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Caution: Unless You Plan Properly, Your Refund Is Not as Close as It Appears

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Amnesty Programs Continue—Taxpayers With Unreported or Underreported Pennsylvania Taxes, Act Quickly!

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The Georgia General Assembly recently passed House Bill 1138, which legislatively overrules the Georgia Supreme Court's recent decision in *Trawick Construction Company, Inc. v. Georgia Department of Revenue*. The legislation became effective when it was signed by the governor on June 3, 2010. The new law marks the final termination point of Trawick's long and tortuous journey through the Georgia court system. More...

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Louisiana Supreme Court Rejects Dormant Commerce Clause Challenge to State's *Ad Valorem* Tax Scheme

In a decision with sweeping implications for interstate pipeline companies that do business in Louisiana, the Louisiana Supreme Court recently upheld the constitutionality of the state's *ad valorem* tax scheme, which requires interstate pipeline companies to pay tax at a 10 percent greater rate than certain intrastate pipeline companies. More...

State Tax Return *is a Jones Day newsletter reporting on recent developments in State and Local Tax. Please send changes in address, requests for permission to reproduce this publication, in whole or part, and comments or suggestions to Christa Smith 214/969-5165 or (statetaxreturn@jonesday.com) in Jones Day's Dallas Office, 2727 N. Harwood Street, Dallas, TX 75201*

Idaho Enacts Complex Withholding And Election Rules For Pass-Throughs

The majority of states and localities, including Idaho, conform to the federal income tax treatment of partnerships, and treat them as conduits, with the income flowing through to the partners, and with the ultimate tax obligation imposed on the partners. More...

Colorado Leads the Charge: Adopts Affiliate Nexus and New Notice and Reporting Requirements for Sales Tax and "Economic Nexus" Rules for Income Tax

The news out of Colorado this legislative session started out badly for taxpayers and just kept getting worse. Like many states, Colorado began 2010 with a significant budget deficit. The General Assembly immediately responded to the state's projected $1.5 billion shortfall by proposing aggressive new legislation focused on closing that gap. More...

Will U.S. Supreme Court, in *Levin v. Commerce Energy*, Expand or Restrict State Taxpayers' Access to Federal Forum?

Plaintiffs have long faced an uphill battle when trying to challenge a state tax in a federal forum. For more than 70 years, the jurisdictional bar imposed by the Tax Injunction Act (TIA) has prohibited federal district court suits that would "enjoin, suspend or restrain the assessment, levy or collection of any tax under State law" where "a plain, speedy and efficient remedy may be had in the courts of such State". More...

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Recent Judicial and Administrative Developments Presented at the Meeting of the Tax Section - Alabama State Bar Alabama Center for Commerce on May 13, 2010

Our guest author, Jeff Patterson practices law in Montgomery, Alabama, with an emphasis on state and local taxation. He represents corporate and individual taxpayers in Alabama and other states. His representations encompass sales and use taxes, income tax, incentives such as the Alabama capital credit, and business privilege tax, among other areas. More...

The "True Object" Test v. Technology

Given the growth of the service industry, the "true object" (or "essence of the transaction") test continues to play an important role in determining the taxability of "mixed transactions"—transactions involving both taxable and nontaxable business activities that are not separable. More...

Appeals and Exemptions in Delaware (Maybe), Amnesty in Indiana, and

Other Breaking News in Unclaimed Property Legislation

We have been tracking a number of changes to state unclaimed property laws over the last few months, both big and small. The Delaware General Assembly, for example, recently considered a bill that would, among other things, provide holders an administrative appeals process following an audit. More...

Redefining the Sale-for-Resale Exemption

Courts in Alabama, Missouri, and Texas have recently considered the scope of the sale-for-resale exemption from sales tax. At first glance, the sale-for-resale exemption may appear straightforward, but the structure and taxability of the resale transaction can affect the exempt status of the original sale. More...

Washington's 2010 B&O Tax Law Changes

This year, the State of Washington made several significant changes to the business and occupation ("B&O") tax in an effort to raise revenue and ease compliance. The following changes were all enacted by Second Engrossed Substitute Senate Bill 6143, which was signed into law on April 23, 2010, by Governor Christine Gregoire and is expected to raise approximately $318 million in taxes for fiscal year 2011. More...

NEXUS: Update On Recent Developments – New Jersey Distinguishes Selling Prewritten Software from Licensing IP; Washington Finds Mere License of Trademark Not "Doing Business"

We keep track of nexus developments on a regular basis - legislation, administrative interpretations, the passage of rules and regulations, and court cases. More...

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JONES DAY STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

ILLINOIS

Caution: Unless You Plan Properly, Your Refund Is Not as Close as It Appears

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In prior years, it was a no-brainer that a state would automatically refund an overpayment reported on a tax return. These days, however, when state economies are struggling, it seems that some states, such as Illinois, have found a new way to balance their budgets. A state may simply refuse to issue a refund, leaving the taxpayer with merely a vague promise of future repayment. Although this article specifically addresses Illinois and its law, this situation may occur in other states as well.[1]

Unfortunately, when a state refuses to refund an overpayment, the taxpayer is left with few options. Typically, the taxpayer's first reaction would be to request that the state apply the refund to next year's estimated tax payments. In fact, Illinois regulations explicitly permit taxpayers to "elect to have any portion of any overpayment shown on a timely original return applied against the taxpayer's estimated tax liability for the taxable year immediately following the taxable year for which the return is filed."[2]

However, as Illinois regulations provide further, such election, "once made, shall be irrevocable."[3] Therefore, any taxpayer that did not elect to apply the overpayment to next year's estimated payments may not elect to do so after the original return has been filed. Indeed, Illinois has taken the position that if a taxpayer has requested on its return a refund of the overpayment, it may not apply the overpayment to

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cover the estimated tax payments.[4] Taxpayers that did not think the state would refuse to issue refunds and had no particular reason to elect to carry forward are now being held to their election.

Neither may the taxpayer refuse to pay the following year's estimated taxes by arguing that the state should apply the overpayment to cover the estimated tax liability. Some taxpayers may think that because penalties are imposed on the amount of tax owed,[5] the penalty would be zero if the overpayment equaled or exceeded the tax liability.

The Illinois statute provides that the Department of Revenue "may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of the tax imposed."[6] While analyzing this particular statute, however, Illinois's Office of Administrative Hearings held that because the statute uses the word "may," the Department is not required to offset the estimated tax liability with the overpayment and may still impose penalties on the taxpayer for underpaid estimates in respect of Year 2, even if Year 1 is overpaid.[7]

To add insult to injury, Illinois's current overpayment interest rate is 1 percent for the first year the overpayment is owed and 4 percent for the period after the first year.[8] Although the overpayment rate may be higher than Illinois's cost of borrowing, query whether it is high enough to bring Illinois to the negotiating table in the case of a large overpayment.

Unfortunately, Illinois tax laws do not address what happens when the state refuses to refund overpayments. The only recourse currently available to taxpayers is to file a refund claim.[9] At best, however—if the taxpayer is successful at the end of the refund-claim process—Illinois would still have kept the money during its duration. At worst, Illinois may still refuse to issue the refund. Needless to say, the costs of litigating this issue could far outweigh the amount of the refund, or the value of accelerating the refund.

The moral of this story is that taxpayers filing their state tax returns should seriously consider the possibility that the state may simply refuse to issue a refund. As evidenced by Illinois and several other states, this situation is not only possible, but a real world issue.

In such an economic environment, the election to apply the overpayment to cover next year's estimated taxes may be the better choice. In fact, taxpayers should consider making this election even if they are not owed a refund, in the event subsequent federal changes produce a refund of state taxes.

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[1] *See* Martha Kramer, *New York State Tax Refunds Put On Hold*, WCBSTV.com, March 18, 2010, wcbstv.com/topstories/paterson.tax.refund.2.1569690.html (web sites herein last visited June 8, 2010). Similar issues have been raised in Alabama, California, Kentucky, and other states. ^TOP

[2] 86 Ill. Admin. Code § 100.9400(b); 2009 Form IL-1120, Corporation Income and Replacement Tax Return, line 60. ^TOP

[3] *Id.* ^TOP
[4] Administrative Hearing Decision No. IT 03-4, 20030523001, Ill. Dep't of Rev., February 18, 2003. ^TOP
[5] See, *e.g.*, 35 ILCS § 735/3-3(b-20)(1) ("The amount of penalty imposed under this paragraph (1) shall be 2% of any amount that is paid no later than 30 days after the due date and 10% of any amount that is paid later than 30 days after the due date"). ^TOP
[6] 35 ILCS § 5/909(a). ^TOP
[7] Administrative Hearing Decision No. IT 03-4, 20030523001, Ill. Dep't of Rev., February 18, 2003. ^TOP
[8] tax.illinois.gov/Individuals/InterestRate.htm. ^TOP
[9] 35 ILCS § 5/909(a). ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

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PENNSYLVANIA

Amnesty Programs Continue—Taxpayers With Unreported or Underreported Pennsylvania Taxes, Act Quickly!

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State and local taxing authorities continue to struggle with ever-widening budget shortfalls. While numerous strategies for dealing with budget deficits have been proposed or adopted, we continue to see states look to tax amnesty programs[1] as a method of bringing in additional revenue. Tax amnesty programs are often attractive to state and local governments because they increase revenues without necessitating the often well-opposed process of increasing taxes. This article provides an update on tax amnesty programs in 2010 and discusses states to watch in the future.

Pennsylvania Amnesty Program

Taxpayers with unreported or underreported liabilities in Pennsylvania must act quickly to determine whether the current amnesty program[2] is advantageous, since it expires on June 18, 2010. The program is unique in that it offers not only a waiver of penalties, but a waiver of 50 percent of any interest due, as well as a limited look-back period for certain taxpayers with unknown liabilities.

Until June 18, 2010, taxpayers with unreported or

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underreported Pennsylvania taxes have an opportunity to report and disclose such taxes with limited repercussions. Taxpayers that come forward during the tax amnesty period will be entitled to a waiver of penalties and 50 percent of the interest imposed on historic tax liabilities. Those taxpayers with "unknown liabilities"[3] will also be entitled to a five-year limited look-back period. Any tax, interest, or penalty related to periods before July 1, 2004, will be waived to the extent it is associated with unknown liabilities.

Amnesty is available for all taxes administered by the Pennsylvania Department of Revenue, regardless of whether the liability is known or unknown to it. However, liabilities that are the subject of active controversy or otherwise known to the Department of Revenue are not eligible for the limited look-back period.[4] Amnesty is not available to any taxpayer that, prior to the amnesty period, was subject to a criminal investigation for violation of the tax law, was named as a defendant in a criminal complaint for violation of the tax law, or was a defendant in a pending criminal action for an alleged violation of the tax law.

It is important to note that the Pennsylvania amnesty benefits are available only for those taxes that were delinquent as of June 30, 2009. Any taxes that became delinquent after that date will be subject to the typical interest and penalty provisions. In addition, the Department of Revenue may later collect any waived interest or penalties if, within two years of the conclusion of the amnesty period, the taxpayer becomes delinquent for three consecutive periods on any semi-monthly, monthly, or quarterly filings or payments or if the taxpayer becomes delinquent for more than eight months on any annual reports or payments.

Taxpayers should keep in mind that any taxes remitted as part of the Tax Amnesty Program will not be eligible for refunds and that any taxpayer which participates in the program will not be permitted to pursue administrative or judicial relief with regard to returns filed under the program. Taxpayers with questionable liabilities will need to consider this in determining whether to participate. Taxpayers that do not participate in the Tax Amnesty Program should note that any liabilities which are later assessed that would have been eligible for the program will be subject to an additional 5 percent penalty, in addition to other penalties and interest required by law.

Pennsylvania has temporarily suspended its voluntary disclosure program[5] during the tax amnesty period. The Department of Revenue has indicated that it will provide information regarding reinstatement of its voluntary disclosure program following the close of the amnesty period. Taxpayers that participated in Pennsylvania's 1995 amnesty program are eligible to participate in the current program; however, anyone participating in the current program will be ineligible for future programs.

The City of Philadelphia has enacted a tax amnesty program[6] that runs concurrently with the Pennsylvania Tax Amnesty Program. Until June 25, 2010, eligible taxpayers will receive a waiver of all penalties and 50 percent of the interest for business privilege tax, net income tax, realty transfer tax, and personal property tax, as well as certain other taxes administered by the City of Philadelphia.

Upcoming Amnesty Programs

A number of other jurisdictions have adopted amnesty programs slated to begin shortly. Beginning July 1, 2010, both Florida and Nevada will be administering amnesty programs that will run for three months. New Mexico is also expected to implement an amnesty program within the next year, though the specific dates have not yet been set. Taxpayers with unreported or underreported liabilities in these jurisdictions should start evaluating the applicable amnesty program provisions to determine whether they are eligible for, and interested in participating in, these programs.

Florida: July 1, 2010, through September 30, 2010

The Florida Legislature recently passed legislation implementing a tax amnesty program [7] for the first time since 2003. The governor signed the bill into law on May 28, 2010. The program will run from July 1, 2010, through September 30, 2010.

The Florida amnesty program is available for taxpayers that have corporate income tax, sales and use tax, gross receipt tax, document excise tax, motor vehicle tax, intangible personal property tax, and insurance premium tax liabilities due prior to July 1, 2010. The program may also apply to local-option taxes if the locality opts to participate in the program. Any taxpayer not currently under criminal investigation or prosecution for failure to comply with Florida revenue laws is eligible to participate in the program; however, taxpayers that have entered into settlement agreements with the Department of Revenue prior to July 1, 2010, may not participate.

Taxpayers that have not been contacted by the Department of Revenue with respect to a given liability will be entitled to a waiver of penalties and 50 percent of the interest that would otherwise be due. Taxpayers currently under audit or investigation by the Department of Revenue—even those with liabilities that are the subject of pending administrative or judicial proceedings—may participate in the program and receive a waiver of penalties and 25 percent of the interest due. The administrative collection processing fee, which is calculated on all tax, penalties, and interest prior to any reduction, will not be waived.

To participate in the program, taxpayers will be required to withdraw any pending administrative or judicial claims and must forfeit the right to protest any assessments paid or to request refunds for any amounts paid under the program.

Nevada: July 1, 2010, through September 30, 2010

Nevada has also adopted an amnesty program that will run from July 1, 2010, through September 30, 2010. The Nevada amnesty program will apply broadly to all taxes, including sales and use and modified business taxes, fees, and assessments required to be paid to the Department of Taxation before July 1, 2010.[8] Eligible taxpayers will be entitled to a waiver of all penalties and interest. The program does not apply to any taxpayer that has entered into a compromise or settlement agreement with the Department of Taxation or the Nevada Tax Commission regarding the unpaid tax, fee, or assessment.

Nevada administered a similar but more narrow tax amnesty program in 2008 that provided a waiver of penalties and interest for sales and use taxes, modified business taxes, and the Nevada state business license fee.[9] At this time, the state has made no indication that taxpayers that did not participate in the 2008 amnesty program may be prohibited from seeking amnesty. The Department of Taxation is expected to release more detailed information regarding the program in the near future.

New Mexico: Dates to Be Determined

The New Mexico Legislature has passed legislation[10] that authorizes the Taxation and Revenue Department to implement a 180-day amnesty program at some point during fiscal year 2010 or 2011. The amnesty program will apply to all taxes owed and administered under the state's Tax Administration Act, including corporate income and gross receipts taxes. A taxpayer that has been contacted by the Taxation and Revenue Department regarding the commencement of an audit will be ineligible for the New Mexico amnesty program.

The terms of the amnesty program will generally conform to those of the state's current Managed Audit Program, but the Taxation and Revenue Department may waive the consideration of certain managed audit eligibility requirements. Under the New Mexico Managed Audit Program, taxpayers may initiate audits of themselves pursuant to which all penalties and interest that would otherwise be due on the tax assessments are waived. In the amnesty program, as with the Managed Audit Program, no interest or penalties will be imposed on taxes remitted if paid prior to the end of the audit period.

Proposed Amnesty Programs

Several other jurisdictions have considered or are currently considering amnesty programs in 2010. Amnesty legislation[11] is currently pending in Illinois that would provide for the waiver of penalties and interest on all taxes due after June 30, 2002, and prior to July 1, 2009, if paid between October 1, 2010, and November 8, 2010. Under the proposed program, the Department of Revenue will waive all penalties and interest applicable to qualifying taxes. Eligible taxpayers that do not participate in the program will be subject to failure-to-participate penalties. The amnesty bill passed both houses of the Illinois General Assembly on May 27, 2010, and currently awaits the governor's signature.

In January 2010, the District of Columbia enacted the Fiscal Year 2010 Budget Support Act of 2009,[12] which authorizes the District's Chief Financial Officer to establish a tax amnesty program for tax periods ending prior to December 31, 2009. Eligible taxpayers will receive amnesty from certain fees, fines, and other civil and criminal penalties imposed by the District for failure to file a report or pay tax due. The implementation of this program is at the discretion of the Chief Financial Officer, and any specific details will be set by the CFO in the future.

Kansas, Michigan, and Mississippi also proposed amnesty legislation during recent legislative sessions, but none of these measures were adopted. Although the bills ultimately died, these states' interest in amnesty may be indicative of things to come.

Other Programs of Note

In addition to amnesty, states have adopted a number of hybrid programs intended to bring in revenue and reduce taxpayer delinquencies. Alabama has adopted a program with respect to offshore accounts, Kentucky will waive penalties and interest for taxes in dispute, Maine has adopted a program that is limited to outstanding receivables, and North Carolina and Wisconsin have adopted programs that are applicable to certain outstanding sales tax liabilities. Each of these initiatives is narrow in focus, but for eligible taxpayers, significant benefits may be realized.

Alabama – Offshore Bank Accounts

The Alabama Department of Revenue is offering tax amnesty to individuals and businesses with offshore bank accounts. The program, which will run until September 30, 2010, allows delinquent taxpayers to avoid penalties and criminal prosecution if they report the offshore accounts, file past-due returns or amend their prior-year returns, and properly report their Alabama tax liabilities. Taxpayers already under investigation by the Department of Revenue or those discovered in information exchanges with the IRS are ineligible for the program.

Kentucky – Expedited Protest Resolution

On June 4, 2010, Kentucky adopted legislation[13] providing an expedited protest resolution under which the Kentucky Department of Revenue will waive penalties and interest on any tax assessment that, as of January 19, 2010, has been protested but has not been the subject of a final ruling. To qualify, the taxpayer must pay the entire amount of the tax assessed before July 31, 2010. Any payment of tax made pursuant to the resolution is final and may not be refunded.

Maine – Tax Receivables Initiative

As a follow-up to the Maine amnesty program that was considered a success last year, Maine is administering two "Tax Receivables Reduction Initiatives" that will run from September 1, 2010, through November 30, 2010.[14] The first initiative, referred to as the "short-term initiative," allows certain taxpayers with tax liabilities that were assessed as of December 31, 2009, to receive a 95 percent waiver of penalties. The second initiative, referred to as the "five-year initiative," allows certain taxpayers with tax liabilities assessed as of June 30, 2005, to receive a 95 percent waiver of interest and penalties.

To qualify for the respective initiatives, taxpayers must have tax liabilities that have already been assessed. Taxpayers currently facing criminal prosecution for violation of the state tax law and taxes resulting from criminal convictions or for which the state has secured warrants or civil judgments will not be eligible. Taxes that are the subject of current administrative or judicial disputes may be eligible for the initiatives if the taxpayers agree to forgo or withdraw the pending protests or proceedings. Taxpayers may not subsequently file refunds for amounts paid under the initiatives.

North Carolina – Internet Transactions Resolution Program

The North Carolina Department of Revenue has adopted an Internet Transactions Resolution Program, whereby the Department of Revenue will agree not to assess certain retailers operating "affiliate programs" in North Carolina for tax, interest, and penalties due before September 1, 2010, if they register for sales and use tax; agree to collect and remit those taxes beginning September 1, 2010; and agree to continue to collect and remit such taxes for at least four years. In an "affiliate program," a retailer enters into an agreement with a North Carolina resident in which the resident, directly or indirectly, through web link or otherwise, refers potential customers to the retailer in exchange for consideration. Also, the retailer's cumulative gross receipts from such sales during the preceding four quarterly periods must exceed $10,000. Pursuant to recent North Carolina legislation, retailers engaged in these affiliate programs are presumed to be transacting business in North Carolina for sales and use tax purposes.

Retailers that are interested in participating in the program must contact the Department of Revenue by June 30, 2010, and enter into a resolution agreement with the Department of Revenue by August 31, 2010. Any retailer that has transacted or is in the process of transacting business in North Carolina by virtue of an affiliate program but fails to participate in the Internet Transactions Resolution Program will be subject to assessment of tax, penalties, and interest for each year that the retailer had nexus and for which the statute of limitations has not run. The North Carolina Department of Revenue is taking the position that the new legislation merely clarifies prior law, and thus, any retailer with nexus under the legislation previously had nexus to the extent such activities existed in the past.

Wisconsin – Streamlined Sales and Use Tax Agreement

In accordance with the Streamlined Sales and Use Tax Agreement ("SSUTA"), which it adopted in 2009,[15] Wisconsin is administering the SSUTA sales tax amnesty program until September 30, 2010. Under the SSUTA sales tax amnesty program, all businesses that are not currently registered to collect Wisconsin sales tax are eligible for amnesty if they voluntarily register and agree to collect and remit sales taxes in every state that is a member of SSUTA, including Wisconsin. Participating taxpayers must continue to collect/remit tax for a period of at least 36 months.

Weighing the Benefits and Burdens of Amnesty

As states scramble to recover revenue through vehicles such as tax amnesty, taxpayers must be mindful of the relative pros and cons associated with participation in a given program. While the benefits of amnesty can be significant, there may also be inherent limitations that make amnesty unattractive. For example, to participate in amnesty programs, taxpayers are often required to forfeit the right to protest the tax or request refunds of the tax paid. If liability is unclear, this may be problematic. However, failure-to-participate penalties must also be considered and, where significant, could induce taxpayers with questionable liabilities to pursue amnesty. Typically, failure-to-participate penalties may not be waived after the expiration of the amnesty period.[16] Taxpayers must weigh the benefits and burdens of each state's amnesty program before deciding whether to proceed.

[1] A "tax amnesty program" is a government-enacted program that allows a taxpayer or potential taxpayer that has failed to file a return or underreported its tax to come forward and pay certain back taxes without facing penalties or, in some instances, interest. The particular provisions of each amnesty program vary by jurisdiction. ^TOP

[2] H.B. 1627, 2009 Gen. Assem., Reg. Sess. (Pa. 2009). ^TOP

[3] "Unknown liabilities" are those tax liabilities that are unknown to the Department of Revenue. If the taxpayer has filed or paid these taxes, or has been contacted by the Department of Revenue regarding these taxes, the liabilities are "known" and thus not eligible for the limited look-back period. ^TOP

[4] If an appeal is pending, the appeal will need to be withdrawn before the tax liabilities will be eligible for the Tax Amnesty Program. ^TOP

[5] Pennsylvania historically offered a voluntary disclosure program whereby eligible taxpayers were entitled to a waiver of penalties, as well as a limited look-back period of five years for corporate income taxes and three years for sales and use taxes. ^TOP

[6] PHILA., PA., CODE § 19-513 (2010). ^TOP

[7] H.B. 5801, 2010 Leg., Reg. Sess. (Fla. 2010). ^TOP

[8] *See* A.B. 6, 26th Spec. Leg. Sess. (Nev. 2010). ^TOP

[9] Emergency Regulation, NEV. ADMIN. CODE § 360.405. ^TOP

[10] S.B. 2, 2010 Leg., 2d Spec. Sess. (N.M. 2010). ^TOP

[11] *See* S.B. 377, 96th Gen. Assem., Reg. Sess. (Ill. 2010). ^TOP

[12] B18-0203, Period 18, D.C. Council (D.C. 2009). ^TOP

[13] H.B. 2, 2010 Leg., Spec. Sess. (Ky. 2010). ^TOP

[14] *See* ME. REV. STAT. ANN. tit. 36, §§ 6601–6607. ^TOP

[15] *See* 2009 Wis. Act 28 (effective July 1, 2009). ^TOP

[16] One exception to this is Oregon, which recently published a new administrative rule allowing the Department of Revenue to waive the 25 percent failure-to-participate penalty adopted during the state's 2009 amnesty program if the taxpayer can show that such failure to participate was due to circumstances beyond its control. See OR. ADMIN. R. 150-305.100-(C). ^TOP

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GEORGIA

Georgia (and New York) Reexamine their IRC § 338(h)(10) Election for S Corporations

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The Georgia General Assembly recently passed House Bill 1138,[1] which legislatively overrules the Georgia Supreme Court's recent decision in *Trawick Construction Company, Inc. v. Georgia Department of Revenue*.[2] The legislation became effective when it was signed by the governor on June 3, 2010.[3] The new law marks the final termination point of Trawick's long and tortuous journey through the Georgia court system.

In *Trawick*, the Georgia Supreme Court overruled an earlier court of appeals decision by holding that an IRC § 338(h)(10) election did not apply to Trawick Construction Company, Inc. ("Trawick") for Georgia income tax purposes.[4] Trawick, a Florida corporation, was a Subchapter S corporation for federal income tax purposes.[5] Under Georgia law, however, Trawick was considered for state income tax purposes to be a Subchapter C corporation.[6] The court held that because the IRC § 338(h)(10) election was made by Trawick's shareholders rather than by Trawick itself, the election did not apply to the determination of Trawick's Georgia income tax.[7] The Georgia Legislature responded by adopting HB 1138, which, among other things, makes all IRC § 338

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elections applicable to calculating Georgia taxable income.[8]

Background

Prior to October 1, 1999, Trawick was a closely held Florida corporation.[9] Pursuant to Section 1362 of the Internal Revenue Code, a small business corporation may elect to be a Subchapter S corporation.[10] Having made this election, Trawick was treated as a Subchapter S corporation for federal income tax purposes,[11] and Trawick's shareholders were required to report their proportionate shares of the corporate income on their individual federal income tax returns.[12]

For Georgia state income tax purposes, however, Trawick was treated as a Subchapter C corporation.[13] Trawick filed a Georgia corporate income tax return on which it reported its business income apportioned to the state.[14] Trawick paid taxes directly to Georgia.

