excludes royalties for the extraction of natural resources from the definition of annual rent. Instead, the Department determined that royalties fall within the definition of "annual rent" contained in New Mexico regulations. Thus, oil and gas royalty payments made under the terms of leases were rent for purposes of calculating the New Mexico property factor.

New York

In *Meredith Corp.*, No. 512597, November 21, 2012, the New York Supreme Court held that Meredith's videotape and satellite programming were includable in its property factor because: (1) the Division had a longstanding policy that programming on videotape was considered tangible personal property; and (2) there was no rational distinction for taxation purposes between programming sent by videotape and programming sent by satellite. The court stated that the Division's position "was effectively the result of retroactively applying a new interpretation of the statute."

Massachusetts

In *Commissioner of Revenue v. New England Power Co.,* 411 Mass. 418, 582 N.E.2d. 543 (Mass. Dec. 16, 1991), the Massachusetts Supreme Judicial Court found that property in the construction-in-process account was includable in the property factor. The Massachusetts Department of Revenue excluded it based on statutory language requiring inclusion of property owned or rented and used during the taxable year. (Emphasis added.) At issue was the proper construction of the word "used." Because Massachusetts has not adopted the MTC regulations in which use is tied to the production of income, the Tax Board construed the word "used" broadly and held that since the taxpayer had derived some benefit from the property, it was properly includable in the factor.

<u>Oregon</u>

DOR Improperly Adjusted Return When Included Intangibles in Property Factor

The Oregon Department of Revenue improperly adjusted a financial organization's return by including intangible property in its property factor, the Oregon Tax Court held in *U.S. Bancorp and Subsidiaries v. Department of Revenue*, No. TC 4531 (Or. Tax Ct. 3/13/07), finding that the organization properly filed its return in accordance with an existing rule, applicable only to financial institutions, that only included real and tangible personal property in the property factor. The regulation relied upon by the department to adjust the financial organization's income did not apply because the regulation did not give the department the authority to require an alternate method on a case-by-case basis, especially where the department's own regulations provide a detailed method, which the taxpayer followed. Further, even if the regulation applied to the financial organization and allowed the department to make case-by-case adjustments, the department did not show that the organization's original return failed to fairly and accurately reflect Oregon taxable income.

THE PAYROLL FACTOR

In General

The payroll factor in the apportionment formula includes the total compensation paid by the taxpayer in the regular course of its trade or business during the tax period.

The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, at the taxpayer's election, compensation paid to employees may be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under such method for unemployment compensation purposes.

Compensation paid to employees for activities connected with the production of nonbusiness income is excluded from the payroll factor.

Example A: The taxpayer uses some of its employees in the construction of a storage building that, upon completion, is used in the regular course of the taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer and are included in the payroll factor.

Example B: The taxpayer owns various securities that it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor if the investment portfolio generates nonbusiness income.

The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor. Direct payments include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services provided that such amounts constitute income to the recipient under the federal IRC.

The term "employee" means (a) any officer of a corporation, or (b) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if he is included by the taxpayer as an employee for payroll taxes imposed by the Federal Insurance Contributions Act. However, people who would not be employees under the usual common-law rules need not be included in the formula although they are employees for purposes of the Federal Insurance Contributions Act.

Denominator

The denominator is the total compensation paid everywhere during the tax period. Thus, compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation (for example, by Public Law 86-272) is included in the denominator of the payroll factor.

Example: A taxpayer has employees in its state of legal domicile (State A) and is taxable in State B. In addition, the taxpayer has other employees whose services are performed entirely in State C where the taxpayer is immune from taxation by Public Law 86-272. As to these latter employees, their compensation will be assigned to State C where their services are performed, (that is, included in the denominator - but not the numerator of the payroll factor) even though the taxpayer is not taxable in State C.

Numerator

The numerator is the total compensation paid in this state during the tax period.

Compensation Paid in this State

Compensation is paid in this state if any one of the following tests, applied consecutively, is met:

- The employee's service is performed entirely within the state.
- The employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The word "incidental" means any service that is temporary or transitory in nature, or that is rendered in connection with an isolated transaction.
- If the employee's services are performed both within and without this state, the employee's compensation will be attributed to this state:

    - ➢ if the employee's base of operations is in this state; or
    - ➢ if there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or
    - ➢ if the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the employee's residence is in this state.

The term "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons, to replenish stock or other materials, to repair equipment, or to perform any other functions necessary to the exercise of his trade or profession.

The above tests are derived from the Model Unemployment Compensation Act that has been adopted by all of the states for unemployment compensation purposes.

Some states (e.g., New York) that have not adopted the MTC regulations require compensation of general executive officers to be excluded from the payroll factor.

In practice, most state auditors refer to federal Form 940 (Employer's Annual Federal Unemployment Tax Return) in checking the denominator of the payroll factor and to the state unemployment form in checking the numerator of the payroll factor.

Important State Decisions Addressing the Payroll Factor

<u>California</u>

In *Appeal of Photo-Marker Corporation of California*, Cal. St. Bd. of Equal., Nov. 19, 1986, the issue was whether compensation was paid in California. The two individuals in issue were officers and/or directors of the New York parent corporation of the taxpayer, a California corporation. The taxpayer argued the individuals' executive duties in New York were more important and permanent than their jobs in California, and that the base of operations for the individuals was New York at the parent's corporate headquarters. The SBE disagreed, and cited to Section and Regulation 25133 which provide that if the employee's services are performed both within and without California, the compensation will be attributed to California if the employee's "base of operations" is in California. The SBE found the evidence demonstrated the base of operations was in California, based upon the long-term presence of the individuals in California and their business related duties in California.

Ohio

In *O.H. Materials, Co. v. Limbach*, No. 5-89-2 (Ohio Ct. App. Nov. 26, 1990), the Ohio Court of Appeals held that the employees of an Ohio corporation, some of which performed services within and without the State and some of which performed services totally without the State, were includable in the Ohio numerator of the payroll factor. Ohio has not adopted the MTC regulations but has adopted language identical to UDITPA in defining the payroll factor. The court found that since the taxpayer was headquartered in the State, the base of operations for these employees was in the State. The court relied on this aspect of the law to attribute all the wages of the employees to Ohio.

Pennsylvania

Intercompany Payroll Costs Excluded from Apportionment Factor

In *UPS Worldwide Forwarding, Inc. v. Commonwealth,* Pa. Commw. Ct., 62 F.R. 2001, 3/1/04, the Commonwealth Court ruled that a company with no employees could not include a payroll factor in its income apportionment formula, despite reimbursement to an affiliate for employee services rendered. The court found that under Pennsylvania law, "compensation" is defined as wages, salaries, commissions and any other form of remuneration paid to "employees," and the taxpayer stipulated that it did not have any statutory employees for the years at issue. "Because Taxpayer did not have any employees, we agree with the Commonwealth that, although Taxpayer had an expense charged to it, it could not have paid any compensation as that term is defined in the Tax Reform Code and thus had no payroll expenses." The taxpayer's appeal was denied on December 8, 2004.

THE SALES FACTOR

In General

With regard to the composition of the sales factor, the first question that arises is, "what is a sale?" Despite the broad take on "sales" provided by UDITPA Sec. 1(g), it should be obvious that neither a state nor a taxpayer can assign gross receipts to a particular state unless and until it is determined that a sale or other transaction giving rise to receipts has occurred.

The MTC regulations define "sales" to mean all gross receipts not subject to direct allocation. Thus, for the purposes of the sales factor of the apportionment formula, "sales" means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business. Generally, that means only apportionable business receipts are included in the sales factor. Following are some rules:

- <u>Manufacturers, Wholesalers, Retailers, etc.</u> - "Sales" includes all gross receipts from the sales of goods or products (or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

- Gross receipts means gross sales, less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) are included in receipts if such taxes are passed on to the buyer or are included as part of the selling price of the product.

- <u>Cost plus fixed fee contracts</u> (such as the operation of a government-owned plant for a fee) - "Sales" includes the <u>entire</u> reimbursed cost, plus the fee.

- <u>Service companies</u> - (such as the operation of an advertising agency, the performance of equipment service contracts, research and development contracts) - "Sales" includes the gross receipts from the performance of such services including fees, commissions, and similar items.

- <u>Taxpayers engaged in renting real or tangible property</u> - "Sales" includes the gross receipts from renting, leasing, or licensing the use of the property.

- <u>Taxpayers engaged in the sale, assignment, or licensing of intangible personal property</u> (such as patents and copyrights) - "Sales" includes the gross receipts therefrom.

- <u>Equipment used in a business</u> - "Sales" includes receipts from the sale of such equipment. For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.

A uniform definition of "gross receipts" has been adopted by the MTC in Reg. IV.2(a)(5), 07/27/01. Under the new definition, gross receipts are the gross amounts realized on the sale or exchange of property, the performance of services, or the use of property or capital in a transaction that produces business income, in which the income or loss is recognized under the IRC. Amounts realized on the sale or exchange of property are not reduced by the costs of goods or the basis of property sold.

Gross receipts do not include:

- repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit;
- the principal amount received under a repurchase agreement or loan;
- proceeds from the issuance of the taxpayer's own stock or from a sale of treasury stock;
- damages and other litigation rewards; property acquired by an agent on behalf of another;
- tax refunds and recoveries;
- pension reversions;
- contributions to capital, except for sales of securities by a securities dealer;
- forgiveness of indebtedness income; or
- amounts realized from exchanges of inventory that are not recognized by the IRC

The definition's exclusion of a particular item is not determinative of its character as business or nonbusiness income.

Denominator

The denominator includes the total gross receipts derived by the taxpayer from transactions and activities in the regular course of its trade or business.

Numerator

The numerator includes gross receipts attributable to this state and derived by the taxpayer from transactions and activities in the regular course of its trade or business. Receipts from the incidental or occasional sale of a significant/fixed asset, such as a plant, may be excluded from the sales factor under the theory that inclusion could distort the overall apportionment of income in a given year by giving undue weight to a particular state. MTC Regs. IV.18.(c)(1). These receipts are excludible under the regulation, even though the asset was used in the taxpayer's regular trade or business.

All interest income, service charges, carrying charges, or time-price differential charges incidental to such gross receipts shall be included regardless of the place where the accounting records are maintained or the location of the contract or other evidence of indebtedness.

Sales of Tangible Personal Property

Gross receipts from sales of tangible personal property (except sales to the United States Government) are in this state:

- If the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

- If the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser (i.e., throw back rule).

Property is deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

Example: The taxpayer, with inventory in State A, sold $100,000 of its products to a purchaser having branch stores in several states including this state. The order for the purchase was placed by the purchaser's central purchasing department located in State B. $25,000 of the purchase order was shipped directly to the purchaser's branch store in this state. The branch store in this state is the purchaser within this state with respect to $25,000 of the taxpayer's sales.

Property is considered delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer's products shipped to the purchaser's warehouse in this state are property delivered or shipped to a purchaser within this state.

The term "purchaser within this state" includes the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to the purchaser's instructions. The sale by the taxpayer is in this state.

When property being shipped by a seller from the state of origin to a consignee in another state is diverted while en route to a purchaser in this state, the sales are in this state.

If the taxpayer is not taxable in the purchaser's state, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under P. L. 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to the state from which the merchandise was shipped.

If a taxpayer whose salesmen operate from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

- If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in such state.

- If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

Example: The taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the manufacturer in State B shipped the merchandise directly to the purchaser. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this state.

Sales of Tangible Personal Property to United States Government

Gross receipts from sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. For the purposes of this regulation, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government.

Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Income From Intangibles

The MTC has developed a special regulation to exclude certain income from intangibles from the sales factor:

> Where business income from intangible property cannot readily by attributed to any particular income producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and must be excluded from the denominator. For example, where business income in the form of *dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities* results from the mere holding of the intangible

personal property by the taxpayer, such dividends and interest is excluded from the denominator of the sale factor.12

MTC Regs. IV.18.(c)(3) (emphasis added). This regulation speaks to the exclusion of dividends and interest, but fails to mention the treatment of royalty income despite the specific reference to royalties received on patents or copyrights as an example of business income resulting from the "mere holding" of the intangible personal property of the taxpayer.

The net result of this rule – by analogy to the exclusion of gross receipts on sales of fixed assets – is that the intangible income is included in the apportionable tax base and assigned to jurisdictions for taxation under a formula that takes no account of the intangible property that generates the receipts.

There are a variety of approaches toward the inclusion of receipts from intangibles, which are distinct from UDITPA/MTC Regulations, in that some states tend to assign such receipts to the state of commercial domicile. Other examples include:

- Connecticut, which apportions all income, assigns gains from the sale or other disposition of intangible assets managed or controlled within the state to that state's sales factor numerator. *Cf.* Trans-Lux Corp. v. Meehan, No. 384914, Conn. Super. Ct. (Dec. 3, 1993).

- New Jersey, which likewise apportions all income, generally assigns receipts from intangibles to the sales factor numerator of the owner's domicile, unless the intangible has acquired a taxable situs in the state, in which case they are assigned to the taxable situs. N.J. Admin. Code § 18:7-8.12(e).

Net Receipts from Investments

In some states, receipts from the frequent sale of treasury investments are either excluded from the sales factor altogether, or included in the factor only to the extent of *net* gain. Although there are exceptions, state courts generally have come down on the side that such receipts must be excluded from the sales factor because their inclusion was distortive to the apportionment formula—in other words, dilute the sales factor so that a higher proportion of sales would be sourced to the state where the treasury activity occurs, generally the state where the taxpayer's accounting department is located.

- Arizona -- The Arizona sales factor does not include return of principal from short-term investments because such inclusion would create distortion, the Arizona Court of Appeals concluded in *Walgreen Arizona Drug Company v. Arizona Department of Revenue,* 209 Ariz. 71 (Ariz. Ct. App., 2004) Walgreen's argued that for sales factor purposes, "total sales" means gross receipts and includes all money coming in everywhere, including the return of investment principal. The department countered that Walgreen's claim ignores the "except as the context requires otherwise" provision. The department asserted that only the net gain from short-term investments should be treated as a sale and that inclusion of return of principal would result in distortion of the sales factor denominator. The court agreed with the department. The inclusion of unadjusted gross receipts from the investment and reinvestment of intangibles artificially distorts the sales factor, the court explained. In addition, the taxpayer's interpretation of "total sales" would create an unintended tax loophole for non-domiciliary businesses, the court stated. The court's ruling was enshrined by the department in corporate tax ruling 97-1, issued on April 3, 2007.

- California -- This issue has been litigated more frequently in California than in any other state. The issue revolves around CRTC section 25134, the sales factor statute, which provides that the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. As defined in CRTC section 25120, subdivision (e), "Sales" means "all gross receipts of the taxpayer" that are not allocated as items of nonbusiness income. Under CRTC section 25136, receipts from the sales of intangibles are assigned to the location where the income-producing activity is performed. CCR section 25136 provides that "income-producing activity" does not include transactions performed on behalf of a taxpayer, including such transactions conducted by an independent contractor. In addition, CCR 25137 provides that where income from intangibles cannot be attributed to any particular business activity of a taxpayer, the income cannot be assigned to any state's sales factor numerator, and therefore, must be excluded from the sales factor denominator. As explained by the California SBE in the *Appeal of Pacific Telephone & Telegraph,* 78-SBE-028, May 4, 1978, the SBE held that the exclusion of gross receipts from the sale of pooled interest bearing and discount securities was appropriate. SBE stated that including the enormous volume of investment receipts substantially overloaded the sales factor in favor of New York, and thereby inadequately reflected the contributions made by other states, including California. Taxpayers have routinely argued that receipts from treasury function activities are sales; and the FTB took the opposite stance. The SBE and the lower courts (below the California Supreme Court) have generally agreed with the FTB.

    The California Supreme Court finally addressed the matter in August 2006 in two decisions. In *Microsoft Corp. v. Franchise Tax Bd*. (2006) 39 Cal.4th 750, the court found that the redemption of marketable securities is economically similar to a "sale" of securities and that the gross proceeds from a redemption qualify as "receipts" for purposes of UDITPA sales factor apportionment formula. However, the court found that the FTB could adopt an alternative apportionment formula and exclude amounts related to the return of principal where the party challenging the standard formula shows by clear and convincing evidence using a quantitative and/or qualitative standard that the use of gross rather than net receipts distorted the level of a taxpayer's business activity in the state. In reaching its conclusion, the court employed a two-part test (cited one year later in *The Limited,* see below). The first test is whether the treasury functions are "qualitatively different" from the taxpayer's principal business; and the second test is whether the "quantitative distortion" of the sales factor caused by inclusion of the gross proceeds is substantial.

    The court in *General Motors Corp. v. Franchise Tax Bd*. (2006) 39 Cal.4th 773, found that transactions that involve repurchase agreements are economically similar to secured loans rather than sales. Accordingly, only the interest generated on such agreements qualified as receipts for purposes of the sales factor formula. California-headquartered taxpayers that generate significant receipts from transactions involving marketable securities (e.g., daily treasury activities, foreign currency transactions) may face potential tax exposures should the FTB assert that such taxpayers must include gross receipts from such transactions in the numerator and denominator of the receipts factor, absent a showing on the part of a taxpayer by clear and convincing evidence that the inclusion of gross receipts distorts the taxpayer's level of income in the state.

In FTB Notice 2004-5, the FTB advised that asserting distortion under CRTC section 25137 on an original return without prior approval from the FTB would result in an accuracy related penalty. Following the California Supreme Court's *Microsoft* decision, the FTB provided some relief in the form of Notice 2006-3 and made an exception for this gross proceeds issue. For purposes of applying the accuracy related penalty, a taxpayer who excludes the amount realized on the redemption of marketable securities as part of its treasury function from the sales factor, and includes only the interest income and net gains from such securities, will not be subject to the accuracy related penalty. The FTB, however, may still audit whether or not such exclusion is necessary to prevent distortion. In contrast, non-California headquartered taxpayers may have an opportunity to challenge the exclusion of marketable securities from the denominator of their sales factor where the FTB fails to meet its burden of proof to show that the standard formula does not fairly reflect the taxpayer's level of business activity in the state.

It is also important to note that the court ruled that the FTB met its burden of proof to show by clear and convincing evidence that the standard apportionment formula did not fairly represent Microsoft's activity in the state and that the FTB's proposed alternative was reasonable. Notably, the court rejected the taxpayers' arguments that the FTB, as the "moving party," was required to show that the income attributed to the state by the standard formula is "out of all appropriate proportion to the business transacted in the state" or has "led to a grossly distorted result." In rejecting these two standards, the court concluded that the taxpayers raised constitutional standards for striking down a tax under the Due Process and Commerce Clauses and that the application of CRTC section 25137 is not limited to correcting unconstitutional distortions. In demonstrating that distortion under CRTC section 25137 existed in *Microsoft*, it is' interesting that the court did not specifically spell out the procedure to demonstrate distortion.

The *Microsoft* Court cites with approval the *Appeal of Crisa Corp.* (2002-SBE-004), decided June 20, 2002, where the SBE rejected the emphasis on a quantitative analysis for proving distortion and concluded that the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula. However, the court cites the differences in profit margins and gross receipts from treasury and non-treasury functions (i.e., quantitative standards) as support for its conclusion. Accordingly, there are open questions remaining as to what is required to show distortion or rebut a distortion assertion with regard to gross receipts from treasury activities.

Citing *Microsoft,* the California Court of Appeal, in *The Limited Stores, Inc. v. Franchise Tax Bd.*, *Cal. Ct. App., No. A102915, 6/8/2007*, held that gross proceeds from short term investments held as part of a treasury function should be excluded from a corporation's sales factor since the treasury function is "qualitatively different" from the principal business of the corporation and the inclusion caused a "quantitative distortion" of the apportionment factor that is substantial. Instead, the court ruled that **only** net income from short-term investments should be included in the sales factor calculation as an alternative apportionment calculation. The Court of Appeal said that the *Microsoft* court established a two-prong test. First, it must be determined whether the treasury functions are "qualitatively different" from the taxpayer's principal business. Second, it must be determined whether the "quantitative distortion" of the sales factor caused by inclusion of the gross proceeds is substantial. In this situation, the court found that the treasury function was "qualitatively different" from the taxpayer's principal business of retail sale of apparel and other products. Also, the court found that inclusion of the gross proceeds caused a substantial distortion of the apportionment factors since short-term investments accounted for less than one percent of the business income but between 52 and 62 percent of the gross receipts, depending on the year. Based on the analysis above, the court found that, in this case, the gross proceeds of short-term investments should not be included in the sales factor. The FTB proposed including the net income from short-term investments in the sales factor calculations and this alternative apportionment calculation was approved by the court.

A number of other appeals are making their way through the briefing process at the SBE that will serve as follow-up to the *Microsoft* decision. The lead case involves an appeal filed by Home Depot and raises several issues. The *Microsoft* decision raises questions as to the standard of proof necessary for demonstrating that the standard apportionment formula does not fairly represent a taxpayer's business activity in California, whether the court adopted two independent tests for distortion and how these relate to the *Appeal of Crisa Corporation, supra,* and whether the courts discussion of the relationship of the sales factor to distortion supersedes the SBE's analysis in the *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (87-SBE-017), decided June 2, 1987.

In a subsequent "gross receipts" case, the superior court in San Francisco held that receipts from buying and selling of commodity futures are not gross receipts for tax apportionment purposes and therefore are excluded from the sales factor. (*General Mills, Inc. v. Franchise Tax Bd.,* Cal. Super. Ct., County of San Francisco, No. 439939, 09/26/07.) The court found that the futures contracts are distinguishable from the marketable securities involved in *Microsoft.* The court determined that the economic reality of futures market transactions is significantly different from traditional cash market transactions, and as a consequence should have different tax implications. Unlike the cash market, where commodities can be purchased and sold, futures market transactions rarely involve the actual purchase or sale of commodities. Instead, the court found that futures contracts are opened in order to hedge against commodity price fluctuations, and may be unilaterally closed by either party by assuming an offsetting position. Further, no true commodities are typically delivered. In its decision, the court stated that "offsetting a futures contract does not constitute performance of the contract," and as such “it is more appropriate that futures contracts [be] viewed as an adjustment to the cost-of-goods sold, not an increase in sales.” The court also found that treating futures transaction proceeds as constructive sales contravenes United States ("US") Generally Accepted Accounting Principles ("GAAP"), since GAAP generally records only net gains and losses from hedging transactions.

In *General Mills v. Franchise Tax Board* No. A120492, Cal. Ct. App., First App. Dist., 4/15/09, the California Court of Appeal held that the full sales price of a company's commodity futures sales contracts should be included as gross receipts in the denominator of the sales factor. The FTB argued that, under the plain language of UDITPA, "futures trading does not qualify as 'sales income' and cannot be used for tax apportionment purposes." The lower court reasoned that futures have no value at inception, are revocable at any time prior to delivery, are not a binding obligation and are not supported by consideration; therefore, futures trading should not be included in the sales factor at all. However, the appeals court held that futures contracts are legally binding contracts and are also supported by consideration, the court concluded. Consideration is received when a futures contract is offset, the court explained, by the offsetting party being relieved of its obligation to purchase or sell the commodity. The court also concluded that the FTB misconstrued the concept that futures contracts have no value at inception because it creates a legally binding obligation to purchase or sell the commodity in the delivery month.

The court next held that including futures sales in the sales factor is consistent with the purpose of UDITPA. The sales factor is designed to reflect a taxpayer's "income producing activity." The court explained that General Mills' futures sales satisfy UDITPA's definition of "income producing activity" because the hedging is done to allow General Mills "to stay in business and to make a profit despite frequent and significant fluctuations in the prices of the raw commodities." Finally, the court held that the "gross receipts" from a futures sales contract are equivalent to the full sales price of the contract. Citing to *Microsoft Corp. v. Franchise Tax Bd.,* 39 Cal.4th 750 (2006), the court noted that "'gross' means the full amount received, not the company's net gain on the transaction or 'gross income' from the transaction." The court explained that if a futures sales contract results in physical delivery, General Mills receives the full sales price in cash. When a futures sales contract results in offset, General Mills receives consideration in the form of being relieved of the obligation to purchase or sell the commodity. That consideration equals the full sales price of the contract, the court concluded. The case was remanded to the trial court to rule on whether the inclusion causes distortion.

Upon remand, the lower court found that it would be distortive to include the entire gross proceeds from the hedging activities. (*General Mills et al. v. Franchise Tax Board*, Cal. Superior Ct., No. CGC05-439932, 11/1/10). The activity produced very little income, and in fact, produced losses for two of the years (from -1.39% to less than 2%). Comparing the profit margin from futures trading (.75% in 1994) to the non-trading activity (6.5% overall), yielded a non-trading profit margin that was 81 times higher than the futures trading profit margin. Based on this analysis, the court allowed the FTB to impose an alternative apportionment formula. The court found that both of the FTB's preferred methods were acceptable, either excluding all futures trading activity from the sales factor or including only the net gains. The FTB opted to include only the net gains from the futures trading activity in the factor.

General Mills appealed to the California Court of Appeal, which affirmed the trial court's decision. The appellate court held that General Mill's hedging transaction gross receipts did not fairly represent its California business activity because General Mill's hedging sales were qualitatively different from their sales of end products to customers for profit and because including the receipts was quantitatively distortive. In its qualitative analysis, the appellate court did not place much significance on whether the General Mills' hedging activity was integral or critical to its business activity. Rather, the court concluded that General Mills' hedging activity served a risk management function that was unrelated to its business of selling its products to customers. While the appellate court acknowledged that the inclusion of the hedging gross receipts did not impact General Mills' sales factor (the average decrease was 8.2%) as much as in previous treasury distortion cases, the court nevertheless concluded that the hedging receipts were quantitatively distortive, particularly when analyzing the profit margins of the hedging transactions and General Mills' consumer product activity. (*General Mills, Inc. v. Franchise Tax Board,* (2012) 208 Ca.App.4th 1290).

<u>The Status of Gross Receipts</u>

Regulation 25137, subdivision (c)(1)(D), adopted on November 28, 2007, specifies a general rule for the sales factor treatment of gross receipts generated by a taxpayer's treasury function and deals with the treasury receipts issue as follows:

- The regulation is effective for tax years beginning on or after January 1, 2007, and excludes interest, dividends, gross receipts, and net gains entirely from intangible assets held in connection with a treasury function from the sales factor.
- A "treasury function" is defined as pooling, managing, and investing in intangible assets for the purpose of satisfying the cash flow needs of the business, such as providing liquidity for a taxpayer's business cycle. A treasury function includes the use of futures and options to hedge foreign currency. A treasury function does not include a trading function for the purpose of hedging price risk of products/commodities consumed, produced, or sold by the taxpayer.
- Amendments do not apply to: (a) taxpayers principally engaged in the business of dealing with intangible assets, such as registered broker dealers, and (b) financial institutions.

Effective for taxable years beginning on or after January 1, 2011, the statutory definition of "gross receipts" as amended under CRTC Section 25120, excludes amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business, and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets. The legislation provides that a taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced. "Treasury function" is defined as the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also includes the use of futures contracts and options contracts to hedge foreign currency fluctuations.

Also excluded from gross receipts are the following items:

- Amounts received from hedging transactions involving intangible assets.
- Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
- The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
- Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock.
- Damages and other amounts received as the result of litigation.
- Property acquired by an agent on behalf of another.
- Tax refunds and other tax benefit recoveries.
- Pension reversions.
- Contributions to capital (except for sales of securities by securities dealers).
- Income from discharge of indebtedness.
- Amounts realized from exchanges of inventory that are not recognized under the IRC

In Chief Counsel Ruling 2012-1, the FTB concluded that gross receipts, as opposed to net gains, resulting from a non-financial broker-dealer's principal trading activity were includible in the California sales factor. With this ruling, the FTB essentially confirmed that a non-financial broker-dealer should still include principal trades at gross, rather than net, in the sales factor notwithstanding the fact that CRTC section 25120 was amended to exclude treasury receipts from the sales factor. Since the gross receipts rules under CRTC section 25120 do not apply to registered broker-dealers, such taxpayers are not excluded from including their trades in at gross.

- Montana--The Montana Supreme Court held that including receipts from the sale of investments in the sales factor would lead to distortion. The Court allowed the state tax administrator to delete such receipts from the denominator of the sales factor under UDITPA Sec. 18. See *American Tel. and Tel. Co. v. Tax Appeals Bd*., 241 Mont. 440, 787 P.2d 754 (Mont. 1990). Following the above-cited case, Montana adopted a regulation which provides for the inclusion in the sales factor of "only the net receipts from the sale or redemption of intangible property." See A.R.M. 42.26.259(2).

- Oregon--Under prior law, the Oregon Supreme Court recently held that the gross proceeds from investment sales should be included in the sales factor, even if it results in factor distortion. Although the Department of Revenue argued that only the gain realized from securities should be included in the sales factor, the court ruled that the definition of the term "sales" as "all gross receipts of the taxpayer" includes receipts from the sale of securities. See *Sherwin-Williams v. Department of Revenue*, Oregon Supreme Court, SC S46023 (January 7, 2000). (Note that effective for tax years beginning on or after January 1, 1995, the Oregon sales factor excludes gross receipts from the sale of intangible assets, including securities, unless the receipts are derived from the taxpayer's primary business).

MTC Reg. IV.18.(c).(4) reads, in part, as follows:

(A) Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg. IV.18.(c).(4).(A), such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain or loss from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

(B) For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayers trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds that hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation that is unitary with the taxpayer, or that has a substantial business relationship with the taxpayer is not considered marketable stock.

(C) For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling liquid assets in the normal course of its trade or business is not performing a treasury function with respect to income so produced.

(D) Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

The regulation provides two examples, one involving a manufacturer that keeps liquid assets for later inventory acquisition, and the other involving a stockbroker acting as a dealer or trader for its own account.

