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Tax Strategies

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HOW US BUSINESS MANAGES ITS TAX LIABILITY

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IntraGroup Debt Issues Continue To Be Overlooked

BY JACK CUMMINGS
(ALSTON + BIRD LLP)

The Basic Problem: Inattention

X, Y and Z are members of a consolidated group. X sells to Y on credit. Y resells to unrelated parties for cash and "banks" the cash with Z through cash sweeps from Y's bank account to Z's bank account. As a result there is a growing intercompany payable from Y to X and another payable from Z to Y. No interest is accrued or paid. The payable from Y to X has not been curtailed for years. This is a disaster waiting to happen.

Why It Matters

Scenario One: The State Tax Audit

In states where less than all of the consolidated group files as a group (or in single entity states), the failure to charge interest on intercompany accounts almost always is improper, and interest income (and expense, in

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Taxes and IP in the Magic Kingdom

Gross Receipts from Destination Sales, Like Disney's, Might be Sourced And Therefore Taxed in NY if a Group Has a Member There

BY LABRY WELTY AND KAREN H. CURRIE (JONES DAY)

The New York Tax Appeals Tribunal ("Tribunal") recently upheld the determination of an administrative law judge ("ALJ") of the Division of Tax Appeals, which concluded that the New York destination sales of a member of a combined group were properly sourced to New York, even though the member standing alone did not engage in activities that exceeded the protection of Public Law 86-272.[1] In doing so, the Tribunal once again adopted the *Finnegan* approach to combined group sourcing,[2] and rejected the ALJ's determination that Public Law 86-272 was inapplicable. The Tribunal also determined that the intangible component relating to the value attributable to film negatives was properly excluded from the property factor of the group's business allocation percentage ("BAP").

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theory) can be imputed by the state on audit either under §§482 or 7872, if the state adopts the Internal Revenue Code, or under analogous state-specific rules.

The worst case scenario is for interest deductions to be lost for prior years by debtor corporations, when the states assert that the payables require that interest income be accrued by the creditor affiliate.

Scenario Two: Foreign Affiliates

If the debtor is not consolidated, as in the case of foreign affiliates, the IRS could treat the payables from the foreign affiliate as not reflecting true debt owed by it, but rather as reflecting previously dividended amounts. See *Alterman Foods, Inc. v. United States*, 611 F. 2d 866 (Ct. Cl. 1979) and *Peoplefeeders, Inc. v. Comm'r, 77 T.C.M. (CCH) 1349* (1999).

Scenario Three: Sale of a Member

Another federal tax consideration is the tax basis of the stock in subsidiaries held by parent corporations in the chains of ownership. Upon a sale of one or more subsidiaries (assuming X is not also part of the sale) the intercompany accounts likely would have to be zeroed

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PUBLICATION STAFF

PUBLISHER: Gary A. Brown, Esq. EDITOR: Judith M. Freedman, Esq.
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Expanding RICO:
Will Second Circuit Decision Create New Wave of State Tax Litigation?

BY MICHAEL J. SEMES (BLANK ROME LLP)

On November 28, 2005, the Supreme Court of the United States granted certiorari in *Ideal Steel Supply Corp. v. National Steel Supply Inc*. If the Supreme Court upholds the Second Circuit's decision, we should expect to see a wave of new and very different state tax litigation.

In this case, the Second Circuit Court of Appeals held that a taxpayer may sue its competitor – National Steel (together with National Steel's principals, Joseph and Vincent Anza) – under the Racketeer Influenced and Corrupt Organizations Act ("RICO") where the competitor failed to properly charge its customers sales tax and fraudulently failed to include those sales on its sales tax returns that it mailed and wired to the State of New York.

Ideal Steel alleged that its competitor, National Steel (and its principals) engaged in a pattern of racketeering that "continues to the present day" by: (1) not charging its cash-paying non-exempt customers the applicable state and local sales tax (8%) (the "cash, no tax" scheme); and (2) repeatedly mailing (and/or wiring – *i.e.*, in violation of federal law) fraudulent sales tax returns (by understating its total sales subject to sales tax) to the State.

The United States Court for the Southern District of New York dismissed Ideal's claim because Ideal did not allege that it had relied on National's misrepresentations (to the State) and had, therefore, failed to state a RICO claim upon which relief could be granted. The District Court found that, although the State may have relied on National's fraudulent tax returns, Ideal did not – and could not – allege that it relied on those returns. The District Court concluded that Ideal must show **its own** reliance (on the fraudulently filed tax returns) in order to overcome a motion to dismiss a RICO cause of action.

The Second Circuit reversed and held that a plaintiff has standing to pursue a civil RICO claim where it alleges facts that show the defendant engaged in a pattern of fraudulent conduct of racketeering activity that was intended to, and did give, that defendant a competitive advantage over the plaintiff. This is so even where the racketeering activity (here, National's mailing and wiring of fraudulent tax returns) was directed to and relied upon by someone other than the plaintiff.

The Second Circuit found that: National's mailing of the fraudulent tax returns was an essential element of the "cash, no tax" scheme because if the State did not rely on them, National "would have had to pay the uncollected sales taxes out of their own assets"; National sought to secure a competitive advantage over Ideal by engaging in the "cash, no tax" scheme; and National's concealing its unlawful activity through racketeering activity allowed it to retain the resulting profits.

Now that National's petition for writ of certiorari has been accepted, this case is a very interesting one to watch for a host of reasons. If upheld this case may cause a new wave of state tax litigation that has the following unusual characteristics and effects:

- the venue is federal court;
- the state taxing agency is not a party;
- taxpayers may be encouraged to sue each other; and, therefore
- state taxing agencies may receive additional revenue without having to put forth much effort.

Further, because RICO is a federal statute, federal court is the proper venue to bring such an action. Because RICO provides a private right of action for treble damages, taxpayers have additional incentive to sue their scofflaw competitors.

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Many businesses have filed civil RICO claims against their competitors. One wonders whether this is the beginning of a trend in which taxpayers file civil RICO actions against competitors who engage in any kind of tax fraud, such as failure to remit employer withholding, filing a fraudulent income tax return, *etc.*

Might this civil RICO action be extended to mail order companies that do not charge sales tax, but are later found to have sufficient nexus to have been obligated to do so? Follow the money!