On October 1, 1999, Trawick shareholders sold all of their stock in Trawick to Quanta Services, Inc., for $36,500,000.[15] Pursuant to Section 338(h)(10) of the IRC, and as part of the stock purchase agreement, "an election was made to treat the transaction as a deemed sale of all corporate assets, the majority of which was goodwill."[16] The "§ 338(h)(10) election allows a purchasing corporation to treat a purchase of the stock of a target corporation as if it was actually the purchase of the assets of the target corporation at fair market value."[17] Moreover, "[t]he target corporation is treated as if it sold all assets in a single transaction and subsequently distributed the purchase proceeds to its shareholders."[18]

A 338(h)(10) election can have beneficial tax consequences for the purchasing corporation. For example, because the purchase is deemed to be a purchase of assets, the transaction results in a stepped-up basis for the target's assets.[19] This stepped-up basis results in future amortization and depreciation deductions.[20]

For the tax year ending on October 1, 1999, Trawick included the gain from the deemed sale of assets in its reported federal taxable income, a small fraction of which it apportioned to Georgia.[21] Trawick's total reported federal taxable income for 1999 was $35,961,518.[22] Of this amount, Trawick allocated $29,689,534 to Florida.[23] The remaining $6,271,984 was apportioned as attributable to Georgia.[24] Trawick then applied the apportionment ratio of .127497 to arrive at a reported taxable business income in Georgia of $799,659.[25] Thus, for the State of Georgia, the total tax due was only $47,980 (6 percent of $799,659).[26]

Not surprisingly, the Georgia Revenue Commissioner disagreed with Trawick's calculations. In 2004, having determined that the income allocated to Florida by Trawick was apportionable, he assessed Trawick an additional $224,820 in income tax, along with accrued interest.[27] The Commissioner determined that Trawick's actual business income subject to apportionment was $35,661,031.[28] He then applied the same apportionment ratio used by Trawick (.127497) to determine taxable business income in Georgia of $4,546,674.[29]

Trawick protested the assessment, claiming that its 338(h)(10) election did not apply for Georgia state income tax purposes.[30] Rather, it argued, O.C.G.A. § 48-7-21 requires that elections made pursuant to the IRC be made *by corporate taxpayers* in order to apply for state income tax purposes in Georgia.[31] But in the case of a Subchapter S corporation, according to federal regulations, a 338(h)(10) election is made jointly by the purchasing corporation and the Subchapter S corporation shareholders.[32] Thus, the shareholders, and not the corporation, must make the election. Because Georgia recognized Trawick as a Subchapter C corporation in Georgia, Trawick was the taxpayer that was required to make any elections under the Internal Revenue Code.[33] The 338(h)(10) election therefore did not apply for Georgia income tax purposes because the election was not, as required by Georgia law, an election made *by the taxpayer* (*i.e.*, by Trawick).[34] Rather, pursuant to federal regulations, the shareholders were the ones who made the election.[35]

Over the next six years, the scenario's complexity confounded and confused Georgia's judicial system as it wound its way through the courts.

Georgia Law

In Georgia, "[a] corporation's taxable income from property owned or from business done in [the state] consist[s] of the corporation's taxable income as defined in the Internal Revenue Code of 1986, with the adjustments provided for [by O.C.G.A. § 48-7-21(b)] and allocated and apportioned as provided in [O.C.G.A. § 48-7-31]."[36] One such adjustment provided for by O.C.G.A. § 48-7-21(b) is that all elections made by corporate taxpayers under the IRC apply to the taxation of corporations for Georgia state income tax purposes, except elections involving consolidated corporate returns and Subchapter S elections.[37] Under Georgia law, Subchapter S elections apply only if all shareholders are subject to Georgia state income tax on their proportionate share of the corporate income.[38] Subchapter S elections are therefore allowed only if all nonresident shareholders consent to pay Georgia income tax on their proportionate share of the corporate income.[39] Trawick's shareholders presumably had not so consented, and Trawick therefore had to be treated as a Subchapter C corporation in Georgia.

The Georgia Supreme Court's *Trawick* Decision

Reversing the court of appeals, the Georgia Supreme Court agreed with Trawick.[40] The court determined that the rules of construction for statutes require the court to read the requirements of O.C.G.A. § 48-7-21 literally.[41] It held that because the 338(h)(10) election was not made "by a corporate taxpayer"—that is, Trawick—the election did not apply to the determination of Trawick's Georgia income tax.[42] Further, the court observed that Georgia had benefited for years by treating Trawick as a Subchapter C corporation.[43] It was therefore neither unfair nor unreasonable to require Georgia to forego a 338(h)(10) election made for a Subchapter S corporation when the state had refused to recognize the election that made Trawick a Subchapter S corporation in the first place.[44] Because the election did not apply, "the gain from the deemed sale of assets recognized by Trawick on its federal income tax return did not constitute Georgia taxable income"[45] because the sale of stock (as opposed to the sale of assets) was sourced for tax purposes to Florida.

The Georgia Reexaminations

Each of the Trawick decisions raised the question of "whether the Section 338 election at issue relieve[d] Trawick of corporate tax liability under Georgia law as to the gain realized upon the proceeds from the deemed sale of its assets."[46] This question was asked and answered no fewer than seven times. Not once did any of the answers agree with the one immediately preceding it. In the end, the legislature had the last word, answering the question by changing the law.

The Georgia Supreme Court had claimed that it was neither unfair nor "unreasonable to require the State of Georgia to forego a Section 338(h)(10) election made for a Subchapter S corporation, when the State has consistently refused to recognize that corporation's original federal Subchapter S election."[47] The Georgia General Assembly responded by enacting HB 1138, which reverses the result in *Trawick*. HB 1138, § 2, amends O.C.G.A. § 48-7-21(5)(b) by adding Subsection (5), which states, simply, that "[a]ll elections under Section 338 of the Internal Revenue Code of 1986 shall also apply under this article."[48] The bill was passed by both the Georgia House of Representatives and the Georgia Senate; the legislation was recently signed by the governor.[49]

The New York Reexaminations

It should also be noted that Georgia's issues are not unique. In New York, for example, the State Tax Appeals Tribunal has held that a nonresident seller of S Corporation stock cannot be taxed on gain from the corporation's deemed asset sale, because the corporate income should be computed as if there were no S election – in which case there would be no valid (h)(10) election.[50] The pending budget legislation proposed by Governor Paterson would reverse that outcome – which obviously is of concern on the buyers' side of such transactions – and would do so retroactively for all open years.[51] However, the retroactivity feature of the proposal has met with some resistance.[52]

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[1] House Bill 1138 (as passed by House and Senate), 150th Gen. Assem. Reg. Sess. (Ga. 2009), *available at* www.legis.ga.gov/legis/2009_10/pdf/hb1138.pdf (all web sites herein last visited June 7, 2010). ^TOP
[2] 286 Ga. 597, 597 (2010). ^TOP
[3] *Governor Signs Legislation to Improve Access to Home-based Care*, June 4, 2010, www.georgia.gov/00/press/detail/0,2668,78006749_78013037_160143973,00.html. ^TOP
[4] *Trawick*, 286 Ga. at 601. ^TOP
[5] *Id.* at 597. ^TOP
[6] *Id.* ^TOP
[7] *Id.* at 601. ^TOP
[8] House Bill 1138 (as passed by House and Senate), 150th Gen. Assem. Reg. Sess. (Ga. 2009). ^TOP
[9] *Trawick*, 286 Ga. at 597. ^TOP
[10] I.R.C. § 1362(a)(1). ^TOP
[11] *Trawick*, 286 Ga. at 597. ^TOP
[12] I.R.C. § 1366(a)(1). ^TOP

[13] *Trawick*, 286 Ga. at 597. ^TOP
[14] *Id.* ^TOP
[15] *Id.* ^TOP
[16] *Id.* ^TOP
[17] *Id.* at 602 (Melton, J., dissenting). ^TOP
[18] *Id.* (Melton, J., dissenting). ^TOP
[19] *Id.* (Melton, J., dissenting). ^TOP
[20] *Id.* (Melton, J., dissenting). ^TOP
[21] *Trawick*, 286 Ga. at 597. ^TOP
[22] *Ga. Dept. of Revenue v. Trawick Const. Co., Inc.*, 269 Ga. App. 275, 275 (2009). ^TOP
[23] *Id.* ^TOP
[24] *Id.* ^TOP
[25] *Id.* ^TOP
[26] *Id.* ^TOP
[27] *Trawick*, 286 Ga. at 597. ^TOP
[28] *Ga. Dept. of Revenue*, 269 Ga. App. at 278. ^TOP
[29] *Id.* ^TOP
[30] *Trawick*, 286 Ga. at 598. ^TOP
[31] *Id.* ^TOP
[32] 26 C.F.R. § 1.338(h)(10)-1(c)(1). ^TOP
[33] *Trawick*, 286 Ga. at 598. ^TOP
[34] *Id.* (citing O.C.G.A. § 48-7-21(b)(7)). ^TOP
[35] 26 C.F.R. § 1.338(h)(10)-1(c)(1). ^TOP
[36] O.C.G.A. § 48-7-21(a). ^TOP
[37] O.C.G.A. § 48-7-21(b)(7). ^TOP
[38] O.C.G.A. § 48-7-21(b)(7)(B). ^TOP
[39] *Id.* ^TOP
[40] *Id.* at 601. ^TOP
[41] *Id.* at 598. ^TOP
[42] *Id.* at 601. ^TOP
[43] *Id.* ^TOP
[44] *Id.* at 600. ^TOP
[45] *Trawick*, 286 Ga. at 601. ^TOP
[46] *Ga. Dept. of Revenue*, 296 Ga. App. at 276. ^TOP
[47] *Trawick*, 286 Ga. at 600. ^TOP
[48] H.R. 1138, 150th Gen. Assem. Reg. Sess. (Ga. 2009). ^TOP
[49] *See* Georgia General Assembly, H.B. 1138, www.legis.state.ga.us/legis/2009_10/sum/hb1138.htm; *Trawick Constr. Co., Inc. v. Ga. Dept. of Revenue*, 286 Ga. 597, 597 (2010). ^TOP
[50] *See Matter of Gabriel S. and Frances B. Baum*, DTA Nos. 820837 et al., December 20, 2007. ^TOP
[51] NYS Executive Budget Bill, released January 19, 2010, Part F. ^TOP
[52] *See, e.g.*, New York State Bar Association Tax Section Letter No. 1206, February 22, 2010, supporting the application of federal section 338(h)(10) principles to S corporations, but expressing concern over the retroactive application of the budget proposal. ^TOP

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Uncertain Tax Positions, And The "Other Shoe"

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In January the IRS issued Announcement 2010-9,[1] heralding the requirement that corporate taxpayers disclose to the IRS, beginning with their 2010 federal income tax return, "uncertain tax positions" in respect of which reserves have been established for financial accounting purposes. Demonstrating a lovely sense of irony, the IRS has described this as part of a "policy of restraint,"[2] under which they will not generally seek to discover the work papers underlying financial reserves for tax positions, a policy that is of heightened interest given the U.S. Supreme Court's recent denial of cert. in *Textron*.[3]

In its most recent, and increasingly controversial guidance, issued in April,[4] the IRS has formalized the disclosure proposal by proposing a specific form (and instructions) on which taxpayers will disclose Uncertain Tax Positions.[5] The form contemplates that taxpayers will provide, among other things, (i) a statement of the rationale for the tax position; (ii) a statement of the reasons that position is uncertain; and (iii) a quantification of the maximum tax adjustment associated with the position in respect of which the reserve was established.

Linking income tax reporting to financial accounting raises a variety of issues, not simply in understanding what the IRS thinks it wants, but also in evaluating the content and tenor of a taxpayer's response, as well as deeper questions of the wisdom, long-term, of

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deriving tax reporting obligations from financial accounting principles. Given the vast expanse of the federal corporate income tax in which even well-intentioned, diligent and thoroughly advised taxpayers simply have no guidance, there is a certain *je ne sais quoi* in asking that taxpayers self-report to those who should be interpreting the tax law the taxpayers' unknowns, and the consequent financial tax exposures.

But the scope of the IRS' disclosure requirements is only one part of the puzzle.[6] States have, in recent years, initiated their own disclosure and reporting requirements, for example California's required disclosure of their "listed transactions,"[7] and New York's reporting requirements for reportable transactions.[8] States have similarly responded to the offshore account mess, for example, by "fess up"[9] shots across the bow, and through explicit reminders that federal disclosures do not resolve state taxes.[10]

The question, then, is where states might go with the IRS's UTP disclosure concept. A simple scenario is that states might require, directly or as a consequence of requiring a copy of the federal return, copying the states on the federal disclosures. That may be relevant in some circumstances; substantive federal income tax positions obviously can materially impact state income taxes, especially when the underlying question is not *when* (timing) but *who* (allocation) or *whether* (deductibility/income in the first place). But there are many federal corporate tax issues that have no meaningful analog in state taxation—in particular for taxpayers with foreign operations.

By the same token, there is a forest of state tax issues for which federal IRS disclosure of federal corporate income tax reserves means nothing. Nexus; combination; allocation; apportionment; the composition of factors; throw-outs; throw-backs; Public Law 86-272 issues; non-income taxes—these are the things SALT advisors spend their days (and nights) addressing. The possibility that SALT issues sufficiently material to require a reserve might soon require state disclosure, and how disclosure might work—especially in circumstances where a reserve relates to not filing at all—raises the specter of significant complexity in SALT compliance, as well as another series of tax pressures that may affect financial reporting.

The IRS Commissioner has opened Pandora's box. The reverberations throughout the tax compliance community are only beginning to be understood. As taxpayers and their advisors process the federal guidance, and the compliance delivered in response, we should also contemplate where the other shoe will lead us.

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[1] I.R.S. Announcements 2010-9, 2010-7 I.R.B. 408, 2010-17, 2010-13 I.R.B. 515; and 2010-30, 2010-19 I.R.B. 668. ^TOP

[2] *See* I.R.S. Announcement 2010-9, *supra*, I.R.S. Announcement 2002-63, 2002-2 Cum. Bull. 72. ^TOP

[3] *U.S. v. Textron, Inc.*, 577 F 3d 21 (1st Cir. 2009), cert. denied, No. 09-750, May 24, 2010. ^TOP

[4] I.R.S. Announcement 2010-30, *supra*. ^TOP
[5] I.R.S. Draft Schedule UTP (Form 1120), issued April 19, 2010. ^TOP
[6] On this subject generally, the Report of the Tax Section of the New York State Bar Association on Announcement 2010-9 offers some interesting observations. NYSBA Tax Section Report #1208, March 29, 2010. ^TOP
[7] *See* Cal. Rev. & Tax Code §19164(b). ^TOP
[8] N.Y. Tax Law §25(a)(3). ^TOP
[9] www.tax.state.ny.us/e-services/vold/program_info.htm. ^TOP
[10] *See, e.g.*, Connecticut's SN 2009(5), relating to the disclosure of offshore accounts. ^TOP

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California Court of Appeal Ruled Taxpayers in Tax Refund Cases Are Entitled to a Jury Trial

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Addressing an issue of first impression, the First District Court of Appeal of California, in *Franchise Tax Board v. Superior Court of San Francisco*,[1] held that a taxpayer has a right to a jury trial for actions permitted under Section 19382 of the California Revenue and Taxation Code ("RTC"). RTC Section 19382 authorizes a taxpayer to bring a refund action against the California Franchise Tax Board ("FTB") for income and franchise taxes that the taxpayer has paid. The FTB petitioned for review to the California Supreme Court, and the petition was granted. However, as of this publication date, an opinion has not yet been rendered.

Facts

The facts of this case are simple and straightforward. In July 2006, Tom Gonzales, the real party in interest, filed a complaint seeking a refund of California personal income tax for 2000 and 2001 totaling more than $15 million. The tax had been paid to the FTB by the estate of the deceased Thomas J. Gonzales II in 2004 in connection with a tax amnesty program. Gonzales alleged that the $15 million tax was not due because the estate was entitled to deductions for substantial capital losses from investments in the year

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2000. The FTB denied the refund, asserting that the losses arose from "abusive tax avoidance transactions," and filed a cross-complaint seeking to recover from the estate a penalty of almost $2.5 million. Gonzales requested a jury trial in a joint case management statement. The trial court denied the FTB's motion to strike the request, and the FTB sought a writ of mandate from the Court of Appeal to compel the trial court to reject the request for a jury.

Discussion of Constitutional Rights and Common Laws

The Court of Appeal started its analysis by setting forth the general principles governing the right to a jury trial in California. The court first looked at the Constitution of California, which in pertinent part provides that "[t]rial by jury is an inviolate right and shall be secured to all."[2] Relying on prior California Supreme Court cases, the court stated that the right to a jury trial under the constitutional provision is the right as it existed in 1850, when the Constitution of California was first adopted. Thus, if there was a right to trial by jury in a refund action at common law in 1850, taxpayers should have the right to a jury trial in modern tax refund cases under RTC Section 19382. The court stated further that as a general principle, at common law, if the action involved a legal claim, a jury trial would be granted. On the other hand, a cause of action dealing with an equitable claim generally did not entitle a claimant to a jury trial.

Classification of the Refund Claim

The court next determined that the "gist" of Gonzales's tax refund action was a legal claim. To reach this conclusion, the court relied on a California Supreme Court case, *Northrop Aircraft v. California Employment Stabilization Commission*,[3] which held that a suit for a refund of taxes is in the nature of a common-law action for money had and received. The action was legal, even though a plaintiff's right to recover depended on equitable principles.

Upon concluding that the gist of Gonzales's action was legal rather than equitable, the court went on to determine whether, as a purely historical question, the right to trial by jury existed for refund actions at common law in 1850. The court began by noting that at common law, an individual had no right of action against a sovereign, whether by jury or otherwise. However, taxpayers were able to assert claims for refunds by suing the tax collectors rather than the government. These suits were legal claims for money had and received, and a plaintiff had a right to a jury trial. Concluding that cases against tax collectors were the closest analogues to modern refund actions, the court ruled that a right to trial by jury exists for tax refund suits.

Evaluation of Sovereign Immunity

The court rejected the FTB's argument that the sovereign immunity doctrine foreclosed any right to a jury trial regardless of any history of common-law refund actions against tax collectors. The FTB contended that suits against tax collectors are not equivalent to suits against the sovereign itself. Even though the FTB's argument was supported by case law under the Seventh Amendment to the U.S. Constitution holding that there is no right to a jury trial in suits against the United States, the court ruled that a refund suit, even against a sovereign, was analogous to a common-law suit against a tax collector. Further, the court concluded that the California legislature provided for refund actions in RTC Section 19382, which constitutes the consent of the government to be sued according to the terms of the statute. In addition, the court found support in California Code of Civil Procedure Section 592, which provides that issues of fact must be tried by a jury in actions "for money claimed as due upon contract, or as damages for breach of contract, or for injuries."[4] The court concluded that a tax refund action is contractual in nature and is therefore covered under the statute.

Refund Claim Distinguished from Tax Collection Claim

It is particularly worth noting that the court distinguished, at least in part, the present case from *Sonleitner v. Superior Court*,[5] where the Second District Court of Appeal of California held that a taxpayer was not entitled to a jury trial in a tax collection case. *Sonleitner* dealt with the collection of motor vehicle license taxes, not a claim for refund. While acknowledging that in 1850 there was no common-law right to a jury trial in tax collection cases, the court refused to follow *Sonleitner*, holding that a refund claim is different from a tax collection claim.

Essentially, the court bifurcated Gonzales's refund claim from the FTB's cross complaint seeking to collect the asserted underpayment penalty. Based on Sonleitner, the court held that Gonzales is not entitled to a jury trial for the FTB's cross complaint seeking an underpayment penalty of almost $2.5 million from Gonzales. The court determined that it is clear there was no common-law right to a jury trial in a proceeding to collect taxes, including tax penalties. Nevertheless, the bifurcation of the penalty collection claim may raise issues of collateral estoppel on the issue of whether the capital losses were properly deductible.

Implication for Taxpayers

This is the first case in California history adjudicating whether a taxpayer in a refund action is entitled to a jury trial in the California courts. While the case deals with California income tax, there is no policy reason to argue that the same rationale and conclusion should not be applicable to other state taxes, such as property tax or sales and use tax.

It is not clear what impact the decision, if left standing by the California Supreme Court, will have on tax litigation. In most cases, jurors are laypersons who do not have much tax background or experience. Many of them might be sympathetic, in various degrees, towards taxpayers and might be inclined to find facts in the taxpayer's favor. In addition, the higher costs of litigation would likely change the bargaining strategies of the government and taxpayers in settlement negotiations.

On the other hand, this case confirmed that a taxpayer in a tax collection case is not entitled to a jury trial. Therefore, the availability of a jury trial could be an important factor for taxpayers to consider in determining whether they want to pay the tax bills first and then seek a refund, or fight against the FTB without paying the asserted tax.

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[1] 99 Cal. Rptr. 3d 73 (Cal. Appl. 1st Dist. 2009), review granted and opinion superseded (Dec. 2, 2009). ^TOP
[2] California Constitution, Article I, Section 16. ^TOP
[3] 32 Cal.2d 872 (1948). ^TOP
[4] California Code of Civil Procedure Section 592. ^TOP
[5] 158 Cal.App.2d 258 (1958). ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

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Louisiana Supreme Court Rejects Dormant Commerce Clause Challenge to State's *Ad Valorem* Tax Scheme

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In a decision with sweeping implications for interstate pipeline companies that do business in Louisiana, the Louisiana Supreme Court recently upheld the constitutionality of the state's *ad valorem* tax scheme, which requires interstate pipeline companies to pay tax at a 10 percent greater rate than certain intrastate pipeline companies. Despite the apparent facial discrimination against interstate pipeline companies embodied by the scheme, the Louisiana Supreme Court reversed two lower-court decisions finding that the disparity treatment violated the dormant aspect of the Commerce Clause, reasoning that imposition of the higher tax rate turned not on the interstate or intrastate character of the companies, but on how the companies were regulated. The fact that all industry operators would be regulated so as to be subject to a higher rate did not amount to facial discrimination. The decision raises interesting and unanswered questions about the proper scope of the facial-discrimination inquiry in a Dormant Commerce Clause challenge to a purportedly discriminatory state tax.

Louisiana's *Ad Valorem* Tax Scheme

The parameters of Louisiana's *ad valorem* tax scheme are laid out in the Louisiana Constitution. Properties classified as "public service properties" are taxed at the rate of 25 percent of their fair market value, whereas property classified as all "other property" is taxed at the rate of 15 percent. La. Const. Art. VII, § 18(B). The Louisiana Legislature, acting under authority granted by the Constitution, defined "public service properties" as "immovable, major movable, and other movable property owned or used but not otherwise assessed in this state in the operations of each . . . *pipeline company*. . . ." La. R.S. 47:1851(M) (emphasis added). "Pipeline company," in turn, is defined as:

> [A]ny company that is engaged in the business of transporting oil, natural gas, petroleum products, or other products within, through, into, or from this state, and which is regulated by (1) the Louisiana Public Service Commission . . . , (2) the Interstate Commerce Commission, or (3) the Federal Power Commission, as a "natural gas company" under the Federal Natural Gas Act, 15 U.S.C. §§ 717–717w, because that person is engaged in the transportation of natural gas in interstate commerce, as defined in the Natural Gas Act.

La R.S. 47:1851(K). Under federal law, all interstate natural gas pipeline companies are regulated by the Federal Energy Regulatory Commission ("FERC"),[1] making all interstate pipeline companies that do business in Louisiana invariably "public service properties" subject to the state's higher 25 percent *ad valorem* tax. But under Louisiana law, only those intrastate pipeline companies that sell to local distributing systems are rate-regulated by the Louisiana Public Service Commission, La. R.S. 30:551(A), meaning only those intrastate companies are "public service properties" subject to the heightened tax; assets held by all other intrastate pipelines are considered "other property" subject to the 15 percent *ad valorem* tax under La. Const. Art. VII § 18(B). Accordingly, the Louisiana ad valorem tax scheme, on its face, requires all interstate pipeline companies to pay a 25 percent tax, whereas intrastate companies may opt out of the tax by strategically structuring their business operations.

The Louisiana Supreme Court's Decision

Several interstate pipeline companies raised a Dormant Commerce Clause challenge to the *ad valorem* tax scheme, contending that the scheme impermissibly discriminates against interstate commerce. Under the U.S. Supreme Court's seminal decision in *Amerada Hess Corp. v. Director, Division of Taxation, New Jersey Department of the Treasury*, a state tax discriminates against interstate commerce if it (1) is facially discriminatory; (2) has a discriminatory intent; or (3) has the effect of unduly burdening interstate commerce. 490 U.S. 66, 75 (1989).

Both the trial court and the Louisiana Court of Appeals found that the *ad valorem* tax scheme facially discriminates against interstate commerce. The Louisiana Supreme Court disagreed. According to that court, "Regulatory status is the factor that determines what is considered a 'pipeline company' [subject to the 25 percent tax], not interstate or intrastate character . . . ." *Transcontinental Gas Pipeline Corp. v. Louisiana Tax Commission*, ___ So. 3d ___ (La. 2010). The court reasoned that the ad valorem tax scheme did not grant a benefit to intrastate companies over interstate companies; the scheme applies equally to both in-state and out-of-state companies because "any rate-regulated pipeline company transporting gas in [Louisiana]" is subject to the 25 percent tax. *Id.*

While the court acknowledged that the scope of FERC's regulation forbids interstate companies from ever taking advantage of the lesser 15 percent tax, it found this to be "an incidental effect of the classification due to preemption of federal law, and not a patent facial discrimination against interstate commerce." *Id.* While the pipeline operators also mounted attacks on the tax's operation, claiming that the different rates and methods of calculation operated to discriminate against interstate commerce, the court found that none of the companies could carry the heavy evidentiary burden of showing that the actual tax rendition was greater under the higher rate, rejecting the companies' argument that different valuation methods—actual valuation and the unit method—would have resulted in the same base of calculation. Because the companies would never be able to prove what actual valuation would have been applied in every individual parish across the state to support such a claim, the standard applied to facial challenge became effectively outcome determination. Accordingly, the Louisiana Supreme Court reversed the court of appeals' decision and upheld the constitutionality of the tax scheme. *Id.*

What Is "Facial Discrimination" Under the Dormant Commerce Clause?