Other State Developments Addressing the Sales Factor

California

The California FTB amended regulation section 25137(c), effective March 1, 2001, to provide that substantial gross receipts from an occasional sale of intangible assets, such as patents, trademarks, or stock in an affiliate, must be excluded from the sales factor of the California apportionment formula. A sale is considered "substantial" if its exclusion results in a 5 percent or greater decrease in the taxpayer's sales factor denominator, or a 5 percent or greater decrease in the sales factor denominator of a combined reporting group. A sale is deemed "occasional" if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.

On September 15, 2016 the Office of Administrative Law approved the FTB's changes to its regulation (25136-2) dealing with sales other than sales of tangible personal property regarding the sourcing treatment of revenue from marketable securities, dividends, goodwill, and interest, effective for tax years beginning on or after January 1, 2015. The amendments provide:

- Two definitions of marketable securities: one for securities and commodities dealers and one for everyone else. For purposes of assignment, the customer's location is determined as follows:
    - Individual customer's billing address
    - Corporate / business entity's commercial domicile, or
    - By reasonable approximation
- Gross receipts from dividends and goodwill are sourced in the same manner as sales of corporate shares (other than sales of marketable securities) or sales of pass-through ownership interests: sourcing is based on whether the underlying entity consists primarily of tangible personal property or intangible assets. If tangible, the sourcing will be in proportion to the entity's property and payroll factors. If intangible, the sourcing will be in proportion to the entity's sales factor.
- Gross receipts from interest are assigned based on the state where the investment is managed, the location of the real property securing the loan, or the location of the borrower for loans not secured by real property.

Shortly after the adoption of this regulation, the FTB initiated another project to update it further.

Electricity Deemed Intangible and Generation and Transmission of Electricity Deemed a Sale of Services for Apportionment Purposes

In *Appeal of PacifiCorp,* Cal. State Bd. of Equal., No. 2002-SBE-005, 9/12/02, the SBE ruled that the generation and transmission of electricity sold to California customers is the sale of a service excluded from the numerator of the apportionment sales factor, where the services were performed for the most part outside the state. On audit of PacifiCorp's California combined report with its affiliates for years ending in 1984 through 1989, the FTB determined that the sales of electricity to power companies, municipalities, and government agencies located in California were California sales that should have been included in the numerator of PacifiCorp's sales factor. The FTB argued that the sales of electricity were sales of tangible personal property, while PacifiCorp argued that the sales were "other than sales of tangible personal property" that should be sourced outside of California because the majority of the income producing activities related to those sales were performed in other The SBE agreed that the sales of electricity were "other than sales of tangible personal property," finding that the sales of electricity by PacifiCorp were "sales of services that essentially consisted of appellant's setting and keeping in motion, through its generation and transmission facilities, electrically charged particles." The SBE explained that this process did not result in either 1) the creation of any arguably tangible particles of electricity; or 2) the injection of those particles into its transmission facilities.

Lawsuit Proceeds Includable in Sales Factor

In *Appeal of Polaroid Corporation,* No. 62415, 05/28/03, the SBE concluded that proceeds from a patent infringement lawsuit must be included in a corporation's sales factor because the amounts are gross receipts and can be attributed to an income-producing activity. The SBE explained that the plain meaning of gross receipts is "quite expansive" and that no case or regulation has narrowed the meaning. The SBE also noted that by giving up its right to pursue additional litigation, Polaroid provided valuable consideration for the money it received. The SBE also noted that the proceeds from the litigation were meant to compensate Polaroid for unrealized profits that it would have earned from sales lost as a result of the patent infringement. Thus, lost sales of tangible personal property must be treated as the income-producing activity giving rise to the income at issue. The SBE explained that these sales would have been included in Polaroid's sales factor denominator and, to the extent they would have occurred in California, in Polaroid's sales factor numerator.

On January 27, 2004, the SBE granted Polaroid a rehearing on the issue of whether the royalty and interest components of the patent infringement award should be included in its California sales factor numerator. Under CRTC section 25136, sales of other than tangible personal property must be sourced to the state where the majority of the income-producing activity takes place. In this instance, that state is Massachusetts--where Polaroid's patent division is located. Thus, Polaroid contends, the reasonable royalty portion of the proceeds belongs exclusively in the sales factor denominator for California tax purposes. Polaroid's argument against the inclusion of the interest portion of the proceeds in the sales factor numerator mirrored its arguments made regarding the inclusion of royalties--that any income-producing activity related to the interest would have occurred in Massachusetts, where its treasury department is located. While not concluding that its decision was erroneous, the SBE conceded that Polaroid's arguments "raise a sufficient question to require a rehearing."

FTB Explains When Taxable Dividends Are in Sales Factor

In Legal Ruling 2003-3, 12/04/03, the FTB ruled that dividends classified as business income are includable in the recipient's sales factor where the recipient does more than hold stock in the paying entity but, rather, participates in the management and operations of the entity,

As dividends constitute a sale of "other than a sale of tangible personal property," the inclusion of dividends in the sales factor is governed under Sec. 25136, which provides that sales are sourced to the state "in which the income-producing activity took place," the FTB explained. If the income-producing activity took place in more than one state, the sale is assigned to the state in which the greater cost of performance occurred. The FTB noted that under applicable regulations, the mere holding of intangible property is not an income-producing activity and that the sales factor excludes business income from intangible property if it is not attributable to an income-producing activity of the taxpayer.

Dividends are includable in the recipient's sales factor only when the recipient engages in an income-producing activity that is more than "mere" holding, the FTB explained. For example, income-producing activity exists if the recipient participates in the management and/or operations of the dividend-paying entity. Such participation does not include: the exercise of voting rights conferred by stock ownership; the receipt and review of stockholder material; and accounting for receipt of dividend income.

Distributive Share of Liquidated LLC Included in California Return in Tax Year of Liquidation

When a taxpayer liquidates its interest in an LLC treated as a partnership for federal and state tax purposes, the taxpayer must include its proportionate share of the LLC's apportionment factors on its California income tax return for the year in which the interest was liquidated, the California SBE ruled in Appeal of Eli Lilly & Co., No. 330522 (Cal. State Bd. of Equal. 2/1/07). In so ruling, the Board explained that California follows federal law, where a partnership's taxable year closes with respect to a partner when the partner's interest terminates. The taxpayer argued that the factors could not be included in the year the taxpayer's interest terminated (1997) because the factors could not be properly ascertained until the partnership's year ended (1998). However, the Board noted that the taxpayer could have used other methods to account for these factors, including the interim closing of the partnership's books or proration.

California Court of Appeal Determines that OEM Licenses are Intangible Property for Sourcing Purposes

The California Court of Appeal recently decided that royalties received from the license to replicate and install software during the manufacture of computers by original equipment manufacturers (OEMs) are receipts from intangible property for sourcing purposes. (*Microsoft Corp. v. FTB* (2012) 212 Cal.App.4th 78.) In this case, the taxpayer, Microsoft, received royalties from OEMs in exchange for the license to replicate and install Microsoft software programs as part of the computer manufacturing process. Unlike the trial court which focused on the "canned" software installed on the computers, the appellate court's analysis focused on the rights that were transferred as part of the license, namely the right to replicate and install the software. Relying on guidance found in sales and use tax cases and in federal authorities, the appellate court held that the OEM licenses were intangible property and therefore the royalties from the OEM licenses should be sourced based on cost of performance.

FTB Chief Counsel Ruling 2013-03 – No Sales Factor Recognition on the Sale of Goods Temporarily Stored in California

In Chief Counsel Ruling 2013-03, the FTB held that property ultimately destined for another state but shipped to a third party warehouse in California for temporary storage pending shipment in the same form as received to the ultimate destination state was not considered a sale within California under CRTC Section 25135. The Chief Counsel Ruling discussed *McDonnell Douglass Corporation v. FTB* (1994) 26 Cal.App.4th 1789 which held that aircraft manufactured for use out of California, but delivered to the purchaser in California who then transported it to their ultimate destination was apportioned to the state of destination rather than the state of delivery. The Chief Counsel Ruling also cited to the *Appeal of Mazda Motors* (1994) 94-SBE-009, Nov. 29, 1994 which held that sales factor numerator should not include vehicles that arrived in California and underwent no modification before common carrier delivered them to Texas. However, *Appeal of Mazda Motors* found that the sales factor numerator should include vehicles stored in California so that repairs could be performed or accessories installed. The Chief Counsel Ruling finally discussed Legal Ruling 95-3 which stated that the FTB would follow the holding in *McDonnell Douglass*. While there is a presumption that goods taken into possession by the purchaser in California are presumed to be delivered or shipped to California for purposes of the sales factor, the presumption can be overcome by proof that property was brought into but not used in California before transportation to another state.

Gross Receipts from a Diversified Media Corporation's Sales of 13 Television Stations Were Not Excluded from the Sales Factor Under the Occasional Sale Rule

The SBE in an unpublished decision in *Appeal of Emmis Communications Corp.*, SBE Case No. 547964, June 11, 2013 found that gross receipts from a diversified media corporation's sales of 13 television stations located outside of California were not excluded from the sales factor under the occasional sale rule in Regulation section 25137(c)(1)(A). There were two questions at issue: (1) whether the occasional sale rule applied to Emmis' television station sales and (2) whether excluding television station sales gross receipts from the apportionment factor was distortive. The SBE decided in favor of Emmis, finding that the occasional sale rule did not apply to the television station sales. While the SBE's questions and discussion focused on the application of the occasional sale rule without reaching a discussion on the distortion question, the SBE did not offer any explanation as to the specific points that led to its determination.

FTB Chief Counsel Ruling 2014-02 - Receipts from a Company's Plan of Reorganization in Bankruptcy Were Not Excluded from the Sales Factor under the Occasional Sale Rule

In Chief Counsel Ruling 2014-02, with facts similar to the *Appeal of Emmis Communications Corp*, the taxpayer began disposing of assets in a common plan. The ruling found that the company's Plan of Reorganization under Chapter 11 of the Bankruptcy Code was designed with the intent and mechanism to achieve the goal of converting business assets to cash at the highest possible value by operating its business as a going concern. To accomplish this goal, negotiation and implementation of asset sale transactions became part of the company's normal course of business. The asset sales transactions took place within a two-year period at short intervals on a regular basis. As a result, the ruling found that these sales were within the company's normal course of business and occurred frequently. Therefore, the asset sales were not 'occasional sales,' and the resulting gross receipts must be included in the sales factor for apportionment purposes.

New York

A taxpayer providing a web site listing for physicians and operating a medical risk participation program for customers is required to source receipts to New York based on the number of persons that view the web site listing in the state and if medical services are performed in the state, the New York Department of Taxation and Finance advised in TSB-A-09(8)C, N.Y. Dep't of Taxn. and Finance (6/16/09).

The department stated that the governing principle for sourcing receipts arising from sales of advertising is to base the allocation "on the number of people who view or read the advertisement in New York." Because the taxpayer's sales of advertising via the listings it maintains on its web site are the same as sales of advertising by publishers, broadcasters, and cable providers, the department concluded that the taxpayer should base the allocation of its receipts on the ratio of persons that viewed or read the listings in New York to the number of persons that viewed or read the listings everywhere. If this data is unavailable, the department stated that the taxpayer may use some reasonable method to estimate the ratio. Regarding medical services, the department explained that although the taxpayer is not directly performing the medical services the customers are receiving, "if an agent, contractor, or other person in New York State performs services for a taxpayer within" the state, the taxpayer must allocate to New York receipts from services performed in the state. Because the taxpayer contracts with the physicians to perform the service, the department concluded the taxpayer must include in the numerator of the receipts factor of the BAP, receipts from arranging for medical services to be performed by physicians in the state.

Massachusetts

Gain From Deemed Asset Sale

Legislation enacted in 2004 (H.B. 4744) provides that, for apportionment purposes, a "target corporation" is treated as having sold its assets in any case in which a purchasing corporation makes an election under Sec. 338, effective for tax years beginning on or after January 1, 2004. As a result, the decision in *Combustion Engineering v. Mass. Commissioner of Revenue* No. F228740 (Mass. App. Tax Bd. Mar. 29, 2000) in which the Massachusetts Appellate Tax Board ruled that receipts resulting from the deemed sale of a target corporation's assets under an IRC §338 transaction are not included in the target corporation's apportionment formula, will no longer be followed. **Note.** Receipts from the sale of stock are excluded from the Massachusetts sales factor.

Gross Receipts From Sales of Securities Excluded from Factor

Amounts received from a subsidiary pursuant to a plan of complete liquidation are excludable from taxable income and receipts from a pension plan reversion must be excluded from the denominator of the sales factor because they are receipts from the sale of securities, the Massachusetts Appellate Tax Board ruled in *Hoechst Celanese Corp. v. Massachusetts Commissioner of Revenue*, Dkt. No. 194694, 6/30/00. The taxpayer argued that the proceeds were not gains from the sale of securities and that the trustee, who is a separate legal entity, conducted the sale of securities. Accordingly, all that was received was a distribution of cash. Regardless of the fact that cash was given by the trustee, the fact remains that the pension fund reversion constituted "gross receipts from the disposition of securities" and therefore the proceeds are properly excludable from the denominator of the sales factor.

Activities of Licensee Considered in Sourcing Royalty Revenue

In *Geoffrey, Inc. v. Commissioner of Revenue,* Mass. App. Tax Bd., No. C271816 (07/24/07), the Massachusetts Appellate Tax Board upheld the validity of a regulation that provides that in determining the income-producing activity for purposes of sourcing licensing income, the activities of the licensee must also be considered. The Board explained that under the sales factor statute, G.L. c. 63, sec. 38(f), sales other than sales of tangible personal property are in the state if: (a) the income-producing activity is performed in the state or (b) the income-producing activity is performed both in and outside the state and a greater proportion of this income-producing activity is performed in the state than in any other state, based on costs of performance. Regulations promulgated under the statute provide that "gross receipts from the licensing of intangible property are attributable to Massachusetts if the property is used by the licensee solely in Massachusetts." The regulations also provide that if the licensee uses the intangible property in more than one state, the gross receipts from licensing are attributable to Massachusetts if the in-state use of property by the licensee in Massachusetts exceeds its use of the property in any other one state. In this instance, the licensee used the marks exclusively in Massachusetts.

Geoffrey argued that the regulation is inconsistent with the statute because the statute looks to its--Geoffrey's--activities and not those of the licensee. The Board disagreed, stating that nothing in the statute "requires so blinkered a view of the relevant income-producing activity as to disregard the important uses to which Geoffrey's Trademarks were put in Massachusetts." In addition, the Board explained that the licensing agreements recognized that the value of Geoffrey's marks contributed to retail transactions in the state. "Given the intended use of its property to facilitate retail sales in Massachusetts, Geoffrey's assertion that its income-producing activity occurred entirely out-of-state is strained and formalistic," the Board concluded.

<u>Missouri</u>

In *Embarq Corp. v. Director of Revenue*, AHC Dkt. No. 10-1485RI, 10/17/12, an Administrative Law Judge held that intercompany dividends were not included in the sales factor as an “intercompany sale” because there were no indicia of a sales transaction. Further, dividend income was includable in the sales factor as income-producing activity when the payee participated in the management and operations of the payer. However, without facts supporting the location where the dividends were derived, including dividends in the sales factor denominator would result in unfair apportionment and therefore all dividends were excluded from the sales factor.

<u>Oregon</u>

In *Oracle Corporation v. Department of Revenue*, Or. Tax Court, TC MD-070762C, 1/19/12, the Oregon Tax Court ruled that the Department of revenue may not exclude a software company's gains from the sale of two subsidiaries' stocks from its sales factor denominator because the gains constituted business income. In this case, the Court held that the Department cannot conclude that the company's acquisition, use and disposition of the foreign subsidiaries' stock was an integral part of its regular business and then claim that the stock sale gain must be excluded from its sales factor.

<u>Pennsylvania</u>

In *Pennsylvania v. Gilmour Manufacturing Company*, No. 66 MAP 2000, 04/28/03, the Pennsylvania Supreme Court ruled that receipts from the sale of tangible personal property picked up by an out-of-state purchaser at a seller's place of business in Pennsylvania and ultimately removed from the state are excluded from the numerator of the sales factor.

Gilmour argued that the state law set forth a "destination rule," which provides that goods purchased by out-of-state buyers and destined for out-of-state locations are out-of-state sales, regardless of whether delivery was completed in Pennsylvania. The Commonwealth argued in favor of a "delivery rule," under which a dock sale for apportionment purposes occurs where the delivery occurs--irrespective of the purchaser's home state or the ultimate destination of the goods.

The court concluded that the statutory language "within this State" modifies the word "purchaser." Thus, only sales to Pennsylvania purchasers are includable in the sales factor numerator. The fact that other states have uniformly adopted a destination test, though not controlling, weighs heavily in favor of Gilmour, the court added. The court also found that the underlying purpose of the net income tax is furthered by the destination rule, noting the commonwealth court's explanation that including sales made to out-of-state purchasers, who come into the state, pick the goods, and leave, would artificially inflate the contribution of Pennsylvania customers to the entity's sales.

Sales Other than Sales of Tangible Personal Property

In February of 2017, the MTC updated their model regulations. The MTC regulations provide for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government) are now included under a market sourced approach.

According to the regulation, sales will be sourced to a state if: (1) in the case of sale, rental, lease or license of real property, if and to the extent the property is located in the state; (2) in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in the state; (3) in the case of sale of a service, if and to the extent the service is delivered to a location in the state.

Additionally, intangible property that is rented, leased, or licensed in connection with a good or service will be sourced to the location of the consumer. Intangible property that is sold will be sourced a state to the extent it is used in the state. Finally, if these cannot be determined, a reasonable approximation may be used.

This regulation replaced the previously long-standing regulation which stated that if the *income-producing activity* ("IPA") that gave rise to the receipts is performed wholly within this state. Also, such gross receipts are attributed to this state if, with respect to a particular item of income, the income-producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on *costs of performance*. In other words, if the income producing activity takes place in more than one state, then the receipts are sourced to the state that bears a greater portion of the cost of performance in relation to the costs of performance incurred in any other state.

Note that this "all or nothing approach" for sourcing sales other than sales of personal property can lead to inequitable results in instances where substantial costs are incurred in more than one state. Some states will receive no tax in connection with the receipts, even though a substantial part of the income producing activity may have been performed within its borders. On the other hand, the state where the receipts are sourced may receive a windfall, since much of the income producing activity may have been performed outside of the state. The same "all or nothing" effect pertains to receipts from the sale of tangible personal property, to the extent that costs associated with those sales are incurred in states other than the state of destination of the goods, as will typically be the case with multistate manufacturers and retailers.

Once the costs of performance ("COP") for a given income producing activity have been isolated and quantified, UDITPA requires that the COP incurred in each state be compared; the state with the "greater proportion of the income-producing activity," *based on costs of performance*, wins the right to include the receipts in the taxpayer's sales factor numerator.

While this appears to be a straightforward comparison of costs incurred on a state-by-state basis, the fact is that various states have altered the basis for comparison of an IPA's costs of performance. For example, under the UDITPA/MTC "preponderance" approach, receipts are attributed to the jurisdiction if a greater proportion of the income-producing activity is performed within the jurisdiction than any other individual state, based on related COP. States adopting this approach include, Arizona, Colorado, and Massachusetts. Thus, if COP related to services are incurred in three preponderance states, with 40% in Arizona, 30% in California and

30% in Colorado, Arizona would include the receipts from such services in the sales factor numerator.

This should be contrasted with the "majority approach," under which receipts are attributed to the jurisdiction if a greater proportion of the income-producing activity is performed within the jurisdiction than all other jurisdictions in the aggregate.

Income-Producing Activity

As amended by the MTC on August 2, 2007, income producing activity (IPA) means "the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor." MTC Reg. IV.17.(2). Income producing activity includes the rendering of personal services by employees, the utilization of tangible and intangible property by the taxpayer in performing a service, and the sale, licensing, or other use of tangible *and* intangible personal property. Thus, the term "income-producing activity" refers to a profit-motivated activity directly engaged in by the taxpayer in the regular course of the trade or business, and, as amended in August 2007, includes, rather than excludes, activities performed "on behalf of" the taxpayer, such as those conducted on its behalf by an independent contractor. The term applies to each <u>separate</u> item of income. Income-producing activities include but are not limited to:

- Rendering personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service

- Sale, rental, leasing, licensing or other use of real property

- Rental, leasing, licensing or other use of tangible personal property

- Sale, licensing or other use of intangible personal property

The mere holding of intangible personal property is not, of itself, an income-producing activity.

The following are special rules for determining when receipts from the income-producing activities described below are in this state:

- <u>Gross receipts from the sale, lease, rental or licensing of real property</u> are in this state if the real property is located in this state.

- <u>Gross receipts from the rental, lease or licensing of tangible personal property</u> are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio by which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period.

Example: Taxpayer is the owner of 10 railroad cars. During the year, the total days each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\frac{10 \times 50}{10 \times 365} \times \text{Total Receipts} = \text{Receipts Attributable to this State}$$

- Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts for the performance of such services shall be attributable to this state only if a greater portion of the services were performed in this state, based on costs of performance. Usually where services are performed partly within and partly without this state the services performed in each state will constitute a separate income-producing activity. In such case, the gross receipts for the performance of services attributable to this state shall be measured by the ratio by which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation that gives rise to such gross receipts. Personal services not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, are excluded from the computations.

Example 1: Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

Example 2: The taxpayer, a public-opinion survey corporation, conducted a poll in State X and in this state for the sum of $9,000. The project required 600 man hours to obtain the basic data and prepare the survey report. Two hundred of the 600 man hours were expended in this state. The receipts attributable to this state are $3,000.

$$\frac{\text{200 man hours}}{\text{600 man hours}} \times \$9{,}000 = \text{Receipts Attributable to this State}$$

In the context of a sale of intangibles – and particularly the sale of trade names and trademarks – the determination of the controlling IPA has been the subject of litigation. Proposed IPAs have included (1) the sales activities surrounding the sale of the intangibles (as measured by the legal services costs incurred in negotiation/consummation of the sale); (2) activities that created value in the trademarks (as measured by the development costs of the trademarks, *e.g.*, cost of efforts to promote name recognition and good will); and (3) actions taken by individuals responsible for making the decisions relative to trademark value creation and the overall management of the entity selling the intangibles (as measured by the executive personnel costs). Most recently, states have contended that the activity giving rise to value is the use of trade names or trademarks in the state in which they are displayed.

MTC Reg. IV.17.(4)(C), adopted on August 2, 2007, an income producing activity performed on behalf of a taxpayer by an agent or independent contractor is attributed to this state if such income producing activity is in this state.

(a) Such income producing activity is in this state:

- when the taxpayer can reasonably determine at the time of filing that the income producing activity is actually performed in this state by the agent or independent contractor, but if the activity occurs in more than one state, the location where the income producing activity is actually performed shall be deemed to be not reasonably determinable at the time of filing;
- if the taxpayer cannot reasonably determine at the time of filing where the income producing activity is actually performed, when the contract between the taxpayer and the agent or independent contractor indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or contractor associated with such performance is determinable under the contract;
- if it cannot be determined where the income producing activity is actually performed and the agent or independent contractor's contract with the taxpayer does not indicate where it is to be performed, when the contract between the taxpayer and the taxpayer's customer indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or contractor associated with such performance is determinable under the contract; or
- if it cannot be determined where the income producing activity is actually performed and neither contract indicates where it is to be performed or the portion of the payment associated with such performance, when the domicile of the taxpayer's customer is in this state. If the taxpayer's customer is not an individual, "domicile" means commercial domicile.

(b) If the location of the income producing activity by an agent or independent contractor, or the portion of the payment associated with such performance, cannot be determined or the taxpayer's customer's domicile cannot be determined or, although determinable, such income producing activity is in a state in which the taxpayer is not taxable, such income producing activity shall be disregarded.

Costs of Performance

The MTC Regulations (Reg. IV.17.(3).) define the phrase "costs of performance" ("COP"), as used for purposes of the income producing activity test, as "direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer." The MTC has proposed an amendment which states, "[i]ncluded in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services which give rise to the particular item of income."

- The MTC Audit Manual elaborates on the term “direct costs,” and states that they are "wages, taxes, interest, depreciation, and other costs involved with real and personal property." This definition sidesteps two relevant issues: (1) What are “direct costs” in the context of other than real and personal property (*i.e*., services, intangibles, etc.), and (2) What is meant by “generally accepted accounting principles”? Note that it is not written as “Generally Accepted Accounting Principles” (GAAP). Does that mean generally accepted principles using book accounting, tax accounting, regulatory accounting, or other system of accounting?

There is tremendous flexibility, and hence opportunity, in the COP analysis. For instance, a taxpayer might include solicitation costs here, relative to a non-solicitation-only IPA. Additionally, one might concentrate on “accepted conditions or practices in the trade or business of the taxpayer” as a potential planning resource with respect to activities for which there is no other specific guidance.

- California - In Legal Ruling 2005-1, 03/21/05, the FTB explained that the term "personal services," for purposes of the apportioning gross receipts using an income-producing activity standard, includes any service performed where capital is not a material income-producing factor. Furthermore, personal services are not limited to professional services or to specialized services performed by one individual.

  California regulations generally require a taxpayer to apportion receipts using a "time spread" method where the contract between a taxpayer and its customer calls for a personal service where capital is not a material income-producing factor, and the corporation performs the contracted-for services utilizing the labor of its employees with little or no utilization of tangible or intangible property, the ruling explains. The time spread method requires a taxpayer to treat the time each employee, including the project manager, spends in each state as a separate income-producing activity for purposes of determining the numerator of the sales factor.

  In a situation in which capital is a material income-producing factor, the special time-spread rule does not apply. Instead, the standard cost of performance rule (see below) would assign the receipts to the state with the greatest cost of performance

- Massachusetts -*Travel Operator Sales Sourced to Massachusetts Based on Costs of Performance.* Massachusetts's tour operator's sales of travel packages must be sourced to Massachusetts based on the costs of performance of the overall sale and marketing of the tour packages and not the sale of individual vacations, the Massachusetts Court of Appeals affirmed in *The Interface Group, and another vs. Commissioner of Revenue*, Mass. App. Ct., No. 08-P-1861,12/8/09, *cert. denied* 456 Mass. 1105, Mar. 31, 2010.

The Interface Group ("Interface") created and marketed travel packages to a variety of out-of-state destinations. The travel packages were sold one at a time, through independent travel agents, to individual customers. Customers paid the travel agents, who deducted their commissions from amounts they remitted to Interface. Interface made the purchases of hotel accommodations, airfare, and ground transportation to assemble the various travel packages. Interface recorded all of its outlays for airfare, ground transportation, and hotel accommodations as its own costs.

Applying an "operational approach," the Commissioner of Revenue issued an assessment, asserting that all of Interface's income-producing activities occurred in Massachusetts, where a majority of Interface's employees were based, and therefore, Interface's sales should be allocated 100 percent to Massachusetts. Interface countered that these sales must be sourced to the out-of-state locations where the related costs (*e.g.* hotel charges, rental cars, etc.) were incurred. The assessment was appealed to the Appellate Tax Board ("Board"), which held that sales of the travel packages must be sourced to Massachusetts based on costs-of-performance where the income-producing activity was the overall sale and marketing of the tour packages. Interface appealed to the Massachusetts Court of Appeals ("Court"), which remanded the decision, saying that the board must explain why it rejected the argument advanced by the taxpayer that income-producing activity be determined on an individual transactional basis. On remand, the Board reiterated its decision that Interface's sales of travel packages must be sourced to Massachusetts based on the income-producing activity of the overall sales and marketing of the tour packages, and not the sale of individual vacations. The Board said that to view Interface's activity as thousands of separate transactions ignored the company's fundamental business activity that gave rise to the income. Interface appealed to the Massachusetts Court of Appeals ("Court").

In making its determination, the Court said that the Board was required to explain its reason not to fracture Interface's business into thousands of mini transactions. The Board reasoned that the Commissioner's operational approach was correct because the regulation placed "an emphasis on the 'direct activity by the taxpayer,' and Interface did not sell travel packages directly to customers." Thus, the Court concluded that the Board had sufficient evidence to support the Commissioner's use of the operational method, and upheld the Board's holding requiring Interface's sales to be sourced to Massachusetts based on the costs of performance of the overall sale and marketing of the tour packages and not the sale of individual vacations.

In *AT&T Corp. v. Commissioner of Revenue*, Mass. App. Tax Bd., No. C293831, 6/8/11, the Massachusetts Appellate Tax Board held that sales of telecommunication services to Massachusetts customers should be sourced using the costs of performance associated with a service provider's integrated telecommunications network rather than costs associated with each individual call.

In this case, because the service provider's income-producing activity was the provision of a complex and comprehensive, reliable telecommunications network and not the connection of individual transmissions over specifically designated wires, costs of performance were primarily incurred at the taxpayer's global operations network and not at the location of the customer.

On appeal, the Massachusetts Court of Appeals affirmed the ATB's ruling. *AT&T Corp. v. Comm'r of Revenue*, Mass. Ct. App., No. 11-P-1462, 7/13/12.

- Idaho - In *Cable One, Inc. v. Idaho State Tax Commission*, Idaho Supreme Court No. 41305-2013. 10/29/14, the Idaho Supreme Court upheld a lower court's decision that a taxpayer's greater costs of internet access services were performed in Idaho, The taxpayer asserted that relevant costs for providing internet access services to Idaho customers included total costs associated with its Arizona Internet backbone facility. The Idaho Supreme Court disagreed, and identified costs that were allocated solely to Idaho activity and used those costs to evaluate where the greater costs of performance occurred.

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- Oregon - In *AT&T Corp. et.al. v. Department of Revenue,* Or. Tax Court, TC 4814, 1/12/12, the Tax Court held that receipts from interstate and international calls that begin or terminate in Oregon are properly sourced to Oregon based on a cost of performance methodology. The Tax Court rejected the taxpayer's approach that the cost transaction focuses on lines of business or product lines because it ignores the location of costs of performance. In this case, charges paid to a local exchange carrier are deemed direct costs under the costs of performance methodology.