Although *Ideal* appears to limit civil RICO actions to those instances where the racketeering activity provides a competitive advantage, it would not be surprising if creative lawyers attempt to stretch the boundaries of what constitutes a competitive advantage.

Will the Supreme Court probe the issue further and ask the question: did National really did gain a competitive advantage because its customers that did not pay sales tax would have had a corresponding use tax obligation? Therefore, at least in theory, those customers would not have been better off purchasing their products from National as opposed to Ideal. If this is the case, there appears to be no competitive advantage.

Might this civil RICO action be extended to mail order companies that do not charge sales tax, but are later found to have sufficient nexus to have been obligated to do so? Follow the money! ❏

Michael J. Semes (215-569-5476 and semes@blankrome.com) is a partner in the business Tax Group of Blank Rome, where he focuses his practice on state and local tax litigation and planning.

Follow Up: Will *Cuno* Decision on State Investment Tax Credits Be Overruled?

BY JUDITH M. FREEDMAN

The October *Strategies* explored the case of *Daimler-Chrysler Corp. v. Cuno*, in which the Sixth Circuit Court of Appeals had held that Ohio's Investment Tax Credit violated the Commerce Clause. The Circuit Court found that the investment tax credit, which Ohio granted to Daimler Chrysler in exchange for Daimler Chrysler constructing a new assembly plant in Ohio, favored in-state economic activity at the expense of out-of-state activity. The Supreme Court granted DaimlerChrylers' petition for certiorari on September 27, 2005.

Since that time further action in the Congress to overturn the decision has occurred. Legislators in both the Senate (Sen. Voinovich (R-Ohio) and the House of Representatives (Pat Tiberi (R-Ohio) have each introduced a bill which would specifically authorize both states and local governments to provide tax incentives for economic development purposes.

Whether the case will reach argument and decision before any action by the Congress is yet to be seen, but *Strategies* will provide the result. ❏

Judith M. Freedman is the Editor of Practical U.S./Domestic Tax Strategies. If you have any questions about this article, or about any items in Practical Strategies, please contact Ms. Freedman at 978-287-0301 or jfreedman@wtexec.com.

IRS Announces Sweeping Settlement Initiative For Abusive Transactions

BY BRIAN C. BERNHARDT, STEVEN D. KITTRELL, RONALD D. AUCUTT, JEFFREY R. CAPWELL, AND CRAIG D. BELL (MCGUIREWOODS LLP)

On October 27, 2005 the IRS announced an initiative to settle twenty-one allegedly abusive transactions affecting more than 4,000 taxpayers. Taxpayers involved in one of these twenty-one transactions have until January 23, 2006 to make an election to participate in the settlement initiative.

The Settlement

Taxpayers who elect to participate in the settlement initiative by January 23, 2006 will have to pay 100% of the tax liability owed on the transaction, 100% of the interest on the tax liability, and a penalty. The penalty assessed by the IRS will vary depending on the transaction. Some transactions will be assessed a 20% penalty, others will be subject to a 10% penalty, and others will be subject to a 5% penalty. Notably, taxpayers will be allowed to deduct transaction costs for the transactions, including professional and promoter fees.

The Transactions That Can Be Settled And the Penalties Imposed

The IRS has divided the twenty-one transactions that are eligible for the settlement initiative into four groups, based upon the amount of penalty the taxpayers are required to pay and the type of transaction.

The first group of transactions are "listed transactions" the IRS has previously announced it believes are abusive. Taxpayers who entered into these transactions and elect to participate in the settlement initiative will be required to pay a 20% penalty. There are three of these transactions:

1. Transactions using inflated basis.
2. Intermediary transactions.
3. Transactions involving losses reported from inflated basis assets from lease strips.

The second group of transactions are also "listed transactions" and require taxpayers who elect to participate in the settlement initiative to pay a 10% penalty. There are four of these transactions:

1. Lease strips and other stripping transactions.
2. Certain common trust fund straddle tax shelters.
3. Transactions using offsetting foreign currency option contracts.
4. Transactions using distributions of encumbered property.

If the taxpayer refuses to extend the statute of limitations on the assessment of tax, the IRS will treat the taxpayer as having withdrawn from the settlement initiative.

The third group of transactions are also "listed transactions" and require taxpayers who elect to participate in the settlement initiative to pay a 5% penalty. There are nine of these transactions:

1. Transactions using specially designed life insurance policies in retirement plans.
2. Transactions involving abusive treatment of Roth IRAs.
3. Transactions involving certain S corporation employee stock ownership plans.
4. Transactions involving transfers to trusts to satisfy contested liabilities.
5. Transactions involving welfare benefit funds.
6. Transactions involving the transfer of employee stock ownership plans that hold stock in S corporations.
7. Debt straddles.
8. Certain trust arrangements seeking exemption from Section 419.
9. Certain distributions by charitable remainder trusts.

The fourth group of transactions are not "listed transactions," but the IRS has concerns regarding their legitimacy. Taxpayers who entered into these transactions and elect to participate in the settlement initiative will also be required to pay a 5% penalty. There are five of these transactions:

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1. Transactions involving false reimbursements for employee parking expenses.
2. Transactions involving false reimbursements for employee medical expenses.
3. Certain transactions involving the management of S corporations and employee stock ownership plans.
4. Abusive conservation easements.
5. Abusive charitable contributions of patents and other intellectual property.

In the October 27 announcement, the IRS acknowledged that taxpayers often enter into the last two types of transactions – conservation easements and charitable contributions of patents and other intellectual property – for legitimate purposes. The IRS only intends to examine and disallow, and subject to this settlement initiative, those conservation easements and contributions of patents and other intellectual property transactions which are abusive. Notably, however, the IRS did not define what it meant by abusive.