The court's reasoning raises important questions for interstate taxpayers about the depth of inquiry permissible in a facial challenge to a purportedly discriminatory state tax. The Louisiana Supreme Court cited no precedent for the proposition that a state tax scheme apportioned by regulatory status—or any other determinative proxy—which is itself based on the interstate or intrastate character of companies is beyond the purview of facial discrimination. Rather, the court supported its facial-discrimination analysis exclusively by distinguishing cases where the court had struck down state taxes as facially discriminatory. The thin precedential basis for the Louisiana Supreme Court's decision is not surprising. As commentators have noted, unlike other discrimination jurisprudence law, the precise scope of the facial-discrimination test under *Amerada Hess—i.e.*, how far from the face of a statute a court can look to establish discrimination—is unclear. *See* David S. Day, *The Expanded Concept of Facial Discrimination in the Dormant Commerce Clause Doctrine*, 40 Creighton L. Rev. 497 (2007).

This is not a purely academic issue. Proving that a legislature acted with discriminatory intent can be extremely difficult, and establishing discriminatory effects is both burdensome and costly, as this case showed. Thus, a facial challenge will almost always be the taxpayer's preferred—and perhaps only usable—line of attack.

In other contexts, it is clear that status or characteristics cannot be used as a proxy for discrimination; if they are, the statute or practice will not be immune from a facial attack. For example, courts have found explicit age-based discrimination where a county used a proxy for age—Medicare eligibility—as a basis for differential treatment. *Erie County Retirees Ass'n v. County of Erie, Pa.*, 220 F.3d 193, 215 (3d Cir. 2000). Likewise, an employer could not use gray hair as the basis for differential treatment because the "'fit' between age and gray hair is sufficiently close that they would form the same basis for invidious classification." *McWright v. Alexander*, 982 F.2d 222, 228 (7th Cir. 1992). Similarly, a school's exclusion of a service dog has been held to be "discrimination because of handicap." *Sullivan v. Vallejo City Unified Sch. Dist.*, 731 F. Supp. 947, 958 (E. D. Cal. 1990). "[A]nd no doubt a policy excluding wheelchairs would be such discrimination, even if the stated purpose of the policy were a benign one." *Alexander*, 982 F.2d at 228.

As mentioned, the extent to which this reasoning applies in the context of a Dormant Commerce Clause challenge remains unclear. The Louisiana Supreme Court's recent decision does nothing to clear up that ambiguity.

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[1] FERC is the successor to the Federal Power Commission. 15 U.S.C. §§ 717–717z. ^TOP

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Idaho Enacts Complex Withholding And Election Rules For Pass-Throughs

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The majority of states and localities, including Idaho, conform to the federal income tax treatment of partnerships, and treat them as conduits, with the income flowing through to the partners, and with the ultimate tax obligation imposed on the partners. The notable exceptions to this rule are Michigan, New Hampshire, Ohio, Tennessee, Texas, and New York City, which impose taxes directly on the entity.

Historically, states that allow flow-through of income have faced compliance and collection problems, when the in-state partnership would distribute income to nonresident partners, who otherwise have limited connections to the taxing state. To combat this noncompliance, many states have now enacted provisions that effectively require the in-state partnerships to pay their partners' taxes. Typically, states require partnerships either to withhold tax out of distributions made to partners, or to make estimated tax payments in respect of the partners.

Effective January 1, 2011, Idaho will require pass-through entities, which include, partnerships, LLCs taxed as partnerships, S corporations, and certain trusts,[1] to withhold tax in respect of individuals "on

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any actual distributions of funds from income . . . ."[2] The relevant "income" is defined as:

> (a) Wages, salary and other compensation paid by the pass-through entity to such officers, directors, owners of an interest in a pass-through entity or beneficiaries to the extent the compensation is Idaho taxable income of the individual to whom it is paid; and
>
> (b) The share of any income, loss, deduction or credit of a pass-through entity required to be included on such individual's Idaho return.[3]

The withholding obligation is applicable only to distributions made to nonresident individuals.[4] The distributions will be taxed at the highest marginal individual tax rate.[5] Alternatively, the nonresident individual may elect to have the pass-through entity itself report and pay the tax relating to the "income," defined above.[6] The election is made annually and, once made, is irrevocable for the taxable year.[7] The income would be taxed at the corporate rates.[8]

Although this election seems innocuous at first glance; it is somewhat analogous to composite return statutes in other states, and there are a number of issues that nonresident individuals and pass-throughs should be aware of. Obviously, the differential between the corporate and individual effective tax rates should be considered in making the election.

More importantly, however, although the pass-through's withholding obligation applies only to "actual distributions,"[9] no such limitation exists in the context of the pass-through paying the tax pursuant to the election.[10] Multiple instances exist where income tax may be imposed even though no actual distribution is made. Cancellation of indebtedness income, for example, or gain on a foreclosure, can create significant income but no cash. Other problems might arise in the context of "deemed distributions" resulting from a reduction of pass-through's liabilities.

Thus, it is possible that by making the election, the nonresident individual would subject the pass-through to paying more taxes than it would otherwise be responsible for if it only had to withhold out of "actual distributions of funds." If the nonresident individual's taxes are paid by the pass-through in these circumstances, the individual may effectively enjoy a cash-flow benefit that his/her co-partners (*i.e.* in-state residents) would not.

Another issue arises when the nonresident individual cannot pay his/her taxes. Because the election is strictly the individual's choice, a pass-through cannot elect out of it, and is, therefore, bound by the election. At least in the context of withholding, the pass-through pays the tax out of the cash owed to the individual. When the individual elects that the pass-through pay the taxes, the pass-through has to pay out of pocket, and then recover the cash outlay from the individual. As a result, the election, and the pass-through's obligation to make payments in respect of nonresident individuals, can create real business issues.

Ideally, these issues should be addressed in the partnership agreement. If tax payments exceed distributions that otherwise would be made, those payments should be treated as loans to the targeted partners, to be repaid to the partnership, with interest. If partners contemplate receiving periodic "tax distributions" in any event, those distributions obviously should be calculated by taking into account the taxes that might be required to be paid on behalf of such individuals.

These Idaho rules are new, and no regulations or instructions have yet been issued by the Idaho Tax Commission. Taxpayers would be remiss, however, if they do not consider the potential impact of the new Idaho legislation on their businesses, and adequately protect themselves. And unfortunately, the issues such provisions create are not unique to Idaho.

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[1] Idaho Code § 63-3006C. ^TOP
[2] Idaho Code § 63-3036B(2). ^TOP
[3] Idaho Code § 63-3022L(2). ^TOP
[4] Idaho Code § 63-3036B(2). ^TOP
[5] Id. ^TOP
[6] Idaho Code § 63-3036B(3)(b); Idaho Code § 63-3022L(1). ^TOP
[7] Idaho Code § 63-3022L(3). ^TOP
[8] Idaho Code § 63-3022L(1). ^TOP
[9] Idaho Code § 63-3036B(2). ^TOP
[10] Idaho Code § 63-3022L(1). ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

Colorado Leads the Charge: Adopts Affiliate Nexus and New Notice and Reporting Requirements for Sales Tax and "Economic Nexus" Rules for Income Tax

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The news out of Colorado this legislative session started out badly for taxpayers and just kept getting worse. Like many states, Colorado began 2010 with a significant budget deficit. The General Assembly immediately responded to the state's projected $1.5 billion shortfall by proposing aggressive new legislation focused on closing that gap.[1] These measures swiftly passed. Effective March 1, 2010, House Bill 10-1193 amended §§ 39-26-102 and 39-21-112 of the Colorado Revised Statutes to add an affiliate nexus provision and novel and controversial notice and reporting requirements for retailers that do not have nexus. The Colorado Department of Revenue (the "Department") also wasted no time in enacting emergency regulations with significant new penalties for noncompliance. In addition, the Department amended its definition of "doing business" for income tax purposes to impose "factor presence" nexus standards.[2]

Affiliate Nexus Provision: The Ties That Bind

Section 39-26-102 now provides that an out-of-state retailer that lacks physical presence in Colorado is presumed to be "doing business" in Colorado, and thus is required to collect and remit sales and use tax, if it is part of a group of corporations that has a member with physical presence in Colorado. The presumption can be rebutted through evidence that the member with physical presence in Colorado did not engage in any solicitation in Colorado on behalf of the out-of-state retailer that would satisfy constitutional requirements.[3]

Notice and Reporting Rules: Noncollecting Retailers Must Notify Customers or Face Stiff Penalties

Through its amendment of § 39-21-112, Colorado also has new notice and reporting requirements for retailers that do not collect and remit sales tax to the state. Beginning May 1, any "non-collecting" retailer that sells to customers in Colorado must do the Department's own "dirty work" by notifying customers twice—once at the time of purchase and then again at the end of each calendar year, beginning in 2010—that the customer is liable for Colorado tax on the purchase; retailers that fail to do so face stiff penalties. Under the new law, the retailer must also file an annual report with the Department, reporting the total amount each Colorado customer paid for its untaxed purchases. Any retailer failing to do so may amass penalties that can quickly rise to as much as $250,000 for the first year and can exceed this cap in later years.
As soon as the new notice and reporting requirements were enacted, there was a flurry of activity at the Department. The Department first issued an emergency regulation addressing the new rules on March 2, 2010. A proposed final regulation soon followed but was withdrawn and replaced with an amended proposed final regulation, which is scheduled for hearing in July 2010.[4] The new law, emergency regulation, and amended proposed final regulation are all summarized below. Until the constitutional issues are fully resolved, however, many retailers face significant new obligations in Colorado or risk penalties for failure to comply.

Customer Notification at the Time of Purchase

Under the new law, retailers that do not collect Colorado sales tax must notify their Colorado customers at the time of purchase that sales or use tax is due on certain purchases made from the retailer.[5] The emergency regulation provides that the notice must appear on each invoice. If no invoice is provided, notice by confirmation email is sufficient. The notice must contain the following information:

- The noncollecting retailer is not obligated to, and does not, collect Colorado sales tax.
- The purchase is subject to Colorado sales tax unless it is specifically exempt from taxation.
- The purchase is not exempt merely because it is made over the internet or by other

remote means.

- The State of Colorado requires the taxpayer to file a sales/use tax return at the end of the year reporting all of the purchases that were not taxed and to pay tax on those purchases.
- Retailers that do not collect Colorado sales tax are obligated to provide purchasers an end-of-year summary of their purchases in order to assist them in filing their tax returns.
- Details of how to file this return may be found at the Colorado Department of Revenue's web site, www.taxcolorado.com.
- Retailers that do not collect Colorado sales tax are required by law to provide the Colorado Department of Revenue with a report of the total amount of all of a purchaser's purchases at the end of the year.

The notice must be both legible and prominent. "Please see important sales tax information" must also appear immediately adjacent to the dollar amount of the transaction in bold font that is the same size as the font used on the rest of the invoice.[6]

Annual Customer Notification

Retailers that do not collect Colorado sales tax must also send their Colorado customers notice by first-class mail by January 31 of each year that sales or use tax is due on taxable purchases made from the retailer. The mailing must say "Important Tax Document Enclosed" and must include the name of the retailer. It cannot be sent with any other shipments or deliveries.[7]

The notice must also include the total amount the customer paid to the retailer during the preceding calendar year and "shall include, if available," the dates of the purchases, the amounts of the purchases, and the general category of the purchases.[8] While the statute provides that the retailer must tell the customer whether the purchase is taxable or exempt "if known," the amended proposed final regulation states that the retailer "may also indicate" whether the item is taxable or exempt, but "no non-collecting retailer is required to include such information."[9]

Annual Report to the Department of Revenue

Any retailer that does not collect Colorado sales tax must also file a report with the Department on or before March 1 of each year showing the total amount each of its Colorado customers paid to the retailer during the preceding calendar year.[10] Under the amended proposed final regulation, the report must include the name, billing address, shipping address, and total amount of purchases for each Colorado customer.[11]

De Minimis *Exceptions*

Under the emergency regulation, retailers that had total gross sales in the prior year of less than $100,000 and reasonably expect sales in the current year also to be less than $100,000 are exempt from having to provide notification at the time of purchase.[12] The amended proposed final regulation clarifies that the *de minimis* exception is based upon Colorado sales.[13]

The amended proposed final regulation also provides that retailers that made total gross Colorado sales in the prior year of less than $100,000 and expect sales in the current year also to be less than $100,000 are exempt from having to provide the annual customer reports. An annual customer report need not be sent to any customer whose total Colorado purchases for the prior calendar year amounted to less than $500.[14] Retailers that are not required to send any annual customer notifications need not file an annual report with the Department.[15]

Penalties for Noncompliance

Noncompliance with the notice and reporting rules can lead to significant penalties. Five dollars is imposed for every failure to provide notice at the time of purchase,[16] $10 is imposed for every failure to send an annual customer notification, and an additional $10 is imposed for every failure to provide an annual report to the Department.[17]

The amended proposed final regulation provides some limits to the penalties—at least for the first year. The total amount of $5 penalties issued for failure to provide notice at the time of purchase is limited to $5,000 where the retailer had no actual knowledge of the requirement and began sending the required notices within 60 days of demand by the Department; it is limited to $50,000 where the retailer failed to send the notices for the first calendar year for which they were required.[18] The total amount of $10 penalties issued for failure to send an annual customer notification or annual customer report to the Department is limited to $1,000 where the notification or report was no more than 30 days late, $10,000 where the retailer had no actual knowledge of the requirement and sent the applicable notification or report within 60 days of demand by the Department, and $100,000 where the retailer failed to send the notification or report for the first calendar year for which the notification or report was required.[19] No penalty will be imposed upon a noncollecting retailer that sells goods that are not taxable in Colorado or that sells goods only to customers not subject to sales or use tax.[20] Notably, there are no caps on penalties beyond the first year following enactment of the new law.

The Department's Subpoena Power

Retailers that do not collect Colorado sales tax and also refuse to voluntarily furnish information when requested by the Department may be subject to a subpoena issued by the Department's Executive Director to compel such information. If a retailer fails or refuses to respond to the subpoena and give testimony, the Executive Director may ask a state court to issue a contempt order.

Constitutional Red Flags Abound

The new affiliate nexus and notice requirements—which apply to remote sellers that have no physical presence in Colorado and thus clearly have no constitutional obligation to collect tax—raise all kinds of constitutional red flags and are certain to be challenged. Commerce Clause and Due Process Clause concerns abound in this context. Indeed, both the notice and reporting provisions and the "affiliate nexus" provision purport to impose sales tax obligations on retailers that lack any physical presence in Colorado. Clearly, this violates the Commerce Clause as interpreted in *Quill Corp. v. North Dakota*.[21] In contrast to the controversy in the courts as to whether or not Quill's physical-presence Commerce Clause test applies to taxes other than sales and use tax, it is clear that physical presence is still a requirement to support state taxing authority under the Commerce Clause. And while *Quill* took a lot of the "bite" out of Due Process Clause protections in general in this context, Colorado's new amendments, by overreaching so far, trigger due-process concerns as well. While maintaining a market in Colorado may be sufficient for the courts to exercise jurisdiction over a retailer, imposing continuing tax notice and reporting obligations based on nothing more than exploiting the marketplace is something different altogether. Thus, Colorado's aggressive new law is vulnerable to attack as inconsistent under the Due Process Clause as well.

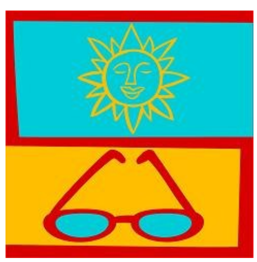
Colorado Adopts MTC's "Factor Presence" Nexus Standard for Corporate Income Taxes

The Department also joined the growing number of states that have adopted the Multistate Tax Commission's "factor presence" nexus standard for income, franchise, or gross receipts tax purposes. Effective April 30, 2010, the Department amended its income tax regulation to impose tax obligations on businesses that have more than $50,000 of property or payroll in the state or generate more than $500,000 in sales attributed to Colorado.[22] A business also meets the new test if 25 percent of its total property, total payroll, or total sales are in Colorado.

Colorado's regulation mirrors the move toward "economic nexus" that has gained momentum in recent years. As a practical matter, the new regulation will not affect a company that is protected by P.L. 86-272. However, service-based businesses or any other business that is not protected by P.L. 86-272 may suddenly face income tax obligations in Colorado as a result of this significant regulatory change. Add Colorado to the growing list of states where a significant customer base and economic ties alone are sufficient to create tax liabilities.

Conclusion

Like many states, Colorado has responded to its budget crisis by enacting new nexus laws, specifically an affiliate nexus provision and notice and reporting rules. These new laws have faced significant backlash from the online retailer community and are also vulnerable to constitutional challenge. However, armed with subpoena power and significant penalties—up to $250,000 in 2010 and more in subsequent years—Colorado appears eager and ready to enforce them.



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[1] Steven K. Paulson and Colleen Slevin, *Colorado Budget Gap, Education Reform Dominate First Day of Legislative Session*, The Huffington Post, January 13, 2010. ^TOP

[2] Col. Code Regs. § 39-22-301.1, effective April 30, 2010. ^TOP

[3] Colo. Rev. Stat, § 39-26-102(3)(b)(II). ^TOP

[4] Colo. Emergency Reg. 39-21-112.3.5; Colo. Proposed Final Reg. 39-21-112.3.5; Colo. Amended Proposed Final Reg. 39-21-112.3.5. ^TOP

[5] Colo. Rev. Stat. § 39-21-112.3.5(c)(1). ^TOP

[6] Colo. Emergency Reg. 39-21-112.3.5(3). *See also* Colo. Amended Proposed Final Reg. 39-21.112.3.5(2)(b) (requiring substantially similar information to be provided). ^TOP

[7] Colo. Rev. Stat. § 39-21-112.3.5(d)(I)(A) and (B). ^TOP
[8] Colo. Rev. Stat. § 39-21-112(3.5)(d)(I)(A). ^TOP
[9] Colo. Amended Proposed Final Reg. 39-21-112.3.5(3)(a)(v). ^TOP
[10] Colo. Rev. Stat. § 39-21-112(3.5)(d)(II). ^TOP
[11] Colo. Amended Proposed Final Reg. 39-21-112.3.5(4)(a). ^TOP
[12] Colo. Emergency Reg. 39-21-112.3.5(3)(e). ^TOP
[13] Colo. Amended Proposed Final Reg. 39-21-112.3.5(2)(e). ^TOP
[14] Colo. Amended Proposed Final Reg. 39-21-112.3.5(3)(c) and (d). ^TOP
[15] Colo. Amended Proposed Final Reg. 39-21-112.3.5(4)(d). ^TOP
[16] Colo. Rev. Stat. § 39-21-112(3.5)(c)(II). ^TOP
[17] Colo. Rev. Stat. § 39-21-112(3.5)(d)(III). ^TOP
[18] Colo. Amended Proposed Final Reg. 39-21-112.3.5(2)(f). ^TOP
[19] Colo. Amended Proposed Final Reg. 39-21-112.3.5(3)(e), (4)(f). ^TOP
[20] Colo. Amended Proposed Final Reg. 39-21-112.3.5(f)(ii)(3); (3)(e)(ii)(4); (4)(f)(ii)(4). ^TOP
[21] 504 U.S. 298, 305–306 (1992). ^TOP
[22] Col. Code Regs. § 39-22-301.1. ^TOP

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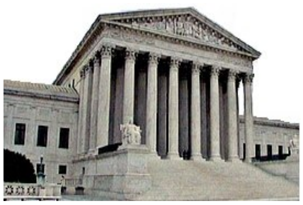

Will U.S. Supreme Court, in *Levin v. Commerce Energy*, Expand or Restrict State Taxpayers' Access to Federal Forum?

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INTRODUCTION

Plaintiffs have long faced an uphill battle when trying to challenge a state tax in a federal forum. For more than 70 years, the jurisdictional bar imposed by the Tax Injunction Act (TIA) has prohibited federal district court suits that would "enjoin, suspend or restrain the assessment, levy or collection of any tax under State law" where "a plain, speedy and efficient remedy may be had in the courts of such State".[1] While the TIA bars federal courts from hearing most state tax cases, its plain language bars only certain prohibited actions where the claimant otherwise has an adequate state remedy.

In *Hibbs v. Winn*,[2] the U.S. Supreme Court ruled that the federal courthouse doors are open to certain suits involving state taxes. According to the *Hibbs* court, the TIA bars only those "cases in which state

SCHEDULE

taxpayers seek federal-court orders enabling them to avoid paying state taxes."[3] Post-*Hibbs*, state taxpayers had a renewed hope for broader access to a federal forum. But state taxpayers were soon faced with another hurdle: even if a case was not barred by the TIA, a federal court might refuse to hear it under the "doctrine of comity."

"Comity," as further described below, is a type of legal reciprocity whereby one jurisdiction (*e.g.*, the federal government) extends certain courtesies to other jurisdictions (*e.g.*, the states) by recognizing the validity and effect of their executive, legislative, and judicial acts. In order to avoid requested litigation and the need to answer unnecessary constitutional questions, federal courts may exercise discretion to abstain from state tax cases requiring interpretation of state law if state courts have jurisdiction to decide the matter.

After *Hibbs* narrowed the reach of the TIA, a circuit split soon developed over the extent of comity's reach. This Term, the U.S. Supreme Court is expected to resolve this circuit split in *Levin v. Commerce Energy*. [4]

This article discusses the federal court jurisdiction to hear state tax cases, historical application of notions of comity in cases seeking equitable remedies to enjoin collection of state taxes, and the evolution of cases invoking comity after enactment of the TIA. In light of this evolution, the article suggests options that the Supreme Court may consider for refining comity's scope, particularly when addressing matters of federal constitutional concern.

FEDERAL DISTRICT COURT JURISDICTION

Federal courts are courts of limited jurisdiction that are able to decide only cases involving certain subject matter, such as "federal questions," claims against the federal government, and "diversity claims" involving parties from different states with amounts in controversy exceeding $75,000. Article III of the U.S. Constitution allows Congress to create federal courts to hear "cases, *in law and equity*, arising under th[e] Constitution, the laws of the United States, and Treaties made, or which shall be made, under their Authority."[5] Congress passed legislation granting federal district courts original jurisdiction in all civil actions arising under the Constitution or federal statutes.[6] Generally, federal courts are obliged to exercise their statutory jurisdiction.

Where equitable remedies, as opposed to legal remedies, are sought to enjoin collection of state taxes on the basis of constitutional challenges, the doctrine of equitable restraint has been of "notable application."[7] Because a federal court's decision to grant an injunction or other equitable relief is discretionary, the court may decline to grant equitable relief when the circumstances warrant. If a taxpayer seeks only legal remedies or common law damages, as opposed to equitable remedies under federal law, less justification for abstention exists.[8]

Pre-Tax Injunction Act

Prior to enactment of the TIA, courts often declined to grant equitable relief in state tax cases under the general principle of equitable restraint. Equitable restraint requires federal courts to refrain from granting equitable relief when the plaintiff has a plain and adequate remedy at law, such that the plaintiff must show exceptional circumstances before invoking a court's equity jurisdiction.[9] Plaintiffs would need to show, for example, that equitable relief was necessary to avoid a multiplicity of suits or irreparable harm. In the state tax context, a taxpayer's ability to request refunds from the taxing authority is considered an adequate remedy generally precluding equitable relief in federal court.

In their earliest practices, federal courts declined to enjoin the collection of state taxes as a matter of judicial discretion. And to explain or reinforce this discretionary decision, federal courts often invoked notions of comity. Generally speaking, comity embodies federal courts' "proper respect for state functions," instructing them to refrain from "unduly interfer[ing] with the legitimate activities of the States."[10] Under the doctrine of comity, where an independent tribunal has concurrent jurisdiction, federal courts are permitted to exercise judicial restraint to avoid collision of the concurrent authorities. Concerns over comity arise in many areas of the law.

State tax disputes in federal court generally raised two comity-related issues. First, in any case where a federal court enjoins the operation of a state government, friction might arise. Second, and unique to the state tax context, a federal injunction against the collection of taxes could place a state in a precarious fiscal position. States rely on taxes to provide public services, and any disruption in these services due to interruptions in the tax stream would ultimately harm the public.[11] Interests of comity thus amplify the importance of equitable restraint in state tax disputes.

Comity is not, however, a free-standing doctrine that allows courts to decline to hear a state tax dispute. While not a rule of law, comity has long been a principle of "practice, convenience, and expediency" that has "substantial value in securing uniformity of decision, and discouraging repeated litigation of the same question."[12] The real basis for a federal court to decline to hear a state tax dispute was the traditional principle of equitable restraint, which comity merely buttressed. Prior to the TIA, then, state tax disputes were kept out of federal court only by the traditional rules of equity.

Notwithstanding the principle of equitable restraint, federal courts still heard state tax disputes, and they sometimes enjoined state tax collection.[13] This situation stemmed primarily from the particularities of federal equity practice, which allowed several exceptions to the general rule of restraint. For example, the "adequate legal remedy" that would preclude equitable relief had to be available in federal (as opposed to state) court. The Eleventh Amendment sometimes barred refund suits against states from proceeding in federal court, so with no other adequate legal remedy available in federal court, state taxpayers could avoid the principle of equitable restraint.[14] Federal courts also strictly construed the requirement that a legal remedy be "plain, adequate, and complete," frequently concluding that state remedies did not suffice.[15] Even if an individual taxpayer had an adequate remedy at law, equitable restraint could be avoided if the relief would prevent a multiplicity of suits.[16] For these reasons and others, federal courts heard state tax cases and sometimes enjoined state tax collection, despite the principle of equitable restraint and notions of comity.

Frequent decisions limiting equitable restraint created two major problems. First, it created a disparity in the relief available to in-state and out-of-state taxpayers, because states often forbade their own courts to enjoin the collection of taxes from domestic taxpayers. In-state taxpayers who had no basis for invoking federal jurisdiction were thus required to pay taxes under protest and then seek a refund. But out-of-state taxpayers, often corporations, could invoke federal court diversity jurisdiction. If they could get past the principle of equitable restraint, out-of-state taxpayers could potentially obtain an injunction, relief unavailable to their in-state counterparts.