- Tennessee -In *Bellsouth Advertising & Publishing Corporation v. Commissioner of Revenue*, Tenn. Ct. App., No. M2008-01929-COA-R3-CV, 8/26/09, the Tennessee Court of Appeals held that the Commissioner of Revenue was authorized to include in-state sales relating to advertising in a taxpayer's sales factor, determined under the cost of performance method, because the formula did not accurately reflect the taxpayer's business activity and income in the state.

  Tennessee law requires the receipts factor be determined by considering the costs incurred in providing the services that generated the revenue. Under Tenn. Code Ann. Sec. 67-4-2014, the Commissioner of Revenue is authorized to adjust the standard allocation and apportionment provisions where such provisions do not fairly represent the extent of the business activities conducted in Tennessee. Claiming that the cost of performance method does not allow for the inclusion of revenue generated from the sales of advertising in the state, the Commissioner included receipts from the sale of advertising to Tennessee customers in Bellsouth's receipt factor numerator, resulting in additional excise and franchise tax liability.

  In holding that the Commissioner's adjustment was appropriate, the court explained that Tennessee courts have repeatedly recognized that the Commissioner may properly exercise her discretion in adjusting the statutory apportion formula when the application of the formula does not fairly represent the taxpayer's business in the state. Additionally, UDIPTA, as originally developed by the Multistate Tax

Commission and adopted by Tennessee, acknowledges that the apportionment formulas do not function very well for certain types of businesses, including advertising, and do not always adequately deal with receipts from sales of other than tangible personal property. As such, a variance from the cost of performance formula would be appropriate under certain circumstances.   As such, because the statutory receipts formula resulted in Bellsouth only paying tax on a de minimum percentage of its Tennessee revenue, the application of the cost of performance formula did not fairly represent Bellsouth's business in the state and the Commissioner's adjustment was appropriate.

- Virginia - In *General Motors Corporation v. Department of Taxation*, Va. No. 032533, 09/17/04, the Virginia Supreme Court ruled that the "costs of performance, includes direct costs incurredby a taxpayer *and* indirect costs incurred by third-party contractors. Accordingly, a Department of Taxation regulation that limits "cost of performance" to direct costs is inconsistent with the plain language of the statute. General Motors Corporation ("GM") included certain third-party costs when calculating the "cost of performance" ratio of its financial corporation subsidiary, General Motors Acceptance Corporation ("GMAC"). The Virginia Department of Taxation ("Department") excluded the costs from the ratio, (which increased GMAC's Virginia taxable income) under a regulation that limits "cost of performance" to direct costs incurred by a taxpayer. In its appeal of the resulting assessment, GM challenged the validity of the regulation. The trial court ruled in favor of the department and concluded that the regulation was a reasonable interpretation of the statute. GM appealed.

  The Virginia Supreme Court explained that Va. Code Sec. 58.1-418 requires a financial corporation to determine its Virginia taxable income by dividing the cost of performance attributable to the corporation's Virginia business operations by the total cost of performance of the corporation's operations everywhere. In 23 Va. Admin. Code Sec. 10-120-150, the department defined cost of performance to mean "the cost of all activities directly performed by the taxpayer for the ultimate purpose of obtaining gains or profit." The regulation further provides that activities performed on behalf of a taxpayer, such as those performed on its behalf by an independent contractor, are excluded from cost of performance, the court explained. The court agreed with GM that nothing in the statute "limits costs 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." The court concluded that "it is self-evident" that the regulation is inconsistent with the plain language of the statute. The court recognized the practical difficulty in determining where third-party costs are incurred, but stated that such a matter must be addressed by the Legislature.

- Wisconsin - The Wisconsin Court of Appeals, in *Ameritech Publishing, Inc. v. Wisconsin Dept. of Rev.*, Wis. Ct. App., Dist. IV, Dkt. No. 2009AP445, 06/24/2010, held that an out-of-state corporation engaged in the business of solicitation, production, and delivery of telephone directory advertising was required to source its advertising receipts wholly to Wisconsin. The Court affirmed the Wisconsin's Tax

Appeals Commission's reasoning that the taxpayer's true income producing activity occurred when the intended audience received the directories containing the advertising in Wisconsin, instead of when solicitation, creation, development, design, assembly and production activities occurred, mostly outside of the state.

Under Wis. Stat. Sec. 71.25(9)(d), in effect for the tax years at issue (1994-1997), sales of other than tangible personal property, such as services, are deemed to be in Wisconsin and includable in the numerator of the apportionment sales factor "if the income-producing activity is performed in this state." If the income producing activity is performed both in and outside Wisconsin, the sales are divided among the states based on the proportion of the direct costs of performance incurred in each such state in rendering the service. The Wisconsin Tax Appeals Commission, after first concluding that the telephone directory advertising sales were sales of services and not of tangible personal property, concluded that all income from the performance of such services were the result of income producing activities in Wisconsin. Because all the income producing activities occurred in the state, the Commission reasoned, the cost of performance method was not implicated.

The Commission relied on its previous ruling in *Hearst Corp. v. Dept. of Rev.* (WTAC, Dkt. No. I-8511, 05/15/1990), to determine whether the taxpayer's sales of advertising services were all performed within Wisconsin and whether the receipts, therefore, were properly includable in the numerator of the sales factor of its Wisconsin apportionment formula. In *Hearst*, the Commission found that national advertising income received by Wisconsin broadcasters should be included in the sales factor numerator because the advertisements were aired in Wisconsin, and thus Wisconsin was where the income producing activities were performed. In the instant case, the Commission agreed with the Department's argument that "what matters to the advertisers... is getting the Directories, with their advertising, in front of the people at whom that particular Directory is aimed."

On appeal, the taxpayer argued that because some of its income producing activity was performed outside the state, a cost of performance fraction should be used to determine the advertising revenues to be included as Wisconsin sales. However, the Wisconsin Court of Appeals agreed with the Commission's reasoning that the "income producing activity of advertising services associate with advertisements run in Wisconsin was performed in Wisconsin when the advertisement reached its intended, Wisconsin audience."

Note: Subsequent to the years at issue, in 2005, Wisconsin amended its statute to provide that "[g]ross receipts from services are in this state if the purchaser of the service received the benefit of the service in this state... If the purchaser of a service receives the benefit of a service in more than one state, the gross receipts from the performance of the service are included in the numerator of the sales factor according to the portion of the service received in this state." (Wis. Stat. Sec. 71.25(9)(d)) The parties agreed that income generated after January 1, 2005, from the advertising services at issue would be sourced to Wisconsin under the revised statute.

Market - Based Sourcing

It should be noted that some states, including, California (explained below), Alabama, Georgia, Iowa, Illinois, Massachusetts, Michigan, Minnesota, New York, New York City, Ohio, Pennsylvania, Utah and Wisconsin abandoned the costs-of--performance approach in favor of market-based sourcing for service income. For example, in Illinois sales would be deemed Illinois sales if the purchaser is in Illinois or the sale is otherwise attributable to the Illinois marketplace. In Michigan, royalties and other income received for the use or privilege of using intangible property are attributed to the state in which the property is used by the purchaser. If the property is used in more than one state, the royalties or other income would be apportioned to Michigan based on that portion of the use that occurs in the state; if that portion cannot be determined, the amounts would be excluded from the sales factor altogether. Sales of services would be attributable to Michigan if the recipient of the services receives all of the benefit of the services in the state. Under revised Georgia regulations, service receipts are sourced to the state where the recipient receives all or part of the benefit, and intangible receipts are sourced to the state where the service is used by purchaser. For all taxable years beginning or deemed to begin on or after January 1, 2014, Nebraska will source sales other than sales of tangible property to the state if the sales are derived from a buyer within the state.

Sourcing Sales Other than Tangible Personal Property - California

Under CRTC §25136, sales other than sales of tangible personal property are included in a taxpayer's California sales factor numerator if the income producing activity which gave rise to the receipts was performed wholly in California. If the income producing activity is performed in both California and another state, the receipts are sourced to California if the greater proportion of income producing activity is performed in California, based on costs of performance. Prior to its revision in 2010 (discussed below), California Code of Regulations ("CCR") Section 25136(b) excluded "transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor."

Nonetheless, in Legal Ruling 2006-2, May 3, 2006, the FTB explained that if the activities are performed on a taxpayer's behalf by an independent contractor, but that contractor is part of the same combined group as the taxpayer, then the activities of the contractor will be considered income producing activities performed by the taxpayer. The FTB notes that as a consequence of a water's-edge election certain members of a unitary group may be excluded from a combined report. If this election is made, then activities performed by the excluded members on behalf of a member of the combined group are not considered income producing activities of the group member.

*Example***.** The FTB provides an example to explain its ruling. Corporation A contracts to provide services for Corporation B in both California and another country. In performing the contract, Corporation A incurs costs of $10 in California and a subcontractor (Corporation C) performs activities on Corporation A's behalf in the other country at a $60 cost.

If Corporation A and Corporation C are members of the same combined group, then the sale of services would not be sourced in California because Corporation C's activities would be considered activities of Corporation A, and the cost of performance would be higher in the other country ($60) than in California ($10). Note that if the group had made a water's-edge election and Corporation C was excluded from the combined group, the sales would be sourced to California because the income producing activity would be considered performed wholly in California.

On June 17, 2010, the California Office of Administrative Law amended regulation Sec. 25136 to remove language requiring that the income-producing activity be "directly" engaged in by the taxpayer. As amended, the regulation now specifically states that such activity *includes,* rather than excludes, transactions and activities performed "on behalf of" the taxpayer, such as those conducted on its behalf by an independent contractor. Further, the amendments specifically state that "[i]ncluded in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income." The amended regulation includes "cascading rules" governing how an income-producing activity performed on behalf of a taxpayer by an agent or independent contractor is attributed to a state, including a default to the domicile of the taxpayer's customer. The amended regulation further provides that if the income-producing activity is in a state in which the taxpayer is not taxable, the income-producing activity "shall be disregarded[.]" This provision would also apply if the location of the income-producing activity cannot be assigned under the cascading rules, or the customer's domicile cannot be determined. The amendments retroactively apply to taxable years beginning on or after January 1, 2008

CRTC Section 25136 - Market-Based Sourcing Rules for Taxpayers using a Single-Sales Factor Apportionment Formula

<u>The market based sourcing rules under CRTC section 25136 apply to: (a) taxpayers electing to apportion under a single sales factor formula for tax years beginning on or after January 1, 2011 and before January 1, 2013; and (b) all apportioning businesses, for tax years beginning on or after January 1, 2013, except for cable companies (see below).</u> CRTC section 25136 provides that for taxpayers electing to apportion under a single sales factor formula, sales, other than sales of tangible personal property, are in this state as follows:

(1) Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state.
(2) Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
(3) Sales from the sale, lease, rental, or licensing of real property are in this state if the real property is located in this state.
(4) Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state.

The focus of the market approach to sourcing sales is determining the location of where the "benefit is received." Accordingly, the FTB promulgated CCR 25136-2, which contains a number of cascading rules and examples to explain the application of the market based sourcing rules in CRTC section 25136.

Special Rules

In general, the following special rules are established in respect to the sales factor of the apportionment formula:

- Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

- Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless such exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as the sale of office furniture, business automobiles, etc.

- Where the income-producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income-producing activity occurs in this state, in the numerator of the sales factor as well. For example, usually the income-producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation IV. 15.(a).(l)(a)) and income from the sale, licensing or other use of intangible personal property (Regulation IV.17.(2)(D)).

- Where business income from intangible property cannot readily be attributed to any particular income-producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest shall be excluded from the denominator of the sales factor.

Sales Recapture (Throwback) and Throwout

UDITPA Sec. 16(b) provides that sales of tangible personal property are thrown back to the state if "the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser."

The phrase "taxable in the state of the purchaser" generally (though not invariably) is interpreted as hinging upon whether or not the destination state has the power to tax the seller, without regard to whether the destination state actually exercises that power. That construction is justified on the grounds that the destination state may choose, as a matter of policy, not to tax vendors selling goods into the state. Alternatively, the destination state may impose other comparable non-income based taxes on the vendor, which may or may not, depending upon the state, strictly satisfy the statutory test.

MTC states and a number of other states employ the concept of sales recapture in determining what sales are assignable to the state. In general, states that have adopted this concept require that all sales that are shipped from a location in the state to a state in which the taxpayer is not subject to tax are includable in the numerator of the sales factor for the state.

It is not unusual to find a taxpayer filing returns in a few states even though it makes sales in many states. A careful check must be made in such situations to determine if, in the states where tax returns are being filed, the recapture rule is applicable. If the rule is applicable and the taxpayer has not complied with it, a substantial state tax liability may exist.

In addition, at least two states currently employ a throwout rule, Maine and West Virginia. Similar to the throwback rule, the throwout rule seeks to curtail the creation of nowhere income. The throwout rule, however, achieves this goal by removing the sales from both the numerator and the denominator of the sales factor, rather than sourcing the sales to a non-destination state. For example, in West Virginia, sales of tangible personal property delivered or shipped to a purchaser within any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any territory or possession of the United States and any political subdivision thereof in which the taxpayer is not subject to a net income tax, a franchise tax for the privilege of doing business or a corporation stock tax shall be excluded from the denominator of the sales factor.

Prior to July 1, 2010, New Jersey had a throwout rule on its books. The throwout rule was repealed under L. AB2722, enacted December, 19, 2008.

The New Jersey Supreme Court ruled that a narrowly-construed throwout rule is facially constitutional when applied to untaxed receipts from states that lack the jurisdiction to tax a corporation due to insufficient nexus or because of congressional actions, such as P.L. 86-272. However, the throwout rule violates the U.S. Constitution when applied to receipts that are not taxed by another state because that state chooses not to impose an income tax. *See Whirlpool Properties, Inc. v. Director, Division of Taxation,* N.J., Dkt. No. A-25, 7/28/11.

In *Lorillard Licensing Co., LLC v. Director,* N.J. Tax Court No. 008772-2006, 8/9/13 the tax court found that the state must use the same “economic nexus” standard used to subject a licensor of intangible property to the state’s Corporation Business Tax that is uses to determine whether that same licensor is “subject to tax” in other states for purposes of the state’s throwout rule. Since the licensor received royalties for property sold in all 50 states, the licensor was “subject to tax” in all 50 states and, therefore, the throwout rule did not apply to any of its sales.

In Illinois, taxpayers must ''throw out'' royalties from patents, copyrights and trademarks if the taxpayer or the taxpayer's unitary group receives less than 50 percent of its gross receipts from such royalties. See, 35 ILCS 5/304(a)(3). In addition, sales of services have to be "thrown out" of the sales factor when the taxpayer is not taxable in the state in which services are received. See, 35 ILCS 5/304(a)(3)(C-5). The Pennsylvania and Kentucky state taxing authorities also attempted to apply the throwout rule in those states, but its application was rejected on the grounds that there was no express statutory authority for the throwout rule. For taxable years beginning on or after December 31, 2010, Alabama enacted a throw-out rule that applies in certain situations where the market cannot be determined.

Important State Developments Addressing the Sales Throwback Rule

California

The California Court of Appeal, Second District, ruled in *McDonnell Douglas Corp.*, 33 Cal.Rptr.2d 12 (Cal. Ct. App. 1994), that for purposes of sales factor sourcing, sales delivered to customers in California, which are subsequently transferred by the purchaser outside California, are sourced to the destination jurisdiction, provided the seller has nexus in the destination jurisdiction.

Prior to this ruling, California Regulations and Legal Ruling No. 348 (Feb. 21, 1973) had interpreted California's adoption of UDITPA to mean that, for sales factor sourcing purposes, property delivered or shipped to a purchaser within California was a California sale, even though the property was subsequently transferred by the purchaser to another state. This interpretation placed emphasis on the place of delivery, rather than the ultimate destination of the goods sold. Based on this interpretation, the California FTB has always assigned "dock sales" occurring in California to the California sales factor numerator. In its decision, the court analyzed several other states' cases construing the identical UDITPA statute and found the case at bar was indistinguishable from those cases. Those cases all held that dock sales should be sourced to the destination location, contrary to the California interpretation. The court found the intent of UDITPA was to give sales factor recognition to the state that produced the buyer (i.e., destination state) and to promote uniformity among the adopting states. As a result, the court held that the "destination" rule should apply to dock sales rather than the "place of delivery" rule used by the FTB.

The FTB issued Chief Counsel Ruling 2012-3 to address the issue of whether the recently enacted economic nexus rules under CRTC section 23101 apply when determining whether the taxpayer or a member of its unitary group is subject to tax in the destination state for purposes of the throwback rules under CRTC section 25135(b). (See above for discussion on Economic Nexus) In this case, the taxpayer had sales of tangible personal property and property other than tangible personal property to all 50 states and several foreign jurisdictions for the taxable year beginning on or after January 1, 2011. The FTB concluded that the taxpayer did not have to throwback its tangible personal property sales to the foreign jurisdictions because it had met the economic nexus standard under CRTC section 23101 and thus would have been taxable in those foreign jurisdictions. The FTB noted that the taxpayer could not rely on P.L. 86-272 to protect the taxpayer from being taxable in a foreign jurisdiction because P.L. 86-272 only applied to interstate, not foreign commerce. The FTB also concluded that the taxpayer's domestic sales were not required to be thrown back to California because the taxpayer, or a member of its combined reporting group would have been subject to tax in the other states because the economic nexus standard was met and the taxpayer was not covered by P.L. 86-272.

In November 2012, the FTB issued a Technical Advice Memorandum ("TAM") clarifying that for taxable years beginning before January 1, 2011, a taxpayer whose only contact with another state was the sale of tangible personal property into that state is not taxable in that state under U.S. Constitutional standards for the purposes of the throwback rule under CRTC section 25122. The taxpayer must demonstrate physical presence the destination state in order to avoid the application of the throwback rule. The FTB also noted that even though the California Legislature amended CRTC section 23101 to include a substantial economic nexus standard, it specifically provided that the amendment would only be applicable to taxable years beginning on or after January 1, 2011. Therefore, for the taxable year beginning before January 1, 2011, a taxpayer only meeting the economic nexus standard in another state could not avoid the throwback rule.

In the *Appeal of Craigslist, Inc,* through a decision rendered on January 15, 2016, the California Board of Equalization held that for tax years prior to the economic nexus standard in 2011, physical presence was required for a taxpayer to be taxable in a state under CRTC section 25122. (Appeal of Craigslist, Inc., Cal. St. Bd. of Equal. January 15, 2015). In this appeal, Craigslist had entered into a determination letter with the FTB agreeing to use an alternative apportionment methodology, and also requiring “throw-out” instead of “throw-back”. The throw-out provisions would apply to sales into states where Craigslist was not taxable under “United States constitutional standards for nexus.” The Taxpayer argued that because the “doing business” standard under CRTC section 23101 required an economic nexus standard, it must be constitutional, and should also allow for the use of an economic nexus standard when determining whether Craigslist was taxable in other states for years prior to 2011. The Board pointed to reliance concerns and a reluctance to rule on constitutional issues when it held that physical presence was required as the constitutional standard for taxability in these years. The Board declined to address whether this decision also cast doubt on the constitutionality of CRTC section 23101 and economic nexus in tax years beginning after January 1, 2011.

In Chief Counsel Ruling 201603, California Franchise Tax Board (7/5/16) (reported August 2016), the Chief Counsel ruled that where a taxpayer’s aggregate sales of tangible personal property and royalties exceed California’s doing business threshold and the taxpayer’s activities exceed P.L. 86-272 protection in such states, the taxpayer should not throw back to its California sales factor numerator sales of tangible property to such states.

For a further discussion of California's application of the throwback rule, see the discussion of the *Joyce/Finnigan* discussion below.

Indiana

The Indiana Department of Revenue explained that it had improperly applied the throw-back rule in attributing the income of a parent corporation's subsidiaries to Indiana because the out-of-state activities of the subsidiaries exceeded mere solicitation. [Ind. Dept. of Rev., Letter of Findings No. 98-00084, 11/21/01]

Initially, the department adjusted the sales factor numerators of two of the taxpayer's subsidiaries, stating that neither had payroll or property in any state other than Indiana, and stated further that another subsidiary did not have any employees, income-producing property, or other income-producing activities in other states. Employing the throw-back rule, the auditor attributed all the subsidiaries' receipts to Indiana.

On appeal, the department explained that, in this instance, the absence of payroll and property factors is not dispositive. In regards to one of the subsidiaries out-of-state initial solicitation activities, the department explained that such initial solicitation is just the first step in an "ongoing, complex, collaborative endeavor" to provide on-site installation, update and training services over an extended period of time, the department ruled that the subsidiary's out-of-state activities clearly exceed "mere solicitation." Accordingly, the throw-back rule was improperly applied to this subsidiary's income.

In another letter of findings, the Department concluded that Indiana law provides that a taxpayer is 'taxable in another state' for throwback purposes when the taxpayer is subject to a state's franchise tax for the privilege of doing business. The Department ruled the taxpayer's sales shipped to California should be thrown back and included in Indiana sales factor because its activities in California did not go beyond solicitation. The taxpayer's documentation shows that activities performed by its salesperson in California did not exceed P.L. 86-272 protection. The salesperson used taxpayer's laptop to perform activities, including preparing quotations, following up on quotations, gather data during the quote follow-up, and all customer's orders were required to be approved by taxpayer's Indiana office. [Ind Dept of Rev., Letter of Findings No 02-20140293, 12/23/14]

<u>Illinois</u>

Tax Return Filing in Destination State Required to Avoid Throwback

At issue before the Illinois Appellate Court in *Dover Corporation v. Illinois Department of Revenue*, 648 N.E.2d 1089 (Ill. App. Ct. Mar. 31, 1995), was whether sales made into jurisdictions in which Dover's activities exceeded PL 86-272, but in which no tax was paid, were properly thrown back to Illinois.

Illinois law provides sales are included in the numerator of the sales factor if the property is shipped from an Illinois location and "[t]he person is not taxable in the state of the purchaser." Dover contended that a person was "taxable" in the destination state if the state possessed the jurisdiction to impose a tax, regardless of whether the person paid a tax. The Department argued that a person was "taxable" only if it actually filed returns and paid tax in the jurisdiction.

The court, relying on the Illinois Supreme Court decision *GTE Automatic Electric*, *Inc. v. Allprin*, 36 N.E.2d 841 (Ill. 1977), found the legislative purpose in enacting formula apportionment provisions was to assure that 100 percent of the business income of a corporation doing multistate business was taxed by states having jurisdiction to tax it. Under Dover's statutory interpretation, "nowhere" sales would be created, a policy found contrary to legislative intent. Therefore, the court held, under Illinois statute, a taxpayer must pay tax in the destination state to be considered "taxable" in that jurisdiction.

Sales Throwback Depends on Taxability of Member Corporation Not Unitary Group

In determining the apportionment factor for a unitary group member subject to the Illinois income tax, sales are "thrown back" to the Illinois sales factor numerator based on whether the unitary group member, and not the unitary group, is taxable in the state of the purchaser, the Illinois Appellate Court, Fourth District held in *Follett Corp. v. Illinois Dep't of Revenue,* 800 N.E.2d 159 (Ill. App., 2003).

Follett Corp. ("Follett") and some of its affiliates operate as a unitary business group (the "Follett Group"). From 1995 to 1997, Follett made sales of goods that were delivered to other states in which Follett was not subject to tax, but in which another member of the Follett Group was subject to tax. The Follett Group's combined Illinois return did not include the destination sales in Follett's Illinois sales factor numerator. The department determined that Follett should have included the sales in its Illinois sales factor numerator because of the state's "throw-back" rule. Under 35 Ill. Comp. Stat. 5/304(a)(3)(B), a sale of tangible personal property is deemed to be in Illinois if the property is shipped from the state and "the person" is not taxable in the state of the purchaser. Follett argued that the term "person" refers to the entire unitary business group, and that a member of the Follett Group was taxable in the states where the Department asserted throwback. The court rejected Follett's argument, finding that the term "person" refers to an individual corporation, not the unitary business group. The court therefore concluded that "the Illinois legislature clearly regards the seller and the purchaser of a sales transaction as individual corporations instead of unitary business groups[.]"

Throwback Not Required Even if Sales Not Taxed By Foreign Jurisdiction

In *Morton International, Inc. v. Illinois Department of Revenue, et al.*, Dkt. No. 01 L 50752, 07/08/04, the Circuit Court of Cook County held that the Illinois Department of Revenue could not "throw back" sales of tangible personal property shipped to buyers in foreign countries, even though the taxpayer admittedly paid no tax on its income stream from the sales in issue in the foreign jurisdictions.

The Illinois statute and UDITPA provide that "[s]ales of tangible personal property are in [Illinois] if . . . [t]he property is shipped from an office, store, warehouse, factory or other place of storage in this State and . . . the [taxpayer] is not taxable in the state of the purchaser." 35 ILCS 5/304(a)(3)(B)(ii). While it was undisputed that the property was shipped from a facility located in Illinois, the parties disagreed on the meaning of "taxable in the state of the purchaser." The court rejected the department's argument that the fact that the particular receipts were not subject to tax in the destination foreign countries meant that Morton was not "taxable in the state of the purchaser" as required by 35 ILCS 5/304(a)(3)(B)(ii). According to the court, the statute requires only that the taxpayer be subject to a net income or other qualifying tax in the destination jurisdiction, and does not require that the taxpayer be taxable with respect to the particular receipts.

Texas

Statutory provisions that require a taxpayer to "throw back" out-of-state sales in computing the earned surplus portion of the Texas franchise tax violate the fair apportionment prong of the Commerce Clause when applied to certain taxpayer situations, the Texas Court of Appeals ruled in *Home Interiors & Gifts, Inc. v. Strayhorn,* Tex. Ct. App., No. 03-04-00660-CV, 7/28/05; *petition for review denied,* No. 05-0939, 3/9/07,.

The taxpayer was subject to the greater of a tax on earned surplus or taxable capital in Texas and protected under P.L. 86-272 from income tax in all states outside Texas. Applying a hypothetical standard under which all states imposed a tax similar to the Texas franchise tax, the court reasoned that an interstate corporation could be subject to an apportioned tax on net worth in every state in which it established a substantial nexus, as well as a tax on 100 percent of its net worth in Texas, while an intrastate corporation would only be subject to Texas tax. The additional out-of-state tax burden creates an internal inconsistency, and therefore a violation of the U.S. Constitution. The court acknowledged that the Supreme Court allows states to provide a remedy, which might include granting a franchise tax credit for any taxes assessed on an interstate corporation's net worth where the throwback rule creates a risk of multiple and discriminatory taxation. However, such remedy must be provided by the Legislature, the court said.

ALTERNATIVE APPORTIONMENT METHODS UNDER SECTION 18

IN GENERAL

UDITPA expressly recognizes that the standard apportionment formula may not be appropriate in all circumstances. For this reason, Section 18 of UDITPA provides that in specified circumstances, a taxpayer may petition for, or the state may require, the use of apportionment methods other than the standard formula if the provisions of the standard formula "do not fairly represent the extent of the taxpayer's business activity" in the state. The section provides in full:

> "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) Separate accounting;

(b) The exclusion of one or more additional factors;

(c) The inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

One of the drafters of UDITPA explained the purpose of this provision as follows:

> Section 18 is a general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used when the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics. (Pierce, "The Uniform Division of Income for State Tax Purposes," *Taxes,* Oct. 1957, 747, 781.)

However, in contrast to this flexible approach, the MTC has interpreted UDITPA Section 18 relief to be available only in limited circumstances:

> MTC Reg. IV.18.(a) permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce *incongruous results*.. (emphasis added)

A request for relief under California law must overcome two hurdles to prevail: (1) that the standard allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state; and (2) that the alternative method proposed is "reasonable." The party seeking relief bears the burden of proving that exceptional circumstances are present. (*Appeal of New York Football Giants, Inc*., Cal. St. Bd. of Equal., Feb. 3, 1977.) In California, as in most other states adopting the relief provision, application of relief is not justified simply because a proponent contends that its method is "better" than the standard formula, for what must be shown is sufficient distortion that the taxpayer's business activity in California is not clearly reflected. (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*., 89-SBE-017 (Cal. St. Bd. of Equal. June 2, 1989).) Nor do mere allegations that the standard formula is not precise justify the use of Section 25137. (*Appeal of Kikkoman International, Inc.*, Cal. St. Bd. of Equal., June 29, 1982.)

California has adopted regulations pertaining to CRTC section 25137, the State's version of UDITPA. Section 25137 is identical to UDITPA and, therefore, the general rules in Regulation 25137 (which track the MTC regulation) can be studied to determine the normal application of the relief statute.

Regulation 25137 sets forth general rules for invoking Section 25137. Specifically, the regulation provides in part:

1. Section 25137 permits a departure from the standard allocation and apportionment provisions "only in limited and specific cases." (Regulation 25137, subd. (a).)

2. Section 25137 may be invoked "only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results" under the standard apportionment and allocation provisions. (Regulation 25137, subd. (a).)

3. In cases deemed appropriate by the FTB, it may elect to hear and decide petitions filed pursuant to Section 25137 instead of having this function performed by staff. As a condition to having such a petition considered by FTB, the petitioning taxpayer must waive in writing the confidentiality provisions of Section 19542 ("Returns confidential") with respect to the petition and to any other facts which may be deemed relevant in making a determination. Consideration of the petition by the FTB shall be in open session at a regularly scheduled meeting. (Section 25137, sub.(d).)

Regulation 25137 also provides that in the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth, the standard allocation and apportionment regulations do not set forth appropriate procedures for determining the apportionment factors.

Important State Developments Addressing Section 18 Relief

<u>California</u>

Party Seeking Deviation Carries The Burden of Proof

In *Microsoft v. FTB*, the California Supreme Court invoked the alternative apportionment CRTC section 25137 to hold that inclusion of the full price of Microsoft's sales and redemptions of short-term marketable securities was distortive. Citing the provisions of CRTC section 25137, the court found that as the party requesting the application of an alternative apportionment formula, the FTB had the burden of proof to show that standard apportionment formula is not a fair representation and that the FTB's proposed alternative apportionment formula was reasonable. (A discussion regarding the gross receipts issue can be found above.)