Complete Penalty Relief Available to Some Taxpayers

Taxpayers who meet certain criteria will be eligible to settle with the IRS without paying any penalties. These taxpayers include (1) taxpayers that have properly disclosed the transaction according to IRS rules and (2) at the discretion of the IRS, taxpayers that received and relied on a written tax opinion which meets certain specified requirements, most notably that it concludes that all significant Federal tax issues arising out of the transaction would "more likely than not" be resolved in the taxpayer's favor.

Taxpayers Who Can Not Participate In the Settlement

Certain taxpayers are ineligible for the settlement initiative. These taxpayers include:

- Taxpayers who entered into one of the transactions and whom the IRS informs, prior to the taxpayer making an election to participate in the settlement, that the transaction is one the IRS has designated for litigation.
- Taxpayers who are a party in litigation regarding one of the transactions.
- Taxpayers against whom the IRS has asserted a fraud penalty.
- Taxpayers under criminal investigation.

Certain other taxpayers are eligible for the settlement initiative only at the discretion of the IRS. These taxpayers are tax shelter promoters and certain persons related to and partners of the tax shelter promoter.

Other Procedural Issues

If a taxpayer elects to participate in the settlement initiative and the statute of limitations on the underlying tax will expire within twelve months after the election, the taxpayer must agree to extend the statute of limitations on assessment of the tax. If the taxpayer refuses to extend the statute of limitations on the assessment of tax, the IRS will treat the taxpayer as having withdrawn from the settlement initiative.

Unlike prior IRS settlement initiatives, taxpayers who do not elect to participate in the settlement and who are under examination will still have the option of presenting their case to the IRS Office of Appeals. The IRS stressed, however, that "such persons should not expect to receive a better offer in Appeals than that offered under this settlement initiative and may in fact receive a less favorable outcome."

Conclusion

This settlement initiative is the most sweeping ever announced by the IRS. Taxpayers who wish to participate only have until January 23, 2006 to make an election. Taxpayers who have entered into one of the twenty-one transactions subject to this settlement initiative should discuss their options with a tax advisor as quickly as possible. ❑

Brian C. Bernhardt is an attorney in the Richmond, Virginia office specializing in civil and criminal Federal tax controversies and litigation. Steven D. Kittrell is a Partner in the Washington, D.C., office specializing in executive compensation arrangements and qualified retirement plans. Mr. Kittrell is the Chair of the McGuireWoods LLP Taxation and Employee Benefits Department. Ronald D. Aucutt is a partner in Tysons Corner, Virginia, office specializing in planning and controversy matters involving estate, gift, and generation-skipping transfer taxes; income taxation of trusts and estates; and rules regarding tax-exempt organizations and charitable contributions. Jeffrey R. Capwell is a Partner in the Charlotte, North Carolina, office specializing in executive compensation arrangements and employee benefits. Craig D. Bell is a Partner in the Richmond, Virginia, office specializing in civil and criminal Federal, State, and local tax controversies and litigation.

When Is a Contract a Partnership?

BY ANDY IMMERMAN (ALSTON + BIRD LLP)

A new IRS Technical Advisory Memorandum[1] (TAM) reinforces the point that contractual arrangements may be treated as "partnerships" for tax purposes, even against the will of the contracting parties.

Background

Contractual relationships do not normally give rise to legal entities, but might create a general partnership under state law – intentionally or, in some cases, unintentionally. Even if not, an agreement might be characterized as an "entity" for federal tax purposes: specifically, a multi-member "business entity," which is taxable by default as a "partnership."

A recent troubled area that might have influenced the TAM's reasoning on the creation of an entity that is a tax partnership is the common practice of claiming that section 1031 applies to the exchange of a fee interest in property for a tenant in common interest, which taxpayers contend is mere co-ownership of property, but which rarely satisfies all the advance ruling guidelines of Rev. Proc. 2002-22, 2002-1 C.B. 733.

Basis Strip

The TAM deals with a basis strip. Bank purchased shares of money market mutual funds on behalf of the Company. Bank, as custodian of the shares, agreed to issue two kinds of certificates for the shares, which, between them, represented the entire interest in the shares. "B Certificates" represented the right to receive dividends on the shares through a specified date. "A Certificates" represented everything else. Thus the holder of the A Certificates received the underlying shares on the date that the dividend right under the B Certificates terminated, and had the right to all dividends paid after that date. The A Certificate holder also received all returns of capital, regardless of the date.

The Company sold the A Certificates to a Counterparty. The Counterparty of course paid less than the full value of the underlying shares, since the Counterparty acquired only a partial interest in the underlying shares. The Company took the position, however, that all of its basis lay in the A Certificates. It allocated no basis to the B Certificates, on the ground that the B Certificates represented only a right to future income. If the A Certificates carried 100% of the basis, but less than 100% of the value, then a sale of the A Certificates at their value would generate a loss for the Company.

Under a "Termination Agreement," the Counterparty agreed to purchase the B Certificates under certain circumstances such as the liquidation of the money market fund. According to the IRS, the Termination Agreement was an integral part of the transaction, and entitled the Company as holder of B Certificates to a return of principal.

Instead of arguing that the Company's basis should be allocated between the A Certificates and the B Certificates in proportion to fair market value, the TAM instead argues that Company did not fully transfer ownership of the underlying shares to Counterparty. Thus, Company and Counterparty were in some sense co-owners, but because the interests were not undivided proportional interests, the arrangements resulted in a "separate entity" for tax purposes, which was a partnership created by Company first selling to Counterparty a proportionate interest (by value) in the underlying shares, presumably at no gain or loss. The second step was a deemed contribution by Company and Counterparty to a new partnership.

Conclusion

The Service sometimes comes to regret its results-oriented decisions. By setting a low threshold for the formation of a partnership in contexts such as TAM 200540010, will the Service inadvertently encourage taxpayers to argue for the existence of partnerships in tax shelters that rely on the partnership tax rules? See *ASA Investerings P'ship v. Comm'r*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000); *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

[1] *I.R.S. Tech. Adv. Mem. 05-40-1010 (Oct. 7, 2005)*

Andy Immerman (404-881-7532 and AImmerman@alston.com is a partner in the law firm of Alston & Bird LLP in Atlanta. He concentrates on domestic and international tax planning and transactional tax work, including joint ventures, limited partnerships, limited liability companies and multinational corporate operations. Mr. Immerman is Vice Chair of the Taxation Committee of the American Bar Association Section of Business Law and LLC Committee of the Georgia Bar Association Section of Business Law.