Second, federal injunctions against the collection of state taxation threatened states' revenue streams. Because in-state taxpayers had to pay first and then sue for a refund, states received a relatively stable stream of revenue from them. In contrast, out-of-state taxpayers were able to tie up substantial amounts of tax revenue in federal proceedings, thus disrupting state and local finances. Desperate states were often forced to settle tax bills for fractions of what they thought was owed to them.

After the Tax Injunction Act

In response to these inequities, Congress passed the Act of August 21, 1937,[17] more commonly known as "the Tax Injunction Act." As amended, the TIA declares that "district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."[18] On its face, the TIA is somewhat limited, barring only certain types of relief, and then only when a "plain, speedy and efficient remedy" is available in state court. But over the years, the TIA has blossomed into a more general bar on federal court interference with most aspects of state tax administration. For example, the U.S. Supreme Court has interpreted the TIA as barring declaratory judgments, even though such judgments are not mentioned in the TIA.[19] The Court has also interpreted the "plain, speedy and efficient remedy" exception to the TIA's prohibition as ordering the states to satisfy only procedural (as opposed to substantive) requirements.[20] The *Rosewell* court noted, "Nowhere in the TIA did Congress suggest that the remedy must be the speediest." Nevertheless, some courts occasionally find that there is no "plain, speedy and efficient" remedy in the state court.

The TIA quickly became the focus of any effort to bring a suit in—or get a suit out of—federal court. But comity still cropped up from time to time. For instance, shortly after the TIA's passage, the U.S. Supreme Court declined to decide whether the TIA barred a federal court from issuing a declaratory judgment in a state tax dispute.[21] The Court found resolution of that issue unnecessary and instead looked to the pre-TIA practice of equitable restraint. As discussed above, federal courts had the discretion to refrain from granting equitable relief such as a declaratory judgment. Accordingly, the principle of equitable restraint, reinforced with notions of comity, was enough to keep suits for a declaratory judgment out of federal court. It was not until almost 40 years later that the Court finally held that the TIA itself barred granting declaratory judgments.[22]

Comity similarly expanded beyond its initial formulation as a reason for exercising equitable restraint into what appeared to be a free-standing doctrine barring federal jurisdiction in virtually all state tax disputes. This progression is exemplified in the Supreme Court's 1981 decision in *Fair Assessment*. The taxpayers in *Fair Assessment* sought damages under § 1983 for allegedly unconstitutional property taxes. Such a suit was not mentioned in the TIA, and equitable restraint had no applicability to a legal remedy such as damages.

Nevertheless, a sharply divided Court held that principles of comity barred § 1983 actions seeking damages for unconstitutional state taxes. The majority invoked several broad statements on comity from its pre-TIA opinions, noting "the important and sensitive nature of state tax systems and the need for federal-court restraint when deciding cases that affect such systems."[23] The Court also suggested that the TIA reflected Congress's belief "that the autonomy and fiscal stability of the states survive best when state tax systems are not subject to scrutiny in federal courts."[24] The majority thus envisioned comity as "the scrupulous regard for the rightful independence of state governments which should at all times actuate the federal courts."[25]

Having found damages suits to be antithetical to this principle, as they would halt the operation of a state tax and generally disrupt state tax administration, the majority therefore held that such suits were barred by the doctrine of comity. In dissent, Justice Brennan sharply criticized the majority for expanding comity—a notion that had previously only informed a federal court's discretion over the granting of equitable relief—into a jurisdictional bar. According to Justice Brennan, Congress had given federal courts jurisdiction over damages suits under § 1983, and courts had no authority to reject this properly conferred jurisdiction due to concerns over comity.[26]

HIBBS' NARROWING OF THE TIA AND THE RESURGENCE OF COMITY

With the expansion of the TIA's reach and courts' evoking broad notions of comity like those in *Fair Assessment*, it seemed that there was virtually no way for state taxpayers to challenge the constitutionality of a tax in federal court. In 2004, however, the U.S. Supreme Court narrowed the scope of the TIA to permit a limited class of state tax cases in federal court. In *Hibbs v. Winn*, several Arizona taxpayers challenged the constitutionality of tax credits for payments to organizations that provide scholarship grants to children attending private schools. The taxpayers asserted that this credit violated the Establishment Clause because the organizations could direct funds to children of a particular religious denomination. The court held that the TIA did not bar the taxpayers' suit, as the TIA barred only suits in which taxpayers sought to avoid paying their own taxes. If the tax credits at issue in *Hibbs* were enjoined, state tax revenues would actually increase.

Hibbs thus seemed to offer new hope to state taxpayers trying to get into federal court: so long as a suit would not interfere with the collection of taxes, the TIA was not a bar. But this slight narrowing of the TIA renewed interest in the independent power of comity to bar state tax disputes. *Hibbs* left comity relatively untouched, as the opinions were nearly silent on the topic. Justice Ginsburg's opinion for the court addressed comity only in a footnote, noting "that [the] Court has relied upon 'principles of comity' to preclude original federal-court jurisdiction only when plaintiffs have sought district-court aid in order to arrest or countermand state tax collection."[27] Justice Stevens' concurrence did not mention comity, and Justice Kennedy's dissent made only one brief mention of it.

Post-*Hibbs*, states soon argued that comity, as broadly defined in *Fair Assessment*, stood as an independent bar to suits that survived the TIA. Taxpayers retorted that comity, like the TIA, barred only suits that would interfere with the collection of state taxes. Courts quickly split over the issue. On one side, the Seventh and Ninth Circuits sided with the taxpayers, holding that comity applied only when a case would tie up state tax revenue. [28] According to these courts, *Hibbs* did not overrule *Fair Assessment* and its broader notions of comity. However, *Hibbs* did limit comity's reach. In contrast, the Fourth Circuit held that *Hibbs* left comity untouched so that comity could bar a suit that seeks to force increased tax collection.[29]

The Sixth Circuit took a more nuanced approach to the issue in *Commerce Energy, Inc. v. Levin*.[30] In *Commerce Energy*, several out-of-state natural gas suppliers challenged Ohio's taxing scheme, alleging that it discriminated against them in favor of in-state natural gas suppliers. The Sixth Circuit held that comity did not bar the suit. But in defining comity's scope, the court noted that the decision to hear a state tax dispute could not be resolved "with abstract generalizations about nontextual constitutional principles of comity and federalism."[31] Thus, while the court rejected a broad reading of comity that would "bar from federal court nearly every state-tax challenge," it was unwilling to adopt any bright-line rules about comity's applicability. The Sixth Circuit instead focused on "the degree to which the claims and relief requested would intrude upon a state's power to organize, conduct, and administer its tax system."[32]

OPTIONS BEFORE THE COURT

The U.S. Supreme Court later granted Ohio's petition for certiorari and is expected to resolve the issue of comity's scope. The court is faced with several options. One extreme position would be to hold that comity bars most federal court interference with state tax administration. This position finds support in some of the court's broader statements on comity, particularly in *Fair Assessment*. But such a decision raises some very troubling questions of federal courts' authority to define their own jurisdiction. As Justice Brennan pointed out in his concurring opinion in *Fair Assessment*, Congress has sole responsibility for defining federal courts' jurisdiction, and it encroaches on this separation of powers when courts attempt to define their jurisdiction to reflect a court's views on proper federal-state relations. This position also provides a relatively undefined, and thus malleable, standard that courts could manipulate or abuse.

The other extreme would be to hold that, like the TIA, comity bars only suits that would disrupt the inflow of state taxes. This position benefits from the certainty of a bright-line rule and is also deeply rooted in comity's historical practice. As the court pointed out in *Hibbs*, comity has been invoked only when taxpayers seek to interfere with the collection of state taxes. But this rule also has its problems. For one, it would generally render the TIA and comity virtually coterminous, except for issues where the federal courts have first interpreted relevant federal statutory or constitutional law. Further, as noted by Justice Breyer during oral argument in *Levin v. Commerce Energy*, such a rule could be manipulated by taxpayers to gain access to federal court in virtually every case involving an alleged discriminatory state tax, simply by challenging another party's right to certain tax credits, deductions or exemptions, instead of claiming the right to a refund or seeking to enjoin a taxing authority's collection of such tax.

Another option would be some sort of middle ground that could provide a more refined rule. The court has, on several occasions, explained that suits addressing "exceptional circumstances" involving federal rights may fall outside the bar of comity, even if those cases restrict a state's collection of revenue. For example, in *Tully v. Griffin*,[33] the court explained that "[a] federal district court is under an equitable duty to refrain from interfering with a State's collection of its revenue *except in cases where an asserted federal right might otherwise be lost*."[34] In a similar vein, in *National Private Truck Council*, the court explained that "extraordinary circumstances" may exist to allow federal courts to grant injunctive or declaratory relief under § 1983 when the "enforcement of the tax would lead to a multiplicity of suits, or produce irreparable injury, [or] throw a cloud upon the title."[35] During oral argument in *Levin v. Commerce Energy*, Justices Sotomayor and Ginsburg indicated that exceptional circumstances might include denial of fundamental rights or claims of discrimination based on a suspect classification such as race.

Regardless of its holding, it is hoped that the court will provide the needed guidance on the applicability of comity to state tax cases. The Court's cases have created much confusion over comity, such as whether it is a jurisdictional bar or just a factor that influences judicial discretion. History indicates the latter. As Justice Story wrote in his early analysis of comity published in the Commentaries on the Conflict of Law:

> [C]omity is and ever must be, uncertain. That it must necessarily depend on a variety of circumstances, which cannot be reduced to any certain rule. That no nation will suffer the laws of another to interfere with her own to the injury of her citizens. That, whether they do or not, must depend on the condition of the country, in which the foreign law is sought to be enforced . . . .[36]

In light of its history and purpose, the doctrine of comity seems unlikely to be refined into a "bright-line rule." Nevertheless, additional refinement is needed to identify the unusual circumstances, if any, where federal courts lose jurisdiction of federal questions.

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[1] 28 U.S.C. § 1341. ^TOP
[2] 542 U.S. 88 (2004). ^TOP
[3] *Id.* at 107. ^TOP
[4] 554 F.3d 1094 (6th Cir. 2009), *oral argument* (U.S. March 22, 2010) (No. 09-223). ^TOP
[5] U.S. CONST. art. III, § 2 (emphasis added). ^TOP
[6] 28 U.S.C. § 1331 (amended in 1980 to eliminate the amount-in-controversy requirement). ^TOP
[7] *See Fair Assessment in Real Estate Ass'n v. McNary*, 454 U.S. 100, 107–08 (1981). ^TOP
[8] *See Quackenbush v. Allstate Ins. Co.*, 517 U.S. 706 (1996); but see Fair Assessment, 454 U.S. 100. ^TOP
[9] *Dows v. City of Chicago*, 78 U.S. 108, 112 (1870). ^TOP
[10] *Younger v. Harris*, 401 U.S. 37, 44 (1971). ^TOP
[11] *See Dows*, 78 U.S. 108, 110. ^TOP
[12] *See Mast, Foos & Co. v. Stover Manufacturing Co.*, 177 U.S. 485, 488 (1900). ^TOP
[13] *See Fair Assessment*, 454 U.S. at 129 (Brennan, J., concurring in the judgment). ^TOP
[14] *See, e.g., City Bank Farmers' Trust Co. v. Schnader*, 291 U.S. 24, 29 (1934). ^TOP
[15] *Hopkins v. S. Cal. Tel. Co.*, 275 U.S. 393, 399–400 (1928). ^TOP
[16] *Gramling v. Maxwell*, 52 F.2d 256, 260–01 (W.D.N.C. 1931). ^TOP
[17] Pub. L. No. 75-332, 50 Stat. 738 (codified as amended at 28 U.S.C. § 1341). ^TOP
[18] 28 U.S.C. § 1341. ^TOP
[19] *See California v. Grace Brethren Church*, 457 U.S. 393, 407,-11 (1982). ^TOP

[20] *Rosewell v. LaSalle Nat'l Bank*, 450 U.S. 503, 512 (1981). ^TOP
[21] *See Great Lakes Dredge & Dock Co. v. Huffman*, 319 U.S. 293 (1943). ^TOP
[22] *California v. Grace Brethren Church*, 457 U.S. 393.] ^TOP
[23] 454 U.S. at 102. ^TOP
[24] *Id.* at 102–03. ^TOP
[25] 454 U.S. at 116 (quotation marks and alteration omitted). ^TOP
[26] The court later backed away from *Fair Assessment*'s broad application of comity in *National Private Truck Council, Inc. v. Oklahoma Tax Comn. (NPTC)*. According to the *NPTC* court, *Fair Assessment* did not hold that comity deprived federal courts of jurisdiction over § 1983 cases challenging the constitutionality of state taxes. Comity instead indicated that Congress would not have authorized a suit that would disrupt the collection of state taxes. According to the NPTC court, Fair Assessment was actually an interpretation of § 1983. That is, the court had found nothing in § 1983 to suggest that Congress intended to deviate from principles of comity, and thus it interpreted § 1983 as not authorizing a suit for damages for unconstitutional taxes. ^TOP
[27] 542 U.S. at 107 n.9 (citation omitted). ^TOP
[28] *Levy v. Pappas*, 510 F.3d 755, 761–62 (7th Cir. 2007); *Wilbur v. Locke*, 423 F.3d 1101, 1110 (9th Cir. 2005). The First Circuit later joined the Sixth, Seventh, and Ninth Circuits. *See Coors Brewing Co. v. Méndez-Torres*, 562 F.3d 3 (1st Cir. 2009). ^TOP
[29] *DirecTV, Inc. v. Tolson*, 513 F.3d 119, 127–28 (4th Cir. 2008). ^TOP
[30] 554 F.3d 1094 (6th Cir. 2009). ^TOP
[31] 554 F.3d 1094, 1100. ^TOP
[32] *Id.* ^TOP
[33] 429 U.S. 68, 73 (1976). ^TOP
[34] *Id.*(emphasis added). ^TOP
[35] *National Private Truck Council Inc. v. Oklahoma Tax Comn.*, 515 U.S. 582, 591 n. 6 (1995). ^TOP
[36] Story, Joseph, *Commentaries on the Conflict of Laws*, § 28 (1834). ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

Commerce Energy Case Update: State Taxpayers' Access To Federal Court Narrows, But Seldom-Used Side Doors Remain Ajar

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In a May 3, 2010, metaphorical Statement Concerning the Supreme Court's Front Entrance, Justices Breyer and Ginsburg expressed regret that the U.S. Supreme Court has decided to close public access to the Court's iconic bronze front doors.[1] Soon, Supreme Court visitors will no longer be able to climb the Court's forty-four marble steps to enter under the famous words, "Equal Justice Under Law." Instead, the public entrance will be through a side door.

Unfortunately for Commerce Energy, the justices did not have the same regret to closing the federal court doors on its claims of discriminatory state taxes. On June 1, 2010, in an opinion written by Justice Ginsburg, the Court distinguished its decision in *Hibbs v. Winn*[2] and ruled that comity bars Commerce Energy's federal court challenge to Ohio's tax scheme.[3] Still, the Court did not lock all federal trial court doors for all state tax matters, even though Justice Kennedy views the Court's rationale *Hibbs v. Winn*[4] as "doubtful," Justices Thomas and Scalia "remain 'skeptical' of the Court's decision in *Hibbs*," and Justice Alito is "doubtful about the Court's ability to distinguish *Hibbs*."[5] For now, federal courts doors should remain open for unusual complaints challenging state tax provisions, including those by "financially disinterested 'third parties'" where "only

SCHEDULE

one remedy would redress the plaintiffs' grievance."[6]

Perhaps of significance in *Commerce Energy* was the fact that "the District Court [had] 'decline[d] to exercise jurisdiction' as a matter of comity" and the Supreme Court expressed concern over the taxpayer's attempt to seek "federal-court aid in an endeavor to improve their competitive position."[7] The Court noted in its citation to *Sinochem*, that a "federal court has flexibility to choose among threshold grounds for dismissal."[8] Thus, the case was not viewed as an inappropriate situation for exercising the courtesy of comity.

Expect to see more state-related cases filed in federal court. As predicted, "the doctrine of comity [is] unlikely to be defined by a 'bright-line rule.'"[9]

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[1] *See* www.supremecourt.gov/orders/journal/jnl09.pdf, at p. 831. ^TOP
[2] 542 U.S. 88 (2004). ^TOP
[3] *Levin v. Commerce Energy, Inc.*, No. 09-223, slip op. (June 1, 2010), www.supremecourt.gov/opinions/09pdf/09-223.pdf. ^TOP
[4] 542 U.S. 88 (2004). ^TOP
[5] *Commerce Energy*, slip op., concurring opinions (Kennedy, J., concurring at 1; Thomas, J., concurring at 1; and Alito, J., concurring at 1). ^TOP
[6] *See Commerce Energy*, slip op. at 15; n.12. ^TOP
[7] *Id.* at 3, 16. ^TOP
[8] *Id.* at 17 (parenthetical describing *Sinochem Int'l Co. v. Malaysia Int'l Shipping Corp.*, 549 U. S. 422, 431 (2007). ^TOP
[9] *See* Charolette Noel and Bryan D. Lammon, *Will U.S. Supreme Court, in Levin v. Commerce Energy, Expand or Restrict State Taxpayer's Access to Federal Forum?*, Tax Management Multistate Tax, Vol. 18, No. 4 (April 23, 2010). ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

Recent Judicial and Administrative Developments Presented at the Meeting of the Tax Section - Alabama State Bar Alabama Center for Commerce on May 13, 2010

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Our guest author, Jeff Patterson practices law in Montgomery, Alabama, with an emphasis on state and local taxation. He represents corporate and individual taxpayers in Alabama and other states. His representations encompass sales and use taxes, income tax, incentives such as the Alabama capital credit, and business privilege tax, among other areas.

Prior to forming his own firm, Jeff served as an assistant counsel with the Alabama Department of Revenue for more than 13 years, where he litigated numerous corporate and individual tax cases, and advised the commissioner and tax-division directors on various tax topics. With his background and with his understanding of the Alabama Department of Revenue, Jeff now focuses his efforts on assisting businesses and individuals to navigate the complicated world of state and local taxation.

Jeff earned a business degree from Samford University in Birmingham and his law degree from the University of Alabama. He, his wife, and two sons are all big Auburn Tiger fans. War Eagle!

SCHEDULE

1. *EX PARTE G. THOMAS SURTEES, AS COMMISSIONER OF THE ALABAMA DEPARTMENT OF REVENUE; EX PARTE VULCAN LANDS, INC.*, ___ So.2d ___, 2008 WL 4369259 (Ala. 2008).

TOPICS: Foreign Corporation Franchise Tax – Remedy

ALABAMA SUPREME COURT – The Department contended that no refund of foreign corporation franchise tax was due based on the "reliance-hardship" defense, *i.e.*, that the state relied on now-overturned precedent and that a refund would create a hardship on the state. The Department also claimed that any refund must be based on the difference between what the Taxpayer paid and what a similarly-situated domestic competitor would have paid, and that the Taxpayer must prove the existence of an actual, favored domestic competitor. The Court held that the Department had abandoned its reliance on overturned precedent prior to Vulcan's first tax payment, as evidenced in oral argument before the U. S. Supreme Court in *South Central Bell Telephone Co. v. Alabama*, 526 U.S. 160, 169 (1999). Therefore, the Taxpayer was entitled to summary judgment on this point, *i.e.*, that the "reliance-hardship" defense was not available to the Department here. As to the "domestic competitor" issue, the Court stated that a company is not required to find a mirror-image domestic competitor to attain a refund. Therefore, the Supreme Court affirmed the Court of Civil Appeals as to this issue (in favor of the Taxpayer). The Supreme Court then remanded for a consideration of newly-raised issues, such as how much the Taxpayer would have paid if it had been a domestic corporation.

TRIAL COURT ON REMAND – On October 19, 2009, the trial court found that the Taxpayer would have paid the $50 minimum tax if it had filed as a domestic corporation. Therefore, the court ordered a refund of what the Taxpayer actually paid as a foreign corporation ($30,261), minus $50. The trial court also found that the Department failed to prove that the Taxpayer passed on the payment of the franchise tax to its customers, because "the evidence showed that the Taxpayer was not a traditional competitive entity and thus did not have the opportunity to pass the economic burden of the tax onto its customers."

2. *EX PARTE ALABAMA DEPARTMENT OF REVENUE (KIMBERLY-CLARK CORP. & KIMBERLY-CLARK WORLDWIDE, INC. v. ALABAMA DEPARTMENT OF REVENUE)*, ___ So.3d ___, 2010 WL 675606 (Ala. 2010).

TOPICS: Corporate Income Tax – "Business" vs. "Nonbusiness" Income

ALABAMA SUPREME COURT – Kimberly-Clark Corporation and Kimberly-Clark Worldwide, Inc., sold a pulp mill and 375,000 acres of timberland located in Alabama. The Court held that the income from the sale failed to meet the transactional test, because the sale of the division did not occur in the companies' regular course of business, as required by this Court's decision in *Ex parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000). Therefore, the income constituted nonbusiness income. Because the real property that was sold was located in Alabama, the income was allocated to this state. Kimberly-Clark and Kimberly-Clark Worldwide applied for rehearing.

3. *RHEEM MANUFACTURING CO. v. ALABAMA DEPARTMENT OF REVENUE*, ___ So.2d ___, 2009 WL 497953 (Ala. Civ. App. 2009).

TOPICS: Taxpayer's Bill of Rights – Jurisdiction – Administrative Law Division – Petition For Refund

COURT OF CIVIL APPEALS – The Court held that the Administrative Law Division lacked jurisdiction to consider an issue that had not been first presented to the Department in a taxpayer's petition for refund, citing *Patterson v. Gladwin Corp., et al.*, 835 So.2d 137 (Ala. 2002). The Court noted that the Administrative Law Division only had authority pursuant to the Taxpayer's Bill of Rights to determine whether issues that had been presented to and rejected by the Department were decided correctly. The Taxpayer's failure to present a particular issue to the Department as a ground for refund precluded the Administrative Law Division's consideration of that ground, because the Department had not been given an opportunity to consider that issue.

CERT DENIED – The Alabama Supreme Court denied the Taxpayer's cert petition on September 11, 2009.

4. *JAMES E. PRINCE, JR. v. ALABAMA DEPARTMENT OF REVENUE*, ___ So.3d ___, 2010 WL 1837773 (Ala. Civ. App. 2010).

TOPICS: Individual Income Tax – Out-Of-State Resident – Stock Sale

FACTS – The Taxpayer was a Mississippi resident and a shareholder in an Alabama "S" corporation, which was an internet service provider. The Taxpayer provided financing for the corporation. The other two shareholders, both Alabama residents, managed the corporation's day-to-day activities. In 1999, the Taxpayer sold all of his stock to an unrelated company, and had no further affiliation with the corporation. The stock sale occurred outside of Alabama.

COURT OF CIVIL APPEALS – In affirming the trial court's grant of summary judgment to the Department, the Court held that there was circumstantial evidence to support the lower court's finding that the parties to the stock sale had made an election pursuant to 26 U.S.C. § 338(h)(10) to treat the stock sale as a sale of corporate assets. The Court refused to apply the *Lanzi* decision, because the *Lanzi* opinion was a plurality. The Taxpayer applied for rehearing. The Court overruled the application on May 7, 2010. The Taxpayer petitioned the Alabama Supreme Court for cert review on May 20, 2010.

5. *ALABAMA DEPARTMENT OF REVENUE v. BOYD BROS. TRANSPORTATION, INC.*, Court of Civil Appeals (#2090276).

TOPICS: Conditional Sales – Trucks – Installment Payments – Purchase Option

ADMINISTRATIVE LAW JUDGE – #S. 08-329 -- The Taxpayer, a trucking company, provided drivers with trucks pursuant to two types of "lease-purchase" agreements. Drivers paid the Taxpayer a monthly amount over 3-5 years. One type of agreement required drivers to pay the fair market value of the trucks over the term of the agreement, and allowed drivers to purchase trucks at the end of the term for $1. Seventy drivers entered such agreements, but only four completed them and purchased the truck for $1. Taxpayer did not transfer title until the driver successfully completed the agreement. The Department took the position that those agreements were conditional sales subject to sales tax. The Taxpayer contended that the transactions were not sales, because title never passed to drivers (except in four instances), citing Ala. Code § 40-23-2 (a)(5). That section defines "sale" as "every closed transaction constituting a sale. Provided, however, a transaction shall not be closed or a sale completed until the time and place when and where title is transferred . . ."

The Administrative Law Judge noted that the transactions were either sales, in which case the Taxpayer would be subject to sales tax, or leases, in which case the Taxpayer would be subject to lease tax, unless the statute of limitations had expired. "The transactions in issue constituted conditional sales pursuant to the above authorities. The Taxpayer was in substance selling the trucks to the drivers at fair market value over time. In *Lawson State*, *supra*, the Alabama Supreme Court stated that 'the right . . . to purchase the equipment for a mere $1.00 at the termination of the lease constitutes an option to purchase at a 'nominal consideration,' and hence, the arrangement between those two parties is no mere bailment lease, but is instead a disguised conditional sale secured by a security agreement.' *Lawson State*, 529 So.2d at 929." Final Order p. 6. The Administrative Law Judge stated that the fact that legal title did not pass to the drivers in those situations where the drivers defaulted did not change the substance of the transactions, *i.e.*, that the transactions were conditional sales. Although a sale is not technically closed until title to the subject property is transferred, any sale proceeds paid by the buyer to the seller before transfer of title clearly constitute taxable gross receipts derived from the sale." Final Order p. 7.

BARBOUR CIRCUIT COURT – The court reversed the Administrative Law Judge, ruling that the lease-purchase agreements were incidental to the Taxpayer's business of hauling freight. Also, the court ruled that no sales occurred (on the sixty-six trailers) because title never passed to the lessees, citing Ala. Code § 40-23-1(a)(5). The court stated that the leasing of the trailers may be subject to the lease tax, but that that issue was not before the court. The Department appealed to the Court of Civil Appeals, and the parties recently finished briefing.

6. *LOGAN'S ROADHOUSE, INC. v. ALABAMA DEPARTMENT OF REVENUE*, Jefferson Circuit Court, # CV-2009-1930 (Final Judgment 4/2/10).