In *Appeal of New York Football Giants, Inc.,* Cal. St. Bd. of Equal., Feb. 3, 1977, the issue was whether FTB under Section 25137 could require the taxpayer to deviate from the statutory sales factor. The taxpayer operated a professional football team in the National Football League that, during the appeal year, played one game in California. The taxpayer received income from the sale of tickets to its home games and under the League's constitution and by-laws, it was obligated to pay either a portion of such gate receipts or a flat fee to the visiting team at each home game. In its apportionment formula for the year in question, the taxpayer included its entire home game gate receipts in the denominator of the sales factor. FTB determined the portion of the gate receipts paid to visiting teams should be excluded from the sales factor. The parties agreed that "gross receipts" are to be included in the sales factor under Section 25134, and that the taxpayer's entire home game receipts were part of "gross receipts." FTB, however, argued it had discretion under Section 25137 to compute the taxpayer's sales factor differently than under Section 25134.

The SBE held for the taxpayer, and found that discretionary adjustments to the statutory allocation and apportionment provisions are authorized only under exceptional circumstances, that is, only where those procedures do not fairly represent the extent of the taxpayer's business activity in California. The SBE stated that in order to ensure that the standard UDITPA provisions are applied as uniformly as possible, the party who seeks to deviate from the statutory formula, whether the taxpayer or the taxing agency, bears the burden of proving that such exceptional circumstances are present. The SBE found that the taxpayer had computed its sales factor precisely as required by Section 25134, and there was nothing in the record to suggest that computing the sales factor in that manner did not fairly represent the extent of the taxpayer's business in California.

SBE Invokes Fairness Standard, Rejects Quantitative Approach

In *Appeal of Crisa Corporation*, 2002-SBE-004 (6/20/02), the SBE denied the taxpayer's request for special apportionment under Section 25137. The SBE explained that the central question under Section 25137 is not whether some numerical quantitative comparison has produced a large enough "distortive" change in the factors. The proper question is whether there is an unusual fact situation that leads to an unfair reflection of business activity in the state under the standard apportionment formula. The answer to this question requires an analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer, the SBE explained. Section 25137 must be analyzed on a case-by-case basis; there is no bright line rule that determines when the standard formula does not adequately deal with a particular situation. The SBE listed five "unusual transactions" that might trigger application of Section 25137:

1. A corporation does substantial business in California, but the standard formula does not apportion any income to California.
2. The factors in the standard formula are mismatched to the time during which the income is generated.
3. The standard formula creates "nowhere income" that does not fall under the taxing authority of any jurisdiction.
4. One or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business.

5. A particular factor does not have material representation in either the numerator or denominator, rendering that factor useless as a means of reflecting business activity.

FTB Legal Notice 04-5

On August 6, 2004, the FTB released FTB Notice 2004-5 titled: Asserting a Revenue and Taxation Code Section 25137 Variation in an Original Return Filing: Accuracy-Related Penalties. This notice was drafted in response to a growing trend of taxpayers choosing to apportion their income in a manner inconsistent with CRTC sections 25120-25136 under the authority of the general provisions of CRTC 25137. According to the FTB, taking the filing position mentioned above will be deemed to be erroneous, absent prior approval, and may result in the assertion of accuracy-related penalty under CRTC section 19164 (incorporating by reference certain provisions of IRC §§ 6662-6665.

Bankruptcy Court Upholds FTB Use of Alternative Apportionment

A U.S. Bankruptcy Court concluded that the FTB established that use of the standard apportionment formula would result in qualitative distortion because the taxpayer's treasury functions were qualitatively different from its principal business of operating restaurants. Further the standard formula would result in quantitative distortion both in examining the taxpayer's margin and income (e.g., 77% of gross receipts from treasury activities, but only 5.4% of income).

In addition, the Court found that, for purposes of the former manufacturer's investment credit, the state did not require that food manufacturing or processing be the only business of the taxpayer, but rather that some of the taxpayer's activities fit in SIC Manual Division D (i.e., manufacturing). *Buffets, Inc. v. California Franchise Tax Board,* U.S. Bankruptcy Court, D. Delaware, No. 08-10141, 8/15/11.

The FTB Limits the Distortion Rules in Chief Counsel Ruling 2012-1

In Chief Counsel Ruling 2012-1, the FTB found that **intrastate** apportionment (the relative share of the group's California activities that is conducted by each taxpayer member of the group) was not a proper subject for alternative apportionment distortion relief under CRTC section 25137. Here, a nonfinancial registered broker/dealer taxpayer requested distortion relief on the basis that inclusion of the receipts generated from its principal trading activity in its California sales factor numerator and denominator would cause the relative intrastate apportionment between the combined group's general and financial corporations. The FTB held that since CRTC section 25137 only discussed fair representation of activities "in this state," CRTC section 25137 cannot be used to remedy intrastate apportionment issues.

FTB Chief Counsel Ruling 2013-01 – Motion Picture Company

The FTB in Chief Counsel Ruling 2013-01 found that the motion picture entertainment company was a “producer” pursuant to Reg. 25137-8.2. The motion picture entertainment company at issue modified two-dimensional and three-dimensional movies into a version that could be displayed in certain theatres. The requisite multi-step process was nearly identical to conventional film production. The FTB reasoned that a motion picture producer generally engaged in all the same activities that the company performed such as enhancing movies for display in movie theatres and using computer programs to change computer pixels for exhibition in movie theatres. As a result, the revenue that the company derived from the modification process were considered gross receipts from "films in release to theatres" and sourced to California to the extent the films were released in California theatres.

Colorado

In *Target Brands, Inc. v. Department of Revenue of the State of Colorado,* District Court, City and County of Denver, No. 2015CV33831 (1/27/17), the Colorado trial court found unreasonable an alternative apportionment formula imposed by the Department of Revenue, which required an intangible property company (which was determined to have nexus) to apportion its income based on the sales factor of its parent company. The trial court found that this alternative method was unreasonable because it failed to consider the significant contributions made by the intangible property company's payroll and property outside Colorado to the value the Department sought to tax. Accordingly, for the taxpayer in this case, the court found that any alternative apportionment formula must include the intangible property company's property and payroll. The ultimate decision did not arrive at an accepted apportionment formula for the company.

Although this decision relates primarily to tax years when a three factor apportionment formula and costs-of-performance sourcing method were applicable (Colorado has imposed a single-sales factor apportionment formula and a modified proportional costs-of performance sourcing method since the 2009 tax year) the case remains instructive for taxpayers with tax years open for examination prior to 2009. The case also may be instructive for taxpayers where the Department asserts an alternative apportionment formula, regardless of the tax year. Even in single-sales factor and modified costs-of-performance sourcing years, the standard for a 'reasonable' alternative allocation method articulated in this case could apply. That is, alternative apportionment factors of an entity providing material contributions to related members could include that entity's property and payroll factors. Stated another way, because the Department asserted alternative apportionment, the ultimate resolution of the 2009 tax year may not be limited to a single sales factor approach.

Idaho

Removal of Accounts Receivable from Sales Factor Upheld

In *Union Pacific Corp. v. Idaho State Tax Comm'n.,* 83 P.3d. 116 (2004), the Idaho Supreme Court held that the use by the Tax Commission of an alternative apportionment method that excludes from the sales factor proceeds received on the sale of accounts receivable is a reasonable alternative to the standard three-factor formula.

UPC argued that its sales of receivables were neither unique nor nonrecurring, and therefore alternative apportionment may not be applied under the tax commission's rule. The court concluded, however that "the mixing of the two accounting systems to represent but one group of sales is the unusual fact situation that led to incongruous results in UPC's application of the standard formula." The court explained that while it is necessary to establish that the application of the three standard apportionment factors does not fairly represent business activity, the court found that the district court "looked at all three factors before determining that the problem rested exclusively in the sales factor." The court also rejected the application of a "constitutional" standard for the evaluation of apportionment formulas, finding that "[t]o engraft a gross distortion requirement onto the application of an alternative apportionment" would be to add to the existing language in Idaho Code Sec. 63-3027.

New York

In the Matter of the Petition of *The McGraw-Hill Companies, Inc.,* New York City Tax Appeals Tribunal, Administrative Law Judge Division, TAT (H) 10-19 (GC) et al., 2/24/14, the Tribunal found that S&P, a division of McGraw-Hill, was a financial information publisher that publicly provided the objective viability of an investment in a given financial instrument. S&P's analysis is designed not just for the use of the rated companies, but for the benefit of all who might read S&P's publications. The Tribunal reviewed US Supreme Court, New York State, and other state and federal decisions to conclude that financial information publishers are members of the press and public credit ratings are constitutionally protected expressions of opinion.

Since S&P was entitled to First Amendment protections when it published financial information to the general public, a tax that treats S&P differently from other members of the press would be 'presumptively unconstitutional.' Accordingly, the Tribunal found that S&P, as a financial information publisher, should be taxed in the same manner as other publishers.

The Tribunal found that S&P's audience-based allocation method was consistent in principle with the circulation/audience methods New York City provides to other publishing companies to allocate City receipts. Accordingly, S&P was "entitled to discretionary adjustment of its receipts factor to allocate S&P receipts according to an audience-based methodology, in order to properly reflect its City activity, business, and income."

Oregon

Intangible Assets Included in Alternative Formula

The Supreme Court of Oregon in *Crocker Equipment Leasing, Inc. v. Dept. of Rev.,* 838 P.2d 559 (Or. 1992) found the taxpayer's alternative formula to represent a reasonable method of attributing income to the State. Crocker maintained that since approximately 98 percent of its earning assets were intangible property, such property must be included in the property factor to avoid distortion. The Oregon Department of Revenue argued that including only tangible property in the factor did not result in distortion because the revenue factor reflected the interest income earned by the intangibles.

The court stated that the "relief" provision of the Oregon statutes allows for alternative formulas to be used when the taxpayer has demonstrated by a preponderance of evidence that the statutory formula does not fairly represent the extent of its business activity in the State and that its alternative method is reasonable. The court found that excluding 98 percent of the taxpayers' assets from the property factor could not be corrected by including the income in the receipts factor because the three factors of payroll, property and receipts were averaged. The disproportionate property factor skewed the results of the calculation and attributed a disproportionate amount of activity to the State. The court further found that the taxpayer's methodology was reasonable in that it established a "realistic relationship to how the income is earned." Based these findings, the court held that intangible property was properly included in the property factor.

South Carolina

In *Media General, Inc., et al. v. South Carolina Department of Revenue*, Opinion No. 26828, June 14, 2010, the South Carolina Supreme Court upheld the use by three affiliated taxpayers of the combined entity apportionment method under the state's alternative apportionment relief statute, rejecting the Department of Revenue's argument that use of this method runs afoul of the legislative intent that the state treats taxpayers as a single entity.

The court explained that under S.C. Code Ann. Sec. 12-6-2320(A), taxpayers may petition, or the Department may require, the employment of any other method to effectuate an equitable allocation and apportionment of a taxpayer's income when the standard allocation and apportionment provisions do not fairly represent the taxpayer's business activity in South Carolina. Although the Department stipulated that the standard statutory method did not fairly represent Taxpayers' income, and that the combined entity apportionment method did fairly measure Taxpayers' business activity in South Carolina, it argued that the combined entity apportionment method is not authorized under state law because of the statutory language requiring the filing of tax returns by a single entity and by defining "taxpayer" as a single entity.

In rejecting the Department's arguments, the court relied heavily on the unambiguous language of section 12-6-2320(A)(4) allowing for "any other" method to be used when seeking relief from statutory apportionment methods resulting in distortion. The Department asserted that other methods, such as changing the factors to be considered in the apportionment ratios, may be used to correct the problems caused by application of the standard apportionment statutes. However, despite its argument, the court noted, the Department did not recalculate Taxpayers' income and taxes using any alternative method that it believed would have fairly apportioned Taxpayers' income. The court emphasized that as a general rule, the Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an alternative method that fairly measures the taxpayer's business activity. However, in this case, since the Department never used any other method, and stipulated that use of the combined entity apportionment method proposed by Taxpayers resulted in a fair computing of Taxpayers' business activities in South Carolina, the court accepted Taxpayers' proposed method. The court noted that the legislative intent of the relief provisions placed no explicit limitation on alternative methods under the "any other" standard.

In *Carmax Auto Superstores West Coast, Inc. v. SC DOR.* S.C. Sup Ct., No. 27474, 12/23/14, the South Carolina Supreme Court held that the party seeking to deviate from the statutory apportionment formula bears the burden of proving beyond a preponderance of the evidence (1) the statutory formula does not fairly represent the taxpayer's business activity in the state; and (2) its alternative accounting method is reasonable. There is no further requirement (as provided by the lower court) that the proponent prove its method is the most reasonable. The court suggested that a taxpayer's motives and lower tax provide insufficient support for whether the statutory formula fairly represents in-state activity.

THE COMBINED REPORT

IN GENERAL

Because California was the first state to impose combined reporting on unitary business groups and because California's combined report is generally more complex than reports required by other combined reporting states, this chapter will be entirely devoted to the California combined report.

Where a single corporation does business within and without California, the process of allocating and apportioning its income between California and other states is usually a relatively simple task under UDITPA. However, a far greater level of complexity is encountered when the corporation's activities in California are part of a unitary business conducted by the corporation and related corporations. California's methodology for addressing this situation is the "combined report" concept. When a group of corporations conducts a unitary business within and without California, California law requires the members of the group to compute their individual tax under the combined report method.

This chapter discusses the basic principles of the combined report where no water's-edge election has been made. It should be kept in mind that some of these principles may not be applicable, or may have been modified by statute or regulation, where a water's-edge election has been made. (See CRTC § 25110 et seq.)

A noted commentator explained the combined report concept as follows:

> "Simply stated, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing state shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations. In cases where one corporation conducts the business, the income is computed as a unit and apportioned by means of an appropriate formula.... The income so attributed to the state is combined with any nonbusiness income which the taxpayer may have from sources within the taxing state . . . to arrive at taxable income. When the combined report is employed, exactly the same procedure is followed, and the same results obtained, in cases where more than one corporation conducts the business. The income is still computed as a unit just as it would be if the business had been conducted by one corporation only." (Keesling, "A Current Look at the Combined Report and Uniformity in Allocation Practices," *Journal of Taxation*, Feb. 1975, p. 106.)

A "combined report" is not a tax return. It is a method by which the income and activities of commonly owned corporations operating as a unitary business are combined into a single report for purposes of calculating income, and then apportioning that income to the various entities involved and to the jurisdictions in which the business is taxable. California in 1999 adopted regulations providing rules for preparing the combined report (See CCR § 25106.5-0 through

25106.5-10). Instructions for this process are also found in FTB 1061, "2004 Guidelines for Corporations Filing A Combined Report," hereafter referred to as "FTB 1061."

In order to determine the total group combined report business income, each member of a combined reporting group must first identify its total separate net income for the period beginning and ending with the accounting period of the principal member of the combined reporting group (CCR §25106.5(c)(1)). After adjustments for intercompany transactions within the Combined Reporting Group are made, this number is then combined with the total separate net incomes of the other group members to arrive at the total group combined report income (CCR §25106.5(c)(1)(A)).

Once the total group combined report business income is determined, it is multiplied by the Taxpayer Member's California apportionment percentage to arrive at that member's California source combined report business income (CCR §25106.5(c)(7)). While the income figure is combined and then apportioned back to individual members, attributes such as NOLs, tax computations, AMT, credits, etc. are all determined and applied on a separate company basis against those individual apportioned income numbers.

The combined report procedure is derived from the general power and duty of the FTB to determine the amount of income attributable to sources within California for tax purposes. CRTC §25101 provides that if a taxpayer has income "derived from or attributable to sources both within and without the state, the tax shall be measured by the income derived from or attributable to sources within this state in accordance with the provisions of . . ." UDITPA as found in CRTC §25120 et seq. The SBE has noted that: "[i]t is well settled that the authority for requiring a combined report rests in Section 25101." (*Appeals of Foothill Publishing Co. and The Record Ledger, Inc.*, Cal. St. Bd. of Equal., Feb. 4, 1986.) The combined report was first judicially approved as a reasonable allocation method in *Edison California Stores v. McColgan* and, more recently, was approved by the U.S. Supreme Court in *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983*).*

ELEMENTS OF THE COMBINED REPORT

As described in greater detail in FTB 1061, a combined report should contain the following schedules:

1. A Combined Profit and Loss Statement showing the profit and loss of each corporation.

2. A Schedule Converting Net Income to Unitary Business Income Subject to Apportionment. This schedule includes adjustments necessary to account for differences between federal and California law, and to account for items of nonbusiness income for each corporation. Typical major adjustments might include add-backs for California Bank and Corporation Tax deducted and capital loss carryovers deducted, and deductions for dividends under CRTC §25106 or 24410.

3. A Schedule Showing the Combined Apportionment Formula. This schedule shows for each corporation the total amount of payroll, property and sales, and the California amount of payroll, property and sales. Certain intercompany transactions are eliminated in this process.

4. Schedule Computing California Net Income and Tax. This schedule calculates the amount of net income for California purposes and applies the tax rate to the amount to determine the amount of tax owed. The schedule first calculates the amount of unitary business income apportioned to California for each corporation by multiplying the combined unitary business income subject to apportionment (from (2) above) by each corporation's California apportionment percentage (from (3) above). To that result is added the amount of nonbusiness income attributable to California for each corporation. Other minor adjustments are then made, including any deduction for contributions), to reach net income.

WATER'S-EDGE FILING

In 1986, legislation was enacted in California to permit a "water's-edge election" to be made by certain taxpayers. This legislation was intended primarily to restrict California's application of the worldwide combined reporting method of determining income from California sources. Rather than ban worldwide combined reporting, the water's-edge legislation provided another option for taxpayers. If a taxpayer would pay more tax under the worldwide method, it may choose to pay less tax by making a water's-edge election.

Stated very broadly, under water's edge, the scope of combined reporting is limited to certain corporations whose income is subjected to tax by the United States government. An entity incorporated in a foreign country, which lacks certain connections with the US, is not subjected to US taxation and therefore is not included in the water's-edge combined report. The federal tax system and the water's-edge system have special rules for CFCs with Subpart F income, foreign sales corporations, export trade corporations, and domestic international sales corporations.

For taxable years beginning prior to January 1, 2003, a water's-edge election was made by "contract" with the FTB for an 84-month (seven-year) period. The contract required the auditor to follow certain procedures in examining certain issues. The taxpayer's responsibilities included an obligation to be subject to the water's-edge rules and to forego the right to file a worldwide combined report for at least seven years.

For taxable years beginning on or after January 1, 2003, the procedures for making a water's-edge election were revised pursuant to CRTC §25113. CRTC §25113 replaced the old election by contract with a statutory election. The statutory election continues to be made for an 84 month period, but must be made on a timely filed, original return for the year of the election (as compared to prior law, which allowed the election to be made on a delinquent return). The taxpayer elects for an initial 84 month period. After the initial seven year period, the taxpayer can choose to terminate the election at any time. However, if a water's-edge election is terminated, the taxpayer cannot re-elect for 84 months (i.e. must file worldwide for the ensuing seven year period). Taxpayers may request FTB consent to terminate the water's-edge election prior to the expiration of the initial 84 month period for good cause.

Finally, CRTC §25113 eliminates the prior statute's "deemed election" regime for acquisitions. Under prior law, if a water's-edge elector entered a unitary group, the entire group was "deemed" to have made a water's-edge election. This was true even if the non-electing group was significantly larger than the water's-edge taxpayer. Under the new law, if a water's-edge taxpayer (or group of taxpayers) becomes unitary with a worldwide group (or is determined to be unitary by FTB at audit) the status of the larger group (worldwide or water's-edge) determines the status of the new combined group. *See* FTB Notice 2004-2.

In 2016, the FTB issued notice 2016-02 to address whether a water's-edge election is invalidated when a foreign unitary affiliate, which did not participate in the original election, subsequently becomes taxable as a result of California's enactment of the 'factor presence nexus' effective in 2011. The notice provides that a unitary foreign affiliate is deemed to have participated in or subsequently elected into a combined group's water's-edge election if certain qualifications are satisfied. In general, the FTB will deem such foreign affiliates to have made an election effective as of the taxable year in which they became a taxpayer. The commencement date of the deemed water's-edge election is the same as the commencement date of the existing water's-edge group's election, whether or not the foreign affiliate is otherwise includible in the water's edge group as a foreign corporation recognizing U.S. source income.

Non Effectively Connected Income ("NECI")

Taxable years beginning prior to January 1, 1992

CRTC §25110 provides that certain foreign corporations are included in the water's edge return to the extent of U.S. source income, provided the income is U.S. source income under federal tax laws, is determined from books of account maintained by the corporation with respect to activities conducted within the U.S. Regulation § 25110(d)(2)(F) as originally drafted provided that U.S. source income includes only income effectively connected or treated as effectively connected under the IRC or treaties. Regulation 25110(d)(2)(F)2b specifically excluded NECI from the definition of U.S. source income. Regulation 25110(d)(2)(F)3 provided that expenses attributable to U.S. source income are determined under Treasury Reg. 1.861-5 (other than interest expense) and 1.882-5 (interest expense). For federal purposes, withholding at source occurs with respect to the gross NECI. Thus, NECI is taxed at gross, not at net. Hence, there are no federal rules to provide expenses or deductions for NECI. There were no California expense attribution rules for NECI, as NECI was not included in the definition of US source income.

Taxable years beginning on or after January 1, 1992

Despite there being no change to the underlying water's-edge statute, FTB amended the regulation in 1992. NECI was included in the definition of U.S. source income. NECI for this purpose included U.S. source income under IRC §861-865 and §897 (e.g. interest, dividends and royalties paid by a U.S. subsidiary to a foreign parent). California will no longer follow federal treaty provisions that limit the amount of effectively connected income.

Amendments effective February 23, 2007

In September 2006 FTB staff reported to the three-member FTB ("the Board") that after further review, FTB Legal Counsel concluded that NECI should be not included in a water's-edge return. In December 2006, the Board approved the recommendation to remove the inclusion of NECI from the regulation. NECI is excluded from the water's-edge return unless the NECI arises from a contract or an agreement where the principal purpose of the contract or the agreement is the avoidance of federal income or California franchise tax. Applicable to tax years beginning on or after January 1, 1992, federal treaty provisions that limit the amount of effectively connected income no longer apply to California.

SB 663 - Coordination of Subpart F and US source income inclusion rules

Effective for tax years beginning on or after January 1, 2006, the coordination rules with regard to partial inclusion of a foreign corporation in a water's-edge group were revised. CRTC §25110 contained several conditions under which foreign corporations are includible in a water's-edge group. These conditions could create situations under which a foreign corporation may be includible under more than one rule. For example, a Controlled Foreign Corporation which is partially includible in the water's-edge group under the Subpart F partial inclusion ratio rule could also be includible under the U.S. source income provisions. CRTC §25110(a)(7)(B) provided a coordination rule to resolve the issue: A foreign corporation that was an "electing taxpayer" was includible only to the extent of its U.S. source income, and not also based upon its Subpart F income. Regulation 25110(d)(2)(G) provided a similar coordination rule for foreign corporations which are not electing taxpayers.

The FTB maintained that the above coordination rules were limited to individual items of income and not the foreign corporation as a whole. SB 663 replaced the controversial provision with a new coordination rule that prohibits a controlled foreign corporation from excluding its "Subpart F" income from a water's-edge combined report, even if it is a California taxpayer or has income from a United States source. The amendments require inclusion in a water's-edge combined report of both United States-source income and "Subpart F" income of a controlled foreign corporation, regardless of whether the corporation is a California taxpayer.

SB 663 is operative for taxable years beginning on or after January 1, 2006. If the taxpayer reported only U.S. source income and not Subpart F income of the CFC in the original return, the taxpayer is deemed to be in compliance with existing law, as it read prior to the enactment of SB 663.

SB 663 requires the FTB to promulgate regulations to prevent the potential double taxation of income when a controlled foreign corporation has both United States-source income and "Subpart F income."

COMMON ISSUES

Corporations Operating Wholly Within California

At one time, a unitary business operating wholly within California was not permitted to use the combined report method. (See, e.g*., Appeals of O.S.C. Corporation, et al*., Cal. St. Bd. of Equal., Dec. 3, 1985.) However, for income years beginning on or after January 1, 1980, Section 25101.15 allows two or more corporations that are engaged in a unitary business solely within California to elect to file a combined report.

This election has been brought into question by Harley-Davidson, Inc. v. Franchise Tax Board (*Harley-Davidson v. Franchise Tax Board*, D064241 (Cal. Ct. App. May 28, 2015), slip op. at 16). In its May 28, 2015 opinion, the California Court of Appeals held that the election for intrastate taxpayers was facially discriminatory against interstate taxpayers. On remand at the Fresno Superior Court, deciding on a motion for summary judgment, the court decided in October of 2016 that the statute survived the strict scrutiny test by advancing a legitimate local purpose that could not be advanced in a non-discriminatory manner. Accordingly, it did not have to answer the question of whether there was discrimination happening due to the disparate treatment of wholly intrastate and interstate taxpayers. Harley-Davidson is currently filing an appeal with Division 1 of the 4th California Appellate District. . Of note, the same issue is being litigated in Fresno County Superior Court by Abercrombie & Fitch. (*Abercrombie & Fitch v. Franchise Tax Board*, Fresno Superior Court no. 12CECG03408).

Inactive Corporations

Combined reporting is predicated upon the unitary concept. Because inactive corporations are not deemed to be conducting a unitary business, they cannot be included within a unitary group or a combined report. (See FTB 1061.)

Part-Year Members

A California reporting corporation may become a member of the unitary group after the beginning of the income year or may cease to be a member of the unitary group during the income year. In these circumstances, the corporation must use the combined report method to calculate its net income for California purposes for the portion of the year it is a member of the unitary business and must use separate reporting to calculate its net income for California purposes for the portion of the year it is not a member of the unitary business. (See CCR §25106.5-9 for examples.) In addition, a part-year member may not be included in the election to file a single return unless its income year is a short period that was unitary for the entire period, has the same statutory due date as the other members participating in the election, and falls entirely within the income year of the principal member.

Corporations Having Different Accounting Periods

Regulation §25106.5-4 provides that the combined report must be computed on the basis of a common accounting period. If one or more of members of a combined reporting group has a different accounting period than that of the "principal member," adjustments must be made to assign an appropriate amount of such member's income/apportionment data to the "principal member's" accounting period in order to apportion total group combined report business income. The regulations provide two methods for making the necessary adjustments, an "interim closing" method and a "pro-rata" method. The regulation applies to income years open to adjustment under applicable statutes of limitation.

As a general rule, each member of the group is required to use the interim closing of the books method. An election to use the pro-rata method of converting income to the principal member's accounting period will only be allowed if the method does not produce a material misstatement of income apportioned to this state. Unless otherwise permitted or required by the FTB, the same method of determining "common accounting period" income and apportionment data must be used for any particular member. In addition, if a member changed its method of determining income/factors for the common accounting period from one year to the next, adjustments are required to prevent income and apportionment data from being omitted or duplicated.

Alternative Minimum Tax

When alternative minimum taxable income (AMTI) is derived from or attributable to sources both within and without California, the income attributable to California must be determined by use of the apportionment formula used in determining income subject to the regular tax. Where the AMTI is attributable to unitary operations of a combined group wholly in California, the income is assignable to each member by use of the average relative ratio of each member's payroll, property and sales of all members times the total AMTI items. (See FTB 1061 for examples; see also Schedule P (100), Alternative Minimum Tax and Credit Limitations-Corporation, and Instructions.)

The SBE ruled that a corporate taxpayer may use certain credits, such as the Enterprise Zone Credit, to reduce AMT. (See *NASSCO Holdings, Inc*., 2010-SBE-001, Nov. 17, 2010 and FTB Notice 2011-02).

Net Operating Losses

California incorporates, with numerous specific modifications, the provisions of IRC Secs. 172 concerning carryovers of net operating losses. Corporations that are members of a unitary group filing a single return determine their NOL based on the combined net loss of the group, and each corporation's intrastate apportioned share of the loss is available to be carried over and applied in subsequent years. (CRTC §25108.) Unlike the treatment on a federal consolidated return, a loss carryover of one member of a combined report may not be applied to the intra-state apportioned income of another member included in the combined report.

Over the years, there have been frequent changes to the NOL rules. NOLs have occasionally been suspended as well. Before 1988, there was no carry forward period. For 1988 through 1999, 50% of the NOL could be carried forward; for 2000 through 2001, 55% can be; for 2002 and to 2003, 60% can be carried over; and for 2004 and later, 100% of the NOL can be carried forward. For 1997 through 1999, the carry forward life is 5 years; for 2000 through 2007, the life is 10 years; and for 2008 and later, the carryover is 20 years.

For tax years beginning after January 1, 2002 and before January 1, 2004, use of the NOL deduction was suspended and the carryover period was extended. For tax years beginning after January 1, 2008 and before January 1, 2010, again the use of the NOL deduction was suspended and the carryover period was extended for each year the NOL is barred. Per CRTC section 24416.9(d), this NOL suspension does not apply to taxpayers that have taxable income below $500,000. This exception applies on an entity-by-entity basis. For taxable years beginning in 2010 and 2011, corporations with net income after state adjustments (pre-apportioned income) of less than $300,000 or with disaster loss carryovers are not affected by the NOL suspension rules. If taxpayers are required to be included in a combined report, the 2010 and 2011 NOL limitation amount of $300,000 or more shall apply to the aggregate amount of pre-apportioned income for all members included in the combined report.

Prior to 2011, California had no provision for NOL carry backs. However, for 2011, 50% of an NOL can be carried back for 2 years; for 2012, 75% of any NOL can be carried back for 2 years; and for 2013, 100% of any NOL can be carried back for 2 years. No NOL carry back will be allowed for any tax year beginning before January 1, 2009.

California conforms to the federal 20 year NOL carryforward for NOLs attributable to tax years beginning on or after January 1, 2008, and the 2 year carryback period for NOLs attributable to taxable years beginning on or after January 1, 2011.