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out prior to closing. If eliminating the payable were done by dividending the payable at that time, the tax basis in the stock would drop by the same amount as the gross value of the subsidiary's assets, resulting in no change in the net gain (or loss) on the stock sale. If the payable cannot be dividended, resolution may be more difficult.

Upon a sale of one or more subsidiaries (assuming X is not also part of the sale) the intercompany accounts likely would have to be zeroed out prior to closing.

Scenario Four: Intercompany reorganization. Suppose X owns Y and Z and Y owes payables to Z that might be recharacterized to equity. Suppose X wants to convert Y into an LLC wholly owned by X. If Y merges into the LLC and if the debt the LLC assumes is treated as equity owned by Z, then the LLC will not be a disregarded entity because it has two owners.

Conclusion

Intercompany accounts should not be left unattended until "something happens." ❑

Jack Cummings (919-862-2302 or jcummings@alston.com is a member of the Federal Income Tax and State and Local Tax Groups in Washington, D.C., and Research Triangle offices of Alston & Bird. Mr. Cummings has served as Associate Chief Counsel (Corporate) of the IRS in Washington, D.C.

The Case For & Against REITs:
Tax-Advantaged Entities, Tax Shelters, Or Inept Legislative Drafting?

BY KIRK LYDA (JONES DAY)

The use of real estate investment trusts, or "REITs," has increasingly become a point of controversy between state taxpayers and state tax administrators. Taxpayers generally take the position that, as a result of federal and state statutes specifically encouraging the use of REITs and providing related tax benefits, REITs and their shareholders are entitled to deductions not afforded to other types of taxpayers. Some state tax administrators take the position that REITs and their shareholders are taking advantage of inconsistent provisions in federal and state tax law to qualify for special tax treatment not intended by lawmakers. This tension has led to litigation over the use of REITs from coast to coast (and beyond), to legislation intended to curb the perceived abusive use of REITs, and even to some states taking the position that in some instances, the use of REITs is a "tax shelter." This article examines the current status of this important controversy.

Overview of Taxation Of REITs

REITs are federally created investment vehicles established by Congress in 1960. A REIT is a corporation or other entity that elects to be treated as a REIT and that meets certain requirements as to its ownership, organization, and the nature of its income and assets. A REIT's activities are generally limited to investing in real estate or loans secured by real estate and related activities. In order to qualify for taxation as a REIT, the entity must pay out substantially all of its ordinary income as dividends. Under the Internal Revenue Code, a corporate REIT generally computes its taxable income and tax in the same manner as non-REIT corporations, except that a REIT is not entitled to the dividends received deduction (DRD) but is specifically entitled to deduct dividends paid to its shareholders (DPD). While a corporate shareholder of a REIT would otherwise be entitled to a DRD for dividends received from the REIT, the IRC specifically denies that deduction for federal income tax purposes. Thus, for federal income tax purposes, a REIT is generally treated as a non-taxable flow through entity, with tax being paid at the REIT shareholder level.

Most if not all states that impose a corporate income tax require corporations to calculate taxable income by reference to the taxpayer's gross income for federal income tax purposes. Many states allow corporations to deduct from their gross income the deductions afforded under the IRC. However, many states expressly deny the benefit of the federal DRD, and instead, provide for a DRD by state statute. Unlike Congress, some states have not denied the state DRD for dividends received by a corporate shareholder of a REIT. In those states, income earned by a REIT and distributed as a dividend to a corporate shareholder qualifies for the DPD at the REIT level because state law incorporates the federal DPD afforded by the IRC. However, the dividend received by the corporate REIT shareholder may not be included in the state's tax base, either because the shareholder is not otherwise "doing business" in the state and is thus not subject to the state's taxing jurisdiction, or because the corporate shareholder claims the DRD afforded by the plain terms of state statute.

Autozone Development v. Kentucky — REIT Entitled To DPD

The Kentucky Board of Tax Appeals recently rejected a challenge by the Kentucky Department of Revenue to the use of REITs in *Autozone Development Corp. v. Department of Revenue*.[1] In 1995, Autozone, Inc. restructured its operations. What had been a single, unitary enterprise was broken up into four discrete entities: Autozone Stores, Inc. ("Stores"), which retailed automobile parts at stores located across the country; Autozone Development Corporation ("Development"), a corporate REIT that owned the real property on which Stores operated; Autozone Properties, Inc. ("Properties"), which owned most of Development's shares; and Autozone, Inc., a holding company that provided management services to the subsidiaries. All four companies were incorporated in Nevada. Development owned or leased land and buildings located in Kentucky.

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For Kentucky corporate income tax purposes, the federal DRD is disallowed but by state statute dividend income is excluded from the gross income of a corporation. Under the Kentucky statutes, corporations are generally entitled to the deductions afforded under Chapter 1 of the IRC, which would encompass the DPD allowed to REITs. On its Kentucky corporate income tax returns, Development claimed the DPD for dividends paid to Properties. Although not discussed in the decision, the dividends received by Properties were presumably not subject to the Kentucky corporate income tax, either because Kentucky lacked jurisdiction to tax Properties, or because the dividends qualified for the DRD under the Kentucky statutes. After reviewing the returns filed by Development, the Kentucky Department of Revenue sought to disallow the DPD presumably on the theory that the DPD was not intended to apply in this situation.

Companies spinning real estate off into a REIT must consider whether the deductions will be valid in a particular state. Know the state where the REIT will be placed.

Development appealed to the Kentucky Board of Tax Appeals and the Board granted Development's motion for summary judgment. The Board reviewed the interplay between the applicable provisions in the IRC and the Kentucky statutes and (without saying so expressly) readily concluded that Development's position was consistent with (if not dictated by) the statutes. Development was entitled to the DPD because the Kentucky statutes incorporate the DPD afforded in the IRC, and the fact that the dividends may have escaped taxation by Kentucky altogether did not change the natural outcome under the statutes. In short, the Board applied the law as written.