<u>TOPICS</u>: Use Tax – Peanuts Provided To Customers – Resale Or Promotion

ADMINISTRATIVE LAW JUDGE – # S. 08-700 (Final Order, 5/28/09) -- The Administrative Law Judge stated: "Taxpayer operates full-service restaurants in Alabama and other Southeastern states. It purchased peanuts at wholesale during the period in issue and then provided those peanuts at no charge to its customers. The issue is whether the Taxpayer is liable for Alabama use tax on its wholesale cost of the peanuts. If the Taxpayer was reselling the peanuts to its customers, then the Taxpayer correctly purchased the peanuts at wholesale and use tax is not due. If, however, the Taxpayer was not reselling the peanuts, use tax would be due on the Taxpayer's use of the peanuts." The Taxpayer purchased peanuts at wholesale, and provided them to its customers before, during, and after meals. Peanuts also were provided to those in restaurants who ordered no food. Taxpayer did not charge a specific price for the peanuts. The Taxpayer argued: "Peanuts were acquired in a wholesale sale (for resale) because the peanuts become part and parcel of the finished product the Taxpayer sells at retail to its customers in the ordinary course of business." The Taxpayer contends that it is reselling the peanuts to its customers because it considers the cost of the peanuts in the price it charges for its menu items, and also because title to the peanuts is transferred to its customers. The Taxpayer analogized this to packets of ketchup, mustard, etc., which are not taxed, according to testimony of the Department's examiner. The Administrative Law Judge ruled that use tax was due, because the Taxpayer was giving peanuts to patrons as a marketing or promotional item, and was not reselling peanuts to patrons.

CIRCUIT COURT – The Taxpayer appealed to the Jefferson Circuit Court, and the court reversed the Administrative Law Judge's ruling. The Taxpayer presented evidence that the cost of the peanuts was included in the price of a meal, although not shown on the check given to a customer. Thus, the Taxpayer's purchase of the peanuts was a wholesale transaction to which the use tax did not apply.

7. *TERRANCE D. LACH v. ALABAMA DEPARTMENT OF REVENUE*, Montgomery Circuit Court, # CV-2009-901197 (Order entered 2/2/10).

TOPICS: Individual Income Tax – IRS Adjustments – Statute of Limitations – Taxpayer Advocate

ADMINISTRATIVE LAW JUDGE – Docket # INC. 09-813 (Final Order Dismissing Appeal 9/14/09) -- The Department entered assessments based on IRS information that the Taxpayer had substantial income from stock sales. The Taxpayer appealed, but failed to respond to subsequent orders, so the Administrative Law Judge dismissed the appeal. Later, because of information provided by the Taxpayer, the IRS adjusted the Taxpayer's liability by reducing one assessment to zero and reducing the other assessment from $4.4 million to $8,800. The Taxpayer's accountant contacted the Department's Taxpayer Advocate, but was told that there was nothing that could be done because the Administrative Law Judge already had ruled on the years at issue. The Taxpayer filed a motion to have the Administrative Law Judge reconsider the matter, based on Ala. Code § 40-2A-7(b)(2)g.2., and the Administrative Law Judge docketed the motion as a new appeal. The Department moved to have the appeal dismissed. The Administrative Law Judge dismissed the appeal, because the Taxpayer did not file his request within the time for rehearing of his initial appeal. Also, the Administrative Law Judge noted that the special one-year rule cited by the Taxpayer only applied to a federal change that resulted in an overpayment of tax. Here, the Taxpayer had not paid the federal tax so, according to the Administrative Law Judge, there was no overpayment, and the one-year statute did not apply. The Administrative Law Judge opined, however, that the Taxpayer Advocate was not barred from considering the matter. The Taxpayer appealed to the Montgomery Circuit Court.

CIRCUIT COURT – The court ruled that the special one-year federal-change rule applied in this case, despite the fact that the Taxpayer had not already paid the tax in issue to the IRS. Therefore, the court ordered the Department to issue a Taxpayer Assistance Order in accordance with federal changes of the Taxpayer's liability.

8. *HENSLEY v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # INC. 09-1225 (Final Order 3/10/10).

TOPICS: Individual Income Tax – Deferred Compensation – Out-Of-State Residents

ADMINISTRATIVE LAW JUDGE – The Taxpayer lived in Alabama until 2000, working for Baptist Health System. The Taxpayer and his wife then moved to Tennessee, where they live currently. In 2008, the Taxpayer received deferred compensation from Baptist Health, and reported it on an Alabama non-resident return as non-Alabama sourced income. The Taxpayers attached a W-2 form showing Alabama tax withheld on the compensation, and requested a refund of that amount. The Administrative Law Judge ruled that the income was Alabama-sourced income, being earned by the Taxpayer while he lived and worked in Alabama, and thus was subject to Alabama income tax. On rehearing, the Taxpayer showed that the income was received from a tax-exempt pension plan, so the Department agreed to void the assessment.

9. *MILNER v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # INC. 09-472 (Final Order 2/25/10).

TOPICS: Individual Income Tax – Bad Debt – Factoring Agreement

ADMINISTRATIVE LAW JUDGE – The Taxpayer began a factoring business and entered into a factoring agreement with his brother's business, American Door & Molding. When American Door made a sale, the Taxpayer deposited the sale price, minus a fee, into the account of American Door. When American Door was paid the sale price by its customer, American Door deposited the full payment amount into the account of the Taxpayer. The Taxpayer profited initially, but American Door went out of business in 2007, because of serious illnesses of the Taxpayer's brother and his wife, and because of the housing industry's decline. In 2007, American Door used the sales receipts to pay operating expenses, instead of putting those receipts into the Taxpayer's account. Also that year, other creditors of American Door obtained judgments against the company and its operator, the Taxpayer's brother. The Taxpayer did not sue his brother to recover the amount due, because he knew his brother was financially destitute, and the Taxpayer did not want to incur the expense of litigation. The Taxpayer filed a return and claimed a bad-debt loss of $183,000 attributable to the failure of American Door to make payments. The Department questioned whether the debt had become worthless in 2007. The Administrative Law Judge reiterated that there must be some event that occurred in the tax year, such as a suit to collect the debt or a change in the financial position of the debtor, to allow the write-off. Despite the fact that the Taxpayer did not sue, there was ample evidence to show that the debt became uncollectible in 2007. Therefore, the deduction was allowed.

10. *MERCEDES-BENZ U.S. INTERNATIONAL, INC. v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # S. 09-519 (Final Order 2/24/10).

TOPICS: Sales Tax – Tooling Machines – Transfer Of Title

ADMINISTRATIVE LAW JUDGE – The Taxpayer manufactured automobiles in Alabama, and assembled the autos using parts obtained from suppliers. Those parts were made by the suppliers using tooling equipment that had been purchased by the suppliers from tooling vendors. At a certain point in the supply process, the suppliers transferred title to the tooling to the Taxpayer, and then leased the tooling back for a nominal amount. The issue was whether the transfer of the tooling to the Taxpayer constituted a taxable retail sale. The Administrative Law Judge discussed the time-consuming production process, and then noted that the reason title was transferred to the Taxpayer was to protect the tooling from the creditors of the supplier, if the supplier ever encountered financial trouble, according to a witness of the Taxpayer. Otherwise, the supplier had all incidents of ownership of the tooling, such as possession and use. Thus, the Taxpayer contended that it was not liable for sales tax, because there was no purchase of the tooling at retail by the Taxpayer. Instead, the Taxpayer contended that the suppliers purchased the tooling at retail from the tooling vendors, and then used the tooling in Alabama. Thus, the suppliers were liable for Alabama use tax on the use of the tooling. The Administrative Law Judge agreed.

11. *ACTION TRUCK CENTER, INC. and AAA COOPER TRANSPORTATION v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # S. 09-371 (Final Order 1/12/10).

TOPICS: Sales Tax – Truck Tractors – Interstate Commerce

ADMINISTRATIVE LAW JUDGE – AAA is a trucking company headquartered in Dothan, Alabama, and operating in multiple states. ATC is a retail motor vehicle dealer also based in Dothan. ATC sold 1055 trucks to AAA during the audit period, and the trucks were either delivered to AAA's headquarters in Dothan or were picked up by AAA from ATC's Dothan facility and taken to AAA's facility in Dothan. All of the 1,055 tractors were registered and titled in Alabama, and no drive-out certificates were executed. At the Dothan facility, decals were applied, and Alabama tags and titles were applied for. The tractors then were assigned to a AAA terminal, and were put into service hauling goods in interstate commerce. Of the 1,055 tractors, 835 were assigned to out-of-state terminals.

AAA paid applicable sales tax on the truck purchases, and ATC remitted the tax. The two entities filed a joint refund petition, claiming 1) that the sales were not subject to Alabama sales tax, and 2) that subjecting the sales to tax would violate the Commerce Clause. First, the Administrative Law Judge explained that the sales of the tractors were subject to Alabama sales tax because they were retail sales and because no drive-out certificates were executed. The fact that the 835 tractors were first used outside of Alabama and, thus, not subject to Alabama use tax, did not mean that the retail sales of those tractors in Alabama also were not subject to Alabama sales tax. The Administrative Law Judge also ruled that there was no Commerce Clause violation because there was no disparate treatment between in-state and out-of-state taxpayers, *i.e.*, such retail sales resulted in sales tax being due regardless of the state of residence of the taxpayer. The Taxpayer appealed to the Houston Circuit Court.

12. *KENNON R. & CAROLYN PATTERSON v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # INC. 06-1080 (Opinion & Preliminary Order on Taxpayers' App. For Rehearing 11/19/09).

<u>TOPICS</u>: Individual Income Tax – Bank Fraud – Dollar Value Of Services – Innocent Spouse

ADMINISTRATIVE LAW JUDGE – The husband was president and chairman of the board of a bank in Alabama, with salary and dividend income of $1.5 million per year. He spent $50,000 - $150,000 per month on work performed on their farm, and some of the work was fraudulently billed to and paid for by the bank. The husband currently is in federal prison. The Taxpayers conceded that the amounts paid by the bank for work performed was includable as income to them, but they contended that the amount was limited to the actual amount of labor ($834,000), instead of the higher amount attributable to labor, insurance, workers' compensation, overhead, and profit ($1.2 million), paid by the bank to contractors. Although the parties speculated at the hearing that the contractors would have billed the Taxpayers less than the contractors billed the bank, the Administrative Law Judge could not make such an assumption, and he upheld the $1.2 million amount as income to the Taxpayers. The Administrative Law Judge also granted the wife innocent-spouse relief.

13. *HELISPEC LLC, AND ITS MEMBERS v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # S. 08-661 (Final Order 7/24/09).

<u>TOPICS</u>: Use Tax – Painting Of Helicopters For Federal Government

ADMINISTRATIVE LAW JUDGE – The Taxpayer painted and refurbished military aircraft under contract with the U.S. government. The Department assessed the Taxpayer for State and Crenshaw County use tax. The Taxpayer argued that it should not be taxed on the paint that it used to paint helicopters belonging to the government, because the paint became a part of the helicopters and the government is tax-exempt. The Administrative Law Judge upheld the tax, however, because the Taxpayer was providing a service, and was not selling the paint to the government. Thus, the Taxpayer should have paid sales tax when it purchased the paint. Because it did not, the Taxpayer now owes use tax.

14. *CC DICKSON COMPANY v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # BIT 09-238, (Final Order 6/9/09).

TOPICS: Income Tax – Federal Income Tax Paid Deduction

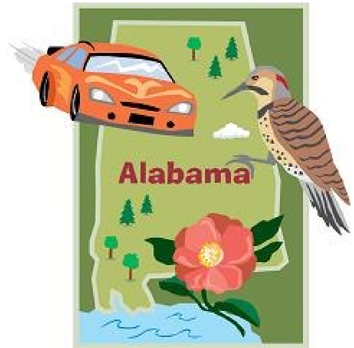
ADMINISTRATIVE LAW JUDGE – The Taxpayer's conversion from a "C" corporation to an "S" corporation caused the Taxpayer to recapture a $16 million LIFO deduction for federal purposes on its 2007 federal return. The recapture resulted in additional federal income tax due of $6.6 million, which federal law allowed the Taxpayer to repay in 4 equal installments, beginning in 2007. The Taxpayer deducted the full $6.6 million on its 2007 Alabama return as "[f]ederal income tax paid or accrued" during the taxable year, pursuant to Ala. Code § 40-18-35(a)(2). The Department disallowed the amount that was not actually paid in 2007, and argued that a full deduction would result in an unfair amount in relation to the income reported for that year. Nevertheless, the Administrative Law Judge ruled that the Taxpayer was entitled to the full deduction, because the statute allowed a deduction for amounts "paid or accrued."

15. *CAPITOL MACHINE & EQUIPMENT CO. LLC & ITS MEMBERS: SUN ENTERPRISES LLC, ROBERT W. SHIVER v. ALABAMA DEPARTMENT OF REVENUE*, Administrative Law Division, # S. 08-619 (Final Order, 4/20/09; Final Order on Rehearing, 6/9/09).

TOPICS: Sales Tax – Machine Rate – Liability Of Individual Members Of Limited Liability Companies

ADMINISTRATIVE LAW DIVISION – The Taxpayer manufactures and sells pneumatic insulation blowing machines, and sells the machines primarily to industrial contractors, who use machines to blow loose-fill and wet-spray insulation. The Administrative Law Judge ruled that machines qualify for the reduced machine sales-tax rate of 1½%, because the machines "process" compacted insulation into the intended final use. The Administrative Law Judge ruled that members of a limited liability company are not personally liable for taxes owed by the entity, besides income tax, because Ala. Code § 10-12-20(a) provides that members are not personally liable for the debts of a limited liability company. The Administrative Law Judge concluded that *Bayside Tire & Exhaust, LLC v. State, ALD*, W. 98-272 (10/13/98), was decided incorrectly, but that members still could be held liable for the 100% penalty in Ala. Code §§ 40-29-72 and 40-29-73.

REHEARING – The Department applied for rehearing, claiming that all other issues were moot because of the ruling that the sales at issue were subject to the reduced machine rate. Therefore, the Department asked that the discussion of the other issues be removed from the Administrative Law Judge's order. The Administrative Law Judge complied, except to one question concerning whether the 6-year statute of limitations applied to the entry of a preliminary assessment.



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The "True Object" Test v. Technology

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Given the growth of the service industry, the "true object" (or "essence of the transaction") test continues to play an important role in determining the taxability of "mixed transactions"—transactions involving both taxable and nontaxable business activities that are not separable. Most commonly, mixed transactions involve the taxable sale of tangible personal property and the nontaxable provision of services. Under the test, if the true object of the transaction is the transfer of tangible personal property, the entire transaction is taxable. If the true object of the transaction is the provision of nontaxable services, the entire transaction is not taxable.

While the test may sound simple, its application is often anything but. Courts have long struggled with the inconsistent application of the test and have developed their own factors in applying it. In the Missouri Supreme Court's recent decision in *Western Blue Print Co. v. Director of Revenue*,[1] the taxpayer prevailed under the court's "true object" analysis. While the Missouri Supreme Court reached the correct decision, the factors applied by the court may become less relevant in the future as technology advances.

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Bright-line rules about the true object of a transaction that once seemed clear are now questionable given the expansion of YouTube, iTunes, the Kindle, and the iPad. Until the legislation catches up with technology, the courts may need to reexamine their reliance on outdated tests.

Western Blue Print Co. v. Director of Revenue

In *Western Blue Print Co.*, the Missouri Supreme Court applied the "true object" test to the "electronic scanning of paper documents onto CDs."[2] Western Blue Print Co.'s customers provided the company with documents they wanted to view in an electronic format. Western Blue Print scanned images of the documents onto CDs and returned the documents and CDs to its customer. The main issue was whether the real object sought by the buyer was the CD or the intangible information on the CD. To resolve the issue, the court looked at Missouri Supreme Court precedent.

Missouri Supreme Court Precedent

James v. TRES Computer Systems, Inc.[3] involved the sale of custom-made computer software on magnetic tapes. The court held that the company's sales were not taxable, other than the $50 value of the tapes already remitted, because the intangible data on the tapes, not the tapes themselves, was the ultimate object of the sale. The court reasoned that the tapes were not important to the transaction because: (1) the tapes could be thrown away after the buyers downloaded the information; and (2) the information could have been sent electronically or on any other tangible form instead of on tape. The tapes themselves were "mere conduits or containers" for the real object of the transaction, the intangible data.

In *K&A Litho Process, Inc. v. Director of Revenue*,[4] the company received film transparencies that it used to create a color key by separating the colors in the transparency onto a sheet of film. The company then sold the color key and the film to printers who used the objects to create plates for printing photographs. After creating the plate, the printers threw away the color key and film. The court held that the sale of the color key and film to the printers was not taxable because the true object of the sale was not the tangible personal property but the company's skill in producing the objects. The court reasoned that the tangible items were just the media of transfer for the transparency colors and, once used, were of no further value. The tangible items were merely a "segment of a larger production operation" that did not render the transactions taxable sales.

Gammaitoni v. Director of Revenue[5] involved the sale of original and duplicated videotapes containing instructional seminars, depositions, and accident reconstructions. The court held that the sales were taxable because the ultimate object of the transaction was the finished videotapes and not the services rendered in making the videotapes. The court reasoned that the buyers already had the information they needed to make the tapes; they just wanted the company to put the information on tape so that others could view it.

In *Universal Images v. Department of Revenue*,[6] the company produced custom advertisements for businesses that were played in movie theaters. The advertisements were produced on films that were then played repeatedly at one or more theaters over a period of time. The court held that the transaction was subject to use tax because the finished film—tangible personal property—was the true object of the sale and was being stored or used in the state.

Application to *Western Blue Print Co*.

The Missouri Supreme Court reasoned that Western Blue Print Co.'s CDs, like the tapes in *TRES*, were mere conduits of data that could be discarded after the data was downloaded to a customer's computer. The court noted that the transactions fell into a category of transactions in which "tangible personal property 'serves only as the medium of transmission for an intangible product or service' " and thus were not taxable. Additionally, the Missouri Supreme Court held that like the color key and film in *K&A Litho Process*, the CDs were only a "segment of a larger production operation."

The court distinguished Western Blue Print Co.'s operations from the facts in *Gammaitoni* and *Universal Images*. Unlike *Gammaitoni*, where the service of manufacturing the tapes was incidental to the sale of the videotapes, Western Blue Print Co.'s CDs were incidental to the intangible data on the CDs. Unlike *Universal Images*, where the customers bought a finished product, the customers in *Western Blue Print* bought the conversion of their data into electronic format as a medium of transmission, not a finished product—the customers will presumably discard Western Blue Print Co.'s CDs once the information is transferred to their computers.

Comment

The Missouri Supreme Court considers several factors when analyzing a transaction under the "true object" test: (1) whether the buyer wants the intangible data/service/skill or the finished product; (2) whether the medium of transfer is of further use to or retained by the buyer after downloading/playing; and (3) whether the information could have been sent by means other than tangible personal property.

From the above cases, it appears that a distinction exists between information that can be sent electronically and information that is not sent electronically (or rather was not sent electronically when those cases were decided), such as movies, records, and books.

This distinction may be outdated in today's world where many forms of media are bought and sent electronically. In 1982, *TRES* emphasized that tapes containing computer software differed from movie films, records, and books in that the data on the tapes could be stored on any form, whereas films, records, and books were the only practicable ways of preserving those types of media. Further, according to *TRES*, "while those articles and the tapes are similar in that they physically represent the transfer of ideas or artistic processes, a more significant distinction is that those articles are inseparable from the ideas or processes, whereas computer programs are separable from the tapes." In 1982, however, the personal computer was in its infancy and the iPad was not yet the apple of its creators' eye.

Given that today movies, CDs, and books are sent, read, and listened to electronically with the help of YouTube, iTunes, the Kindle, and the iPad (to name but a few), it may be harder to argue that the medium is really inseparable from the ideas. While the "true object" test continues to play an important role in determining the taxability of mixed services, until the legislation catches up with technology, the courts may need to reexamine the factors they use to apply the test.

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[1] No. SC 90172 (Mo. 2010). ^TOP
[2] No. SC 90172 (Mo. 2010). ^TOP
[3] 642 S.W.2d 347 (Mo. 1982). ^TOP
[4] 653 S.W.2d 195 (Mo. 1983). ^TOP
[5] 786 S.W.2d 126 (Mo. 1990). ^TOP
[6] 608 S.W.2d 417 (Mo. 1980). ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

DELAWARE

Appeals and Exemptions in Delaware (Maybe), Amnesty in Indiana, and Other Breaking News in Unclaimed Property Legislation

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We have been tracking a number of changes to state unclaimed property laws over the last few months, both big and small. The Delaware General Assembly, for example, recently considered a bill that would, among other things, provide holders an administrative appeals process following an audit. If enacted, the Delaware legislation would also provide a limited exemption for uninvoiced payables—an issue that has been hotly debated around the country. Outside Delaware, many states have been reconsidering the treatment of gift cards and other types of property. These and other recent changes in state unclaimed property laws, including Indiana's amnesty offer, are highlighted below.

Possible Changes on the Horizon in Delaware

A common complaint regarding Delaware's unclaimed property laws is that the state does not provide holders an independent administrative appeals process following an unclaimed property audit. This concern is addressed in S.B. 272, 145th Gen. Assem. (Del. 2010), introduced on May 13, 2010, which would make several significant changes to Delaware's unclaimed property law (Chapter 11, Title 12, of the Delaware Code), including adding a process for

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appeals.

Section 1 of S.B. 272 would amend Section 1156 of the Delaware unclaimed property laws to include a new administrative review process following an audit. [1] Under the new procedures, a holder would have 30 days from the issuance of a statement of findings to file a written protest with the audit manager setting forth the property types and amounts of abandoned or unclaimed property being protested and the specific grounds of the protest. Any asserted liability that is not being protested would need to be remitted along with the protest. The holder will be permitted to submit additional documentation and written materials for consideration by the audit manager; however, only issues raised in the protest will be considered. This first level of internal reconsideration by the audit manager is intended to expedite the resolution of disputed items.

The audit manager is expected to issue a written determination on the protest, after which the holder will have 30 days to file a notice of appeal with the Secretary of Finance. The holder's appeal would then be assigned to an "independent reviewer." The independent reviewers (who will be former Delaware judges, former masters of any Delaware court, and qualified Delaware licensed attorneys), although not employed by the Department of Finance, would be appointed by the Secretary of Finance. The proposed legislation provides that appeal to the reviewer will be *de novo* on the record created before the audit manager. The independent reviewer will hold an oral hearing on the appeal and issue a written decision, which the Secretary of Finance may adopt or reject in whole or in part.

Also of note, Section 2 of S.B. 272 would create a limited exemption from the definition of unclaimed property for uninvoiced payables between merchants. The limited exemption would generally cover: (i) amounts due for goods ordered and received by the holder that were never invoiced by the seller; (ii) the value of goods received by a holder where the amount ordered and the amount received do not match; and (iii) unsolicited goods received by a holder. This reporting exemption would not extend to accounts payable, accounts receivable, or any other type of credit due to a creditor. The proposed law does not create a general business-to-business exemption. If enacted, uninvoiced payables exemption would apply to all pending examinations and litigation as of the date of enactment. S.B. 272, Section 13(b). This exemption would help clarify one of the more contentious areas in Delaware's unclaimed property policy.

S.B. 272 would also codify the State Escheator's long-held belief (and current audit practice) that it has "inherent authority" to estimate liability when adequate records do not exist. S.B. 272 would add a new clause to Section 1155 of the Delaware unclaimed property laws indicating that the State Escheator may reasonably estimate the amount due "on the basis of any available records of the holder or by any other reasonable method of estimation." S.B. 272, Sections 3 and 4.

Although it contains some less than ideal provisions, S.B. 272 also adds some helpful and needed provisions. The bill is working its way through the General Assembly and was reported out of the Delaware Senate Banking Committee following a hearing on June 2, 2010. The General Assembly adjourns on June 30, 2010, however, so any action on the bill will need to occur soon.

Indiana Offers Amnesty

Companies with delinquent unclaimed property reporting obligations in Indiana are encouraged to consider the amnesty program being offered by the state. Indiana is offering a one-time amnesty program to allow noncompliant businesses to come into compliance in exchange for the waiver of penalties and interest.[2] Amnesty is available to any business that meets the following qualifications:

• The business is not currently under examination by the state.

• The business has not been notified by the state of its intent to conduct an unclaimed property examination of the business's books and records.

• The business or its principals are not presently in arrears in payment of taxes; permit fees; or other statutory, regulatory, or judicially required payments to the state, including the Office of the Attorney General's Unclaimed Property Division.

• The business warrants that it has no current, pending, or outstanding criminal, civil, or enforcement actions initiated by the state.

Indiana's offer extends to businesses that have unreported unclaimed property which should have been reported currently or in prior years and to businesses that have not reported "in full compliance" with the state's unclaimed property laws.[3]

An eligible business seeking to take advantage of the program has until November 1, 2010, to: (i) download and complete an amnesty agreement;[4] (ii) audit its books and records and file a report of findings for the prior 10 years (or for as long as the company has been in business if less than 10 years); (iii) file a report for the current year; and (iv) remit (on the forms provided by the state) all funds and shares due to the state.

Gift Cards Remain a Hot Topic

The appropriate treatment of gift cards remains an area of concern for many states. Recently, South Dakota, Indiana, Colorado, and Washington each adopted changes to their unclaimed property or consumer protection laws that impact state treatment of gift cards.

South Dakota, for example, recently amended its unclaimed property laws to exempt certain types of gift cards. South Dakota S.B. 81, 85th Leg. Sess. (S.D. 2010), signed by the Governor on March 29, 2010, amends Chapter 43-41B of the South Dakota Codified Laws to exempt from the state's unclaimed property provisions open-loop prepaid cards if: (i) the cards have no expiration date; and (ii) the issuer's records do not list the card owner's identity. An "open-loop prepaid card" is defined as an electronic payment device that: "(1) [i]s purchased or loaded, or both, on a prepaid basis for the future purchase or delivery of any goods or services, and (2) [c]an be used to purchase goods and services at multiple unaffiliated merchants or service providers." S.B. 81 also exempts any rewards cards issued pursuant to an awards, loyalty, or promotional program for which no money was paid by the cardholder. Notably, S.B. 81 provides that only the card purchaser or owner has rights to an unredeemed open-loop prepaid card or rewards card and that such cards are not subject to any claims made by any state acting on behalf of the purchaser or owner.