On September 23, 2011, the FTB issued Legal Ruling 2011-04 in order to answer questions about the calculation of a taxpayer's remaining NOL carryover period when the NOL deduction is suspended under California Law. The legal ruling provides examples illustrating how the NOL suspension provisions operate on the remaining carryover periods in certain situations. Prior to the Legal Ruling 2011-04, there was ambiguity regarding what portion of the NOL (full amount generated or amount denied via the suspension) was available for the carryover period extension. The Legal Ruling 2011-04 clarified that if even a portion of an NOL generated in a particular year is denied, the carryover period for the entire NOL generated in that year is extended, and if none of the NOL carryover would have been used during the suspension period, then the carryover life of that NOL is not extended.

NOLs generated in tax years beginning before 2013 cannot be carried back. However, for NOLs attributable to tax years beginning on or after January 1, 2013, California requires the carrying back of the NOLs to the two previous tax years. (CRTC §§ 24416.20, 24416.22.) Based on the FTB’s guidance, the carry backs are limited to 50% of the NOL created in 2013, 75% of the NOL created in 2014, and 100% of the NOL created in 2015 and later. The additional NOL generated that has not been carried back will be available for use in subsequent years. Thus, in accordance with Legal Ruling 2011-04, taxpayer does not lose excess NOLs that remain after being carried back because taxpayer can carry forward the excess NOLs.

Capital Gains and Losses

California conforms to the federal provisions of netting gains or losses from involuntary conversions, §1231 assets and capital assets, and limiting the ability to deduct capital losses. Regulation §25106.5-2 provides rules for applying these capital gain/loss netting and loss limitation provisions in a combined report.

In a combined reporting group, the members' business gains and losses in each class (i.e. involuntary conversions, §1231, short term, or long term capital gain) are combined, and each taxpayer member determines its share of the California source business gains/loss items based on its apportionment percentage. Business gains and losses from the sale or exchange of capital assets, §1231 property, and involuntary conversions that are intrastate apportioned to California, and nonbusiness gains and losses from such transactions that are allocated to California, are then netted by each taxpayer member using the rules of IRC §1231 and §1222. The resulting California source capital or ordinary income of a taxpayer member is then added to all other California source income or loss of that member, unless the loss is a capital loss limited under IRC §1211.

If the netting process results in net capital losses, the losses are not deductible in the current year, but may be carried over to subsequent years. The California source net capital loss carryover is treated by the taxpayer member as a California source short-term capital loss, and may be offset only against California source capital gains intrastate apportioned or allocated to that member in subsequent years. Unlike the treatment on a federal consolidated return, a capital loss carryover of one member of a combined report may not be applied to the intra-state apportioned capital gain of another member included in the combined report.

The Joyce/Finnigan Issue

In General

In *Appeal of Joyce, Inc*., Cal. St. Bd. of Equal, Nov. 23, 1966, the California SBE held that sales to California customers by an out-of-state seller that was part of a unitary business could not be included in the California sales factor of the combined report for members of the unitary business that were subject to California taxation, because the seller itself was immune from taxation in California under P.L. 86-272. *Joyce* concluded that the FTB was required to allocate to Joyce and to include in the measure of its tax only a "reasonable portion" of the unitary net income that the FTB determined was attributable to California sources. The SBE stated this allocation should be made on the basis of Joyce's payroll, property and sales within California, "in a manner designed to reasonably reflect the contribution of those factors to the total unitary net income."

In *Appeal of Finnigan Corporation* ("*Finnigan I*"), Cal. St. Bd. of Equal., Aug. 25, 1988, the SBE was presented with the issue of whether the FTB, for purposes of calculating the sales factor of the apportionment formula, properly applied the "throw-back" rule to the non-California destination sales made by the taxpayer's unitary subsidiary. The SBE concluded the sales should not be thrown back to California even though the subsidiary, as a separate corporate entity, was not taxable in those states, since another member of the unitary group, Finnigan Corporation, was taxable in the state into which the sales were made.

The FTB filed a petition for rehearing from the adverse decision in *Finnigan I,* and the SBE then issued its opinion on petition for rehearing, "*Finnigan II*," on January 24, 1990. The *Finnigan II* opinion stated that it was "analytically and philosophically incompatible with *Joyce*," and the SBE expressly announced that it was overruling the apportionment rule of *Joyce*. *Finnigan I* had raised questions regarding whether the sales at issue would ever be taxed if the sales could not be taxed in California (under the throw-back rule) and the entity making the sales could not be taxed on them in the destination state because of P.L. 86-272. This situation caused some to wonder whether the SBE in *Finnigan I* was suggesting that the destination state somehow had jurisdiction to tax those sales notwithstanding P.L. 86-272. The SBE in *Finnigan II* attempted to resolve any doubts as to whether there was a jurisdictional aspect to *Finnigan I* by stating that "it is only an apportionment rule which has been changed" (emphasis original) and that nothing said in the cases "alters or affects in any way the existing rules concerning a state's jurisdiction to tax a particular corporation."

The SBE decided in *Nutrasweet,* 92-SBE-024 (Cal. St. Bd. of Equal. Oct. 29, 1992), that its *Finnigan II* decision applied retroactively. Nutrasweet, in tax years prior to *Finnigan II*, filed a combined report with its Puerto Rican subsidiary and included the California sales of the subsidiary in the California factor of its combined report even though the subsidiary did not have nexus with California. Upon determining that such sales were protected under *Joyce*, the company filed an amended return seeking a refund. Stating that *Finnigan II* overruled *Joyce*, the SBE denied the refund claim and found the sales properly attributable to the State.

However, there has been no shortage of commentary on the *Finnigan* opinions, especially on the subject of how they should be implemented. (See Corrigan, *Finnigan's* Wake or *Joyce's*? "The Application of the Unitary Principle to Combined Groups", *Journal of California Taxation*, Fall 1989, p. 5; Corrigan, "Computing the Sales Factor in Unitary Combination States: *Finnigan II* Displaces *Joyce*", *Interstate Tax Report*, Vol. 8, No. 6, 1990, p. 7; Leegstra & Marcus, "*Joyce* Overturned - Justice Denied?," *Journal of California Taxation*, Summer 1990, p. 5.)

Effective January 1, 2011, California amended CRTC Section 25135 to adopt the *Finnigan* rule in assigning sales from tangible personal property to California. Under *Finnigan,* all sales by members of the combined reporting group properly assigned to the state are included in the numerator of the California sales factor, regardless of whether the member of the combined group making the sale is subject to California tax. For throwback purposes, sales are excluded from the sales factor numerator if a member of the combined reporting group is taxable in the state of the purchaser. This change, coupled with the California 'doing business' rules effective

January 1, 2011, is likely to create litigation over the constitutional validity of attributing protected P.L. 86-272 sales, under *Finnigan*, to other members of the combined report that are 'doing business' in California.

Note. New York State has also grappled with the issue of whether the New York destination sales of members of a unitary group that are not, by themselves, subject to the corporate franchise tax are includable in the receipts factor numerator of the New York combined return. In *Disney Enterprises, Inc., v. New York Tax Appeals Tribunal,* N.Y., No. 37, 3/25/08, the New York Court of Appeal concluded that Public Law 86-272 does not bar the inclusion of a non-nexus member's New York destination sales in a combined group's sales factor numerator. At issue was the New York destination sales of Buena Vista Home Video, one of the affiliates included in Disney's combined New York report. Disney maintained that including Video's receipts in the combined group's apportionment sales factor numerator amounted to an imposition of tax on Video, which was prohibited under P.L. 86-272 because of Video's limited contacts in the state. The court disagreed. Courts have long acknowledged that the inclusion of receipts in a sales factor numerator is not tantamount to the imposition of tax, the court said. Unitary reporting merely relieves affiliated taxpayers from the need to separately account for the flows of value among them by treating all unitary members as a single economic entity with regard to calculating taxable New York income, the court observed. The Department of Taxation's inclusion of Video's New York destination receipts "represented not a tax on Video but a reflection of Disney's economic reality," the court concluded. After reaching this determination, the court also concluded that Video was *not* protected by P.L. 86-272 based on the in-state activities of other members of the Disney unitary group. Public Law 86-272 provides that "[n]o State... shall have power to impose... a net income tax on the income derived within such State" if "the only business activities within such State by or on behalf of such person during such taxable year are... the solicitation of orders." The court focused on the word "person" as used within P.L. 86-272. The court noted that, for purposes of the statute, a "person" is defined to include corporations, companies, and associations. Finding no authority expressly contradictory, the court determined that a "person" could also include a unitary group, a conclusion consistent with treating a unitary group as "one entity" for franchise taxation. Therefore, the activities of Disney's unitary group, treated as a single "person" under the court's interpretation, exceeded the limited protection of P.L. 86-272, and, therefore, Video was not protected under the federal statute.

Effective January 1, 2015, New York adopts a *Finnigan* approach by providing that the apportionment factor for a combined report includes the receipts, net income, and net gains of all group members, whether or not they are a taxpayer. (N.Y. Tax Law Sec. 210-C.5)

Arizona (*Airborne Navigation Corp. v. Dept. of Rev*., Dkt. No. 395-85-I, 2/5/1987), Indiana (*Tax Policy Directive* #6), Kansas (Revenue Ruling 12-91-1), and Utah (Reg. R865-6F-24) have all agreed with New York and *Finnigan* that the sales factor includes sales of all unitary group members. Like, New York, Arizona and Kansas have extended the rule so that nexus exists for all unitary group members.

Challenges to Finnigan

The *Finnigan* issue had also been challenged in the courts. In *Brown Group Retail, Inc*, California Superior Court, Los Angeles County, No. C714010, October 8, 1993, the court found the method of sales factor assignment espoused in *Finnigan II* to be unlawful because it resulted in the implicit taxation of such members in contravention of a Congressional Act. The court found that while much of the writing on this issue concerned the question of public policy, the true issue was not whether "a particular approach supports or defeats the purpose of unitary taxation," but was, rather, whether the California approach was consistent with P.L. 86-272. The court looked to the prior SBE ruling in *Joyce*, and found the State was trying to do indirectly what the Public Law prohibited it from doing directly. The court found the SBE to have been "disingenuous" when stating that *Finnigan II* was merely a change in an apportionment rule and did not affect the State's jurisdiction to tax.

On appeal to the California Court of Appeal, No. B081329 (April 22, 1996), the court reversed the trial court's decision holding Brown was immune from the State's franchise tax under Public Law 86-272. As a result, the court did not address the *Finnigan* issue.

In The Matter of the Huffy Corporation, 99-SBE-005 (Apr. 22, 1999), the SBE decided to revert to the unitary sales factor sourcing rules enunciated in *Joyce* on a prospective basis, for tax years beginning on or after April 22, 1999. The Board also announced, in the course of denying a rehearing and amending its original opinion in part, that it rejected the appellant's request to have *Joyce* apply to inbound-sales contexts and *Finnigan* to outbound-sales contexts. The Board stated that: "Such a conclusion would allow clearly taxable income to escape taxation by all states and is contrary to the fundamental premise of the Uniform Distribution of Income for Tax Purposes Act which is intended to assure that '100 percent of income, no more [and] no less,' will be subject to taxation. The treatment of both inbound and outbound transactions hinges on the same legal theory and must be resolved in a consistent fashion." In *Citicorp North America, Inc. et al. v. Franchise Tax Board,* California Court of Appeal, First Appellate District, Division One, , No. A086925, , 83 Cal. App. 4th 1403 , 100 Cal. Rptr. 2d 509, October 2, 2000, as amended by order modifying opinion, November 1, 2000. Rehearing denied. Petition for certiorari denied, U.S. Supreme Court, Dkt. 00-1537, June 29, 2001 the court agreed with the return to *Finnigan* and its' application prospectively.

On February 20, 2009, California enacted legislation which enacts the F*innigan* rule. Under the legislation, for taxable years beginning on or after January 1, 2011, all sales of the combined reporting group properly assigned to the state are included in the numerator of the California sales factor, regardless of whether the member of the combined group making the sale is subject to California tax. Further, the legislation provides that sales are excluded from the sales factor numerator if a member of the combined reporting group is taxable in the state of the purchaser.

INTERCOMPANY TRANSACTIONS

Effective for transactions occurring on or after January 1, 2001, California adopted a regulation generally applying the same methodology for accounting for intercompany transactions as is contained in the federal consolidated return regulations (see discussion below). Transactions occurring prior to that date are subject to the less defined rules previously in place. Before the regulation was adopted, there was no statute or regulation that explained how California treated intercompany transactions for combined reporting purposes. Despite the lack of statutory authority, there are FTB publications and case law attesting to the FTB's long-standing practice of either eliminating or deferring income resulting from intercompany transactions. (See, e.g., FTB Publication 1061.)

In *Appeal of Yamaha Motor Corp. USA,* Cal. St. Bd. of Equal., No. 99A-0226, November 2, 2000, the SBE initially ruled that a taxpayer's treatment of gains from intercompany sales of inventory in a water's edge combined report will be upheld where the FTB has failed to issue clear statutory, regulatory, or administrative guidance. The Board subsequently granted the FTB's petition for rehearing and withdrew the original opinion.

Upon a rehearing of this controversy, the original opinion was withdrawn. The SBE voted to include the intercompany profits in income on a pro-rata basis over five years. This treatment was consistent with guidance issued by the FTB in Notice 89-601 with regard to deferred intercompany gains. The opinion on rehearing was not published and does not establish precedence. Under fact patterns similar to those in Yamaha, the FTB staff is continuing to assert that a domestic company will be required after a water's-edge election to recognize a foreign affiliate's intercompany profits which had been eliminated in prior-year worldwide combined reports. The same issue was raised in *Appeal of Canon U.S.A., Inc.* and the SBE again ruled against the taxpayer in a non-citable decision. CA SBE Ltr. 55446 (1/14/03).

In *Appeal of Mitsubishi Electric America, Inc.,* Cal. Stat. Bd. of Equal, No. 207902, 2/18/04, the SBE ruled that gain on the sale of inventory purchased from a foreign affiliate and sold to an unrelated entity was properly computed using the carryover basis of the inventory when the inventory was purchased in a year in which an affiliated group filed returns on a worldwide combined basis and sold in a year in which the affiliated group filed on a water's-edge basis.

On their water's-edge combined report, the taxpayers stepped-up the cost bases of the inventory items to the amount of the purchase prices of the items from the foreign affiliates. The FTB determined that the taxpayers were required, but failed, to properly utilize the "elimination and basis transfer" (or carryover basis) method of accounting for the inventory items that they had acquired in 1989 and later resold in 1990.

Citing CRTC section 24913, the SBE explained that utilization of the stepped up basis was improper and ruled that the "appellants should have utilized the carryover basis method and reported the 1990 beginning inventory value in amounts equal to the 1989 ending inventory values." Furthermore, while CRTC section 24912 provides that the "basis of property shall be the cost of the property," the taxpayer's purchases of the inventory items were eliminated from the 1989 worldwide combined report. "Thus, for California tax purposes, the 1989 intercompany purchases should be disregarded in calculating the cost basis of the transferred items."

The FTB has provided further clarification on the application of CRTC section 25106(a)(2)(A) pertaining to the elimination of dividends paid within a combined reporting group. (See Chief Counsel Ruling 2012-8.) In its recent Chief Counsel Ruling 2012-8, a taxpayer engaged in a series of reorganization transactions to facilitate an acquisition. As a result of the reorganization, the historic parent company was dropped under a new company and paid out a dividend to the new company. The taxpayer sought FTB guidance on whether the dividend could be eliminated from the income of the payee and not taken into account for purposes tax. The FTB concluded that since the dividend was paid out of historic unitary earnings, the dividend qualified for intercompany elimination even though the new company had not existed in the years the earnings and profits were earned.

Regulation § 25106.5-1

According to regulation § 25106.5-1, adopted by the FTB and effective January 1, 2001, intercompany transactions generally must be reported to California in the same manner as required by federal regulations, with changes to reflect differing requirements in such areas as apportionment and the distinction between business and nonbusiness income. The regulation states that it conforms "to the extent possible" with the federal consolidated return rules concerning intercompany transactions contained in Treas. Regs. § 1.1502-13 to "enable ease of administration and compliance."

The regulation generally adheres to the federal "matching rule," which treats the buying and selling corporations as divisions of a single corporation for purposes of taking items into account from transactions. In addition, the rulemaking follows the federal "acceleration rule," which provides that if an object of an intercompany transaction is converted to a nonbusiness use, then it is no longer part of the unitary business operations. Therefore, the taxpayer must take the intercompany gains attributable to that asset into account before the nonbusiness conversion.

In Chief Counsel Ruling 2012-2, the FTB reiterated that California's treatment of intercompany transactions as set forth in the combined reporting regulations only apply to transactions between corporations that are members of the same combined reporting group. The ruling addressed the sale of a partnership interest from a corporation (through a disregarded entity) to a disregarded LLC whose sole owner was a partnership. All the entities involved were unitary with one another. Because the disregarded LLC is treated as a division of a partnership (rather than a corporation), it is not considered to be a member of the corporation's combined reporting group. Therefore, since the transaction is not between corporations that are members of the same combined reporting group as specifically required under CCR 25106.5-1, the FTB concluded that the regulation did not apply to any gain generated from the transaction could not be deferred.

Apportionable Income

Intercompany items are treated as current apportionable business income in the year in which they are taken into account, according to the regulation. The selling member may not include the sale of the items in its sales factor for either the transaction year or the years the items are taken into account; however, gross receipts from the third-party sale generating the buying member's corresponding items are included in the buying member's sales factor for the year of the sale. Intercompany transactions do not include transactions that produce nonbusiness income or loss to the selling member or that produce income attributable to a separate business activity of the selling member, according to the regulation. Rather, such transactions are treated as being between corporations that are not members of the combined group.

In addition, the regulation does not adopt a federal rule excluding intercompany dividend distributions from the gross income of the receiving member. Instead, intercompany income distributions are included in the income of the member receiving the distribution, except where the dividends are excluded as dividends paid out of the income of the unitary business under §25106.

The regulation does not conform to Treas. Regulation §1.1502-32 relating to investment adjustments to the basis of the stock of a subsidiary, or to Treas. Regulation §1.1502-19 relating to excess loss accounts (ELA). However, the regulation provides for a "deferred C" (DISA) which will operate in a manner similar to the federal excess loss account for the limited purpose of deferring gain from intercompany distributions which exceed the payor's earnings and profits and stock basis.

One very important distinction between a DISA and an ELA is that a DISA is NOT treated as a negative basis account. Therefore, while an ELA will be reduced when capital contributions or investment adjustments (under Treasury Regulation 1.1502-32) are made to the parent's interest in the stock of the subsidiary, no such reductions will occur with the DISA amount. Further, for federal purposes an ELA is eliminated permanently upon the liquidation of the subsidiary into the parent, or downstream merger of the parent into the subsidiary. The regulation would require that the DISA be recognized in the event of a tax-free liquidation or downstream merger.

Intercompany transactions occurring before the member becomes taxable in California will be treated as though the regulation applied to the year of the transaction. Also, taxpayers withdrawing from the state take their intercompany transactions with them, and the acceleration rule is not applied to capture the items in the state.

The FTB issued Notice 2009 - 01 reminding taxpayers' of their annual disclosure of DISA balances on the California corporate tax returns. CCR § 25106.5-1(b)(8), requires an annual disclosure requirement for deferred intercompany stock account ("DISA") transactions. To assist taxpayers in complying with their annual disclosure requirement, the FTB has issued Form 3726 - DISA and Capital Gain Information. In conjunction with Form 3726, Forms 100 and 100WE have been revised to include a question asking whether taxpayers have a DISA balance and, if so, the amount of that balance.

If the prior DISA balances for years 2001 through 2007 are not reported as income due to the occurrence of a triggering event described in CCR § 25106.5-1(f)(1)(B), or disclosed as required, then pursuant to CCR § 25106.5-1(j)(7), the undisclosed balances may be required to be taken into the California income base. This could result in additional tax liability and the imposition of various penalties, including the accuracy-related penalty under CRTC §19164 and the large corporate underpayment penalty under CRTC § 19138. On a related note, California S.B. 858, enacted on October 19, 2010, amended CRTC § 19138 to narrow the provision. The amended section provided that the penalty only applies to an understatement of tax if the underpayment exceeds the greater of (1) one million dollars, or (2) twenty percent of the tax shown on an original return (or an amended return filed on or before the extended due date). These amendments became operative on January 1, 2010.

Effective beginning April 1, 2014, the FTB amended Regulation section 25106.5-1 to address several DISA issues: 1) mergers between brother/sister corporations will not trigger a DISA - instead, the deferred amount will be spread proportionally to the stock in the surviving entity; 2) taxpayers can reduce DISAs by making subsequent capital contributions; and 3) distributions through various tiers of stock ownership will no longer create multiple, separate DISAs. The amendments to Regulation section 25106.5-1 apply to intercompany transactions occurring on or after January 1, 2001. However, a taxpayer may elect to have these DISA rule changes apply *prospectively* as of April 1, 2014.

Water's-Edge Entities

The regulation also provides that where the selling corporation is partially included in a water's-edge combined reporting group, the transaction is an intercompany transaction if the resulting income, gain, deduction, or loss would otherwise be included as apportionable business income in the water's-edge combined report. The regulation incorporates rules governing the application of the water's-edge corporation's "partial inclusion ratio" under CRTC section 25110(a)(6) to determine the extent to which a transaction will be treated as an intercompany transaction. These rules supersede the rules currently under Cal. Regs. § 25110(e).

Eliminations as Income

In the *Appeal of CTI Holdings*, 96-SBE-003 (Cal. St. Bd. of Equal. Feb 22, 1996), the SBE rejected an argument that items "eliminated" by the use of a combined report were no longer income. The issue was presented by the taxpayer arguing that foreign withholding taxes on interest, royalties, and dividends were not taxes upon income because such amounts were "eliminated" in a combined report. The SBE held that regardless of their treatment for combined report purposes, payments would be classified as income or not based upon their general treatment for tax purposes.

COMMON STATE/FEDERAL DIFFERENCES IN COMPUTING INCOME

Corporations that have a federal reporting requirement usually calculate net income for California tax purposes by using federal reconciliation. The taxpayer generally begins with line 28 of its federal Form 1120, and then enters California adjustments to the federal net income figure to reach California net income, and eventually, net income for California tax purposes. (See FTB 1061, see also Form 100, California Corporation Franchise or Income Tax Return, and Instructions.) Some of the more significant California adjustments are as follows:

California Income/Franchise Taxes

California does not permit a deduction for California corporation franchise or income taxes paid. (CRTC §24345.)

Other Taxes On/Measured by Income/Profits

Under CRTC §24345, California does not allow a deduction for any taxes on or according to or measured by income or profits paid or accrued within the income year. Regulation 24345-7, which is applicable to "dual capacity taxpayers" provides additional rules in the especially complex area of determining deductibility of “taxes” paid to foreign countries. (See also, Coffill, “The Treatment of Foreign Income Taxes Under the California Bank and Corporation Tax Law,” 17 *Pac. L. J*. 77 (1985).)

Subsidiary Stock Basis Adjustment

Under CRTC §29416(a), California allows an adjustment for expenditures, receipts, losses, or other items properly chargeable to capital account. However, California does not incorporate the federal consolidated return regulations (with the exception of the intercompany transaction regulations discussed above). Thus, there is no authority for applying to California combined groups the federal rule (Treas. Regs. Sec. 1.1502-32) that allows a corporate parent to make investment adjustments to the stock basis of its subsidiaries.

In *Rapid-American*, No. 96-SBE-019 (October 10, 1996), No. 97-SBE-019-A, (May 8, 1997), the SBE did not allow a corporation to increase its basis in the stock of sold subsidiaries by the amount of retained earnings and profits that were previously reported on its combined return but which had not been distributed up as dividends prior to the sales.

Rapid-American Corporation (Rapid) and its subsidiaries filed combined California tax returns on a worldwide unitary basis. During fiscal year 1982, Rapid and certain of its unitary affiliates sold several wholly-owned subsidiaries, realizing capital gains on the sales. Upon filing its combined unitary tax return, Rapid increased its basis in the stock of the sold subsidiaries, adding to its acquisition costs the amount of retained earnings and profits that had previously been reported on the combined returns, and which had not been distributed up as dividends prior to the sales.

Upon audit, the FTB disallowed the claimed basis adjustments. Rapid argued that California law permitted the stock basis adjustments. Rapid also claimed that double taxation resulted when its retained earnings and profits from prior years were included in the combined returns and in the gain recognized on the stock sales.

California law provides that basis adjustments shall be made for expenditures, receipts, losses, or other items properly chargeable to capital account. The SBE rejected Rapid’s argument that the other items language provided authority for the basis adjustment. Finding no statutory, regulatory, or judicial support for Rapid’s position, the SBE held that California did not intend to allow adjustments to stock basis in a subsidiary due to the presence of retained earnings on the subsidiary’s balance sheet when the stock was sold.

The SBE also rejected the double taxation argument, stating that while the operating earnings may have been included in the measure of tax at the entity level (i.e., the corporate subsidiary), they were not previously taxed at the shareholder level. As a result, Rapid's basis adjustment was disallowed.

The holding of the SBE in Rapid-American was recently upheld by the Court of Appeal in *Jim Beam Brands Co. v. Franchise Tax Board*, (2005) 133 Cal.App.4th 514 when it held that the taxpayer was not entitled to adjust its basis in the stock of a subsidiary to reflect certain undistributed earnings and profits of that subsidiary." The California Supreme Court, on January 4, 2006 declined to review this decision.

Interest on Government Obligations

Corporations subject to franchise tax must report all interest received on government obligations, such as federal, state or municipal bonds, even though exempt from state or federal income tax. (However, interest received on government obligations (federal, State of California and its political subdivisions) is exempt from the corporation income tax.)

The FTB issued Legal Ruling 2006-01 on April 28, 2006. The Legal Ruling explained that receipts from activities that give rise to exempt income are excluded from the receipt factor formula. In addition, receipts from income that is proportionately exempt from tax should be proportionately removed from the formula. For example, if a taxpayer receives a $1,000 dividend and 75 percent of the dividend is excluded from income, only $250, or 25 percent of the total dividend is included in the receipts factor. Further, if a corporation's activities produce both taxable business income and exempt income, the activities must be separated into component part, with only the parts relating to taxable income included in the apportionment factors.

Net Capital Gain

The amount of net capital gain for federal and California purposes may not be the same for a number of reasons, the most typical of which are the basis adjustments.

Depreciation and Amortization

California law is substantially different from federal law. California adopted provisions of the federal Class Life Asset Depreciation Range System (ADR), which provides a range of useful lives. However, California law requires use of the mid-range class life. California law does not allow depreciation under the current federal Modified Accelerated Cost Recovery System (MACRS), or its predecessor, ACRS. Although the Bank and Corporation Tax Law did not conform to the current federal Modified Accelerated Cost Recovery System (MACRS), the Personal Income Tax Law did. While a corporation may not depreciate its assets using MACRS, or its predecessor, ACRS, as a corporate partner in a partnership, the corporation would be entitled to use MACRS to depreciate the partnership assets since the rules governing partnerships are contained in the Personal Income Tax Law. See FTB Notice 89-528, October 18, 1989.

Contributions

California law limits the contribution deduction to 10 percent of California net income, without regard to charitable contributions and special deductions (e.g., NOLs, dividends). Federal law limits the contribution deduction to 10 percent of federal taxable income. Accordingly, the definition of California net income differs from federal taxable income for computing the deduction.

California generally limits the contribution of appreciated property to the basis in the property. (CRTC §24357.1)

Section 78 Gross-Up

For federal purposes, where the foreign tax credit is elected dividends received from foreign affiliates are "grossed up" under IRC §78 to include income taxes paid to foreign countries on the dividends. (The taxpayer is then allowed to take a federal foreign tax credit for the gross-up amount.) California has no such provision, and the gross-up amount/income should be eliminated.

Subpart F Income

For federal purposes, a U.S. shareholder must include in income its pro rata share of the Subpart F Income of a controlled foreign corporation. California has no such provision, and this income should be eliminated. Refer to the discussion below of *Appeal of Apple* for the analysis of how Subpart F impacts a water's edge filer.

Section 1248 Gain on Foreign Stock

For federal purposes, gain from certain sales or exchanges of stock in certain foreign corporations is included in income as a dividend under IRC §1248. For California purposes, the provisions of IRC §1248 do not apply to transactions occurring after August 20, 1990, in income years beginning on or after January 1, 1990. (CRTC §24990.7.)

Section 338 Elections

California generally allows state-only IRC §338 elections. A taxpayer desiring different California treatment must file a separate California election (e.g. must "elect out" of the federal election). Note, however, if an entity makes a proper federal election prior to becoming a California taxpayer, the entity is deemed to have made the same election for California purposes and may not make a separate California election unless a separate election is expressly authorized by the CRTC or by regulations issued by the FTB. CRTC §23051.5(e)(3)(B). Regulation §25106.5-3 allows taxpayer members of a combined report group to make allowable California elections on behalf of non-taxpayer members of the group. Presumably, this regulation allows California-only §338(h)(10) elections if the buyer and/or seller are members of a combined reporting group that includes California taxpayers, even if the buyer/seller are not taxpayers themselves.

In an information letter issued October 28, 2003, FTB indicated that its position is that a §338(h)(10) election cannot be made for California purposes unless both the buyer and the seller are California taxpayers. The letter does not reconcile this position with the "deemed election" rule in section 23051.5(e), that a taxpayer that comes into the state is bound by federal elections it made in the past, or with the ability of taxpayer members of a combined report to make elections for non-taxpayers under Regulation §25106.5-3. This information letter has no precedential effect, however.