Louisiana v. Autozone Properties — REIT Shareholder Liable For Louisiana Income Tax On Dividends Received

The Louisiana Supreme Court sustained a different theory for challenging the Autozone REIT structure in *Department of Revenue v. Autozone Properties, Inc*.[2] Stores paid 8% of its gross sales to Development as rent and deducted that expense from its income for Louisiana corporate income tax purposes. Development paid the 8% to Properties as a dividend, thus qualifying for the DPD in Louisiana. Since Properties itself had no presence in Louisiana, and Nevada, Properties' legal domicile, imposes no corporate income tax, the 8% passed into Properties' hands without the imposition of Louisiana corporate income tax.

The Louisiana Department of Revenue sought to tax the 8% not by attempting to disallow the DPD as Kentucky had tried, but instead by asserting jurisdiction to tax Properties. Although the Louisiana courts initially rejected the Department's attempt to reach out and tax Properties, the Louisiana Supreme Court ultimately ruled in favor of the Department. Relying on International Harvester,[3] the Louisiana Supreme Court held that the Due Process Clause of the United States Constitution does not prevent a state from taxing a nonresident shareholder's investment income based on its investment in a separate corporation engaging in business activities in the taxing state. In reaching that rather expansive conclusion, the Supreme Court was no doubt swayed by the Department's allegations that the use of pass through entities, and REITs in particular, is some sort of evil "tax shelter." Having found that Louisiana had jurisdiction to tax the REIT shareholder, the Louisiana Supreme Court remanded the case back to the lower courts to determine Properties' tax liability.

UNB Investment Company v. New Jersey — DRD Not Allowed

The New Jersey courts have also considered the tax issues surrounding REITs in *UNB Investment Co. v. Director, Division of Taxation*.[4] United National Bancorp implemented a REIT structure somewhat similar to the REIT structure of Autozone. UNB Investment Company, a New Jersey corporation, owned all of the outstanding stock of Bridgewater Mortgage Company, Inc., a corporate REIT doing business in New Jersey. The REIT distributed its income to UNB as a dividend and claimed the DPD for both federal income tax and New Jersey corporate business tax purposes. UNB reported the dividend payment on its New Jersey corporate business tax return, but claimed a DRD pursuant to the New Jersey statutes. During the years in issue, the New Jersey statutes allowed a corporate taxpayer to exclude from its entire net income 100% of the dividends paid by subsidies in which it owns at least an 80% interest, without any express exception for dividends received from a REIT. The New Jersey Division of Taxation sought to disallow the DRD on the theory that the disallowance was consistent with the federal treatment of dividends received from REITs.

The matter reached the New Jersey Tax Court which held that although UNB was not entitled to a DRD, the Division of Taxation was prohibited from disallowing the deduction in these circumstances since the Division had failed to duly issue a regulation providing notice that a DRD would be disallowed in these situations. The Tax Court recognized that in cases in which the statutory language is unambiguous on its face, a court should not go beyond that language to determine the legislature's intent. The New Jersey statute on its face provided for a DRD. The Tax Court nevertheless held that since another New Jersey provision linked the meaning of "REIT" to the federal definition, and since under the federal scheme the shareholders of a REIT generally pay income tax on the dividends they receive from a REIT, the New Jersey statute providing for a DRD was ambiguous. In searching for the legislative intent underlying the statute, the Tax Court concluded that it is highly unlikely that the legislature ever recognized or considered the tax consequences of permitting a REIT to take a DPD while generally affording a DRD to corporate shareholders. The Tax Court ultimately concluded that in providing for a DPD, the legislature intended to provide relief from double taxation, but did not intend to exclude income earned by a REIT from taxation altogether.

Having found that UNB was not entitled to a DRD, the Tax Court considered whether disallowing the deduction was warranted in this situation. The Tax Court held that if the Division's position in the case amounts to a "rule" under the Administrative Procedure Act, the Division was required to formally promulgate that "rule." The Tax Court held that the Division's position was a "rule" because, in part, it was intended to apply to all corporate shareholders of REITs. Since the Division had failed to formally promulgate its position as a rule, the court held that "it is unfair to penalize taxpayers through ad hoc adjudication under the facts presented here where they have not been put on notice of the Director's position." The court accordingly held that the tax assessment was invalid.

BankBoston Corp. v. Massachusetts — Dividend from A REIT Is Not A "Dividend"

The issue of whether distributions from a REIT qualify for the DRD is currently in litigation in Massachusetts in *BankBoston Corp. v. Comm'r of Revenue*.[5] The BankBoston companies used a REIT structure similar to the structures discussed above. The REIT distributed its income to its corporate shareholder, Multibank Leasing Company. The REIT qualified for the DPD for federal income tax purposes. Since Massachusetts specifically allows deductions afforded under the IRC, the REIT qualified for the DPD for Massachusetts corporate income tax purposes as well. The shareholder, MLC, did not qualify for the DRD for federal income tax purposes since dividends from a REIT are specifically excluded from the federal DRD. However, since during the period in issue Massachusetts, like Kentucky, did not incorporate the federal DRD, and instead by Massachusetts statute broadly allowed corporations to deduct 95% of dividends received, with no exception for dividends from a REIT, MLC claimed the DRD on its Massachusetts corporate income tax returns.

On audit, the Massachusetts Department of Revenue denied the DRD. The Department reasoned that since the Massachusetts statutes generally provide that only deductions allowable under the IRC may be deducted from Massachusetts gross income, and no DRD was allowable under the IRC in this situation, MLC was not entitled to the deduction. The Department maintained that position even though the taxpayer had claimed the deduction under the plain terms of the Massachusetts DRD statute, and not because the deduction was allowable under the IRC. The Department further claimed that Massachusetts had adopted the federal scheme for taxing REITs and their shareholders at the shareholder level, and allowing the Massachusetts specific DRD would allow all but five percent of the REIT income to totally escape taxation by Massachusetts. The taxpayer argued that it was entitled to the deduction under the plain terms of the Massachusetts DRD statute since the statute broadly allows a deduction and does not contain an express exception for dividends from REITs.