Indiana also amended its unclaimed property laws relating to the treatment of gift certificates and gift cards. Unlike the South Dakota amendment, the Indiana amendment merely clarified existing law as it applies to gift cards and gift certificates. H.B. 1083, 116th Gen. Assem., 2nd Reg. Sess. (Ind. 2010), amends Indiana Code § 32-34-1-17 to remove "gift certificates" from the definition of "property." The amendment removes any inconsistency between the "property" definition and Indiana Code § 32-34-1-1(f), which provides that "[t]his chapter does not apply to gift certificates or gift cards."

Missouri is also currently considering a bill that would exempt "gift certificates" from the state's unclaimed property laws. Missouri H.B. 1522, 95th Gen. Assem., 2nd Reg. Sess. (Mo. 2010), would create a new statute, Mo. Rev. Stat. § 407.1175, providing that no "gift certificate" would be considered abandoned for purposes of the state's unclaimed property law. "Gift certificate" would be generally defined as "any tangible record evidencing a promise by the seller or issuer of the record that goods or services will be provided to the owner of the record to the value shown in the record" and will include a gift card, stored-value card, store card, or similar record or card. "Gift certificate" would not include certificates distributed under an awards, loyalty, or promotional program for no consideration or certain certificates sold below face value at a volume discount to employers or to nonprofit and charitable organizations. The bill would also prohibit gift certificates that are subject to expiration dates or service fees.

While the states mentioned above addressed the treatment of gift cards in their unclaimed property laws, several states also recently addressed the treatment of gift cards and similar property through amendments to the states' consumer protection and business reporting laws. *See, e.g.*, Colorado S.B. 10-155, 67th Gen. Assem., 2nd Reg. Sess. (Colo. 2010) (amending Colo. Rev. Stat. § 6-1-722); Colorado H.B. 10-1114, 67th Gen. Assem., 2nd Reg. Sess. (Colo. 2010) (amending Colo. Rev. Stat. § 11-102-305); Kentucky S.B. 83, 2010 Reg. Sess. (Ky. 2010) (amending Ky. Rev. Stat. § 367.890); Washington S.B. 6371, 61st Leg., 2010 Reg. Sess. (Wash. 2010) (amending Wash. Rev. Code 19.230).

The recent legislative activity relating to gift and rewards cards shows states taking a more sophisticated approach to this type of property by distinguishing between types of cards and the manner in which the cards are issued. You can expect to see more states refine their treatment of gift cards in this manner, which could have ramifications for unclaimed property reporting in the future. We may also see a continued push for federal rules on gift cards. *See, e.g.*, Connecticut Senate Joint Res. No. 4 (2010) (calling on Congress to pass federal legislation specifically authorizing states to impose consumer protection laws on gift cards issued through national banks).

Other Notable Items

Arizona 2009 Supplemental Report: In November 2009, the Governor of Arizona signed a bill (S.B. 1003, 49th Leg., 4th Spec. Sess. (Ariz. 2010)) significantly reducing dormancy periods for 15 property types. In conjunction with these amendments, Arizona required that holders file a supplemental 2009 report that included property reportable as of June 30, 2009 under the new law. The required report was due on or before June 1, 2010. Companies that missed the June 1st deadline should complete the required due diligence and file the supplemental report as soon as possible. While the Arizona Unclaimed Property unit is not permitted to grant extensions to the June 1 due date, we have been informed that Arizona does not intend to impose penalties or interest on delinquent June 1 reports. The regular annual reports are due November 1 as always.

Arizona Increases Dormancy Periods: Reversing 2009 legislation that reduced the dormancy periods for several property types, Arizona has again amended Arizona Revised Statutes § 44-302. H.B. 2111, 49th Leg., 2nd Reg. Sess. (Ariz. 2010), effective July 29, 2010, increases the dormancy period for traveler's checks to 15 years, reversing the 2009 amendment that reduced the dormancy period to just three years. H.B. 2453, 49th Leg., 2nd Reg. Sess. (Ariz. 2010), also effective July 29, 2010, raises the dormancy periods from two years to three years on (i) stocks; (ii) the principal and interest on most business debt; and (iii) any dividend, profit, distribution, interest, redemption, payment on principal, or other sum owed to shareholders, certificate holders, members, bondholders, or other security holders.

Indiana Reduces Dormancy Periods: H.B. 1083, 116th Gen. Assem., 2nd Reg. Sess. (Ind. 2010), amends Indiana Code § 32-34-1-20 to decrease the dormancy period from five years to three years for the following property types: (i) demand, savings, or matured time deposits; (ii) property payable as a result of the demutualization, rehabilitation, or related reorganization of a mutual insurance company; and (iii) all other property types not specifically listed in Section 32-34-1-20. The amendments are effective July 1, 2010.

Oregon Requires Separate Delivery of Funds in Lawyer Trust Accounts: A new provision in Oregon's reporting rules effective January 1, 2010, requires amounts identified as lawyer trust account funds in a holder's abandoned property report to be delivered by the holder to the Oregon State Bar along with a copy of the report. Or. Rev. Stat. § 98.386(2). The State Bar is authorized to use the funds to fund the state's Legal Services Program, which provides legal services to the poor, and to pay property owner claims. Or. Rev. Stat. §§ 9.572, 98.386(2). Claims filed by owners of lawyer trust account funds will be forwarded by the Department of State Lands to the Oregon State Bar for review and payment. Or. Rev. Stat. § 98.392(2).

Florida Incorporates Its Reporting Manual Into the State's Regulations: The Florida Department of Financial Services has incorporated its 57-page unclaimed property reporting instruction manual into the state's administrative rules. Fla. Admin. Code § 69I-20.041 requires holders to follow the procedures in the Florida Unclaimed Property Reporting Instructions Manual, effective May 3, 2010. The manual is available at www.fltreasurehunt.org/Reporting-Instructions.jsp.

Idaho Transfers Administration Duties: Effective July 1, 2010, Idaho has transferred the responsibility for administering its unclaimed property laws from the State Tax Commission to the State Treasurer. H.B. 680, 60th Leg., 2nd Reg. Sess. (Idaho 2010). Idaho has also passed a bill requiring electronic reporting for 10 or more items of unclaimed property and authorizing the waiver of interest and penalties for holders who report in good faith. H.B. 385, 60th Leg., 2nd Reg. Sess. (Idaho 2010).

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[1] The review process will be available to audits completed after the date the bill is enacted. S.B. 272, Section 13(a). ^TOP

[2] The Indiana Attorney General announced the program in a public notice available at ucp.indianaunclaimed.com/attorneygeneral/ucp/newsRoom.html (all web sites herein last visited June 9, 2010). ^TOP

[3] See Amnesty Program FAQs at ucp.indianaunclaimed.com/attorneygeneral/ucp/amnesty.html#3. ^TOP

[4] ucp.indianaunclaimed.com/attorneygeneral/ucp/files/Unclaimed%20Property%20Amnesty%20Agreement.pdf. ^TOP

JONES DAY STATE TAX RETURN NEWSLETTER

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Redefining the Sale-for-Resale Exemption

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Courts in Alabama, Missouri, and Texas have recently considered the scope of the sale-for-resale exemption from sales tax. At first glance, the sale-for-resale exemption may appear straightforward, but the structure and taxability of the resale transaction can affect the exempt status of the original sale.

Alabama's Complimentary Nuts

On April 2, 2010, an Alabama circuit court held in *Logan's Roadhouse, Inc. v. Ala. Dep't of Rev.*[1] that a restaurant chain did not owe use tax on the wholesale cost of peanuts subsequently provided to its customers. Logan's Roadhouse, Inc. ("Logan's") offers buckets of complimentary peanuts in its restaurants and allows customers to eat the peanuts before, during, and after their meals. Logan's even permits guests who do not order anything from the menu to consume the peanuts. The Department of Revenue (the "Department") assessed Logan's for use tax on the wholesale price of the peanuts purchased for consumption at its restaurants. Logan's appealed the assessments, arguing that the peanuts were not subject to use tax because they were subsequently "sold" to customers.[2] Logan's asserted that it took the cost of the peanuts into account when setting menu prices and that title to the peanuts passed to customers upon consumption.

Upon administrative review, an administrative law judge (the "ALJ") disagreed with Logan's and affirmed

SCHEDULE

the assessments.[3] The ALJ held that Logan's did not sell the peanuts to its customers; rather, Logan's used the peanuts "as a marketing or advertising tool to entice customers into its restaurants."[4] Relying on case law from other states,[5] the ALJ refused to accept Logan's argument that the peanuts became an integral part of the menu items, pointing out that the complimentary nuts were provided to all customers regardless of whether they actually purchased anything from the menu.

Upon review, the circuit court reversed the administrative decision, finding that Logan's "sold" the peanuts at retail and therefore was not liable to remit use tax.[6] The court accepted Logan's argument that a nonseparately stated charge of $0.09 per meal amounted to consideration for the transfer of the peanuts. The court reasoned that whether they knew it or not, customers "paid" for the peanuts, similar to condiment packets in fast-food restaurants, which are deemed by the Department to be "sold" to customers as part of the menu items.[7]

Just Plain Nuts

The Department has appealed the circuit court's decision. Whether providing a complimentary nonmenu food item to customers constitutes a retail sale is an issue of first impression in Alabama. Logan's presented evidence that it considers the cost of the peanuts when fixing menu prices, yet a customer may consume the peanuts without purchasing anything. It will be interesting to see where the Alabama Court of Civil Appeals comes out on this issue.

Missouri's Lack of Charity

Last year, the Missouri Supreme Court issued two opinions, both of which narrowed the sale-for-resale exemption. In *ICC Management, Inc. v. Dir. of Rev.*,[8] the court refused to apply the resale exemption to sales of items that were later resold to tax-exempt municipalities. Shortly thereafter, the court held in *Music City Centre Management, LLC v. Dir. of Rev.*[9] that a theater was liable for sales tax on its sale of tickets to local businesses if the tickets were subsequently given to customers who took time-share tours. In both opinions, the court's reasoning was that "[t]he resale exemption applies only where the item purchased is later subject to a taxable sale at retail."[10]

Remedial Measures

The Missouri General Assembly responded earlier this year by enacting legislation that abrogates the two decisions.[11] Senate Bill 928, which was signed by the Governor and became effective on May 12, 2010, adds a new statutory provision addressing the sale-for-resale exemption.[12] The new statute generally provides that a sale for resale will not be subject to sales tax, provided such subsequent sale is (1) subject to tax in Missouri or any other state, (2) for resale, (3) excluded from Missouri sales tax, (4) subject to but exempt from Missouri sales tax, or (5) exempt from the sales tax laws of another state, if the subsequent sale is in such other state.[13]

Also of note, the statute treats charges for admission or seating accommodations at places of amusement, entertainment, or recreation and charges for rooms, meals, and drinks at places that regularly serve such items to the public differently from all other transactions.[14] Operators of such places must remit tax on the gross receipts that they receive, and subsequent sales will not be subject to tax if the sales are arm's length transactions for fair market value with unaffiliated entities.[15]

Senate Bill 928 is an example of the legislature stepping in to correct what it perceives as an ambiguity in the former law. The newly enacted legislation appears to be the more reasonable and appropriate application of the Missouri sales tax law.

Texas's Rule of Substantial Consideration

The Austin Court of Appeals recently held in *Laredo Coca-Cola Bottling Co. v. Combs*[16] that a distributor's provision of soda fountain equipment to a retailer free of charge in exchange for a minimum-purchase commitment does not constitute a resale of the equipment for purposes of the sale-for-resale exemption under Section 151.302 of the Texas Tax Code. Although the court read the statute correctly, query whether the taxpayers may have qualified for the exemption based on the true intent and essence of the transaction.

Coca-Cola Enterprises, Inc.[17] and Laredo Coca-Cola Bottling Company (the "Distributors"), appellants in the case, distribute branded soft drinks and sell various soda products, including syrup, carbon dioxide, cups, and straws, to retailers for use in providing fountain soft drinks. The Distributors also lease soda fountain equipment or provide it for no separately stated charge under commitment agreements with retailers that agree to purchase a minimum amount of soda products from the Distributors and to use only the Distributors' products in connection with the fountain equipment. The Distributors retain ownership of the equipment, but the retailers "assume liability for any damage or loss to the equipment."[18]

The Distributors filed sales tax refund claims totaling $750,632 for the period January 1, 1990, through June 30, 1996. The Distributors asserted that their purchases of the fountain equipment subsequently provided to retailers under commitment agreements were exempt from sales tax as sales for resale. The Texas Comptroller of Public Accounts (the "Comptroller") denied the refund claims, and the Distributors filed suit in district court. Both parties moved for summary judgment. The district court granted the Comptroller's motion on March 6, 2009, and the Distributors appealed.

The Austin Court of Appeals upheld summary judgment in favor of the Comptroller, holding that the sale-for-resale exemption applies only when an item is purchased and subsequently transferred to another for consideration. The court rejected the Distributors' arguments that the contractual terms of the commitment agreements constituted consideration for the provision of the fountain equipment.

Specifically, the Distributors argued that the commitment for minimum purchase, exclusive use, and assumption of risk-of-loss provisions in the retailers' agreements amounted to consideration (*i.e.*, a detriment to the retailers) for the transfer of the equipment. The court disagreed, noting that the Distributors did not charge a premium on product prices to retailers under the commitment agreements and did not restrict the sale of competitor products by the retailers. Further, the Distributors' remedies for breach were limited to repossessing the equipment or charging rent prospectively. The Distributors had no right to recover the amounts by which product orders fell short of the commitments.

Finally, although the risk of loss passed to the retailers, there was no evidence that they were required to carry additional insurance or that the Distributors actually enforced this provision. The court viewed the above requirements as either no consideration or, at most, consideration for the soda products rather than the fountain equipment. Thus, the transfer of the equipment was not supported by consideration and did not constitute a "sale" for purposes of the sale-for-resale exemption.

Lines in the Texas Sand Define Consideration Under Chapter 151

Each "sale" of a taxable item in Texas is subject to sales tax.[19] To constitute a "sale," the "transfer of title or possession of tangible personal property" must be "done or performed for consideration."[20] Although "consideration" is not defined under the Texas Tax Code, the Austin Court of Appeals stated in *Laredo Coca-Cola Bottling*, "Consideration can be either a benefit to the promisor or a loss or detriment to the promisee, and surrendering a legal right represents valid consideration."[21] Apparently, the benefit of exclusivity of sales from the machines, the detriment of risk of loss, and other good and valuable consideration in the committee agreement didn't draw a deep enough line in the sand to constitute relevant consideration.

The Comptroller previously grappled with the concept of consideration in somewhat similar situations. The Comptroller has issued several decisions and rulings as to the taxability of "hostess rewards"—incentives provided to independent contractors who host sales parties on behalf of direct sellers. If sellers "give" credit vouchers, "hostess dollars," "hostess rewards," or similar items to hostesses based upon the volume of goods sold at the hostesses' parties, and the hostesses later redeem the credit vouchers for "free" goods, then the subsequent acquisition of the "free" goods is considered a sale for consideration, and the sales tax applies to the retail price of the goods.[22] Since the direct-sale companies benefit from the hostesses' services, such services are treated as consideration for the transferred credits that the hostesses later use to "purchase" goods.[23]

In contrast, goods that are provided to hostesses free of charge simply for hosting parties, regardless of the volume of sales at those parties, are treated as gifts.[24] As such, the "hostess free goods" are subject to use tax paid by the transferors rather than sales tax paid by the transferees.[25]

The Texas Winds Continue to Blur the Lines in the Sand

Might the outcome have been different in *Laredo Coca-Cola Bottling* if the Distributors had been provided with credit vouchers to be used toward the lease of the fountain equipment? Perhaps the lines in the sand would have looked differently and the transfer of the equipment would have qualified as a "sale," such that the Distributors could have qualified for the sale-for-resale exemption on their original equipment purchases.[26]

Conclusion

To qualify for the resale exemption, a taxpayer purchasing items for resale must ensure that the subsequent transfer constitutes a "sale" of the item (*i.e.*, for consideration). If the subsequent transfer is not a "taxable sale," the taxpayer may be liable for sales or use tax on the cost of the transferred item. The contrasting opinions recently handed down by Alabama in *Logan's Roadhouse* and by Texas in *Laredo Coca-Cola Bottling* courts illustrate the hidden complexities of the sale-for-resale exemption. Furthermore, legislatures, like the Missouri General Assembly, often enact legislation to remedy a perceived judicial error in the application of resale exemptions. Taxpayers should be aware of these recent refinements and plan accordingly in order to avoid unwanted liabilities.

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[1] No. CV-09-1930 (10th Jud. Cir. Ct. Apr. 2, 2010). ^TOP

[2] Alabama law defines a "wholesale sale" as a sale to a licensed retailer for resale. ALA. CODE § 40-23-1(a)(9). Wholesale sales (i.e., sales for resale) are not subject to sales tax. However, if the taxpayer does not subsequently resell the item that was originally purchased at wholesale, the taxpayer owes use tax on the wholesale price of the item. *See id.* § 40-23-61(a). ^TOP

[3] Logan's Roadhouse, Inc., No. S. 08-700, slip op. at 11 (Ala. Dep't of Rev. May 28, 2009). ^TOP

[4] *Id.*, slip op. at 8. ^TOP

[5] The ALJ cited a line of cases addressing whether fast-food restaurants were reselling certain nonfood items that they transferred to customers along with food items. *See In re Burger King, Inc. v. N.Y. State Tax Comm'n*, 416 N.E.2d 1024 (N.Y. 1980) (holding that hamburger wrappers, beverage cups, and French fry sleeves were "a critical element of the final product sold to customers. So regarded, the packaging material is as much a part of the final price as is the food . . ."); *Celestial Food of Massapequa Corp. v. N.Y. State Tax Comm'n*, 473 N.E.2d 737 (N.Y. 1984) (holding that "[u]nlike the packaging in Burger King, the [napkins, straws, stirrers, plastic utensils, and similar items] respondent here seeks to exclude from sales tax are not a critical element of the product sold . . ."). ^TOP

[6] *Logan's Roadhouse, Inc. v. Ala. Dep't of Rev.*, No. CV-09-1930, slip op. at 3 (10th Jud. Cir. Ct. Apr. 2, 2010). ^TOP

[7] *Id.* ^TOP

[8] 290 S.W.3d 699 (Mo. 2009). ^TOP

[9] 295 S.W.3d 465 (Mo. 2009). ^TOP

[10] *ICC Management*, 290 S.W.3d at 699. ^TOP

[11] S.B. 928, 95th Gen. Assem., 2nd Reg. Sess. (Mo. 2010). ^TOP

[12] MO. REV. STAT. § 144.018. ^TOP

[13] *Id.* § 144.018(1). ^TOP

[14] *Id.* § 144.018(2)–(3). ^TOP

[15] *Id.* This is essentially a "reverse" sale-for-resale exemption. ^TOP

[16] No. 03-09-00157-CV, 2010 WL 1507819 (Tex. App.—Austin Apr. 15, 2010, no pet. h.). ^TOP

[17] Appellant Coca-Cola Enterprises, Inc., is the successor to Coca-Cola Bottling Company of Texarkana and Austin Coca-Cola Bottling Company. ^TOP

[18] *Laredo Coca-Cola Bottling*, 2010 WL 1507819, at *1. ^TOP

[19] TEX. TAX CODE ANN. § 151.051(a). ^TOP

[20] *Id.* § 151.005(1). ^TOP

[21] *Laredo Coca-Cola Bottling*, 2010 WL 1507819, at *4 (citing *Northern Natural Gas Co. v. Conoco, Inc.*, 986 S.W.2d 603, 607 (Tex. 1998)). ^TOP

[22] *See, e.g.*, Tex. Policy Ltr. Rul. No. 200911504L (Nov. 18, 2009). ^TOP

[23] *See, e.g.*, *id.* ^TOP

[24] *See* Tex. Comptroller's Decision No. 38,184 (Oct. 14, 1999); Tex. Policy Ltr. Rul. No. 200911504L. ^TOP

[25] *See* Tex. Comptroller's Decision No. 38,184; Tex. Policy Ltr. Rul. No. 200911504L. ^TOP

[26] The Distributors would still have been liable to remit sales tax on the retail price (*i.e.*, the retail rent rate) of the fountain equipment when provided to the retailers, but the Distributors could have passed this

tax along to the retailers at that time. ^TOP

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JONES DAY STATE TAX RETURN NEWSLETTER

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Washington's 2010 B&O Tax Law Changes

WASHINGTON

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This year, the State of Washington made several significant changes to the business and occupation ("B&O") tax in an effort to raise revenue and ease compliance. The following changes were all enacted by Second Engrossed Substitute Senate Bill 6143, which was signed into law on April 23, 2010, by Governor Christine Gregoire and is expected to raise approximately $318 million in taxes for fiscal year 2011.

Economic Nexus

According to the Washington Legislature, out-of-state businesses without a physical presence in the state earn significant income from in-state residents by providing services or collecting royalties on the use of intangible property in the state.[1] The economic nexus provisions, which apply to "apportionable activities," including activities falling under the "services and other activities" category and receiving income from intangible property, are an attempt to extend the B&O tax to such businesses.[2] Effective June 1, 2010, an out-of-state business is deemed to have substantial nexus with the state if the business has (1) more than $50,000 of property (including intangible property) in the state; (2) more than

$50,000 of payroll in the state; (3) more than $250,000 of receipts from the state; or (4) 25 percent or more of its total property, total payroll, or total receipts from the state.[3] The minimum nexus thresholds are determined on a tax-year basis, which is generally based on the calendar year.[4]

For 2010, the minimum nexus thresholds are based on the entire 2010 calendar year, but taxes are due under the new thresholds only from June 1, 2010, forward.[5] The Department of Revenue will review the nexus threshold amounts each year and adjust the amounts based on changes of 5 percent or more in the consumer price index.[6] Once economic nexus has been established, substantial nexus is deemed to exist not only for the current year but also for the following tax year.[7]

Property used to determine the property threshold is "tangible, intangible, and real property owned or rented and used in [Washington] during the calendar year."[8] Property does not however, include ownership of or rights in computer software.[9] The value of the property is determined by averaging the values at the beginning and end of the tax year.[10] The Department of Revenue may require the averaging of monthly values if reasonably required to properly reflect the average value of the taxpayer's property.[11] Property other than loans and credit card receivables is valued at its original cost basis.[12]

Payroll counting toward the threshold is the total amount paid by the taxpayer for employee compensation in Washington during the tax year plus nonemployee compensation paid to representative third parties in Washington.[13] Employee compensation is considered in Washington if the compensation is properly reportable to the state for unemployment compensation tax purposes, regardless of whether the compensation was actually reported in the state.[14] Nonemployee compensation is considered in Washington if the service performed by the representative occurs entirely or primarily in Washington.[15]

The receipts threshold includes only those amounts included in the numerator of the taxpayer's receipts factor—only those related to apportionable income from apportionable activities.[16] The 25 percent threshold is determined by dividing the value of property located in Washington by the total value of the taxpayer's property, the payroll located in Washington by the taxpayer's total payroll, or the receipts attributed to Washington by the taxpayer's total receipts.[17]

Single Receipts Factor Apportionment Replaces Complicated Cost Apportionment Method
The new Washington B&O law abandons the complicated cost apportionment method used

for the "services and other activities" category and adopts a more common single receipts factor apportionment method.[18] The legislature attributed the switch to the difficulty in assigning certain costs of doing business under the prior cost method, the dissimilarity of the cost method to methods used in other states, the relative ease and commonality of the single receipts factor, and the potential for increased business in the state due to the absence of a property or payroll factor.[19]

Effective June 1, 2010, the new single receipts factor applies to the "services and other activities" category and to receiving income from intangible property, among others, but does not apply to activities falling under the retailing, wholesaling, or manufacturing categories, to name a few.[20] The receipts apportionment factor is determined by dividing gross income from engaging in an apportionable activity in Washington into gross income from engaging in an apportionable activity worldwide.[21] An "apportionable activity" includes, for example, an activity under the "services and other activities" category or receiving income from intangible property, and a separate receipts factor must be calculated for each apportionable activity.[22]

Receipts Sourced by Benefit Location With "Throw-Out" Rule

Income for B&O purposes is sourced to Washington for purposes of the numerator of the receipts factor if the benefit of the service was received in Washington or if the customer used the intangible property in Washington.[23] If the benefit was received or the intangible property was used in more than one state, gross income is attributed to Washington if the benefit of the service was received primarily in Washington or the intangible property was used primarily in Washington.[24]

A series of alternative attribution rules apply where the taxpayer is unable to attribute the receipts to a determinable benefit location. The alternative rules include the location (i) from which a royalty agreement was negotiated, (ii) to which invoices are sent, (iii) from which the customer sends payment, (iv) of the customer's address in the taxpayer's business records maintained in the ordinary course of the taxpayer's business, or (v) of the customer's commercial domicile.[25] The new apportionment formula also includes a "throw-out" rule, in which income is excluded from the denominator if the income is attributed to a state where the taxpayer is not taxable.[26] A taxpayer is generally considered not taxable in a state where the taxpayer is not subject to a business activities tax by that state; however, a taxpayer is considered taxable in the state in which it is organized or commercially domiciled, or where it meets the new economic nexus standards, regardless of whether such state imposes a business activities tax.[27]

Special Single Receipts Factor for Financial Institutions

It should be noted that the new apportionment rules do not apply to financial institutions; however, the Washington Legislature directed the Department of Revenue to create rules for the apportionment of income of financial institutions that provide for a single receipts factor.[28] An emergency rule, effective from June 2, 2010, until September 30, 2010, provides that any financial institution that is

> organized under the laws of a foreign country, the Commonwealth of Puerto Rico, or a territory or possession of the United States, except such institutions that are

> exempt under RCW 82.04.315, whose effectively connected income (as defined under the Federal Internal Revenue Code) is taxable both in this state and another state, other than the state in which it is organized, must allocate and apportion its gross income as provided in this rule.[29]

The rule goes on to provide for a single receipts factor and enumerates the specific types of gross income included in the numerator.[30] For example, interest, fees, and penalties in the nature of interest from loans secured by real property are in the numerator if the property is located in Washington.[31]

Taxpayers required to use receipts factor apportionment, including financial institutions, may report their apportionable income for the most recent calendar year for which the taxpayer has information.[32] If the taxpayer does not use the most recent calendar year for which it has information, the taxpayer must use current-year information.[33] Under either method, when the taxpayer has the information from which to determine receipts for a calendar year, it must file a reconciliation and either obtain a refund or pay additional tax.[34]

Temporary Rate and Small Business Credit Increases

From May 1, 2010, to June 30, 2013, the tax rate for real estate brokers, "contests of chance," and business activities falling under the "services and other activities" category was temporarily increased from 1.5 percent to 1.8 percent.[35] The rate increase, however, does not apply to hospitals or to persons engaged in scientific research and development.[36]

For businesses that report at least 50 percent of their taxable income under the "services and other activities" category, the legislature correspondingly increased the small business credit from $420 per year ($35 per month) to $900 per year ($75 per month).[37]

Corporate Directors Are Subject to the B&O

The B&O tax applies to independent contractors but not to employees. Previously, many corporate directors considered themselves employees of the corporation and thus exempt from the B&O tax. The new legislation makes clear that corporate directors are considered independent contractors and are subject to tax.[38]

Effective July 1, 2010, "amounts received by an individual from a corporation as compensation for serving as a member of that corporation's board of directors" are taxed under the "services and other activities" category.[39] However, if an individual is serving a corporation in the role of director and as an employee, nothing in the new provisions implies that the individual would be taxed on the income received as an employee. Further, out-of-state corporate directors of Washington corporations may be subject to the B&O tax if the directors have substantial nexus with Washington under the new economic nexus rules.[40] The most likely situation would be that the out-of-state director will have received 25 percent or more of his or her income from the Washington corporation, thus subjecting the director to Washington B&O tax.