DIVIDEND ELIMINATIONS/DEDUCTION ISSUES

Corporations for federal purposes can generally deduct 70 percent of dividends received from taxable domestic corporations, or 80 percent if the recipient owns at least 20 percent of the distributing corporation. Affiliated corporations that do not file consolidated returns are allowed a 100 percent dividends received deduction for federal purposes for qualifying dividends received from members of the affiliated group. None of these deductions applies for California purposes. Instead, and as explained below, a deduction is allowed under California law for (1) intercompany dividends paid from unitary income (CRTC §25106); (2) dividends paid from income previously included in the measure of tax (CRTC §24402(see "**Dividends Previously Included in Measure of Tax**" below for new treatment of dividends after CRTC section 24402 was declared unconstitutional);; (3) certain dividends received from insurance companies (CRTC §24410); and (4) certain dividends for water's edge taxpayers (CRTC §24411).

Intercompany Dividends - Section 25106

CRTC §25106 provides that where the tax of a corporation has been determined with reference to the income and apportionment factors of another corporation engaged in a unitary business, and the dividends were paid out of the income of the unitary business, the dividends are eliminated from the income of the recipient corporation. Dividends received from nonunitary income may not be eliminated under CRTC §25106, but may be deductible under CRTC §24410, discussed below, or for water's-edge taxpayers, CRTC §24411.

In *Appeal of Willamette Industries, Inc*., Cal. St. Bd. of Equal., March 2, 1989, the issue was whether dividends paid to the taxpayer at a time the payor was a member of the taxpayer's unitary group, but paid from income not generated in the course of the unitary business (i.e., not from E & P of the unitary business) could be eliminated under CRTC §25106. The SBE concluded that CRTC §25106, on its face, provides for elimination of dividends that are paid out of the unitary business income of the corporations engaged in the unitary business. Therefore, the SBE reasoned that only those dividends that were paid out of business income "generated in the course of the unitary business" can be eliminated under CRTC §25106. Accordingly, the SBE held that dividends paid from earnings and profits a corporation earned before it became a part of the unitary business cannot be eliminated under CRTC §25106 (even if the dividends are paid at a time the payor is part of the unitary business).

The taxpayer filed a suit for refund following its loss before the SBE. In *Willamette Industries, Inc. v. Franchise Tax Board*, 33 Cal.App.4th 1242 (1995), the California Court of Appeal held dividends paid by a subsidiary to the parent corporation are excludable from income under Section 25106 only to the extent they are “unitary” intercompany dividends. Specifically, the court held that Section 25106 excludes from a corporation’s income intercompany dividends (1) if the payor and recipient corporations were engaged in a unitary business; and (2) to the extent the dividends were paid from the income of the unitary business. The court held the dividends paid to Willamette from pre-acquisition earnings of the payor/subsidiary did not qualify for the Section 25106 exclusion because the earnings and profits before the acquisition were not “unitary.”

In *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal. App.4th 459, referred to in lower court decisions as "the *Amdahl"* decision, the court addressed the ordering rule for dividends eliminated/deducted under CRTC §25106 and §24411. The Court of Appeal in *Fujitsu* held that dividends received from lower-tier subsidiaries “should be treated as paid (1) first out of earnings eligible for elimination under section 25106, with (2) any excess paid out of earnings eligible for partial deduction under section 24411.” This decision overturned Regulation §24411, which had used a pro-rata basis to determine the portion of dividends paid out of earnings eligible for elimination under CRTC §25106. In arriving at its decision, the Court questioned the clarity of FTB’s guidance on the subject. The Court also noted that the lower court was concerned that FTB’s pro-rata ordering of the dividends might raise a constitutional concern about CRTC §24411 because the burden on foreign commerce would be lesser or greater depending on whether dividends are treated as coming first or last from income of the unitary group. Ultimately, the Court of Appeal indicated that it selected the construction that comports most closely with the apparent intent of the legislature and is consistent with applicable constitutional provisions. In enacting CRTC §25106, the Court recognized that the Legislature intended to avoid double taxation on the distribution of unitary income between members of the combined group.

Despite the ruling in *Fujitsu,* the FTB in Legal Notice 2005-1, March 4, 2005, proposed amendments to existing regulations under CRTC §24411 that ignore the ruling in Fujitsu and instead require the use of the pro-rata method to determine the portion of dividends paid out of earnings eligible for elimination under CRTC §25106 as well as to treat the dividends as being paid out of the earnings and profits of the corporation on a last-in first-out basis. At FTB's April 4, 2007 Board Meeting, regulations dealing with the ordering of corporate dividends (24411 and 25106.5-1) were placed in the formal regulatory process.

In the *Appeal of Apple Computer Inc*., Cal. State Bd. Of Equal, No. 152016, November 20, 2006 the SBE ignored the valid and precedential decision by the Court of Appeal in *Fujitsu*. The FTB attempted to have the *Fujitsu* decision overturned, first when it asked the Court of Appeal in its petition for rehearing, and then when it asked the California Supreme Court to either accept its petition for review and/or request to depublish the Court of Appeal's decision. Both the Court of Appeal the California Supreme Court denied the FTB's requests. The SBE held in *Apple Computer Inc*. that under the last-in-first-out ("LIFO") ordering provisions, dividends from the accumulated earnings of a partially included controlled foreign corporation of a water's-edge filer must be treated as coming from current years' earnings until exhausted and then from the most recent year's earnings without regard to whether the earnings represent included or excluded income. Further, dividends received from a CFC must be prorated between income included in and excluded from the combined report. In so ruling, the "preferential ordering" method of drawing the dividend first from included income until fully exhausted and then from excluded income as outlined in *Fujitsu* was rejected.

In the *Appeal of Apple Computer, Inc*., Cal. Sup. Ct., County of San Francisco, CGC-08-471129, January 26, 2010, the California Superior Court reached the same conclusion as the SBE on the issue of the LIFO ordering rule. Dividends from the accumulated earnings of a partially included CFC of a water's edge filer are governed by LIFO ordering provisions and must be treated as coming from current year's earnings until exhausted and then from the most recent years' earnings, without regard to whether the earnings represent included or excluded income, the California Superior Court held in a final statement of decision. Further, the "preferential ordering" method of drawing the dividend first from included income until fully exhausted and then from excluded income as outlined in *Fujitsu IT Holdings* was upheld, but only to the extent it reconciles with the LIFO ordering rule. Also, interest expense attributable to funds proven to have some economic connection to the generation of taxable income qualifies for deduction. On September 12, 2011, the California Court of Appeal affirmed the trial court's decision on this issue, and subsequently the California Supreme Court denied review of the appellate court decision on January 4, 2012. [*Apple Inc. v. Franchise Tax Board*, 199 Cal. App. 4th 1 (Cal. Ct. App., 1st Dist., Sept. 12, 2011), petition for review denied, Cal. Supreme Court (S197381, Jan. 4, 2012).]

Prior to an appellate decision in *Apple Computer Inc.,* the FTB issued Technical Advice Memorandum ("TAM") 2011-02 to provide guidance on the LIFO and proration approaches to ordering dividend distributions from CFCs that are partially included in the water's edge combined report. In the TAM, the FTB provided that the FTB would continue to follow LIFO ordering to determine the order of the years from which dividend distributions are made, starting with the current year. With respect to ordering of distributions within a given year, the FTB abandoned its prior proportional method and stated that it would deem that dividends are first paid out of E&P that was included in the unitary group's combined report, making the dividends eligible for complete elimination under Section 25106. When that pool of E&P is exhausted, then the dividends are deemed paid from other earnings eligible for elimination under other provisions of the Corporation Tax law, until those earnings are depleted.

On September 12, 2011, the California Court of Appeal affirmed the *Apple* court's decision on foreign dividends and interest expense allocation, concluding that the dividends from the accumulated earnings of a partially included CFC of a water's edge filer are governed by the LIFO ordering provisions and must be treated as coming from current year earnings until exhausted and then from the most recent years' earnings, without regard to whether the earnings represent previously taxed income. This is consistent with the treatment provided for in FTB's TAM 2011-02. Also, the appeals court affirmed the trial court's holding that interest expense attributable to funds proven to have some economic connection to the generation of California taxable income qualify for deduction. The California Supreme Court subsequently denied review of the appellate court decision on January 4, 2012. [*Apple Inc. v. Franchise Tax Board*, 199 Cal.

App. 4th 1 (Cal. Ct. App., 1st Dist., Sept. 12, 2011), petition for review denied, Cal. Supreme Court (S197381, Jan. 4, 2012).]

The SBE held 4-0 in a non-precedential decision that dividends paid from one controlled foreign corporation ("CFC") within the combined report to another CFC should not be treated as Subpart F income to the dividend recipient. See, *Appeal of Baxter Healthcare Corporation*, Cal. St. Bd. of Equal., Aug. 1, 2002. While the result is very clear for federal purposes based on IRC §959(b) which excludes dividends of previously taxed income from the U.S. parent's deemed subpart F dividend income, California does not adopt the deemed dividend mechanism set forth in IRC §951. Instead, California uses subpart F "income" as determined by IRC §952 and §954, as the numerator of an inclusion ratio designed to approximate a foreign corporation's subpart F activity. California applies the inclusion ratio to the corporation's income and factors and includes the resulting amounts in the California water's edge combined report.

The taxpayer argued that the similar rationale underlying the Subpart F rules for federal and state purposes should render a similar result. The taxpayers pointed to the federal §954 regulations, which specifically exclude dividends described in IRC §959(b) from subpart F income, and relied heavily on state law which, in the absence of a state law or regulation to the contrary, requires the FTB to follow applicable federal regulations. The SBE concurred with the taxpayer.

The issue was revisited in *Fujitsu IT Holdings.* The Court of Appeal agreed with the taxpayer that California's incorporation of the federal subpart F definition causes the dividends to be excluded from the inclusion ratio. In addition, the Court found additional support in the fact that section 25106 prevents intercompany dividends from being taken into account in *any* manner.

Under A.B. 3078, enacted September 25, 2008, § 25106 applies to dividends paid by a member to a corporation formed subsequent to the accrual of the income, if the recipient was part of the combined unitary group from its formation to its receipt of the dividends, applicable to tax years beginning on or after January 1, 2008. The FTB may deny the dividend elimination if the FTB determines the transaction is entered into with a principal purpose of evading the franchise tax

A.B. 3078 specifies that the dividend elimination provision applies to income earned by combined unitary group members during the tax years when no group member was taxable in California to the extent that the group's income would have been included in a combined report had any member been subject to the California franchise tax at the time the income was earned. The legislation provides that this amendment does not constitute a change in, but instead is declaratory of existing law.

Dividends from Insurance Companies - Section 24410

CRTC §24410 was repealed and re-enacted with amendments in 2004 to allow a deduction for dividends received from an insurance company in which the taxpayer owns at least 80% of each class of stock for taxable years commencing on or after January 1, 1997. This deduction is available irrespective of the location of the insurance company or the source of its income. In exchange for allowing a deduction for insurance company dividends, this section now contains complex anti-stuffing provisions designed to prevent the use of insurance companies to shelter income. Although these anti-abuse provisions are aimed at captive insurers, the provisions are very broad and may impact non-captive insurers as well.

Taxable years beginning on or after January 1, 2008

A deduction allowed will be equal to 85% of all qualifying dividends.

Taxable years beginning on or after January 1, 2004 and before January 1, 2008

A deduction allowed will be equal to 80% of all qualifying dividends.

Taxable years ending on or after December 1, 1997 and beginning before January 1, 2004

A deduction of 80% of the qualifying dividends was allowed for taxpayers that made an irrevocable election by March 28, 2005 and remitted any amounts due for the qualifying years as a result of that election. An electing taxpayer may not pursue any refund claims requesting a greater dividend received deduction than the amount allowed under the election.

Limitations

There are two major limitations on the dividend received deduction that will often cause a taxpayer's actual deduction to be much less than the 80% (or 85%) ceiling.

First, the dividend received deduction is phased out to the extent the insurance company is deemed to be overcapitalized. This provision considers the ratio of the 5 year average net written premiums for all insurance companies in a commonly controlled group to the 5 year average total income of that same group. The dividends qualifying for the dividend received deduction are reduced if the group's ratio falls below 60% (70% beginning in 2008).

Secondly, no dividend received deduction is allowed for dividends attributable to premiums received or accrued by the insurance company from a member of its commonly controlled group. This provision is not limited to captive insurers. Any insurance company that insures the risks of its commonly controlled group will be subject to this dividend carve-out.

The Ceridian Issue

Former CRTC §24410(a) allowed a corporation commercially domiciled in California owning at least 80 percent of the stock of an insurance company a deduction for dividends received from the insurance company, to the extent the insurance company was taxable on its gross premiums in California. CRTC §24410(b) limited that deduction to dividends paid from California sources.

In *Ceridian Corp. v. Franchise Tax Board,* 102 Cal.Rptr.2d 611 (2000), the California Court of Appeals held that these provisions were an unconstitutional violation of the Commerce Clause. Ceridian Corp., successor in interest to Control Data Corp. and Commercial Credit Company, sought a refund of taxes paid by the predecessor corporations as a result of an audit of tax years 1979 through 1982. During the years at issue, Control Data, a Delaware corporation headquartered in Minnesota, engaged in the manufacture and sale of computers, computer systems, and peripheral equipment. In addition, Control Data provided a range of computer-related services. During those same years, Commercial Credit, Control Data's wholly-owned subsidiary, a Delaware corporation headquartered in Maryland, provided financial services and insurance to businesses and individual customers.

By limiting the dividends received deduction to only domestic corporations, subsection (a) was clearly unconstitutional, the appeals court said. In addition, subsection (b) was invalid because it facially discriminates against interstate commerce by imposing a heavier tax burden on a taxpayer merely because it chooses to invest in insurance corporations that conduct business outside California.

If a state collects an erroneous or unlawful tax, it must provide a clear and certain remedy, the appeals court said, citing *McKesson Corp. v. Florida Alcohol & Tobacco Div.,* 496 U.S. 18 (1990). Under *McKesson,* a state may: (1) refund a taxpayer the difference between the tax it paid and the tax it would have paid but for the unlawful provisions; (2) assess and collect back taxes from taxpayers that benefited from the unlawful provisions; or (3) fashion a combination of a partial refund and a partial assessment, the appeals court explained. Specifically, CRTC section 19393 provide that if any tax code deduction provision is ruled invalid, the favored taxpayer must be assessed tax retroactively.

In Ceridian's situation, the board was prohibited from assessing tax because the years at issue were closed to assessment. Accordingly, because the statute does not provide a meaningful remedy where the tax may not be assessed, the board was directed to issue a refund. The decision was also silent as to what remedy should apply to other taxpayers. FTB's response to the Ceridian decision was to allow a 100% deduction for insurance company dividends regardless of the taxpayer's domicile or where the insurance company was located, but only for taxable years ending prior to December 1, 1997. (This position was circulated in an internal FTB memo dated April 26, 2002.) For subsequent years that were still open under the normal statute of limitations, the FTB proposed to disallow all deductions under CRTC §24410. This resulted in a large volume of refund claims, with taxpayers claiming that they should receive a deduction under CRTC §24410 for years ending on or after December 1, 1997. The election addressed above to apply the new §24410 provisions retroactively to 1997 was intended to resolve these claims. Taxpayers that did not make that election continue to dispute the FTB's position to disallow all deductions under §24410 for tax years beginning on or after December 1, 1997 and before January 1, 2004.

Dividends Previously Included in Measure of Tax - Section 24402

CRTC §24402 provides that a deduction is allowed for dividends received during the year declared from income that has been included in the measure of tax imposed under Chapter 2 (corporation franchise tax) or Chapter 3 (corporation income tax). The intent of this provision is to avoid double taxation of a corporation's income.

CRTC section 24402 contains two limitations. One limitation is modeled after Federal law. The deduction is:

1. 100 percent in the case of any dividend received from a "more than 50 percent owned corporation,"

2. 80 percent in the case of any dividend received from a "20 percent owned corporation,"

3. 70 percent in the case of any dividend received from a "less than 20 percent owned" corporation.

The second limitation is a statutory provision that ties the general corporation dividends received deduction to the payor's level of California in-state activity. It is this limitation that the court found created an unconstitutional burden on interstate commerce and was invalid.

As discussed below, FTB's position is that the deduction is no longer available. Since CRTC §24402 has not yet been repealed, its application continues to be the subject of controversy. It is likely that final resolution will only be achieved through legislation or litigation.

In *Farmer Brothers Co. v. Franchise Tax Board*, 134 Cal. Rptr.2d 390 (2003), rev. den. Aug. 27, 2003, cert. den. Feb. 23, 2004, the California Court of Appeals ruled that statutory provisions that tie the general corporation dividends received deduction to the payor's level of California in-state activity create an unconstitutional burden on interstate commerce and are invalid. The FTB has taken the position that the statute is invalid and unenforceable because it was held to be unconstitutional. The FTB is therefore, not allowing the deduction for tax years ending on or after December 1, 1999.

The FTB subsequently announced in June 2004 that, given the applicable statute of limitations, it would allow the deduction to all qualified corporate taxpayers for tax years ending before December 1, 1999. However, it said that it would disallow the deduction for all later tax years. The FTB explained that a statute deemed unconstitutional is void and ceases to operate, and under CRTC section 19393, in the case of an unconstitutional deduction, the tax for taxpayers that benefited from the deduction is recomputed and the deduction disallowed.

In a non-precedential decision on September 12, 2006, the SBE upheld the FTB's position following *Farmer Brothers* in the *Appeal of River Garden Retirement Home*. River Garden Retirement Home received dividends from two companies in 1999 and 2000. River Garden subsequently deducted the dividends on its California returns for those tax years pursuant to CRTC section 24402. The FTB disallowed River Garden's deductions and assessed additional tax. River Garden appealed, arguing that the disallowance of the deduction would "cause double or triple taxation" and is "against the principles of equitable taxation for all taxpayers." The SBE agreed with the FTB and upheld the assessments, noting that River Garden offered "no legal analysis" with respect to how to apply CRTC section 24402 following the Farmer Brothers decision. Instead, the SBE agreed with the FTB's argument that the proper remedy following *Farmer Brothers* is to disallow the deduction to all taxpayers pursuant to CRTC section 19393. The SBE noted that under section 19393, if a deduction is ruled unconstitutionally discriminatory, the appropriate result is to assess taxes to those benefited by disallowing the deduction. The SBE noted that because the statute of limitations was not open for all taxpayers for taxable years ending prior to December 1, 1999, applying the retroactive denial of the deduction envisioned by section 19393 was not possible. Because the River Garden decision is non-precedential, the controversy continues regarding the FTB's policy to disallow all §24402 deductions for years ending on or after December 1, 1999.

In *Abbott Laboratories et al. v. Franchise Tax Board, B204210, California Court of Appeal* (3/20/09), the taxpayer argued that *Famer Brothers* had only invalidated a portion of CRTC section 24402, and that Abbott could still claim the deduction. The California Court of Appeal held that Abbott was not entitled to a refund of tax paid on dividend income because CRTC section 24402 was found to be unconstitutional in *Farmer Bros. Co. v. Franchise Tax Board,* and could not be judicially rewritten or reformed. This opinion, however, is not a published decision.

Expenses Relating to Tax Exempt Income

CRTC §24425 provides that deductions are disallowed for expenses allocable to income not included in the measure of tax. In an unpublished decision, the California SBE upheld FTB's disallowance of a parent corporation's interest expense deduction related to insurance company dividends. (*Appeal of Fremont General Corporation*, No. 27969, 12/21/01.) The years involved were 1982 through 1985. The FTB first determined the portion of the parent corporation's interest expense that was directly traceable to the DRD, then allocated the remainder of the interest expense based on the ratio of the deducted dividends to total gross income. The FTB limited its disallowance of directly or indirectly allocable interest expense to the amount of the DRD. No dividends had been received from the insurance subsidiaries during the 1985 year. Sometime after the protest, FTB asserted that directly traceable interest expense should nonetheless be disallowed in 1985. Although the SBE allowed FTB's expense disallowance for 1982 - 1984, the SBE held that FTB's failure for 1985 to follow its previous procedure of limiting the expense disallowance to the amount of the DRD was a "new matter" for which the FTB had not met its burden of proof.

In *Appeal of American General Realty Investment Corporation*, No. 156726, June 25, 2003, a non-precedential 2003 SBE opinion, the SBE held that the FTB properly disallowed a pro rata portion of interest expenses incurred by the taxpayer's unitary financial and real estate subsidiaries because the expenses were indirectly traceable to insurance company dividends the subsidiaries received that were not subject to the California corporation franchise tax. However, the taxpayer filed suit for refund to contest this disallowance of its interest expense. The San Francisco Superior Court in *American General Realty Investment Corp., Inc. v. Franchise Tax Board*, No. CGC-03-425690, April 28, 2005, determined that the FTB erred in disallowing a portion of the taxpayer's interest expense deduction, because all of the interest expense was directly traceable to the active conduct of the taxpayer's consumer finance and real estate businesses, both of which generated taxable income. The FTB's inference that a portion of the indebtedness was incurred to generate nontaxable insurance company dividend income was rebutted by uncontroverted evidence of the taxpayer's dominant business purpose for incurring the indebtedness. The ruling in *American General Realty Investment Corp.* has been subsequently followed by the SBE in *the Appeal of Beneficial California Inc.*No. 203445, September 1, 2005.

Interest Expense Denial – §24425

CRTC §24425 was expanded by AB 263 to deny deductions for interest and other expenses paid to insurers that are members of the taxpayer's commonly controlled group. In general, the following types of expenses are disallowed:

- Interest or other expenses attributable to money or property that was contributed to the capital of the insurance company.

- Interest paid or incurred within five years after the taxpayer acquired the insurance company.

Interest paid or incurred to an insurer will be limited to the extent that the insurer is deemed to be overcapitalized (under the amended section 24410 of the Revenue and Taxation Code) or to the extent that it receives intercompany premiums from members of its commonly controlled group.

Credit Utilization and Assignment

CRTC §23663 was added by AB 1452 and allows the assignment of eligible credits among members of the same combined report. CRTC § 23663 is specifically operative for assignments made in taxable years beginning on or after July 1, 2008 and for applications of assigned credits against the "tax" of the assignee in taxable years beginning on or after January 1, 2010. "Eligible credit" is defined as any credit earned by the taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned in any taxable year beginning before July 1, 2008, that is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008. Credits include R&D, EZ hiring and equipment, and MIC carryovers.

The election to assign any credit shall be irrevocable once made, and shall be made by the taxpayer allowed that credit on its original return for the taxable year in which the assignment is made. The taxpayer assigning any credit shall reduce the amount of its unused credit by the face amount of any credit assigned, and the amount of the assigned credit shall not be available for application against the assigning taxpayer's tax in any taxable year, nor shall it thereafter be included in the amount of any credit carryover of the assigning taxpayer.

INTEREST OFFSET

CRTC section 24344 provides that the interest expense deductible by a taxpayer from its business income is limited to the amount equal to business interest income subject to apportionment plus the amount, if any, by which the balance of the interest expense exceeds nonbusiness interest and nonbusiness dividend income. The purpose of the CRTC section 24344 interest offset provision is to give effect to interest expense incurred for the production of nonbusiness interest and nonbusiness dividend income. This provision may have the effect of negating any change from business interest income or business income dividends to nonbusiness classification, or vice versa, because nonbusiness interest and nonbusiness income may act to reduce otherwise deductible interest on a dollar-for-dollar basis.

However, in *Hunt-Wesson Inc. v. California Franchise Tax Board*, 120 S. Ct. 1022 (2000), the U.S. Supreme Court ruled that statutory provisions that require a taxpayer to reduce its interest expense deduction on a dollar-for-dollar basis by the amount of its nonbusiness interest and dividend income violate the Due Process and Commerce Clauses of the U.S. Constitution by allowing a state to tax income from nonunitary business operations.

Hunt-Wesson Inc. is successor-in-interest to Beatrice Companies Inc., the original taxpayer in the case. During tax years 1980 to 1982, Beatrice was domiciled in Illinois and primarily engaged in the food service business in California and the world. In addition, Beatrice held interests in nonunitary subsidiaries that paid dividend income.

During the years at issue, Beatrice incurred interest expense related to its business operations and deducted the interest in full in computing taxable income. In addition, it earned dividend income from the nonunitary subsidiaries and treated the income as nonbusiness income allocable to its commercial domicile.

On audit, the FTB recomputed Beatrice's taxable income by offsetting Beatrice's net interest expense dollar-for-dollar by its nonbusiness interest and dividend income (*i.e.*, interest offset rule). Beatrice challenged the adjustment asserting that the interest offset rule violates the Due Process and Commerce Clauses of the U.S. Constitution by effectively taxing income California is constitutionally prohibited from taxing. Beatrice also asserted that the interest offset rule violates the Commerce Clause by facially discriminating against interstate commerce by disallowing a deduction based solely on the commercial domicile of the taxpayer. The interest offset rule favors corporations domiciled in California while at the same time disadvantaging corporations commercially domiciled elsewhere, Beatrice said.

The trial court agreed with the taxpayer's assertions and the FTB appealed. The California Court of Appeal reversed the trial court's ruling, citing *Pacific Telephone & Telegraph v. California Franch. Tax Bd.,* 7 Cal.3d 544 (Cal. 1972), a 1972 ruling dealing with a domestic corporation. In so ruling, the appeals court dismissed the taxpayer's assertions that the adjustment results in an indirect tax on dividend income California could not tax directly. In addition, the court dismissed the taxpayer's assertions that the statute violates the Equal Protection Clause of the U.S. Constitution by creating an irrational classification that discriminates solely based on a corporation's state of domicile.

In *Pacific Telephone*, the California Supreme Court had held that inclusion of nontaxable dividends in the statutory offset computation does not constitute taxation of the dividends themselves. Relying on that ruling, the appeals court reasoned that the interest offset rule is a valid part of the state's overall apportionment scheme that applies to foreign and domestic corporations without distinction. Deductibility of interest expense is determined not by a corporation's domicile but by the character of the income, the court said.

The U.S. Supreme Court agreed with the taxpayer's assertion that the interest offset rule violates the Due Process and Commerce Clauses of the United States Constitution. Nonunitary (*i.e.*, nonbusiness) income may not be constitutionally taxed by a state other than the corporation's domicile unless there is some other connection between the taxing state and the income, the Court explained. California does not directly impose a tax on nonunitary income, rather it simply denies the taxpayer the use of a portion of a deduction in computing income from unitary operations. By limiting a taxpayer's interest deduction dollar-for-dollar by the amount of its nonunitary income, California is attempting to tax income it is prohibited from taxing, the Court said.

By way of example, the Court discussed a situation where a taxpayer operates a manufacturing business and has income from nonunitary operations. In its example, the Court explained that if the taxpayer has interest expense of $150,000 and earns income of $100,000 from its nonunitary operations, California's rule would operate to limit the interest deduction to $50,000, the net amount by which the taxpayer's interest expense exceeds its income from nonunitary operations. The Court also dismissed California's assertion that due to the fungible nature of money the interest offset rule is necessary to prevent taxpayers from claiming a deduction against unitary income for borrowing actually related to nonunitary income. Reasonable efforts to allocate a deduction between taxable and tax-exempt income have consistently been upheld, the Court noted. However, the California statute pushes this concept beyond reasonable bounds.

It is unrealistic to assume that all of a taxpayer's borrowings relate to tax-exempt income, the Court said. No other taxing jurisdiction has taken so absolute an approach to dealing with this problem. Instead, most taxing jurisdictions have opted to allocate interest expense between taxable and tax-exempt income using a formula based on asset values or by a modified tracing approach.

These formulas recognize that borrowing, even if undertaken for a taxpayer's unitary business operations, may also support nonunitary operations. They do not assume, as the California rule does, that all borrowing first supports nonunitary operations. While the formulas may not be accurate in any given year, it is reasonable to assume that over time the formulas will approximate the amount of borrowing devoted to the different categories of income.

California's interest offset rule does not reasonably allocate expenses to the income that generates the expenses, the Court said. Accordingly, it constitutes an impermissible tax on income earned outside its jurisdiction. The Court remanded the case for determination of a remedy not inconsistent with its opinion.

Following *Hunt-Wesson*, the FTB issued notice 2000-9, released on December 19, 2000, to allow both California-domiciled and non-domiciled corporations to claim a full deduction of interest expenses in an amount equal to business interest income. In addition, California-domiciled corporations may reduce nonbusiness interest and dividend income allocable to California in amount equal to the amount by which interest expense exceeds business interest income. Interest expense in excess of nonbusiness interest and dividend income is deductible against apportionable income. The notice also provides that for all tax years beginning on or after February 22, 2000, and for prior periods, if the taxpayer asserts a constitutional violation based upon the Court's ruling in *Hunt-Wesson*, no interest expense deduction will be disallowed by operation of Secs. 24344(b) as an offset against interest and dividend income allocable outside of California. Accordingly, non-California corporations may claim a deduction for the amount of interest expense equal to nonbusiness interest and dividend income allocable outside of California in computing income subject to apportionment.

On August 10, 2001, the California Legislative Counsel issued a nonbinding opinion letter stating that the interest expense deduction provisions of CRTC section 24344(b) are invalid in their entirety and should not be enforced by the FTB. The legislative counsel found that under Hunt-Wesson, the second prong of Sec. 24344(b) is inoperative and unenforceable with respect to a nondomiciliary corporation. However, the legislative counsel continued, the three components of Sec. 24344(b) are inseparable, forming an interlocking system for the allocation of interest expense from whatever source. Severing the second prong from the remaining parts would destroy their intended application, the legislative counsel concluded. In addition, the legislative counsel found, even if the second prong could be severed, the remaining components "would still allocate interest expense without any rhyme or reason as to the type of income generated by that expense, and therefore involve just as arbitrary an allocation method as the court found unconstitutional in Hunt-Wesson." This flaw applies equally in the case of a California-domiciled taxpayer, the legislative counsel concluded.

The legislative counsel also found that that Cal. Code Regs. tit. 18, Sec. 25120(d) would apply in the absence of Sec. 24344(b) and provides a tracing method that allocates interest expense to the income that generates the expense in conformity with *Hunt-Wesson*.