The Massachusetts Appellate Tax Board ruled against the taxpayer and held that the DRD was not allowed. While noting that the taxpayer's position has a certain logic, the Board concluded that the distribution from the REIT was not a "dividend" within the meaning of the Massachusetts DRD statute. The Board reasoned that because a dividend from a REIT is not treated as a dividend under the federal DRD provision, it is similarly not a "dividend" under the Massachusetts DRD statute, even though the Massachusetts statute did not expressly adopt the federal definition of a "dividend." The Board reached that conclusion despite the fact that the Massachusetts Supreme Judicial Court had previously held the

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term "dividend" in the Massachusetts DRD statute was broader than the term "dividend" in the federal DRD statute. *See Dow Chemical Co. v. Comm'r of Revenue*, 378 Mass. 254 (1979). The Board buttressed its holding by suggesting that applying the Massachusetts DRD statute according to its plain terms and allowing the deduction would allow both the REIT and the REIT shareholder to totally escape taxation on all but five percent of the distribution, an "illogical and unwarranted result" in the view of the Board.

The Board noted that during 2003, the Massachusetts legislature amended the corporate income tax provisions to disallow the DRD for distributions from a REIT. As the Board noted, the legislature generally made that amendment retroactive back to tax years beginning on or after December 31, 1999, not far enough back to impact the years in issue in the BankBoston case. When the "REIT issue" was discussed at a recent state tax forum, a prominent state tax administrator with the Massachusetts Department of Revenue proudly proclaimed that Massachusetts had dealt with the REIT issue through legislation, retroactive legislation to boot, triggering a chorus of jaundiced laughter from the taxpayers and tax practitioners in attendance.

In California a REIT is res ipsa a tax shelter, and deductions are reportable.

REITs as Tax Shelters? — California Legislation & Litigation

Not one to be bashful in terms of corporate income tax policy, the California Franchise Tax Board has suggested that claiming a DRD attributable to a consent dividend[6] from a REIT is a "tax shelter." Effective January 1, 2004, California enacted fairly broad "tax shelter" legislation. Under those provisions, any "person" liable for any tax imposed by the California personal income tax law, the corporation tax law, or related administrative provisions, that has participated in a "reportable transaction" must file the appropriate Franchise Tax Board returns and disclose information as required by IRC ß 6011 and the related regulations, as modified for California purposes. A "reportable transaction" includes any transaction that the federal Treasury under IRC §6011 or the Franchise Tax Board determines as having a potential for tax avoidance or evasion. This includes listed transactions, defined as any transaction that is the same as, or substantially similar to, a transaction specifically identified for federal income tax purposes under IRC ß 6011 or for California income or franchise tax purposes as a tax avoidance transaction. The Franchise Tax Board Chief Counsel has specifically identified as a reportable transaction, transactions in which a REIT takes a dividend deduction for a consent dividend but the REIT owners do not report the consent dividend as income.[7]

The California Franchise Tax Board's efforts to label REITs as tax shelters in some situations has spilled over into the courts. On June 10, 2005, City National Corporation filed suit against the California Franchise Tax Board in Los Angeles Superior Court. One of the issues in the suit is whether the taxpayer engaged in "tax shelter" transactions involving REITs and regulated investment companies during the subject years. The amount in controversy exceeds $84M. Commenting on the issue during a recent state tax forum, a prominent state tax administrator with the California Franchise Tax Board remarked that if the taxpayers prevail in these types of cases, the Franchise Tax Board may well advocate the wholesale repeal of the DRD.

REIT Litigation in Hawaii

The REIT tax issue is too big to be confined to the Continental United States. The REIT issue is being litigated in Hawaii. Banks in Hawaii claimed a DRD for the distributions they received from their REIT subsidiaries. The Hawaii Department of Taxation disallowed the deductions and the banks appealed to the Hawaii Tax Appeal Court. In 2004, the Tax Appeal Court granted summary judgment in favor of the Department of Taxation in one of the cases. The taxpayer appealed to the Hawaii Supreme Court, but the case was settled before a decision was issued. The appeal in the other case, In Re Tax Appeal of CPB Inc. and Central Pacific Bank, Nos. 02-0075 & 03-0155, is set for trial in December 2006.

Implications & Commentary

The REIT tax dispute raises a number of interesting issues. The overriding issue — whether a taxpayer is entitled to a deduction plainly afforded by statute if, in the view of some, the deduction is not what was intended by lawmakers — extends well beyond the dispute over REITs. The concept that taxpayers and their advisors should be allowed to rely on the law as written without having to psychoanalyze what the lawmakers subjectively intended does have some merit. If the written law is not what the lawmakers intended, perhaps the lawmakers should change the law without relying on tax administrators or the courts to do it for them.

It is often said that bad facts make bad law, and the Louisiana Supreme Court's opinion in Autozone is a case in point. The Court was obviously influenced by the Department of Revenue's "tar and feather" approach of disparaging the REIT structure as a "tax shelter," and the Court apparently thought that upholding jurisdiction to tax the nonresident shareholder was the appropriate remedy. However, the law cannot be that merely owning equity in a separate entity doing business in a given state subjects the nonresident shareholder to income taxation in that state. If that were indeed the law, then I guess that means that all members of the Louisiana Department of Revenue are duly filing personal income tax returns and paying tax in all applicable states in which corporations in whose stock the members have invested are "doing business." Surely the members would not engage in "sheltering" their income from state taxation.

For a variety of reasons, tensions between state taxpayers and their advisors and state tax administrators are very high. As is often reported in the press these days, it's easy to point the finger of blame at certain taxpayers and their advisors. However, actions such as those in Massachusetts in which the substantive state tax law was seemingly changed, retroactively, certainly do not help. There's plenty of blame for the tension to go around. ❑

[1] *Autozone Development Corp. v. Finance and Administration Cabinet Dep't of Revenue Commonwealth of Kentucky*, No. K04-R-16 (Ky. B.T.A. Oct. 10, 2005).