Tax-Avoidance Transactions

In order to ensure that all taxpayers pay their fair share and to stop transactions and arrangements that are designed to unfairly avoid taxes, the Washington State legislature enacted provisions requiring the Department of Revenue to disregard certain tax-avoidance transactions and to deny any tax benefits that would result from such transactions.[41] As a further deterrent, a 35 percent penalty must be added to any deficiency in tax that results from engaging in a tax-avoidance transaction.[42] Included in the disregarded transactions are

> [a]rrangements through which a taxpayer attempts to avoid tax under [the B&O tax] by disguising income received, or otherwise avoiding tax on income, from a person that is not affiliated with the taxpayer from business activities that would be taxable in Washington by moving that income to another entity that would not be taxable in Washington.[43]

In determining whether such a transaction must be disregarded as a tax-avoidance scheme, the Department of Revenue can consider several factors, including: (1) whether an arrangement or transaction changes in a meaningful way, apart from its tax effects, the economic positions of the participants in the arrangement when considered as a whole; (2) whether substantial nontax reasons exist for entering into an arrangement or transaction; (3) whether an arrangement or transaction is a reasonable means of accomplishing a substantial nontax purpose; (4) an entity's relative contributions to the work that generates the income; (5) the location where the work is performed; and (6) any other relevant factors.[44]

The Department of Revenue provided the following example of a B&O tax transaction that will be disregarded under the new provisions

> A Washington company with its only place of business in Washington provides online services subject to B&O tax to Washington customers. The Washington company forms a LLC in another state. The Washington company causes the out-of-state LLC to contract with its Washington customers to provide the online services. The out-of-state LLC hires the Washington company as a subcontractor to provide the online services to customers. The out-of-state LLC has no employees or other property and pays only a nominal fee to the Washington company for the services. The out-of-state LLC collects customer payments and makes distributions to the Washington company. The Washington company claims the distributions are from its capital account with the out-of-state LLC and exempt from B&O tax under RCW 82.04.4281.
>
> The Department will disregard the transactions between the Washington company and the LLC and assess the Washington company for tax on the income collected by the out-of-state LLC.[45]

The tax-avoidance provisions are effective for tax periods beginning January 1, 2006.[46] Thus, these provisions have a retroactive effect.

There are a couple of safe-harbor provisions where the legislation will not be applied retroactively. A transaction will not be disregarded if the transaction or arrangement was initiated before May 1, 2010, and the taxpayer reported its tax liability in conformance with either: (1) specific written instructions provided by the Department of Revenue to the taxpayer; (2) a determination published under the authority of RCW 82.32.410; or (3) other documents made available by the Department to the general public.[47] This provision applies as long as the transaction or arrangement does not differ materially from the transaction or arrangement that was addressed in the specific written instructions, published determination, or other document made available by the Department to the general public.[48] Also, the provision does not apply to tax periods beginning before May 1, 2010, if the periods were "included in a completed field audit conducted by the department."[49]

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[1] 2ESSB 6143, § 101(1). ^TOP

[2] *Id.* §§ 104(6), 1702. "Apportionable activities" also include activities subject to the following classifications: (i) travel agents and tour operators; (ii) international steamship agents, customs house brokers, freight forwarders, vessel and/or cargo charter brokers in foreign commerce, and/or international air cargo agents; (iii) stevedoring; (iv) disposing of low-level waste; (v) title insurance producers or agents, or surplus line brokers, (vi) public or nonprofit hospitals; (vii) real estate brokers; (viii) research and development performed by nonprofits; (ix) inspecting, testing, labeling, and storing canned salmon owned by another person; (x) representing and performing services for fire or casualty insurance companies as an independent resident managing general agent; (xi) contests of chance; (xii) horse races; (xiii) international investment management services, (xiv) room and domiciliary care to boarding-home residents; (xv) aerospace product development; (xvi) printing or publishing a newspaper (but only for advertising income); (xvii) printing materials other than newspapers and publishing periodicals or magazines (but only for advertising income); and (xviii) cleaning up radioactive waste and other byproducts of weapons production and nuclear research and development, but only for activities that would be taxable as an "apportionable activity" under any of the tax classifications listed above. WAC § 458-20-19401(2). ^TOP

[3] 2ESSB 6143, § 104(1)(c). For taxes imposed on other activities, a person has substantial nexus "if the person has a physical presence in this state, which need only be demonstrably more than a slightest presence." *Id.* § 104(b). "[A] person is physically present in this state if the person has property or employees in this state" or "either directly or through an agent or other representative, engages in activities in this state that are significantly associated with the person's ability to establish or maintain a market for its products in this state." *Id.* ^TOP

[4] WAC § 458-20-19401(1)(a) (Emergency regulation effective June 2, 2010, until Sept. 30, 2010, unless the Department of Revenue adopts a permanent rule prior to that date). ^TOP

[5] *Id.* ^TOP

[6] 2ESSB 6143, § 104(5)(a). ^TOP

[7] *Id.* § 102(2). ^TOP

[8] WAC § 458-20-19401(2)(c)(i). ^TOP

[9] *Id.* § 458-20-19401(2)(c)(ii). ^TOP

[10] 2ESSB 6143, § 104(2)(c). ^TOP

[11] *Id.* ^TOP

[12] *Id.* § 104(2)(b)(i). ^TOP

[13] *Id.* § 104(3)(a). ^TOP

[14] *Id.* § 104(3)(b). ^TOP

[15] *Id.* § 104(3)(c). ^TOP

[16] *Id.* § 104(4). ^TOP

[17] WAC § 458-20-19401(7). ^TOP

[18] *See* 2ESSB 6143, § 105. ^TOP

[19] *Id.* § 101(2)(a), (b). ^TOP

[20] *Id.* §§ 105(1), 1709. *See supra* note 2 for the other activities using single receipts factor apportionment. ^TOP

[21] *Id.* § 105(3)(a). ^TOP

[22] *Id.* §§ 105(1), 108(4)(a). ^TOP

[23] *Id.* § 105(b)(i). ^TOP

[24] *Id.* § 105(b)(ii). If the taxpayer is unable to attribute gross income based on the benefit of the service or the use of intangible property, the section provides a hierarchical list of ways to attribute the income. *See*

id. §§ 105(b)(iii)–(b)(vii). ^TOP
[25] 2ESSB Sec. 105(3)(b)(iii)-(vii). ^TOP
[26] *Id.* § 105(c). ^TOP
[27] *Id.* ^TOP
[28] *Id.* §§ 105(d), 108(2). ^TOP
[29] WAC § 458-20-19404(2)(a). ^TOP
[30] *Id.* § 458-20-19404(4)(b)–(4)(l). ^TOP
[31] *Id.* § 458-20-19404(4)(b). ^TOP
[32] 2ESSB 6143, § 105(4), WAC § 458-20-19404(2)(c). ^TOP
[33] 2ESSB 6143, § 105(4), WAC § 458-20-19404(2)(c). ^TOP
[34] WAC §§ 458-20-19402(6)(b), 458-20-19404(2)(c). ^TOP
[35] 2ESSB 6143, § 1101(1). ^TOP
[36] *Id.* § 1101(2)(a), (b). ^TOP
[37] *Id.* § 1102(1). ^TOP
[38] *Id.* § 701. ^TOP
[39] *Id.* § 702(2). ^TOP
[40] *See id.* § 104(1)(c). ^TOP
[41] *Id.* § 201(1), (2). ^TOP
[42] *Id.* 203(6). The tax will not be assessed if the taxpayer discloses its participation in a prohibited transaction before the Department of Revenue discovers the participation. *Id.* ^TOP
[43] *Id.* § 201(3)(b). The other transactions that are prohibited involve joint ventures between contractors and developers and arrangements to avoid sales and use taxes. *See id.* § 201(3)(a), (c). For purposes of applying this section, "affiliated" means under common control. *Id.* 201(7). "Control" means "the possession, directly or indirectly, of more than fifty percent of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise." *Id.* ^TOP
[44] *Id.* § 201(2). ^TOP
[45] Washington Department of Revenue Special Notice (May 27, 2010). ^TOP
[46] 2ESSB 6143, § 1703. ^TOP
[47] *Id.* § 202(1)(a). "Specific written instructions" means "tax reporting instructions provided to the taxpayer and which specifically identify the taxpayer to whom the instructions apply." *Id.* § 202(3). The instructions "may be provided as part of an audit, tax assessment, determination, closing agreement, or in response to a binding ruling request." *Id.* ^TOP
[48] *Id.* § 202(1)(b). ^TOP
[49] *Id.* § 202(2). ^TOP

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NEXUS: Update On Recent Developments – New Jersey Distinguishes Selling Prewritten Software from Licensing IP; Washington Finds Mere License of Trademark Not "Doing Business"

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We keep track of nexus developments on a regular basis - legislation, administrative interpretations, the passage of rules and regulations, and court cases. This issue of our newsletter updates important nexus developments during the Third and Fourth Quarter of 2009 and the First Quarter of 2010. It is organized by the kind of activity that tends to give out-of-state entities nexus planning and litigation difficulties, such as attendance at trade shows or seminars, sales personnel who travel in and out of states, affiliate nexus, intangible nexus, and doing business in the state if you are a non-resident shareholder in an S Corporation, and a "drop shipment" ruling from the New Mexico Taxation & Revenue Department that is sensible. It also highlights Wisconsin's new "affiliate nexus" statute (effective July 1, 2009) and Connecticut's "economic nexus" statute (effective for taxable year on and after January 1, 2010).

Decisions from New Jersey and the City of Seattle deserve special attention. The New Jersey Tax Court made a careful and correct distinction between selling prewritten software and licensing intellectual property in the AccuZIP case. In Blistex Bracken, a

SCHEDULE

Seattle B&O assessment on royalty income was reversed on Due Process grounds because there was insufficient nexus between a limited partnership that received the royalties and the B&O tax.

EMPLOYEE VISITS

ILLINOIS

An agreement by which a company promoted the sale of drugs manufactured by another created income tax nexus – the Department determined that P.L. 86-272 did not apply to income generated by "distribution rights."

General Information Letter IT 09-0023-GIL, Illinois Dept. of Rev., CCH T 402-002 (Aug. 14, 2009).

1. Taxpayer is an out-of-state company in the business of researching and developing pharmaceutical products. Taxpayer entered into a contract with an unrelated third party to develop, use, sell, promote, offer for sale, import and distribute pharmaceutical drugs. Taxpayer's employees occasionally visited with the third party's representatives in Illinois to coordinate efforts to sell their products. Neither Taxpayer nor its employees had an office in Illinois. Taxpayer also employed account executives, who met with doctors to promote the use of Taxpayer's products. Account executives did not deliver the product or take orders, but generated "pull through" sales. These sales generated revenue to taxpayer.

2. The Illinois Department of Revenue determined that Taxpayer's activities were related to the sale of intangible property and, thus were not protected under P.L. 86 272 (U.S.C. § 381-84) from tax. Due to taxpayer's employees activities, which the Department characterized as "activities related to a distribution right," the Department determined Taxpayer likely had sufficient nexus with Illinois and was subject to corporate income tax.

3. The Department was unable to respond to the Taxpayer's questions about apportionment due to lack of facts.

As it always does, the Illinois Department of Revenue noted that nexus determinations were highly fact specific. Whether sales from a retailer's mobile unit created nexus went unanswered.

Illinois Dep't of Rev., General Information Letter ST09-0130-GIL, ¶20091027016

1. Taxpayer received less than one percent of its business from Illinois. Eight percent of its Illinois sales were made from a mobile unit that traveled to Illinois twice per year, while the remaining 92% of sales were accepted and rejected outside the state. Taxpayer had no property or payroll in Illinois and sought to avoid the imposition of Retailer's Occupation Tax.

2. The Department of Revenue responded that a vendor is only liable for Illinois tax if it has sufficient nexus with Illinois and determinations regarding nexus are very fact specific. The Department would not provide a determination as to whether the company had nexus with Illinois, but provided guidelines regarding nexus. For instance, any type of physical presence in Illinois, including the presence of any agent or representative of the seller in Illinois, constituted sufficient nexus.

WASHINGTON

In-person customer visits created B&O tax nexus, even though the New Jersey manufacturer had no employees, property, or inventory in Washington. The "economic nexus" standard was applied.

Lamtec Corp. v. Washington Department of Revenue,
No. 35716-811 (Wash. Ct. App. Div. II, Aug. 4, 2009).

1. The Washington Court of Appeals found that the activities in Washington of an out-of-state manufacturer established nexus for business and occupation ("B&O") tax purposes for the audit period 1997 through June 30, 2004, even though the company did not have an office in the state and made no direct sales. The B&O tax is an excise tax levied for "the privilege of doing business." Ford Motor Co. v. City of Seattle, 156 P.3d 185 (2007). The court found nexus because company employees visited customers to establish and maintain a market for sales in the state. Affirming the trial court, the Court of Appeals also held that the company's customers received its products in Washington.

2. Lamtec (the taxpayer) manufactured vapor barriers and insulation facings. Lamtec wholesaled these and related products to customers on a nationwide basis. Among other things, Lamtec claimed that its activities within Washington did not satisfy the statutory nexus requirement under WAC 458-20-193(7), which parallels the rule for determining nexus under federal commerce clause analysis. Lamtec's primary argument was that it did not have substantial nexus with Washington because it did not maintain a physical presence in the state. Relying on Quill Corp. v. North Dakota, 504 U.S. 274 (1977), it contended that to show substantial nexus, the Department must establish that Lamtec had a physical presence akin to "a small sales force, plant or office" within the taxing state. The Washington Court of Appeals noted, however, that since Quill, courts have developed a split in authority as to whether the Supreme Court's holding was limited to sales and use taxes. The Washington court concluded that "[a] close reading of Quill reveals that its language supports those courts that have limited Quill to cases involving sales and use taxes." The Quill Court did not attempt to equate the substantial nexus requirement with a universal physical presence requirement.

3. The Washington court then concluded that Lamtec's business activities in Washington significantly contributed to its ability to establish and maintain its market in the state. Given Lamtec's business strategy - maintaining long-term relationships with a small number of customers - its in-person customer visits were critical to maintaining its existing Washington customers. While in Washington, Lamtec employees provided information, listened to concerns about and answered questions concerning Lamtec products, participated in telephone calls that the customers placed to Lamtec's technical and customer service departments in New Jersey, fielded questions concerning potential price increases and new products, and maintained general client relations.

4. The court rejected Lamtec's distinction that its employees solicited no sales during their visits to Washington, holding that the test is whether Lamtec's in-state activities were significantly associated with its ability to establish and maintain its market in Washington, not whether it employed people within the state. The court repeatedly cited Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue, 483 U.S. (1987), and Gen. Motors Corp. v. Washington, 377 U.S. 436 (1964), in support of its reasoning, two cases with expansive readings of nexus in the B&O context. In sum, the court found that Lamtec had substantial nexus with Washington. Its employees' activities within the state were significantly associated with its ability to establish and maintain its market, particularly in light of Lamtec's business model that entailed maintaining a small number of high-volume customers long-term.

OTHER SPORADIC PHYSICAL CONTACTS

ALABAMA

Commerce Clause and Due Process Nexus Found – Alabama successfully assessed personal income tax against a Mississippi resident who was a shareholder in an Alabama "S Corporation." The Mississippi resident was

an investor and did not engage in day-to-day management of the S Corporation's business.

Prince v. State Dep't of Revenue, ___So.3d___, No. 2080634, 2010 WL 245578 (Ala. Ct. Civ. App. Jan. 22, 2010).

1. Taxpayer, an individual, owned 1/3 shares of Zebra.Net, an S corporation organized and doing business in Alabama. Taxpayer was a resident of Mississippi. Taxpayer did not engage in the operation or management of the corporation.

2. In 1999, the shareholders of Zebra.Net entered into a merger agreement. As part of the merger agreement, the shareholders agreed to have the acquisition of Zebra.Net treated as an asset acquisition pursuant to 26 U.S.C. § 338(h)(10).

3. Taxpayer paid income tax on his proportional distribution from the asset sale of Zebra.Net in Mississippi, his state of residence. He did not pay income tax. The Alabama Department of Revenue assessed income tax with penalties and interest against Taxpayer. Taxpayer appealed, arguing he lacked both minimum contacts and a substantial nexus with Alabama.

4. The Alabama Court of Civil Appeals held that nonresident shareholders of S corporations that conduct business activities in Alabama are subject to income tax on their distributive share of an asset sale of the S corporation. The Court concluded that both due process and commerce clause nexus existed.

TRADE SHOWS OR SEMINARS

KANSAS

No trade show nexus exists if the retailer does not accept purchase orders or negotiate sales at the Kansas trade show.

1. On August 28, 2009, the Kansas Department of Revenue issued an Opinion Letter (0-2009¬011) confirming that when an out-of-state retailer attends a trade show in Kansas and takes orders, negotiates sales, or otherwise engages in sales activities, nexus is created. However, the Letter stated that if the retailer does not receive purchase orders or negotiate sales, then nexus is not created. An out-of-state retailer is considered to be engaging in sales at a trade show when it: 1) accepts orders and processes them after it leaves Kansas; 2) forwards orders taken in Kansas to an out-of-state office for final approval; or 3) provides the means for trade-show attendees to place purchase orders over the Internet or by other electronic means.

MINNESOTA

If sales are made by an out-of-state vendor at craft shows, art fairs, flea markets and other Minnesota venues, sales tax must be collected.

1. In July, 2009, the Minnesota Department of Revenue issued Sales Tax Fact Sheet No. 154, stating that out-of-state businesses must collect Minnesota tax on all taxable sales of arts and crafts made while in Minnesota. The Department noted that this included sales at "craft shows, art fairs, flea markets and similar events, private homes or nonprofit events such as church bazaars. The Fact Sheet pointed out that sales to Minnesota residents after the taxpayer leaves the state of Minnesota, or orders taken for future direct mailings, are sales that may be subject to Minnesota tax. It went on to say, "If you come into Minnesota for a selling event you are subject to income tax if you meet the minimum filing requirements."

IN-STATE PERSONNEL

INDEPENDENT CONTRACTORS, SALES REPRESENTATIVES, AND MANUFACTURING REPRESENTATIVES

FLORIDA

An independent contractor in Florida, who had no contacts with the out-of-state company's vendors and customers, did not create nexus in Florida.

Florida Dep't of Rev., Technical Assistance Advisement, No. 09A-058 (Nov. 9, 2009).

1. Taxpayer makes interstate sales of goods through the mail to customers located in Florida. It previously leased a building in Florida but terminated the lease and vacated the building. It utilizes the services of an independent contractor consultant who provides process improvement services while working out of her home in Florida, but presents her advice to Taxpayer personnel outside Florida. Consultant has no contact with Taxpayer's customers or vendors. Taxpayer does not maintain an office or other place of business in Florida, nor does not store inventory in Florida or have any employees in Florida.

2. Under such circumstances, the former sublease and the use of the independent consultant who has no contact with Florida customers does not create sales and use tax nexus with the State of Florida.

WEB NEXUS

ILLINOIS

The Illinois Department of Revenue reminded everyone that in-state representatives can create nexus, depending on the particular facts and circumstances.

General Information Letter No. ST 09-0098-GIL, Illinois Dept. of Rev., CCH 120090825037 (July 30, 2009).

1. A company annually collects information regarding the application of state tax laws. Such information is compiled into a "publication" which is used as a reference tool for state tax departments, attorneys, CPAs, and corporate tax departments. It sought information as to whether a retailer has a use tax collection obligation when it enters into an agreement with Illinois residents in which it agrees to pay commissions to the resident for directly or indirectly referring potential customers to the retailer through a link on that resident's website.

2. The Illinois Department of Revenue explained that Illinois is considering the promulgation of a regulation that addresses the issue but has not yet done so. Thus, according to the Department, the Department's regulation at 86 Ill. Adm. Code 150.201 identifies when a retailer is "maintaining a place of business in Illinois" and makes it clear that representatives, including independent contractors, can create nexus for a retailer.

RHODE ISLAND

"Web nexus" was created effective June 30, 2009.

R.I. Gen. Laws § 44-15-15 (enacted 2009 H.B. 5983).

1. This new bill was signed into law by the Governor of Rhode Island on or around July 2, 2009. The new provision establishes a rebuttable presumption for Rhode Island sales and use tax purposes that a seller is soliciting business in the state through an agent if the seller enters into an agreement with a state resident under which the resident refers potential customers to the seller through a website link or otherwise. The bill includes a $5,000 threshold before the tax will be imposed. The new law became effective June 30, 2009.

INCIDENTAL OWNERSHIP OF PROPERTY

COLORADO

An out-of-state company that stores inventory in Colorado has income tax nexus.

General Information Letter No. GIL-2009-012, Colorado Dept. of Rev., CCH T 200-903 (July 7, 2009).

1. This letter dealt with corporate income tax nexus. The taxpayer is an out-of-state company that sells glassware and shipped approximately .35% of its 2007 sales to Colorado destinations by common carrier. The company used a public warehouse located in Colorado for storage of its inventory for subsequent shipment to its customers in the Northwest.

2. The Colorado Department of Revenue determined that P.L. 86-272 did not prohibit the state from imposing income tax liability on the taxpayer because it maintained a warehouse and inventory in Colorado.

WASHINGTON

Vonage had nexus in Seattle because it purchased the right to use telephone lines in Seattle through an affiliate.

Vonage America, Inc. v. City of Seattle, No. 63234-5-1 (unpublished opinion), Washington Court of Appeals, Division One (July 6, 2009).

1. Vonage, the taxpayer, provided VoIP service to its customers, including residents of Seattle. VoIP technology enables consumers to conduct voice communications (calls) via a high-speed (broadband) Internet connection. To use Vonage's VoIP service, customers were required to purchase special software through Vonage's website or were required to acquire a "plug-and-play" device (VoIP device), which they could purchase from third party retail stores or obtain from Vonage's website at no cost.

2. When a customer initiates a call, the software or VoIP device converts the customer's outgoing analog audio signal into digital data packets. If the call recipient is also a Vonage customer, the digital data is transmitted directly over the Internet through the recipient's broadband connection to the recipient's computer (similar to the way in which e-mail communications are sent and received). The recipient's VoIP device or software then converts the incoming digital data into an analog audio signal, enabling the recipient to hear the call.

3. However, if the recipient is not a Vonage customer, the digital data is processed through one of several regional data centers. These centers convert the digital data into an analog audio signal, which is then directed to the Public Switched Telephone Network (PSTN). Vonage contracts with its affiliate, Vonage Networks, Inc., which provides services that allow for VoIP-to-PSTN and PSTN-to-VoIP calls. In turn, Vonage Networks purchases telephone communication services from traditional telephone companies that complete the communication to the recipient. In Seattle, WilTel Communications and Global Crossing provided these services during the disputed period. When a non-Vonage customer calls a Vonage customer, the process occurs in reverse order.

4. In December 2002, Vonage began selling VoIP service to Seattle residents. Acting through advertising agencies, Vonage purchased promotional materials that were broadcast or circulated in Seattle through television, radio or newspapers. Vonage, however, did not own or lease any property or employ any employees in Seattle during this period. When the City audited Vonage for the period between December 1, 2002 and December 31, 2005, it determined that Vonage was subject to the City's telephone utility tax. Vonage appealed the assessment.

5. One of the grounds on which Vonage appealed the assessment was that the federal commerce clause bars the City's tax because Vonage's contacts with Seattle were insufficient to establish "substantial nexus" with the City.

Specifically, Vonage argued under Quill Corp. v. North Dakota, 504 U.S. 274 (1977), that it lacked substantial nexus with Seattle because it had no physical presence in the City. The court noted, however, that it was not clear whether a physical presence requirement for nexus applies beyond sales and use taxes.

6. In any event, the court concluded that Vonage had sufficient contacts to establish the requisite nexus. In so finding, the court relied on General Motors Corp. v. City of Seattle, 25 P.3d 1022 (2001), a post-Quill decision in which the Washington Supreme Court declined "to extend Quill's physical presence requirement" beyond traditional sales and use taxes. While there was no evidence that Vonage owned or leased property in Seattle or that it had employees in Seattle during the audit, it obtained a sufficient physical presence in the city by purchasing the right to use telephone lines in Seattle through its affiliate, Vonage Networks, Inc. In addition, Vonage advertised its VoIP service in Seattle to "establish and maintain a market" in the City. Vonage sold its services to Seattle customers with Seattle billing addresses. According to the court, this was sufficient to establish the requisite nexus.

AFFILIATE NEXUS

UTAH

This very detailed advisory from the Commission reminds retailers of Utah's basic "doing business" standards. Importantly, it concluded that out-of-Utah business activity did not create nexus for a non-Utah business, including affiliates.