ELECTION TO FILE A SINGLE RETURN

The FTB adopted Regulation 25106.5-11, which became effective on January 8, 2005, and provides the details for making the election to file a single group return on behalf of two or more members of a combined reporting group. Regulation 25106.5-11 allows a group of corporations subject to combined report procedures may elect to file a single return. The election to file a single return and pay the entire tax due for all taxpayers included in the combined report is made by completing Schedule R-7, Election to File a Unitary Taxpayers' Group Return and List of Affiliated Corporations, of Form 100 at the time of filing each combined return. The elective filing of a single return does not eliminate the separate statutory reporting requirements of the individual electing corporations, and each member corporation incorporated, qualified to do business or doing business in California must still pay at least the minimum franchise tax.

Corporations are prohibited from filing a single return if they: (1) have different accounting periods; (2) were acquired or disposed of during the income year, except that part-year members may be in the single return if they were unitary for an entire short period, and if the due date for the short period return is the same as the due date for the single return; or (3) determine California income on other than a single formula basis.

Unless the election is terminated, payment will be made only by the parent or key corporation designated on Schedule R-7, and any subsequent adjustments will be billed or paid to that corporation. However, if the key corporation does not make payment on behalf of a member, each member may be separately billed. (See Schedule R-7, and Instructions.)

CALIFORNIA TAX SHELTER LEGISLATION

California legislation enacted in 2003 requires taxpayers to disclose "reportable transactions" on their California tax returns, and requires promoters to register and maintain lists of investors. In addition, the legislation significantly increases penalties and interest that may be imposed on investors, promoters, and organizers for transactions the FTB deems to be abusive tax shelters; extends the statute of limitations for issuing tax and penalty assessments attributable to abusive tax shelter transactions to eight years; and established a limited time frame during which taxpayers could voluntarily come forward and pay all tax and interest due as a result of the use of perceived abusive tax shelters to avoid increased penalties.

On March 25, 2011, the governor signed a bill that establishes an amnesty/voluntary compliance initiative (VCI 2) for taxpayers that had entered into an "abusive tax avoidance transaction" (ATAT) or had unreported income from the use of an offshore financial arrangement. The bill contained the following changes:

- Amended the California noneconomic substance transaction (NEST) penalty to include any penalty assessed for federal purposes attributable to the federal codification of economic substance rules. The portion of the penalty applicable to the California understatement will not be abated unless the taxpayer can show that the federal penalty is erroneous.
- The legislation expanded the definition of a NEST to include any disallowance of claimed tax benefits due to the transaction lacking economic substance under IRC section 7701(o).
- Extended the statute of limitations from 8 years to 12 years, for notices mailed on or after August 1, 2011, for an assessment due to ATAT activity.
- Imposed a 50 percent penalty when an amended return is filed to report an ATAT after contact by the FTB but prior to receiving a deficiency notice. Under the prior law, a taxpayer could avoid this penalty if an amended return was filed within this window.

Under the VCI 2 program, taxpayers that chose not to participate will be subject to a penalty equal to 100 percent of interest due from the original due date of the return until the date that the deficiency is assessed. The amnesty program period ran from August 1, 2011 through October 31, 2011 and applied to tax years beginning prior to January 1, 2011. According to the FTB, VCI 2 raised $350 million with $293 million received in cash and an added $57 million expected by June 15, 2012, from instalment payments. More than 1,000 taxpayers participated and individual taxpayers comprised more than 90 percent of participation. Business taxpayers paid more than $100 million in added tax and interest.

Disclosure Requirements

The legislation generally conforms to the federal provisions requiring tax return disclosure of reportable transactions, so that a listed or other reportable transaction for federal purposes will also be treated as a listed or other reportable transaction for California purposes. The disclosure requirement for listed and other reportable transactions applies to taxable years beginning on or after January 1, 2003. Such transactions are generally disclosed in the same time and manner as required for federal purposes under Treasury Regulation §1.6011-4. In addition, high net worth individuals and large entities must disclose federal listed transactions for pre-2003 years at the time of filing the 2003 return. This applies to transactions entered into after February 28, 2000 and before January 1, 2004 that become a listed transaction at any time.

The legislation requires the FTB to identify and publish listed transactions, whether identified by the IRS or FTB. Chief Counsel Announcement 2003-1, dated December 31, 2003, identifies transactions that are "listed" transactions for California to date:

1. All federal listed transactions.
2. Certain REIT transactions where the REIT takes a deduction for consent dividends.
3. Certain RIC transactions involving entities that registered as RICs in contravention of the Investment Company Act of 1940 and claimed dividends paid deductions, with its shareholders also claiming a dividends received deduction.

California only listed transactions (items 2 and 3) entered into prior to September 2, 2003 are not required to be disclosed unless the transactions meets one of the other reporting requirements under Treasury Regulation §1.6011-4 (e.g. book to tax difference greater than $10 million, etc.).

On January 6, 2011, the FTB issued Notice 2011-01, describing a new listed transaction. The transaction involves apportioning corporate taxpayers that use one or more partnerships or other pass-through entities to increase the denominator of the California sales factor while eliminating the gain or loss generated by those sales from net business income of the combined reporting group, thereby reducing the amount of business income apportioned to California. Taxpayers that entered into such a transaction or a substantially similar transaction on or after 9/2/03 and before 8/3/07, or filed a return reflecting the apportionment structure described in the Notice during this period, must disclose their participation for all such years by the earlier of 4/6/11, or the first California return filed after 1/6/11. Taxpayers that entered into the transaction on or after 8/3/07 or filed a return reflecting the apportionment structure described in the Notice during this period, must disclose their participation for all years by 4/6/11.

The FTB issued Notice 2011-03 on April 22, 2011, describing another new listed transaction for California income and franchise tax purposes. The transaction involves parent corporations that artificially increase their basis in the stock of subsidiaries without any outlay of cash or property, prior to selling the stock of the subsidiary to an unrelated third party. Taxpayers that first entered into the new listed transaction or a substantially similar transaction on or after 8/3/07, or filed a return reflecting the tax treatment of such transaction during this period, must disclose their participation for all such years by 7/11/11. Taxpayers that entered into the new listed transaction or a substantially similar transaction on or after 9/2/03 and before 8/3/07, or filed a return reflecting the tax treatment of such transaction during this period, may disclose their participation for all such years by the earlier of the first California return filed after 5/22/11, or 7/21/11.

Major Penalties Imposed

The legislation enacted new and enhanced penalties for taxpayers who used an abusive tax shelter to underreport their income tax liability, as well as penalties for promoters/organizers and sellers of abusive tax shelters.

Failure to Disclose Reportable Transaction Penalty under CRTC §19772. This penalty is $15,000 for other reportable transactions, $30,000 for listed transactions, and applies for years 2003 and subsequent.

Reportable Transaction Understatement Penalty under CRTC §19773. This penalty applies to all listed transactions and to other reportable transactions if a significant purpose of the transaction is tax avoidance. The penalty is 20% if the transaction is disclosed and 30% if the transaction is not disclosed. The penalty applies for taxable years beginning on or after January 1, 2003. For taxable years beginning on or after January 1, 2005, the penalty provision was repealed and moved to §19164.5 which now provides substantial conformity to IRC 6662A.

Noneconomic substance transaction understatement penalty under CRTC §19774. This penalty is 20% if transaction disclosed, 40% if transaction not disclosed, and applies to all years for which SOL is open.

Interest-Based Penalty under CRTC §19777. This penalty applies to the entire deficiency if any portion of the deficiency is attributable to a potentially abusive tax shelter. It is an interest penalty of 100% of interest on the deficiency accrued through the Notice date. It applies for all years for which SOL is open.

Most of these penalty provisions have limited reasonable cause exceptions and FTB's determination that the penalty is appropriate generally is not reviewable by the SBE or the courts and can only be rescinded by the FTB Chief Counsel. FTB has developed Form 626 for taxpayers to request Chief Counsel review of penalties.

CALIFORNIA LARGE UNDERSTATEMENT PENALTY

Senate Bill 28, enacted October 1, 2008, imposes a penalty equal to 20% of the entire amount of the understatement, if the understatement of tax exceeds $1 million. The penalty applies to each taxable year beginning on or after January 1, 2003, which remained open under the statute of limitations. However, pursuant to legislation enacted on October 19, 2010 (S.B. 858), the penalty was revised such that for years beginning on or after January 1, 2010, the understatement must exceed the greater of either $1 million or 20% of the tax reported on the original return. The penalty is in addition to any other penalty imposed.

The $1 million threshold applies to the aggregate amount of the tax liability of all taxpayers that are required or authorized to be included in a combined report. The penalty for each combined group member is computed by applying the 20 percent penalty to the understatement attributable to that member. The total amount of the penalties will be aggregated and reported on a group basis.

The penalty will not be imposed on understatements attributable to a change in law (which includes regulation changes and rulings) that becomes final after the earlier of: (a) the date the taxpayer files a return for the tax year for which the change applies; or (b) the extended due date for the return of the taxpayer for the tax year for which the change applies. An additional safe harbor exists for understatements attributable to a taxpayer's reasonable reliance on a legal ruling by Chief Counsel of the FTB. Additionally, under AB 154, the penalty will not be imposed on additional tax amounts attributable to a section 338 election, a federal accounting method change, or a successful distortion determination by the FTB under CRTC section 25137.

CALIFORNIA'S ENTERPRISE ZONE CREDIT PROGRAM

On April 26, 2012, the California Supreme Court issued its decision in *Dicon Fiberoptics, Inc. v. FTB.* (*Dicon Fiberoptics, Inc. v. FTB* (2012) 53 Cal.4th 1227.) In this case, the primary issue centered on whether vouchers issued by governmental agencies constituted prima facie proof that a worker was qualified for purposes of claiming the Enterprise Zone Hiring Credit ("EZ Credits") provided in the CRTC. EZ Credits are one of several tax incentives available to businesses locations in an EZ and provides a credit against California franchise and income. They are based on wages of qualified employees for which businesses are required to obtain voucher certifications from designated governmental agencies. In this case, the California Supreme Court held that a voucher issued by a local government agency could not be relied upon as prima face proof for qualification and that the FTB may require additional documentation to support an employee's eligibility for the EZ Credit.

On July 11, 2013, California passed AB 93 and SB 90 which eliminated the current EZ program and replaced it with a new three-pronged temporary incentive: 1) new sales and use tax exemption for manufacturing and research and development equipment; 2) new hiring credit for businesses in specific areas with high unemployment and poverty rates; and 3) new California Competes tax credit. The new California Competes Credit provides an income tax credit to businesses either coming to or remaining in California.

AN ANALYSIS OF ISSUES AND OPPORTUNITIES IN COMBINED AND CONSOLIDATED RETURNS IN SELECTED STATES

IN GENERAL

The states vary broadly in their application of tax concepts inherent in combined and consolidated returns. In particular, the tax base of state combined/consolidated returns can vary substantially from the Federal treatment, because many states do not adopt the Federal consolidated return regulations. This creates tax traps and opportunities in an area in which there is little guidance or authority from many of the states.

An increasing number of states have migrated to a combined reporting regime. As of this writing, 26 states impose some form of combined reporting regime, including Massachusetts, West Virginia, and Wisconsin, and another 15 states have recently considered or proposed similar legislation. In 2007, New York switched from discretionary combined reporting to mandatory combined reporting upon the occurrence of substantial intercorporate transactions (explained below).For tax years beginning on or after January 1, 2015, New York adopted full unitary water's edge combined reporting with an ownership requirement of more than 50%. Rhode Island also mandated combined reporting for unitary businesses effective in 2015. Texas and Ohio -- states that abandoned taxes on income in favor of ones based on gross receipts--have implemented mandatory combined reporting regimes. Most recently, New York City followed the state and adopted combined reporting, and Connecticut's combined reporting took effect in 2016.

The Multistate Tax Commission ("MTC") at its August 17, 2006 annual meeting, voted to adopt a model statute mandating unitary combined reporting. Generally, the statute requires combined reporting by a taxpayer engaged in a unitary business with one or more other corporations. The statute requires worldwide combined filing, although it allows taxpayers to make a water's-edge election, with significant carve-outs (*e.g.,* inclusion of income and factors of members that are "doing business" in a tax haven). In addition, while the combined reporting requirement applies only to state corporate income taxpayers (thus, for example, insurance companies subject to a tax on premiums in lieu of a corporate income tax would not be included in the combined report), the statute provides that a state's revenue director "may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included" as corporate income taxpayers "but that are members of a unitary business, in order to reflect proper apportionment of income of the entire unitary businesses."

Prior to adoption, the statute was amended to clarify that the total income of the combined group is the sum of the incomes of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. The purpose of the amendment was to make clear that "income separately determined" means starting with federal consolidated income, and backing out federal consolidated adjustments, the MTC explained.

Under the recently adopted §385 regulations, all members of a federal consolidated group are treated as one corporation. However, <u>uncertainty exists</u> with respect to whether and how states conform to this ‘one-corporation’ exception. For example, this exception may not apply in (a) states that do not conform to the consolidated return regulations or that do not permit the filing of consolidated returns or (b) unitary combined and certain elective consolidated filing states because intercompany transactions generally are eliminated.

The following section examines the combined/consolidated filing provisions in Florida, Georgia, Illinois, Massachusetts, New York and Virginia.

WHO IS IN THE GROUP?

Florida

Florida allows consolidated filing which, once elected, requires the taxpayers to seek permission to cease such filing. A corporation that is subject to income tax in the state and that is the parent of an affiliated group of corporations may elect to consolidate its taxable income with the other members of the group. This election may be made regardless of whether the other members of the consolidated group are subject to tax in Florida. The affiliated group must have filed a consolidated federal income tax return for the same taxable year and be composed of the identical members as those included in the federal return.

The Director of the Department of Revenue may require consolidated filing for those members of an affiliated group that are subject to Florida tax and that are eligible to elect consolidated filing in Florida, if filing separate returns improperly reflects their taxable incomes. (See Fla. Stat. Ann. Sec. 220.131)

Georgia

Affiliated corporations that file a consolidated federal income tax return must file separate state income tax returns unless they have prior approval or have been requested to file a Georgia consolidated return by the department. A request for permission beyond the time prescribed by the department will not be considered and will result in the filing of separate income tax returns for the applicable year. (See Ga. Code Ann. Sec. 48-7-21(b)(7)(A)(i))

Illinois

Taxpayers that are corporations (other than Subchapter S corporations) and that are members of the same unitary business group are treated as one taxpayer and required to file a combined return. (See IITA Sec. 502(e).) Under IITA Sec. 1501(a)(27), a unitary business group is a group of persons related through common ownership, the business activities of which are integrated with each other, and whose business activities are dependent upon and contribute to each other. Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50 percent of the outstanding voting stock of the persons carrying on unitary business activity. A unitary business can ordinarily be illustrated where the activities of the members are: (1) in the same general line; or (2) steps in a vertically structured enterprise or process; and, in either instance, the members are functionally integrated through the exercise of strong centralized management.

A unitary business group may not include members that are ordinarily required to use different apportionment formulas, except for a unitary group composed exclusively of either insurance companies or businesses engaged in transportation services and a holding company for such taxpayers. (The definition of "financial organization" includes rules regarding holding companies of financial organizations). The term "ordinarily required to apportion business income" includes any member that would be required to use the apportionment method except for the fact that it derives business income solely from Illinois.

The Illinois unitary business group does not include any member that has 80 percent or more of its business activity outside the United States. For persons required to apportion under the general single sales factor, business activity is measured by property and payroll. Persons required to use the special apportionment formulas for financial organizations, transportation companies or insurance companies must use these respective factors for the business activity test. (Ill. Adm. Code Sec. 100.9700(c).)

Massachusetts

Effective for tax years beginning on or after January 1, 2009, Massachusetts requires a corporation engaged in a unitary business with one or more corporations "subject to combination" to calculate its taxable net income based on its share of the apportionable income or loss of the combined group attributable to Massachusetts. The term, "unitary business," is defined to mean a group of two or more corporations related by common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts. For these purposes, "common ownership" means more than 50 percent of the voting control of one or more corporations directly or indirectly owned by a common owner or owners (whether such owners are corporate or non-corporate and whether such owners are included in the combined group). The definition of unitary business is intended to be broad and should be construed "to the fullest extent permitted under the United States Constitution."

Corporations subject to combination include financial institutions, general business corporations, S corporations, utility corporations, certain insurance companies not classified as such for federal tax purposes, real estate investment trusts, and regulated investment companies (although regulated investment companies are exempt from the general corporate excise). Corporations not subject to combination include Massachusetts security corporations, most insurance companies, and tax-exempt organizations. Massachusetts' combined reporting law calls under 830 CMR 63.32B.2 (5)(b) for a water's-edge *default;* worldwide and affiliated group are elections. The following members would be included in the water's edge combined group:

- Any member incorporated in the United States or formed under the laws of the United States, any state, the District of Columbia, or any territory or possession of the United States;
- Any member (regardless of the place of incorporation or formation) if the average of its property, payroll, and sales factors within the United States is 20% or more; and
- Any member that earns more than 20% of its income (directly or indirectly) from intangible property or service related activities the costs of which generally are deductible for federal income tax purposes against the business income of other members of the group, but only to the extent of such intercompany income and related apportionment factors.

Under 830 CMR 63.32B.2 (5)(c), the members of a combined group may make a "worldwide election" on a timely filed original return to determine the combined group's taxable income. The election will be binding for a period of ten years, subject to regulations adopted by the Department of Revenue. Alternatively, taxpayers may elect to file as a Massachusetts affiliated group. A Massachusetts affiliated group is an affiliated group as defined in IRC § 1504 that files a federal consolidated return and also includes all corporations that are under common ownership that are includible in a combined group irrespective as to whether such corporations are engaged in one or more unitary businesses.

The Massachusetts combined group may contain taxable and non-taxable members. A non-taxable member is not subject to tax on its own income in Massachusetts. A non-taxable member, however, may nonetheless be subject to the non-income measure of the corporate excise tax.

New York

Effective for tax years beginning on or after January 1, 2007, taxpayers that own or control the capital stock of another corporation, or are so controlled by another corporation, are required to file a combined franchise tax report where there are substantial intercorporate transactions, regardless of the transfer price for such transactions.

In determining whether there are substantial intercorporate transactions, the Commissioner of Taxation and Finance must consider and evaluate all activities and transactions of the taxpayer and its related corporations including, but not limited to: (1) manufacturing, acquiring goods or property, or performing services, for related corporations; (2) selling goods acquired from related corporations; (3) financing sales of related corporations; (4) performing related customer services using common facilities and employees; (5) incurring expenses that benefit, directly or indirectly, one or more related corporations; and (6) transferring assets, including such assets as accounts receivable, patents or trademarks from one or more related corporations. A combined report would include only domestic-U.S. corporations. Combined reporting would also be required for insurance franchise taxpayers (with differences in the activities that indicate substantial intercorporate transactions). In addition, non-life insurance corporations cannot be included in a combined Article 33 report. (N.Y. Tax Law Sec. 211(4)). Division regulations further provide that combined filing may be allowed or required where: (1) the taxpayer owns or controls, directly or indirectly, substantially all of the capital stock of the corporations to be included in the combined report; (2) the corporations to be included in the combined report are engaged in a unitary business; and (3) filing on a separate company basis results in a distortion of a taxpayer's activities, business, income, or capital. (See N.Y. Comp. Codes R. & Regs. tit. 20, Sec. 6-2.2; 6-2.3)

Prior to the law being amended in 2007, the Division of Taxation had discretion to permit or require corporations subject to New York State tax to file combined reports where the division determines that combined reporting is necessary to properly reflect the tax liability.

Corporations, with certain exceptions, may not be included in a combined report if they are subject to tax under another article of the Tax Law. For example, a bank or bank holding company taxable under Article 32 may not be included in the combined report of corporations taxable under Article 9-A. New York S corporations may not be included in a combined report except with other New York S corporations and/or foreign (non- New York) corporations not subject to New York tax that have made a federal S election. An alien (non-U.S.) corporation (except FSCs) may not be included in a combined report, unless the Tax Commission determines that inclusion is necessary to reflect the liability of any group member.

Effective in 2015, New York replaces its existing combined reporting provisions with a unitary combined reporting system. A combined report must be filed by any taxpayer:

1. that owns or controls, directly or indirectly, more than 50% of the capital stock of one or more other corporations or
2. more than 50% of the capital stock which is owned or controlled either directly or indirectly by one or more other corporations or
3. more than 50% of the capital stock of which, and the capital stock of one or more other corporations, is owned or controlled, directly or indirectly, by the same interest *and*
4. that is engaged in a unitary business with those corporations.

Combined returns include (1) a captive REIT or a captive RIC that is not required to be included in a combined insurance tax report under Article 33, (2) a combinable captive insurance company. A combinable captive insurance company is an entity that is treated as a corporation under the IRC and that: 1) more than 50% of the voting stock of which is owned or controlled, directly or indirectly, by a corporation subject to the federal income tax; 2) licensed as a captive insurance company under the laws of New York or another jurisdiction; 3) whose business includes providing, directly and indirectly, insurance or reinsurance covering the risks of its parent and/or members of its affiliated group; and 4) 50% or less of its gross receipts consist of premiums from arrangements that constitute insurance for federal income tax purposes, and (3) an alien corporation that satisfies the state ownership and unitary thresholds and that is treated as a domestic corporation under IRC Sec. 7701 or has effectively connected income for the taxable year.

Corporations may elect to be combined with their non-unitary affiliates provided the ownership thresholds are met. (N.Y. Tax Law Sec. 210-C).

Virginia

Affiliated corporations may elect to file separate returns, a consolidated return or a combined return, regardless of how the federal return is filed. (See Va. Code Ann. Sec. 58.1-442.) It should be noted that what Virginia terms a "consolidated" return is substantially the same as what other states term a "combined" return. Similarly, a Virginia "combined" return is a mere consolidation of separately computed returns. For purposes of this outline, only the consolidated filing option will be considered.

Corporations actually included in a consolidated federal return are presumed to satisfy the ownership criteria of the Virginia definition of "affiliated" (80 percent ownership of voting stock).

The Virginia consolidated return is a single return for all eligible members of an affiliated group of corporations. No affiliated corporations, otherwise eligible, will be denied the privilege of consolidation merely because other members (*e.g.*, non-nexus) are not eligible to be included. A corporation cannot be included in a consolidated return if it is exempt from Virginia income tax under Va. Code Ann. Sec. 58.1-401 or under P.L. 86-272, is not affiliated, is not subject to Virginia income tax if separate returns were to be filed, or if using a different taxable year. Members of the affiliated group of corporations that become subject to Virginia income tax in subsequent years must conform to the initial election made by the group unless permission to change is granted by the department.

A consolidated return may not include a controlled foreign corporation the income of which is derived from sources without the United States.

Once an affiliated group has made a consolidated return election, all returns for subsequent years must be filed on the same basis and the group may not change its filing status unless permission is granted by the department.

IS THE GROUP TREATED AS ONE TAXPAYER?

Florida

Unless "manifestly inconsistent with the provisions of the Florida Income Tax Code," the consolidated taxable income for a consolidated return year is determined in the same manner and under the same procedures, including intercompany adjustments and eliminations, as are required by the federal income tax regulations for consolidated returns. Thus, the consolidated group will generally be treated as a single taxpayer for Florida income tax purposes.

If a consolidated return includes the income of a corporation that was not a member of the affiliated group at any time during the consolidated return year, the tax liability of the corporation is determined based on a separate return (or a consolidated return of another group). (Fla, Reg. Sec. 12C-1.0131)

Georgia

Corporations that file a consolidated Georgia income tax return are required to consolidate their separate company income or loss on a post-apportionment basis. Intercompany transactions are not eliminated (unless specifically required by the Commissioner) when computing the Georgia taxable income of each group member. (Ga. Comp. R. & Regs. 560-7-3-.13)

Illinois

Corporations (other than Subchapter S corporations) that are members of the same unitary business group are treated as one taxpayer for purposes of any original return, amended return that includes the same taxpayers of the unitary group which joined in filing the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under the Act. (IITA Sec. 502(e); Ill. Adm. Code Sec. 100.5200.)

However, in calculating the numerator of the sales factor and in applying the throwback rule, the word "person" has been held to refer to an individual group member when a unitary business group was involved. (See *Dover Corp. v. Dep't of Revenue*, 648 N.E.2d 1089 (Ill. App. Ct. 1995); *Hartmarx Corp. v. Bower*, 723 N.E.2d 820 (Ill App. Ct. 1999); *Beatrice Companies, Inc. v. Whitley*, 685 N.E.2d 958 (Ill. App. Ct. 1997).)

Massachusetts

Members included in a combined Massachusetts group may be subject to different tax regimes, different apportionment formulas and even different rates, based on the type of entity (e.g. financial institution, manufacturer). Accordingly, each taxable member of the Massachusetts combined group should determine its own apportionment percentage to apply against the group's combined taxable income based on the particular apportionment formula such taxpayer is required to utilize under Massachusetts law (e.g., a three factor formula consisting of property, payroll, and sales vs. single sales factor for certain industries). Each taxable member then multiplies its apportioned taxable income by the tax rate applicable to such member of the group.

The combined reporting statute adopts a "common denominator" approach, under which the apportionment factor denominators of every member of the group is individually determined based upon the apportionment provisions applicable to each member. Each member's apportionment factor denominators are subsequently aggregated, taking into account any eliminations for intercompany transactions. 830 CMR 63.32B.2(7)New York

The New York allocation factors are computed as if the combined group were one company. The tax is measured by the combined entire net income, combined minimum taxable income, combined pre-1990 minimum taxable income or combined capital, of all the corporations included in the report. (N.Y. Tax Law Sec. 211(4)(b)(1)). In the *Disney* decision (explained previously), the court determined that a "person" could also include a unitary group, a conclusion consistent with treating a unitary group as "one entity" for franchise taxation.

Under N.Y. Tax Law, Section 210-C, 4(A) in computing the tax base for a combined report, the combined group is treated as a single corporation, effective in 2015

Virginia

Under the Virginia consolidated return rules, the income/loss of each member is aggregated prior to apportionment. (Va. Admin. Code Sec. 10-20-322).

TREATMENT OF TAX CREDITS

Florida

The Florida Department of Revenue has historically taken the position that, when the statute creating a credit does not expressly provide for the use of the credit by consolidated group members, the credit is restricted to the group member that generated the credit. Conversely, taxpayers have argued that, if there is no prohibition against sharing a credit, the spirit of Florida's consolidated return provisions is to look at income, losses, and credits on an aggregate basis. As a result of this tension, some Florida credit statutes expressly provide for the use of the credit on a consolidated return basis for taxpayers that file a Florida consolidated return.

Georgia

Tax credits must be calculated and claimed on a separate company basis. To the extent the credit is limited to a certain percentage of a taxpayer's Georgia taxable income, that percentage shall be applied to the taxpayer's separate company liability. Again, it should be noted that Georgia provides for the assignment of credits, either in whole or in part, under certain conditions. To the extent the credits may be assigned, the taxpayer may assign such credits to other members of the consolidated group; however, the assigned credits must still be applied on a separate company basis. (Ga. Comp. R. & Regs. 560-7-3-.13(7).)

Illinois

The group's designated agent is to compute any credit allowed by the Illinois Income Tax Act based on the combined activities of the members of the combined group and such credit is to be applied against the combined liability of the combined group. (Ill. Adm. Code Sec. 100.5270(d)(1).) Any combined credit carryforward is available to the combined group for the next combined-return year. (Ill. Adm. Code Sec. 100.5270(d)(6).) In addition, the members of the combined group are responsible for the recapture of any personal property replacement tax or income tax when property ceases to be qualified property. (Ill. Adm. Code Sec. 100.5270(d)(7).)

Massachusetts

If a combined group taxable member has a credit that is attributable to the combined group's unitary business, it may be shared with another taxable member of the combined group to the extent such sharing of the credit is consistent with the statutory requirement for claiming the credit (taking into account the nature of the business and activities of each of the taxable members that seek to share the credit). In other words, a taxable member's credit can be shared with other members of the combined group if that other member could have validly claimed a credit under the applicable section. Members electing to file as part of an affiliated group are not required to prove that the credit is attributable to the combined group's unitary business in order to share the credit (See 830 CMR 63.32B.2(9)).

New York

Generally, credits earned by one company in the combined group can be applied against the tax of the group. One exception is the QEZE Tax Reduction Credit, which requires the amount of the credit to be based on the ratio of the individual company's income to the income of the combined group.

Effective in 2015, under N.Y. Tax Law Sec. 210-C.4, credits are computed separately for each member of the combined group. However, credits earned by one company in the combined group can be applied against the tax of the group. If the use of a credit is limited to the fixed dollar minimum amount, the fixed dollar minimum is the amount attributable to the designated agent of the combined group.

Virginia

Where a consolidated Virginia corporate income tax is filed which includes corporations that were not eligible to claim a credit, special rules apply. In such cases, the credit is utilized to offset the combined or consolidated Virginia corporate income tax liability. Any remaining credit, however, can only be used to offset other state taxes incurred by the corporations in the consolidated or combined group that actually earned the credit. (Va. Dept. of Taxn., P.D. 97-409 (Oct. 8, 1997).)

CAPITAL LOSSES

Florida

For Florida income tax purposes, a capital loss is allowed to the extent it is allowed for federal tax purposes. That is, it is allowed to the extent of capital gains for federal purposes provided the deduction does not exceed the Florida carryover available (See Fla. Regs. Sec. 12C-1.013(15)).

If a corporation that was a member of an affiliated group that filed a consolidated return ceases to be a member of the affiliated group or is granted permission to file a separate return, the portion of any consolidated net capital loss attributable to that member is an amount equal to the consolidated net capital loss multiplied by a fraction, the numerator of which is the separate net capital loss of such corporation, and the denominator of which is the sum of the separate net capital loss of all members of the group in such year having such losses. The net capital loss carryover that is allocated to that corporation is based on the consolidated apportionment factor in effect for the year of the loss.