[2] *Bridges, Secretary, Dep't of Revenue, State of Louisiana v. Autozone Properties, Inc.*, No. 2004-C-814 (La. March 24, 2005), *rehearing denied* (May 13, 2005).

[3] *Int'l Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944).

[4] *UNB Investment Co., Inc. v. Director, Division of Taxation*, 21 NJ Tax 354, 2004 WL 1161809 (N.J. T.C. May 12, 2004).

[5] *BankBoston Corp. v. Comm'r of Revenue*, No. C270546 (Mass. App. Tax Bd. Sept. 6, 2005).

[6] Consent dividends are one component of the overall DPD afforded to REITs.

[7] California Franchise Tax Board Notice No. 2003-1 (Dec. 12, 2003).

Kirk Lyda (214-969-5013 or klyda@jonesday.com), attorney and CPA, concentrates his practice on state tax litigation, controversies and planning. In addition to his practice, he has co-authored Accounting and Finance for Lawyers and Business Purpose: What Is It? How Much Is Enough? An earlier version of this article appears in the State Tax Return, a Jones Day monthly newsletter reporting on recent developments in state and local tax law. Comments and suggestions should be sent to Christine Rhodes (614-281-3911 or crhodes@jonesday.com.

Office Max Update:
Sixth Circuit Rebuffs IRS on Excise Tax

BY C. DOUGLAS JARRETT AND ARTHUR S. GARRETT III
(KELLER AND HECKMAN LLP)

Strategies **in its October issue provided advice regarding the significant tax refunds which might be available to companies litigating with the IRS the issue of the 3% federal excise tax on inter-exchange telecommunications services. At the time of publication, the most recent information was that the IRS had issued a Notice[1] stating that notwithstanding its loss on this issue in several circuits, it would "continue to assess and collect the tax under §4251 on all taxable communications services..." At the time of that Notice, an appeal in the case of *Office Max v. United States* had been briefed and already argued in the Sixth Circuit Court of Appeals, but the decision had not been released. Now it has been released, and a review of the decision follows.**

We continue to advise corporate taxpayers to file refund claims with the Internal Revenue Service.

The United States Court of Appeals for the Sixth Circuit recently rejected the arguments of the IRS, holding that the 3% excise tax can only be imposed on toll telephone services for which rates are computed on the basis of both "distance" and "elapsed transmission time." In deciding *OfficeMax, Inc. v. United States*, 2005 WL 2861031 (6th Cir., Nov. 2, 2005), the Sixth Circuit followed the Eleventh Circuit's holding in *American Bankers Ins. Group v. United States*, 408 F. 3d 1328 (11th Cir. 2005), stating that toll charges "must vary by both distance and elapsed transmission time in order to be taxed."[1]

With this decision, the Sixth Circuit has joined every other federal court – with the exception of a district court ruling which was subsequently reversed by the 11th Circuit – in ruling against the Internal Revenue Service. Two of these cases,

Honeywell and *AOL*,[2] are pending in the Court of Appeals for the Federal Circuit.

Despite the tide of adverse decisions, the Internal Revenue Service recently issued a notice stating that the government is "prosecuting appeals in five different circuits" and that the "Service will continue to assess and collect the tax."[3] The notice also specifically instructs tax collectors to continue collecting the excise tax in the Eleventh Circuit.[4] Lastly, the Internal Revenue Service notified corporate taxpayers that any claims for which appellate venue would lie within the Eleventh Circuit will not be processed while there are cases pending in the other federal appellate courts.

We continue to advise corporate taxpayers to file refund claims with the Internal Revenue Service. As the refund claims for the 3% excise tax are denied, corporate taxpayers are positioned to commence suit against the IRS. Plaintiffs in the Eleventh and Sixth Circuits have the advantage of *American Bankers* and *Office Max*, respectively, as binding precedent.

In many ways, the persistence of the IRS in imposing the 3% federal excise tax despite these court decisions truly "adds insult to injury" for corporate taxpayers. The charges for most toll telephone services are also subject to a Universal Service Fund ("USF") assessment that ranges from 10% to over 12% per month. ❑

1 *OfficeMax, Inc. v. United States*, 2005 WL 2861031 (6th Cir., Nov. 2, 2005).
2 *America Online, Inc. v. United States, 64 Fed. Cl. 571 (2005); Honeywell Int'l, Inc. v. United States*, 64 Fed. Cl. 188 (2005).
3 IRS Notice 2005-79.
4 At the time of this Notice, the Sixth Circuit case had not been decided.
5 *See generally*, http://www.fcc.gov/cgb/consumerfacts/usfincrease.html

Doug Jarrett, (202-434-4180 and Jarrett@khlaw.com), represents corporate customers and institutions in negotiating domestic and international telecommunications and networking services agreements with the major telecommunications carriers. Art Garrett, (202-434-4248 and Garrett@khlaw.com), specializes in litigation and insurance recovery matters and represented multiple clients in litigation that resulted in substantial recovery of taxes assessed on exporters for harbor maintenance under the Water Resources Development Act of 1986.

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Facts

Disney Enterprises ("Disney") is a diversified international company engaged in family entertainment. During the years at issue, Disney filed a combined New York franchise tax return together with most of the members of its federal consolidated group, including Buena Vista Home Video. Buena Vista Home Video's activities in New York were limited to the solicitation of sales of tangible personal property by sales personnel in the state. Prior to joining the Disney combined group, Buena Vista Home Video filed a separate company corporation franchise tax return reporting a zero allocation percentage on the basis that the company was protected from nexus by Public Law 86-272. The primary issue examined by the Tribunal was whether the Division of Taxation could include the New York destination sales of Buena Vista Home Video in the numerator of the receipts factor of the BAP for the combined group.[3]

Inclusion of Receipts for Non-Nexus Companies

The heart of this decision involves Public Law 86-272 and whether it applies in the context of the calculation of the gross receipts factor of the BAP for a combined group of companies. Pursuant to Public Law 86-272, a state is prohibited from imposing a net income tax on income derived within its borders if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property. Disney argued that Public Law 86-272 should apply in the context of a combined return in the same manner as it applies to a separate company return because the economic distortion in the combined versus separate filing context is the same. Stated differently, Disney argued that Public Law 86-272 cannot be voided merely because companies are included in the filing of a combined report.

The Tribunal, in rejecting Disney's argument, relied on its opinion set forth in *Alpharma*[4] concluding that the apportionment formula is merely a formula for determining the BAP and does not in any way give the state jurisdiction to tax. The inclusion of the New York destination sales is not an imposition of tax upon the sales of the nontaxpayer members, but merely a calculation of the BAP for the combined group. The Tribunal concluded that Public Law 86-272 was not violated because it applies only to the imposition of a net income tax.

Though the Tribunal reached the same conclusion as the ALJ, it did so on different grounds. The ALJ looked to the subsidiaries' unitary relationship with the Disney business in concluding that the inclusion of the receipts was permitted. The judge effectively looked to the activities of the other members as creating nexus that was not protected by Public Law 86-272. As such, Disney found itself in the unenviable position of having to explain its own statements relating to the interdependency of the companies. In its petition to file a combined report, Disney itself advocated the inclusion of Buena Vista Home Video in its New York combined group based on the fact that the companies were so unified and interrelated that a proper reflection of their New York franchise tax liability was impossible without combination. At the same time, Disney argued that the nexus creating activities of its subsidiaries should be analyzed on a separate company basis.

Like the ALJ, the Tribunal looked to the relationship of the Disney affiliates but not for the premise that the affiliates created nexus on behalf of Buena Vista Home Video. Instead, the Tribunal concluded that once the companies were included in the combined filing, the task of computing the BAP does not take into account nexus or Public Law 86-272.

Disney argued that the synergistic relationship only has a direct implication on the filing of a combined report, not the calculation of the BAP. However, by requesting that the company be included in a combined report, Disney effectively affirmed that the separate calculation of income would be distortive because certain synergies make the companies completely interdependent. Once distortion was shown, the subsidiary was properly included in the combined group. According to the Tribunal, the fact that the company was protected by Public Law 86-272 was no longer relevant for purposes of keeping its attributes out of the BAP calculation.

Intangible v. Tangible Personal Property

Disney also argued that certain film masters (i.e., movie negatives) should be included in the property factor of the BAP based on the fair market value of these items, rather than at cost. The issue relates to the fact that the film masters themselves have a minimal cost associated with the tangible personal property used in making the masters; however, the fair market value of the film masters includes a significant intangible component associated with the ability to reproduce movies for retail sale. By including the fair market value of these items, Disney would be able to dilute its New York property factor based on the premise that the film masters are largely located outside the state.

On this point, Disney again found itself stuck between a rock and a hard place. On one hand, to

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dilute its property factor Disney must argue that the fair market value of the film masters, which includes a significant intangible component over and above the costs of the negatives themselves, should be included in its property factor. On the other hand, the New York property factor statutorily includes only real and tangible personal property (not intangible property). As such, Disney must argue that the film masters are in fact tangible personal property, or they run the risk of exclusion based on the intangible nature of the property.

The Tribunal agreed with the ALJ that the film masters were intangible property and the value of an intangible asset cannot be included in the property factor of the BAP. Thus, the value attributable to the film negatives, which is largely related to the ability to reproduce such negatives, was properly excluded from the property factor.

Disney argued that whenever an item of tangible personal property is valued for property factor purposes, the value associated with any related intangible rights cannot be removed. Disney's position was that tangible personal property is valued by the marketplace by taking into account the uses that can be made of the property because the usage of the property determines its value. This argument is not without merit. Many sales of tangible personal property include an intangible element that cannot be, and is not, carved out for purposes of computing the property factor. However, the Tribunal noted that Disney was unable to provide any case law demonstrating its position and did not take exception to the conclusion that intangible assets are excluded from the property factor. Thus, the Tribunal concluded that the intangible value of the film masters cannot be included in the property factor for purposes of the New York allocation percentage.

Conclusion

Apportionment planning is a common practice of taxpayers and can be a significant benefit. However, companies with complex organizational structures should be cautious when evaluating reporting methodologies to be certain that a change in reporting methodology does not trigger additional tax.

[1] *In re: Disney Enterprises, Inc.*, N.Y. Tax App. Trib., No. 818378 (Oct. 13, 2005).

[2] There are two distinct approaches to sourcing receipts, which are set forth in several California cases relating to the "throwback" of sales for purposes of computing the receipts factor in a combined return context. The "*Joyce* rule" provides that each company in a combined group should be reviewed on a corporation-by-corporation basis. *See Appeal of Joyce, Inc.*, SBE-XIV-215, 66-SBE-069 (St. Bd. of Equal. of Cal. 1966). The "*Finnegan* rule" provides that the group must be looked at as a whole and thus, for purposes of throwback, the entire group can escape its application if one of the member corporations is subject to tax in the destination state. *See Appeal of Finnegan*, 88-SBE-022, 88-SBE-022-A (St. Bd. of Equal. of Cal. 1990).

[3] At the Division of Tax Appeals level, Disney also contested the inclusion of the New York receipts of two other entities, The Walt Disney Catalog, Inc. and Childcraft, Inc., in the numerator of the gross receipts factor for purposes of the BAP. These entities were both non-nexus companies with no property or payroll in the state. On Appeal, Disney chose not to protest the determination that these receipts should be included in the numerator of the gross receipts factor, instead limiting its argument to the Public Law 86-272 issue.

[4] *In re: Alpharma, Inc.*, N.Y. Tax App. Trib., No. 817895 (Aug. 5, 2004).

Labry Welty (214-969-4842 and lwelty@jonesday.com) concentrates his pactice on multistate tax planning, compliance and controversy matters. Karen H. Currie (214-969-5285 and kcurrie@jonesday.com) practices law in the area of multistate taxation. An earlier version of this article appears in the State Tax Return, a Jones Day monthly newsletter reporting on recent developments in state and local tax law. Comments and suggestions should be sent to Christine Rhodes (614-281-3911 or crhodes@jonesday.com.