Georgia

Capital losses of each member taxpayer will only be available to offset the capital gains of that separate corporation. Pursuant to Ga. Comp. R. & Regs. 560-7-3-.13, each member of the Georgia consolidated group is required to prepare a separate company Georgia Form 600 and then report the consolidated Georgia taxable income of all group members on a Group Form 600. Georgia requires that the taxable income reported on Form 600 be federal taxable income before net operating losses and special adjustments with certain specified modifications. No modifications are provided that would alter the federal limitation on the utilization of a capital loss.

Illinois

In determining combined base income, the designated agent treats all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions and the limitations on consolidation of life and non-life companies in Treas. Reg. Sec. 1.1502-47 do not apply. (Ill. Adm. Code Sec. 100.5270(a)(1). See Part II of the Schedule UB.)

Massachusetts

If a member or members have a capital gain or loss derived from the sale of property used in the unitary business of the group, including a § 1231 gain or loss, such gains and losses are required to be netted to determine whether there is a net gain to be taxed to the combined group for such year. If a net gain results, it is included in the combined taxable income of the member , but if a net loss results, it is not deducted in determining the combined group's taxable income and it cannot be carried forward. The same rules apply in the case where an affiliated group election is made, except that all gains and losses from the sale of a capital asset are netted, not just those that result from the sale of a capital asset used in the unitary business. 830 CMR 63.32B.2(6)(c)(8).

New York

Capital losses are offset against capital gains, contributions are deducted, and intercorporate profits are treated in computing combined entire net income as if each corporation in the group had filed its Federal income tax return on a separate basis. However, corporations may offset capital losses against capital gains, deduct contributions, and defer intercorporate profits as if the corporations in the group had filed a consolidated Federal income tax return if the group of corporations included in the combined report consistently computes combined entire net income by this method. Changes in the method of computing combined entire net income may be made only with the approval of the Commissioner. N.Y. Reg. 18.2.6.

Virginia

For purposes of an affiliated group filing a consolidated Virginia return, federal taxable income (before and after deductions for net operating losses, net capital losses, and charitable contributions) is computed as if a federal consolidated return had been prepared only for the members included in the Virginia return. Federal taxable income is computed without giving effect to the deferral of any gain, loss, or deduction arising from a transaction with a corporation not subject to Virginia income tax. Where the deferred gain, loss or deduction arises from a prior transaction with an affiliate, the item will be recognized when the affiliate subsequently ceases to be an affiliate or when the asset involved is transferred to a non-affiliated entity. (Va. Admin. Code Sec. 10-20-320.D.1.a.(1)).

NONBUSINESS INCOME AND LOSSES

Florida

Florida regulations provide that a single consolidated apportionment factor is constructed for the group, which is then multiplied by the consolidated adjusted federal income to determine the income apportioned to Florida. (Fla. Reg. Sec. 12C-1.015(7)(c)(1)) Likewise, nonbusiness income is allocated and added to the group's income.

Georgia

Taxable income of each member of the Georgia consolidated group is separately calculated, allocated and apportioned by each member using only that member's property, payroll and sales. The consolidated reporting group's Georgia taxable income is the consolidated post-apportioned and allocated taxable income of each separate member. (Ga. Comp. R. & Regs. 560-7-3-.13.)

Illinois

The regulations provide that the combined base income allocable to Illinois is the sum of the combined business income or loss apportioned to Illinois plus the combined nonbusiness income or loss allocated to Illinois plus the combined nonunitary partnership income or loss allocated to Illinois, less the combined net loss deduction. (Ill. Adm. Code Sec. 100.5270(b).) In order to determine the combined nonbusiness income or loss allocable to Illinois, the designated agent must first determine the amount for each member of the combined group and then combine these amounts. Similarly, the amount of combined nonunitary partnership income or loss allocable to Illinois is computed by first determining the amount for each member and then combining these amounts. (Ill. Adm. Code Sec. 100.5270(b)(2).)

For tax years beginning on or after January 1, 2003, a taxpayer may make an annual election to treat all income other than compensation as business income and, once made, the election shall be irrevocable. 35 ILCS 5/1501. It should also be noted that this election is made on an entity-by-entity basis and a determination should be made with regard to whether this election was made for any income flowing up from a pass-through entity.

Massachusetts

Massachusetts does not adopt the UDITPA business/nonbusiness income concept. All income is subject to apportionment. Mass. Dept of Rev., Tech. Info. Release 1992-5.

New York

New York does not adopt the UDITPA business/nonbusiness income concept; rather New York divides income into: 1) income from investment capital; 2) income from subsidiary capital (which is not taxed in New York) and 3) income from business capital, which is subject to the three factor apportionment.

Oregon

Recently an Oregon court rejected the DOR's challenge to "Inconsistent Reporting" of gains as business income in California and nonbusiness in Oregon. Specifically, an Oregon taxpayer was not required to classify income for Oregon tax purposes in the same manner in which it classified the income for tax purposes in California, its state of domicile, the Oregon Tax Court ruled in *Oracle Corporation v. Department of Revenue,* Oregon Tax Court, No. TC-MD 070762C, 2/11/2010. In addition to a lack of legal authority to support such a requirement, the Court found that such a policy would prove unworkable, produce incongruous results, and violate principles of federalism.

The taxpayer sold stock and other corporate assets and reported the gain as business income in California, its domicile state, but reported the gain as nonbusiness income on its Oregon return. The Oregon Department of Revenue challenged the differing classification of the income, asserting in a motion for partial summary judgment before the Oregon Tax Court that the taxpayer violated a duty of consistent or uniform reporting under the provisions of UDITPA, codified in ORS 314.605 to ORS 314.675. Alternatively, the Department contended that the taxpayer was estopped from classifying the income as nonbusiness on its Oregon return because it reported the income as business income to its domiciliary state. Specifically, the Department argued that "courts recognize a duty of consistency or quasi-estoppel in federal income tax cases to compel consistent treatment of a tax item with the taxpayer's treatment of that item in a year barred by the statutes of limitations when there is no doubt concerning its correct treatment." The taxpayer countered that the duty of consistency that the Department asserted had only been applied in federal cases where a taxpayer sought to change the treatment of an item from one year to another on its federal return.

The Court explained that while it agreed that UDITPA is premised on a goal of uniformity, and the Multistate Tax Compact, which includes UDITPA, was intended to promote this goal, the consideration of such goals represents a matter of policy and not law. The Court concluded that the question of whether an item of income is business or nonbusiness must be governed by the applicable state law; to require the uniformity and consistency that the Department sought would produce illogical and unworkable results, the Department explained. First, taxpayers would be confronted with the decision as to which state's law or classification governed. Second, this policy would raise the question as to whether the taxing state would accept the treatment of another state that was adverse to its interests. The Court asked rhetorically: "Why should Plaintiffs' characterization of the income on its California return dictate how the income should be reported in Oregon?" It answered: "Perhaps the income should be reported as nonbusiness income in California, which would also produce the uniformity and consistency [the Department] seeks. Ultimately, the question of whether an item of income is business or nonbusiness must be governed by Oregon law, not by some judicially declared doctrine that may pervert the law in a given situation." Finally, while the Court agreed with the Department that it appeared the taxpayer did not comply with the intent of the Department's disclosure rule, "there are no legal sanctions for untimely disclosure." There being no legal basis for the Department's motion, the

Court denied its request for partial summary judgment. This constitutes an interim order which may not be appealed until a final written decision is issued by the Court on all the underlying issues (including the substantive issue of the correct classification of the taxpayer's gain as business or nonbusiness income under Oregon law).

Virginia

Virginia does not adopt the UDITPA business/nonbusiness income concept. Virginia does provide that dividends should be allocated to the commercial domicile of the corporation, but all other income should be apportioned. For purposes of the Virginia consolidated return, apportionment factors must be included for all members of an affiliated group that would be subject to Virginia income tax if separate returns were to be filed. Va Code §58-1.407, 408, 23 VAC 10-120-140.

NET OPERATING LOSSES

Florida

The Florida income tax laws "piggyback" on the IRC, and taxpayers are instructed to utilize, to the greatest extent possible, the rules and concepts of the IRC Florida generally follows the IRC regarding the computation and handling of NOLs. However, Florida does not allow carrybacks and applies the apportioned NOL carryover (determined under the apportionment factors for the year of the loss) against apportioned income. In addition, while Florida additions or subtractions under Fla. Stat. Ann. Sec. 220.13(1) do not create or increase the amount of the NOL, the Florida NOL carryover is reduced by excess addition over subtraction modifications for the year. 12C-1.013(15)

Georgia

The consolidated return regulations (Ga. Comp. R. & Regs. 560-7-3-.13.) provide specific guidance with respect to the utilization of separate member NOLs. The Georgia consolidated net operating loss for a taxable year includes the separate company federal taxable income or loss of each member corporation, with certain adjustments. In calculating the separate company income or loss of each member corporation, no deduction will be taken for either federal or Georgia net operating losses from other years. “Georgia separate return year” means a tax year of a corporation for which it files a separate Georgia return or for which it joins in the filing of a consolidated Georgia return by another group. “Georgia separate return limitation year”, or “GSRLY”, is any Georgia separate return year of a corporation or of a predecessor of a corporation.

A consolidated Georgia NOL deduction consists of any consolidated NOL of the group that is carried forward or carried back to a consolidated year, plus any NOL incurred by members of the group in Georgia separate return years which may be carried over to that year. However, the use of a NOL incurred by a member corporation in a Georgia separate return limitation year is limited and may be used to reduce the group's income only to the extent of the income contributed by the

GSRLY member. This computation must be performed first and then any consolidated loss of the group would be applied against any remaining income of the group.

If a Georgia consolidated NOL can carry forward to a Georgia separate return year of a corporation that was a member of an affiliated group when the loss arose, then the portion of the NOL attributable to the corporation must be apportioned to the corporation and be used as an NOL to the corporation’s Georgia separate return year. However, such amounts cannot be included in determining the affiliated group’s consolidated NOL carryovers in the same consolidated return year.

If a corporation ceases to be a group member during a consolidated return year, any Georgia consolidated NOL from a prior tax year must first be carried to the Georgia consolidated return year even if the NOL is attributable to the corporation that ceases to be a member of the group. To the extent not absorbed by the group, the portion of the consolidated NOL attributable to the corporation leaving the group can be then carried forward to the corporation's first Georgia separate return year.

Illinois

The combined filing regulations provide that a combined group’s current year combined taxable income may be less than zero, in which case it shall be determined by applying the provisions of Treasury Regulation 1.1502-21(f) (consolidated net operating loss) to the unitary business group. (Ill. Adm. Code Sec. 100.5270(a)(2)) In calculating a combined group’s combined base income, any carrybacks and carryovers are determined for each member and not for the group. A pro rata share of the loss is attributable to each of the loss members. (Ill. Adm. Code Sec. 100.5270(a)(3)) Regulation Sec. 100.2340(c) provides that if a combined return is filed, any Illinois net loss deductions are combined and subtracted from combined Illinois net income. If a separate return is filed, the Illinois net loss deduction of that member only would be subtracted from that member’s separate Illinois net income.

Massachusetts

For taxable years beginning on or after January 1, 2009, a combined group member (other than a financial institution or a utility corporation) may carry forward its apportioned share of the combined group's loss to offset its post- apportionment income in a subsequent year consistent with the requirements and limitations provided under Massachusetts law.

In addition, a taxable member of a combined group that has a NOL carry forward derived from a loss incurred from the activities of the combined group in a taxable year beginning on or after January 1, 2009, may be able to share the NOL carryforward with the other taxable members of a combined group. The taxable member with the NOL carry forward must first deduct its carry forward against its post-apportioned Massachusetts taxable net income. The excess NOL carryforward may be shared among the other taxable members of the combined group if: (1) they were members during the year in which the underlying loss was incurred; and (2) are not classified as financial institutions or utility corporations under Massachusetts corporate tax law. In such cases, the other taxable members of the combined group must first deduct any NOL carry forwards that they individually possess before applying any excess NOL carry forward of any other combined group member. Any amounts remaining are attributed to and carried forward by the taxable member that originally generated the loss.

Where a taxable member has an excess NOL carry forward that can be shared with more than one taxable members, such amount must be allocated among those other members in a manner that is proportionate to the respective amounts of income that each such eligible member has for the taxable year after applying each such group member's own NOLs. 830 CMR 63.32B.2(6)(c)(8).

New York

Generally, NOLs may be used to offset the income of other companies in the combined group.

For a corporation that reports on a combined basis with related corporations, either in the taxable year in which an NOL is sustained or in the taxable year in which the NOL deduction is claimed, the NOL deduction is subject to the same limitations that apply for purposes of the Federal income tax "as if such corporation had filed for such taxable year a consolidated Federal income tax return with the same related corporations." (N.Y. Regs. Sec. 3-8.7(a).)

In general, any carry-back or carry-forward from a year in which a combined report (for purposes of Article 9-A) was filed must be based on the combined NOL of the group of corporations filing the combined report. The portion of the combined loss attributable to any member of the group that files a separate report for a preceding or succeeding taxable year is an amount bearing the same relation to the combined loss as the NOL of that member bears to the total NOLs of all members of the group having such losses, to the extent that they are taken into account in computing the combined NOL.

Effective in 2015, under N.Y. Tax Law Sec. 210-C, a combined group’s the net operating loss deduction (NOLD) may reduce the higher of the tax on capital or the fixed dollar minimum. A combined NOLD is computed on a post apportionment basis and is no longer limited to the federal NOL or source year.

Virginia

For groups filing a consolidated Virginia return, the federal taxable income (before and after deductions for net operating losses, net capital losses, and charitable contributions) of the affiliated group is computed as if a federal consolidated return had been prepared that included only the members included in the Virginia consolidated return for the current year. If a federal deduction for a net operating loss, net capital loss or charitable contribution in the current year affects or is affected by another taxable year, then a similar computation must be made for every such taxable year beginning on and after the year for which an election was made, or permission granted, to file a consolidated Virginia return, and federal taxable income must be computed on a separate basis for every such taxable year before consolidated Virginia returns were filed.

Losses incurred by an affiliate before joining the Virginia consolidated return are treated as being incurred in a separate return year. The federal SRLY provisions do not apply if all the following apply for the taxable year of the loss: 1) the affiliate was subject to Virginia income tax and its loss was reported on a timely filed Virginia return; 2) the affiliate satisfied the Virginia ownership requirements for "affiliated" corporations on every day of that taxable year; and 3) either the affiliate was prohibited from being included in a consolidated Virginia return solely because of its apportionment factor or permission to file a consolidated return was granted pursuant to the provisions of 23 VAC 10-120-324.A.3.

A corporation or an affiliated group of corporations may elect to forgo carryback of a net operating loss or net capital loss for Virginia purposes independent of any such election for federal purposes if the affiliated group files its Virginia and federal returns on a different basis, or files a federal consolidated return including corporations that are not subject to Virginia income tax.

BASIS IN STOCK

Florida

Unless "manifestly inconsistent with the provisions of the Florida Income Tax Code," the consolidated taxable income for a consolidated return year is determined in the same manner and under the same procedures, including intercompany adjustments and eliminations, as are required by the federal income tax regulations for consolidated returns. Therefore, consolidated members use the federal consolidated return investment account adjustments for subsidiary stock basis. (Fla. Reg. Sec. 12C-1.0131)

Georgia

The outside basis of a consolidated member's stock should be calculated on a pro-forma basis as if separate federal returns had been filed. The regulations expressly provide that a group member's Georgia taxable income shall be calculated on a separate company basis.

Illinois

In determining combined base income, the designated agent treats all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions and the limitations on consolidation of life and non-life companies in Treas. Reg. Sec. 1.1502-47 do not apply. (Ill. Adm. Code Sec. 100.5270(a)(1).) Therefore, combined members use the federal consolidated return investment account adjustments for subsidiary stock basis.

Massachusetts

Differences in Massachusetts and federal rules to be taken into account when determining Massachusetts basis of property. 830 CMR 63.32B.1.

New York

Investments in combined subsidiaries are eliminated. Generally, this is the amount shown on the pro forma federal return of the parent company.

Virginia

For purposes of an affiliated group filing a consolidated Virginia return, federal taxable income (before and after deductions for net operating losses, net capital losses, and charitable contributions) is computed as if a federal consolidated return had been prepared only for the members included in the Virginia return. Therefore, consolidated members use the federal consolidated return investment account adjustments for subsidiary stock basis.

EARNINGS AND PROFITS

Florida

Unless "manifestly inconsistent with the provisions of the Florida Income Tax Code," the consolidated taxable income for a consolidated return year is determined in the same manner and under the same procedures, including intercompany adjustments and eliminations, as are required by the federal income tax regulations for consolidated returns. (Fla,. Reg. Sec. 12C-1.0131)

Georgia

Earnings and profits of members of a Georgia consolidated group should be calculated as if each member filed a separate Georgia income tax return on a pro-forma federal separate company basis.

Illinois

In determining combined base income, the designated agent treats all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions and the limitations on consolidation of life and non-life companies in Treas. Reg. Sec. 1.1502-47 do not apply. (Ill. Adm. Code Sec. 100.5270(a)(1).)

New York

The entire net income of each company in the combined group is computed based on its separate pro forma federal taxable income. The separate amounts are then added together and intercorporate dividends are eliminated. (See N.Y. Reg. Sec. 3-2.10(a).)

Virginia

For purposes of an affiliated group filing a consolidated Virginia return, federal taxable income (before and after deductions for net operating losses, net capital losses, and charitable contributions) is computed as if a federal consolidated return had been prepared only for the members included in the Virginia return.

TREATMENT OF INTERCOMPANY SALES--APPORTIONMENT

Florida

When a consolidated return is filed, intercompany sales may be included in the sales factor. Indications that the amounts may be included as sales include the following factors: 1) amounts called sales on the books; 2) amounts invoiced as sold to a related party; 3) actual payment from a related party; or 4) amounts included in consolidated federal income tax return as "gross receipts or sales." (Fla. Regs. Sec. 12C-1.0155)

Georgia

Members of the consolidated group separately apportion their taxable income using the member's property, payroll, and sales. In light of this, intercompany sales presumably will not be eliminated from the sales factor. It should be noted, however, that the Commissioner may point to the “clearly and equitably reflect Georgia taxable income” requirement as a basis to require the exclusion of intercompany receipts from a consolidated group member’s gross receipts factor. Under the prior regulations, it has not been uncommon for the Commissioner to place certain stipulations on the grant of permission to file consolidated. These stipulations have included requiring that certain deductions be disallowed, limiting prior year NOL carryforwards and excluding members from the group that would otherwise qualify for exclusion. Whether similar stipulations will be used (and whether such stipulations may expand to include the elimination of intercompany receipts from certain members’ gross receipts factor) is yet to be seen.

Illinois

Items of income and deduction arising from transactions between members of the unitary business group must be eliminated whenever necessary to avoid distortion of the denominators used by the unitary business group in calculating apportionment factors, or of the numerators used by the combined group or by ineligible members of the group in calculating apportionment factors. (Ill. Admin. Code Sec. 100.5270(b)(1))

Massachusetts

In determining the numerator and denominator of the apportionment factors of the members of a combined group, transactions between combined group members that relate to the unitary business are generally disregarded. 830 CMR 63.32B.2(7)(g).

New York

The receipts factor on a combined report is computed as though the corporations included in the report were one corporation. All intercorporate business receipts are eliminated in computing the combined business receipts factor. Intercorporate receipts are receipts by any corporation included in the combined report from any other corporation included in the combined report. (N.Y. Comp. Codes R. & Regs. tit. 20, Sec. 4-4.7.)

Under New York Tax Law, Sec. 210-C.5, intercorporate receipts, income and gains are eliminated from the apportionment factor, effective 2015.

Virginia

Intercompany sales to corporations subject to Virginia income tax are not included in the sales factor. Sales are included in the sales factor only if the gross receipts or net gain are included in Virginia taxable income. (See Va. Adm. Code Sec. 10-120-210(B)) Note that taxable income is computed without giving effect to the deferral of any gain, loss, or deduction arising from a transaction with a corporation not subject to Virginia income tax, and sales to such corporations are not eliminated from the sales factor.

TREATMENT OF INTERCOMPANY SALES--GAIN

Florida

Unless "manifestly inconsistent with the provisions of the Florida Income Tax Code," the consolidated taxable income for a consolidated return year is determined in the same manner and under the same procedures, including intercompany adjustments and eliminations, as are required by the federal income tax regulations for consolidated. (Fla. Reg. Sec.12C-1.0131)

Georgia

Corporations that file a consolidated Georgia income tax return are required to consolidate their separate company income or loss on a post-apportionment basis. Intercompany transactions are not eliminated (unless specifically required by the Commissioner) when computing the Georgia taxable income of each group member. Again, the Commissioner may point to the “clearly and equitably reflect Georgia taxable income” requirement as a basis to alter the pro-forma, separate company treatment of intercompany transactions.

Illinois

Combined base income is computed by treating all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions do not apply. (Ill. Adm. Code Sec. 100.5270(a)(1).)

New York

Intercorporate profits should be treated in computing combined entire net income as if each corporation in the group had filed its Federal income tax return on a separate basis. However, corporations may defer intercorporate profits as if the corporations in the group had filed a consolidated Federal income tax return, provided the group of corporations included in the combined report consistently compute combined entire net income by this method. (N.Y. Comp. Codes R. & Regs. tit. 20, Sec. 3-2.10(b).)

Virginia

For purposes of an affiliated group filing a consolidated Virginia return, federal taxable income (before and after deductions for net operating losses, net capital losses, and charitable contributions) is computed as if a federal consolidated return had been prepared only for the members included in the Virginia return. Federal taxable income is computed without giving effect to the deferral of any gain, loss, or deduction arising from a transaction with a corporation not subject to Virginia income tax. Where the deferred gain, loss or deduction arises from a prior transaction with an affiliate, the item will be recognized when the affiliate subsequently ceases to be an affiliate or when the asset involved is transferred to a non-affiliated entity. (23 Va. Admin. Code Sec. 10-120-320.)

MANAGING STATE TAX AUDITS

IN GENERAL

Managing state tax audits is an integral part of the multistate tax professional's work. As with the tax laws themselves, each state has its own rules, procedures, and idiosyncrasies with respect to the audit process. However, there are general rules that relate to most states and that will provide a framework for managing the audit effectively.

ANTICIPATE THE AUDIT

How can a tax professional anticipate an audit and what issues may prompt an audit? Professionals must consider the past audit history of a client, any outstanding deficiencies, and whether the client is a party to pending litigation. There may also be certain issues on the face of a tax return that might trigger an audit such as allocation or expense attribution. The following may also trigger an audit (1) federal RARs; (2) whether separate filers are part of an affiliated group; (3) loss companies and factor impact on a combined return; and (4) a non-filer's presence in a jurisdiction where affiliates may be present.

A voluntary disclosure agreement ("VDA") might be a viable alternative to an audit defense where ambiguities may rise to an unacceptable level. VDA programs generally allow taxpayers to limit the lookback period, provide a waiver of penalties that might otherwise be assessed on outstanding liabilities, and may limit interest. Taxpayers should also determine whether the state has an amnesty program in place.

HANDLING THE AUDIT REQUEST

Handling the initial request to audit is crucial. However, your treatment should vary depending on the type of request.

- Letter request regarding specific items or errors on a return. Respond immediately to these requests. By doing so you will likely head off the need for a field audit. If you don't respond you are simply sending an engraved invitation that you want a field audit performed.

- Letter or telephone message requesting an opportunity to conduct an audit. Whether the request is to conduct an audit at a specific time or at the convenience of the taxpayer, always promptly respond to these requests by telephone. The telephone approach allows you to secure information that should be imperative to you prior to scheduling the audit; i.e., try to find out everything you can about the auditor's information needs and the type of audit to be performed. The information requested usually indicates the scope of the auditor's review. Don't hesitate to ask very specific questions during this telephone interview with the auditor. If this phase of the audit is properly handled, you should end up with very few surprises during the actual audit.

Following is a list of questions that should be asked if applicable:

1. What type of audit will be performed, i.e. unitary worldwide, unitary domestic, consolidated return of companies doing business in the state or a specific legal entity audit?

2. Will there be more than one auditor involved in the audit?

3. Will the auditors be arriving from out of the area, i.e., does the state have a local or regional audit office nearby?

4. How long is the audit expected to last?

5. What company or companies are being audited and for what years?

6. Is there any specific adjustment or problem that has initiated the audit? If so, is there some way the problem can be taken care of without requiring a field audit?

7. What information or records will the auditor require upon his arrival?

8. Auditor(s) name, telephone number and address.

The telephone approach may also avoid a field audit. If, for instance, the auditor is reacting to one particular item on a return, agreeing to the adjustment and agreeing to file an amended return may avoid the field audit. Alternatively, the auditor may be planning to audit several years that were profitable, but be unaware of the fact that there are significant losses on the current year's return. If the auditor's state allows an NOL carryback, a field audit may be avoided by demonstrating the NOL will more than offset any potential audit adjustments.

Once the requests and information related to the audit have been analyzed and an initial plan or strategy has been developed, you will have an idea of how much time will be needed for preparation. Determine a time that will be convenient for you in relation to preparation time and then discuss your preferred dates with the auditor by telephone. After agreeing on a date, ask the auditor to write you a letter confirming:

- Type of tax;
- Type of audit;
    - Full
    - Test
- Period to be audited;
- Auditor's name;

- Date of appointment; and,
- Hearing and review procedures.

BEFORE THE AUDIT

Become familiar with the returns under examination. Search for areas of exposure and plan for them. The following actions should be taken:

1. Determine amount of adjustment (worst case)
2. Research current status of issue
3. Analyze effects on other areas, i.e., other taxes or other states.
4. Consider performing a reverse audit in order to determine whether areas of overpayment exist that can offset underpayments for which the auditor will be searching.

Consider an entrance conference to limit the time frame and scope of the audit.

Always keep the practicalities in mind. Don't fight issues for which you have little grounds for support. Don't spend time on minor adjustments. However, don't accept minor adjustments to items or areas that will become major items in the future; that is, don't allow the state to set a precedent.

Before the audit commences, the workspace to be provided for the auditor should be determined. The location should be away from areas where confidential information, either written or oral, is accumulated, communicated or disseminated. Additionally, a decision as to which persons the auditor may direct questions to should be made. The staff in the work area chosen for the auditor should be made aware of where the auditor is and that any of the auditor's questions should be referred to the designated individuals.

COMMENCEMENT OF THE AUDIT

Maintain professionalism and respect. In most instances, it is in our best interest to expedite the audit process. Consequently, a courteous and professional manner should be used in furnishing the auditor with all materials and information to which he/she is entitled.

- Do not underestimate the knowledge of the government auditor. The auditor spends full-time on that one state's tax and is privy to published and unpublished information.

- Do not give misinformation. When an embarrassing question or document arises, it is better to tell the auditor that you do not know the answer, but that you will find out and get back to him/her. You want the auditor to feel that your explanations are reliable and accurate.

- Do not accept all state tax regulations as gospel. Research the law and if you question the legality of a regulation, request opinion of counsel. You may be able to receive a favorable opinion without litigation.

- A discussion with the auditor during the course of the examination may enable you to obtain and present additional information that will clarify the dispute and result in the auditor accepting your viewpoint.

- After completion of the audit, discuss the audit thoroughly with the auditor. Any disputed items can be corrected at this time if you can convince the auditor that errors exist.

By working closely with the auditor, you will become aware of issues or potential adjustments as they develop. Many issues can be resolved or settled with the auditor and as such do not have to be dealt with in the review, assessment and litigation stages of the audit. If the auditor is allowed to proceed unchallenged, proposed adjustments may be made that may reflect an unreasonably high assessment. Once the adjustments are written up, they normally have to be dealt with formally. Finally, review the audit adjustments before the auditor leaves the company.

Ask for a meeting before the auditor formalizes the proposed adjustments. The basic thrust of this meeting is to become informed of all the adjustments that the auditor is proposing prior to their being submitted to the next level for review. It also affords one last chance to reach agreement with the auditor on the issues. Ask the auditor for a copy of the proposed adjustments. If you obtain a copy, you've got a head start on preparing a response for the assessment.

HANDLING THE AUDIT ASSESSMENT

Review the assessment for accuracy and issues in addition to checking it for mathematical accuracy. On occasion, a clerical and or calculation error occurs. In addition, check to be certain the adjustments included in the audit are adjustments that were all discussed with the auditor. If a new adjustment appears in the assessment, call the auditor immediately to ascertain the exact nature of the adjustment and its source.

Respond to the assessment in a timely manner. Whatever you do, be certain to file a timely protest to the assessment. Even if you don't have time to develop the protest arguments to the extent necessary, you must file the protest on a timely basis. In some cases, to meet the protest deadline, it may be necessary to simply indicate an issue you protest without providing arguments and authorities for your position. It is important however, that you carefully research the statutes for that state prior to preparing the protest to assure you have covered what is necessary.

In preparation of the protest, consider including every issue that may even be remotely contested. If all issues are not raised at this point, you may be precluded from doing so as the settlement procedure evolves.

You should always close with a paragraph requesting the opportunity for an informal conference. Every opportunity to discuss the audit represents an opportunity to settle some or all of the issues at the lowest possible level.

STATUTE OF LIMITATIONS

The statute of limitations (three years in most jurisdictions, four years in California) generally operates only if a tax return has been filed. The statute of limitations does not apply if a taxpayer intends to evade the law by wilfully filing a false or fraudulent return. Thus, when either no return or a fraudulent return has been filed, a taxpayer can be assessed with no limitations on time.

This means for example that, when a corporation is doing business but not filing returns, a taxing authority can assess back taxes for all years during which a jurisdiction to tax existed.

The audit process is one that requires close management. The overriding objective is to resolve as many issues as possible before they are formalized as adjustments. The adjustments that are written up should not be a surprise; therefore, preparation and planning for the negotiation and/or appeal stages should be simplified.

Finally, the practical aspects of dealing with the audit process once the adjustments have been formalized should always be kept in mind. The weight of authority for your position, as well as the economics of successfully maintaining your position at higher administrative levels and in the courts, must be carefully considered.