Private Letter Ruling, Opinion No. 09-008 (Utah State Tax Commission, March 4, 2009 (published Sept. 3, 2009).

1. The Utah State Tax Commission found that an out-of-state related seller ("Retailer") of an out-of-state nexus seller ("Nexus Seller") was not required to register to collect and remit Utah sales and use tax. Nexus Seller was a web-based provider of e-commerce services and had Utah customers. Nexus Seller wanted to send two or three employees to Utah to visit a potential customer, with the purpose of the visit being to discuss the services that Nexus Seller provided and how the services could be used by the customer. Nexus Seller also wanted to open an office in Utah to support and service its Utah customers and it was anticipated that Nexus Seller would have employees working from its Utah office.

2. Nexus Seller was affiliated with other entities, including Retailer. Retailer was an internet seller of tangible personal property and digital goods to customers around the world, including customers in Utah. Retailer was located outside of Utah and did not operate any retail stores, engage in any Utah activities, or own or lease any real property in Utah, and was not registered as a retail merchant in Utah. Retailer also had no employees in Utah. Nexus Seller did not provide advertising, marketing or sales services for Retailer, nor would Nexus Seller provide these activities from its proposed

Utah office. Nexus Seller would potentially provide Retailer with certain business services for its back-end infrastructure, including content delivery network and storage services. However, these services would not be provided from Utah.

3. The question presented to the Commission was: Assuming Nexus Seller would be required to collect and remit Utah sales and use tax based on its proposed visits to Utah, would Retailer be required to register to collect and remit Utah sales and use tax? The Commission found that Nexus Seller's out-of-state business activities could not create nexus for Retailer, regardless of whether Nexus Seller had a Utah presence. Retailer did not meet any of Utah's statutory "doing business" requirements that would trigger a duty to register in that it did not have a physical facility in Utah, did not maintain tangible personal property or inventory in the state, and did not maintain personnel in the state to solicit orders. In addition, in order to create Utah nexus for a related seller, the services needed to be provided from a place of business within Utah, which was not the case.

4. The Commission specially stated that it "does not believe that business activity provided in a state outside of Utah can create nexus for a non-Utah business. This holds even if a business performing the activity for an affiliated retailer has a Utah presence."

5. Additionally, Retailer satisfied the requirements of the statutory Affiliate Nexus Exception, which provides that if a seller is a related seller and the seller to which the related seller is related does not engage in certain activities on behalf of the related seller (advertising, marketing, sales, or other services), then the related seller is not required to register to collect and remit Utah sales tax. Thus, Retailer also did not have affiliate nexus because Nexus Seller did not provide advertising, sales services, or marketing for it.

WISCONSIN

Wisconsin passed an affiliate nexus statute which is like most state statutes of this nature, generally incorporating an agency nexus standard.

2009 Act 28, create sec. 77.51(13g)(d), effective July 1, 2009 (Tax Bulletin No. 162, Wisconsin Department of Revenue, July 2009).

1. This provision, effective July 1, 2009, expands the definition of "retailer engaged in business in this state" to specifically include any person who has an affiliate in Wisconsin, if the person is related to the affiliate and if the affiliate uses facilities or employees in Wisconsin to advertise, promote, or facilitate the establishment of or market for sales of items by the related person to purchasers in Wisconsin or for providing services to the related person's purchasers in Wisconsin, including accepting returns of purchases or resolving customer complaints.

2. For purposes of this provision, two persons are "related" if any of the following apply:

a. One person, or each person, is a corporation and one person and any person related to that person in a manner that would require a stock attribution from the corporation to the person or from the person to the corporation under section 318 of the Internal Revenue Code owns directly, indirectly, beneficially, or constructively at least 50% of the corporation's outstanding stock value;

b. One person, or each person, is a partnership, estate, or trust and any partner or beneficiary; and the partnership, estate, or trust and its partners or beneficiaries; own directly, indirectly, or beneficially, or constructively, in the aggregate, at least 50% of the profits, capital stock, or value of the other person or both persons;

c. An individual stockholder and the members of the stockholder's family, as defined in section 318 of the Internal Revenue Code, owns directly, indirectly, beneficially, or constructively, in the aggregate, at least 50% of both persons' outstanding stock value.

IN-STATE ADVERTISING/SOLICITATION

VIRGINIA

Here, based on additional evidence, the Virginia Department of Taxation reversed its July, 2008, decision that the Virginia activities of a District Sales Manager and an employee veterinarian exceeded sales solicitation under P.L. 86-272.

Ruling of Commissioner, P.D. 09-172, Virginia Dep't of Taxation, October 23, 2009 (CCH ¶205-102).

1. In P.D. 08-142, the Virginia Department of Taxation ruled on July 30, 2008, that certain activities performed by the district manager and the veterinarian of a foreign corporation exceeded the protection afforded by Public Law (P.L.) 86-272 (15 U.S.C. § 381), and upheld assessments issued for the taxable years ended October 31, 2002 through 2005. The Taxpayer asked the Department to reconsider its decision, contending that the facts were misstated or inaccurately interpreted in P.D. 08-142. The taxpayer was a manufacturer of animal medications which it sold through sales representatives.

2. Based on additional evidence and testimony, the Department determined that while the district manager does recruit, hire, train, and assign responsibilities of the sales representatives who report to him, his responsibilities do not include many of the activities that were attributed to his position in P.D. 08-142, including providing sales forecasts, making budget recommendations, evaluating costs, tracking expenditures, and providing market input on pricing, positioning, and competitive activities.

3. Additionally, the Taxpayer presented evidence that its employee, a

veterinarian, demonstrated products and explained technical training prior to the sale in order to encourage other veterinarians to order the products. All post-sale technical support was performed outside of Virginia. Distinguishing the current facts from P.D. 01-70 (5/25/2001), the Department determined that technical information provided prior to a sale would be ancillary to sale solicitation because such activity would not occur but for the solicitation of sales. However, any post-sale technical training or support provided to customers would create nexus with Virginia.

4. Based on the subsequent evidence provided by the Taxpayer, the Department found that the activities of the district manager and the veterinarian did, in fact, constitute solicitation of sales, were ancillary to sales solicitation, or provided a de minimis connection with Virginia. Accordingly, the Taxpayer did not have nexus with Virginia for the taxable years at issue and the assessments for the taxable years ended October 31, 2002 through 2005 were abated.

TEMPORARY NEXUS

The Illinois Department of Revenue concluded that machine part sales made to Illinois customers do not create nexus for an out-of-state vendor that used common carriers to make deliveries.

Illinois Dep't of Revenue General Information Letter, IT 09-0045-GIL, CCH ¶ 402-070, 2009 WL 5407993(Dec. 10, 2009).

1. Taxpayer company is incorporated and has its principal place of business outside Illinois. Taxpayer imports machinery from foreign countries for sale in North America. The machines are very large, so when they are sold, they are shipped directly from point of entry to the customer. Taxpayer installs the machines with its own personnel. Taxpayer also stocks parts at its principal place of business for sale to customers that bought machines. Parts are shipped via interstate commerce. Taxpayer does not own its own trucks. Taxpayer may only sell five machines per year in North America. Taxpayer frequently sells parts to Illinois customers. Sales are generated by telephone, and Taxpayer may visit a customer from time to time to secure a sale.

2. The Department of Revenue advised that under these facts, whether or not Taxpayer has the requisite nexus with Illinois for a taxable year likely depends on whether or not it has machine sales to Illinois customers during that year. Installation of machines sold to Illinois customers is an unprotected activity under Public Law 86-272 and subject to state taxation. However, in taxable years in which Taxpayer has no machine sales in Illinois, it may be exempt from Illinois income tax because the parts it ships from its office for delivery to customers are ordered via telephone and delivered by third party carriers.

"INTANGIBLE" NEXUS

MARYLAND

Another intangible holding company loss -- the Maryland Court of Special Appeals affirmed the assessment against the holding company that owned and licensed intangible property to an affiliated entity that operated retail stores in Maryland.

The Classics Chicago, Inc. v. Comptroller of the Treasury, Tax Appeal No. 06-IN-OO-0226, CCH ¶ 201-815 (Md. Tax Apr. 11, 2008), aff'd, CCH ¶ 201-856 (Cir. Ct. Balt. City Oct. 8, 2008), aff'd, CCH ¶ 201-897, 985 A.2d 593 (Md. Ct. Special App. Jan. 4, 2010).

1. The Talbots (Talbots) is a Delaware corporation with its principal place of business and commercial domicile in Massachusetts. Talbots conducted a women's retail clothing business by catalog and through retail stores located in many states, including Maryland. In 1973, General Mills, Inc. acquired Talbots. In 1988, General Mills sold its interests in Talbots to Jusco USA, Inc. (Jusco USA), a subsidiary of Jusco Co. Ltd. (Jusco), a Japanese corporation. At the same time, Talbots sold all of its trademarks, trade names, and related intellectual property (trademarks)to Jusco Europe BV (Jusco BV), a Dutch subsidiary of Jusco. Jusco BV and Talbots entered into a license agreement pursuant to which Jusco BV licensed to Talbots the right to use the Talbots trademarks in exchange for a royalty fee. Incident to an initial public offering of a minority portion of its interest in Talbots, Jusco USA incorporated The Classics Chicago (Classics), a Delaware wholly-owned subsidiary of Talbots with its principal place of business in Illinois. Classics purchased all of the Talbots trademarks. Classic and Talbots then entered into a license agreement similar to the agreement between Jusco BV and Talbots. Classics maintained and preserved the Talbot trademarks. Classics rented office space from Talbots for its offices in Chicago.

2. Classics and Talbots appealed from a judgment entered by the Circuit Court for Baltimore City affirming a Maryland Tax Court decision which approved income tax assessments against Classics and Talbots. The basis of the assessments was that during the taxable period, Talbots filed Maryland income tax returns and deducted royalty payments to Classics, but Classics did not file Maryland state income tax returns and did not report the royalty payments as taxable income to Maryland. Classics and Talbots argued that Classics lacked a substantial nexus to the state of Maryland. As support for this argument, Classics and Talbots pointed to the fact that the transfer to Classics was executed for numerous business reasons and not structured to avoid state taxation.

3. The Court of Special Appeals held that Classics had a substantial nexus with Maryland by virtue of Talbots' royalty payments. The Court applied an economic reality test and determined that because Talbots' business in Maryland was what produced the sole income of its subsidiary, Classics, a sufficient nexus existed. In so holding, the Court also noted that the motivation behind the transaction is not dispositive when assessing economic reality.

NEW JERSEY

Another round in the extended battle between a Delaware Holding Company that licensed patents, trade secrets and technology to corporate affiliates that did business in New Jersey. The Delaware Holding Company lost in the New Jersey Tax Court, won on appeal, but ultimately lost in the New Jersey Supreme Court.

Praxair Technology, Inc. v. Director, Division of Taxation, No. 007445-05 (N.J. Tax Ct.), rev'd 961 A.2d 738 (N.J. Sup. Ct. App. Div. 2008), rev'd, No. A-91-92/08, 2009 N.J. LEXIS 1406 (N.J. Dec. 15, 2009).

1. Praxair Technology, Inc. ("Praxair Technology"), a Delaware corporation with its principle place of business in Connecticut, engaged in the sole business of owning intellectual property in the form of patents, trade secrets and technology. Praxair Technology formed a subsidiary, Praxair, Inc., which was engaged in the business of manufacturing and selling industrial gases throughout the United States and New Jersey ("Parent"). In exchange for fees, Praxair Technology entered into a license agreement with its Parent, whereby the Parent used Praxair Technology's intellectual property in the manufacture of industrial gases.

2. In 2002, the Director of the Division of Taxation made an assessment against Praxair Technology for New Jersey's corporation business tax (CBT), including interest and late filing penalties, for each of the 1994 to 1999 tax years. Praxair Technology filed a complaint before the Tax Court, arguing that it was not "doing business" in New Jersey for the taxable years 1994 to 1996 because the regulation promulgated to implement the CBT did not include a subsidiary trademark example until 1996. Praxair Technology did not contest the fact that it was subject to the business tax following the addition of the 1996 example to the regulation.

3. The Tax Court relied on the plain language of the CBT statute to find Praxair Technology liable for the tax because the law itself "clearly applie[d] to [Praxair Technology] without the assistance of regulation." Thus, because the Parent had facilities in New Jersey, Praxair Technology had a sufficient nexus with the state.

4. Citing Lanco, Inc. v. Director, Division of Taxation, 21 N.J. Tax 200 (N.J. Tax Ct. 2003), rev'd, 879 A.2d 1234 (N.J. Sup. Ct. App. Div. 2005), aff'd, 908 A.2d 176 (N.J. 2006), petition for cert. denied, 2007 U.S. LEXIS 7736 (June 17, 2007) (§ III.J.9.a of this outline), the Appellate Division agreed that New Jersey can tax income generated by intangible property even where the assessed corporation lacks a physical presence in the state. The Appellate Division reversed, however, concluding that the 1996 addition of the trademark example to the regulation indicated that, prior to that point, doubt existed regarding the Director's ability to tax subsidiary trademark entities such as Praxair Technology.

5. The New Jersey Supreme Court subsequently reversed the Appellate Division, describing the Tax Court's interpretation of the plain language of the

CBT statute as "unassailable." Further, the New Jersey Supreme Court noted that Praxair Technology's arrangement with its Parent corporation was designed to minimize or evade taxes. This corporate form, however, did "not trump substance," and therefore, Praxair Technology was "doing business" in New Jersey in a manner sufficient for taxation nexus.

WEST VIRGINIA

A third loss! Another out-of-state intangible holding company, which received royalty payments from its corporate affiliates for the use of licensed trademarks and trade names, was subject to West Virginia corporation net income tax.

Redacted Decision, West Virginia Office of Tax Appeals, Nos. 06-544N & 06-545, ¶20100208005, Jan. 6, 2010.

1. Petitioner, a Nebraska corporation, licensed trademarks and trade names to other entities, including affiliated companies, which then sold trade-named products to West Virginia customers.

2. In a thorough analysis of law and fact, the Administrative Law Judge ("ALJ") determined that Petitioner was subject to both the State's corporate franchise tax and its net income tax, justifying the application of each of these taxes on nexus and minimum contacts considerations.

3. Due Process Nexus

a. Under a Quill analysis, the ALJ found that Petitioner had the requisite minimum contacts with West Virginia and that the tax was rationally related to activities conducted in West Virginia.

b. Looking to minimum contacts, the ALJ found that Petitioner licensed trademarks and trade names to entities that manufactured goods bearing those names for sale in West Virginia. Because Petitioner benefited from the sale of these licensed products in the state, it necessarily availed itself of West Virginia's economic market.

c. Also, basing its findings on precedent from other jurisdictions, the ALJ found that the taxes were rationally related to the trademark activity being taxed.

d. Commerce Clause Nexus

(i) The ALJ also found that the Petitioner had sufficient nexus with West Virginia under Complete Auto, and the ALJ further affirmed that the tax was fairly apportioned, did not discriminate against interstate commerce, and that it was fairly related to the benefits provided by West Virginia.

(ii) Noting that several jurisdictions including West Virginia have limited Quill's physical presence requirement to sales and use taxes, the ALJ instead relied on a "substantial economic presence" standard considering the frequency, quantity and systematic nature of Petitioner's contacts with the state.

(iii) The ALJ found substantial economic presence by looking to the heavy penetration of Petitioner's trademarks into the West Virginia marketplace. The ALJ emphasized that "[p]roducts bearing its trademarks and trade names can be found in many, perhaps most, retail stores in West Virginia that sell food products." This finding was supported by consideration of various redacted sales and royalty figures.

(iv) The ALJ also rejected Petitioner's attempt to "compartmentalize the transactions" to individual license sales, noting that Petitioner's aggregate sales, and specifically its sales to affiliated companies, produce a substantial economic impact.

e. Of note, the ALJ dismissed the Tax Commissioner's assertion that the sales of trademarks and trade names to affiliate entities were "sham" transactions solely for tax evasion purposes. This face was "irrelevant," according to the ALJ, and the real issue was whether the Petitioner could be constitutionally subjected to taxation by West Virginia.

DOING BUSINESS IN THE STATE

ARIZONA

The Arizona Department of Revenue refused to apply P.L. 86-272 to one entity in a consolidated return. Nexus was dependent on the principal taxpayer and it had nexus in Arizona.

Arizona Dep't of Rev. v. Central Newspapers, Inc., 218 P.3d 1083 (2009).

1. A subsidiary of taxpayer conducted no business activities in Arizona beyond the solicitation of orders. It did not have employees or maintain a sales office or store in Arizona. Taxpayer argued that under P.L. 86-272 (15 U.S.C. § 381), its subsidiary's income should not be included in Taxpayer's consolidated return.

2. The Court rejected taxpayer's argument because the taxpayer had chosen to file a consolidated return, so it had to include its subsidiaries. Moreover, "the primary trigger for the application of [15 U.S.C. § 381] is not the receipt of income from interstate commerce, but the lack of contacts by the taxpayer with the taxing state." Because the taxpayer itself had sufficient contacts, its subsidiary's lack of contacts were immaterial.

COLORADO

This advisory applies P.L. 86-272 to situations in which in-state employees solicit sales. If the vendor has no employees or merchandise in Colorado, it is not subject to income tax liability.

Colorado Dep't of Rev., FYI Income 58, ¶200-926, October 2009.

1. A corporation must file a Colorado corporate income tax return if it does business in Colorado or derives business from Colorado sources. If a corporation's only activity in Colorado is soliciting sales of tangible personal property, and the sales orders are sent out of Colorado for acceptance and fulfillment, the corporation does not have a filing obligation with Colorado.

2. Corporations that do not have employees nor stocks of goods in Colorado and do not engage in activities in the state, other than the shipping of goods to customers in Colorado pursuant to orders received by mail, telephone, or the Internet, are not "doing business" in Colorado and are not subject to Colorado income tax. Likewise, if sales are made to customers in Colorado pursuant to orders taken by independent brokers or dealers, if such corporations have neither employees nor stocks of goods in Colorado and engage in no other activities in the state, a corporation is not subject to Colorado income tax.

<u>CONNECTICUT</u>

Regardless of physical presence, "substantial economic nexus" will create income tax nexus in Connecticut for out-of-state corporations and S corporations.

HB 6802 (2009).

1. On August 31, 2009, the Connecticut General Assembly passed a bill which established an "economic nexus" standard for determining whether an out-of-state corporation is subject to the corporation business tax. The bill became law on September 8, 2009.

2. Effective for taxable years beginning on or after January 1, 2010, the bill states that, to the extent allowed by the U.S. Constitution, an out-of-state corporation and certain partnerships and S corporations with "substantial economic presence" in Connecticut are subject to the corporation business tax, regardless of a physical presence, if there is substantial economic presence in Connecticut or derived income from sources in the state. A "substantial economic presence" in Connecticut means purposefully directing business towards the state. Such "purpose" is determined by the frequency, quantity and systematic nature of economic contacts with the state.

3. The same kind of "economic presence" standard was also enacted for S corporations. The test is evidence of "a purposeful direction of business" toward Connecticut.

INDIANA

Sometimes nexus is a good thing. This taxpayer was allowed to apportion its income to non-Indiana jurisdictions.

Letter of Findings No. 08-0583, Indiana Department of Revenue (July 29, 2009).

1. Taxpayer's sales force operated out of their homes and used their own vehicles, solicited orders in other states and forwarded the orders to taxpayer's Indiana offices, which then shipped the goods to the out-of-state customers. Taxpayer sought to apportion its income so Indiana could not tax it all for a given year. The Department's initial audit determined that taxpayer was not entitled to apportion its income because it did not establish nexus in any other state except Indiana. Taxpayer challenged the audit and the Department reversed.

2. When a taxpayer proved that it filed and paid net income tax in other states, it could apportion its income to avoid double taxation. In addition, when a taxpayer established that it was subject to taxes in other states, sales to customers in those states would not be "thrown back" to Indiana for income tax purposes.

An Illinois auto dealer had nexus in Indiana because it had an Indiana office. It was immaterial that the dealer's customers registered cars in states other than Indiana.

Indiana Dep't of Rev., Letter of Findings No. 09-0154, ¶20091030012 (Oct. 28, 2009).

1. Taxpayer is an Illinois car dealership renting an office and selling cars in Indiana. Taxpayer protested assessments of income tax. Taxpayer argued that customers from out of state and cars sold to them were registered in states other than Indiana, so sales were not generated from Indiana. The Department rejected Taxpayer's arguments, explaining that Taxpayer still was "doing business in Indiana" because Taxpayer maintained an office in Indiana and the sales forms were generated by Taxpayer's Indiana office.

KANSAS

This is an excellent summary of nexus creating activities in Kansas.

Information Guide No. KS-1510, CCH ¶ 201-270 (Oct. 2009); Information Guide No. KS-1520 CCH ¶ 201-265 (Oct. 2009).

1. Two Kansas Department of Revenue publications explain "nexus," for purposes of the Kansas retailers' compensating use tax as a "'means of connection' or a 'link'" that varies from situation to situation. The publications set forth the following as "some of the areas the department looks for" in

nexus determinations:

a. Business location in Kansas, including an office;

b. The presence in Kansas of sales or service representatives;

c. Operation of mobile stores in Kansas (example: trucks with a driver salesperson);

d. Stocking inventory in a Kansas warehouse or on consignment;

e. Providing tangible personal property for lease or rental in Kansas;

f. Delivering merchandise to Kansas customers using company vehicles or contract carriers, other than interstate common carriers; and

g. Providing or contracting for installation, construction, repair, or other services in Kansas (such as maintenance contracts).

KENTUCKY

Kentucky passed a new law that creates a "doing business" rule for ownership interests in a Kentucky general partnership, for tax years on and after January 1, 2005.

Ky. Rev. Stat. § 141.040.

1. On March 18, 2005, the Kentucky Legislature amended Ky. Rev. Stat. §141.040 (effective January 1, 2005) eliminating the physical presence standard relied on by the Board in Ashworth Corp. v. Kentucky Revenue Cabinet, 2006 Ky. Tax LEXIS 63 (Ky. BTA Jan. 27, 2006), rev'd, Kentucky Revenue Cabinet v. Ashworth Corp., No. 06-CI-00288 (Ky. Cir. Ct. Dec. 4, 2007), aff'd in part, Kentucky Revenue Cabinet v. Ashworth Corp., 2009 Ky. App. LEXIS 229 (Ky. Ct. App. Nov. 20, 2009). Effective for tax years beginning on or after January 1, 2005, the amended statute instead adopts a "doing business" nexus standard. Under this new standard, every corporation doing business in Kentucky is subject to the corporate income tax. "Doing business" is defined for this purpose as including, among other things, "maintaining an interest in a general partnership doing business in [Kentucky]," and "deriving income from or attributable to sources within [Kentucky]." Ky. Rev. Stat. §141.010(25)(e) and (f). Accordingly, the Board's decision in Ashworth should not be solely relied on for tax years beginning on or after January 1, 2005.

MASSACHUSETTS

While the use tax audit had Commerce Clause issues, the Supreme Judicial Court reversed the assessment on burden of proof grounds and lack of audit evidence.

Town Fair Tire Centers, Inc. v. Commissioner,
No. SJC-10360, CCH T 401-256 (Mass. 2009).

1. Taxpayer is a Connecticut corporation with the principal business of the retail sale and installation of automobile tires. During the period at issue in this matter, Taxpayer operated 60 stores in New England, including 18 stores in Massachusetts and three stores in New Hampshire. Taxpayer collected and remitted Massachusetts sales tax on tire sales at its Massachusetts stores, but it did not collect Massachusetts use tax in connection with the sale of tires at its stores outside Massachusetts.

2. An auditor with the Massachusetts Department of Revenue, using a single month as a sample, discovered that Taxpayer's three New Hampshire stores had 313 invoices that listed a Massachusetts address beneath the name of the purchaser. The auditor determined that Taxpayer should have collected and remitted Massachusetts use tax for the 313 sales. Taxpayer appealed and the Appellate Tax Board found that the sales at issue were sales of tangible personal property to be used in Massachusetts and held that the assessment of use tax was proper.

3. The Court reversed the Board's decision, pointing out that there was no evidence that the tires were actually used in Massachusetts. The Court said it was particularly significant that there is no statutory presumption that a vendor's knowledge that a purchaser is a resident of Massachusetts will permit a finding that the goods purchased out-of-state were purchased for use in Massachusetts.

4. The Court did not rule on the Commerce Clause issues raised by the taxpayer.

NEW JERSEY

These very interesting cases hold that, in and of itself, licensing computer software does not create nexus – and that the New Jersey Tax Court does not blindly apply Lanco.

AccuZIP, Inc. v. Division of Taxation;
CCH 91 401-462 (N.J. Tax Ct. Aug. 13, 2009).

1. AccuZIP, Inc. and Quark, Inc. are two computer software corporations that were domiciled out of state and appealed from final determinations issued by the Division of Taxation finding the corporations liable for the Corporation Business Tax ("CBT"). Nexus assessments against them were overruled by the Tax Court, although Quark was found to be doing business in New Jersey because of a resident sales person, P.L. 86 272 prohibited the CBT assessment.

2. AccuZIP is a Nevada corporation with offices in California. It has no agents, officers, or employees in New Jersey, and its management, offices,

and other places of business are not located in New Jersey. Furthermore, it did not own or rent any real property in New Jersey. AccuZIP develops and sells computer mailing programs to customers nationwide. It marketed its products by placing advertisements in national trade magazines and maintaining a website. Customers placed orders via telephone, e-mail, or fax with an AccuZIP employee in California. The products were then shipped to customers from the California office.

3. Between 1999 and 2001, AccuZIP had 93 customers in New Jersey who generated 2% of the company's total gross income. In 2002, AccuZIP completed a Nexus Survey at the request of the Director of the Division of Taxation. The Director found that AccuZIP was "doing business" in New Jersey for CBT purposes because it retained title to licensed software in New Jersey.

4. The Tax Court, however, found that the nature and extent of AccuZIP's activities in New Jersey, as well as the continuity, frequency and regularity of those activities, were de minimus. Importantly, the Court found that AccuZIP was selling tangible personal property - prewritten software - and not licensing intellectual property to New Jersey customers. Accordingly, the Court held that AccuZIP was not "doing business" in New Jersey, as there was no substantial nexus between AccuZIP and New Jersey.

5. Quark is a privately held Colorado corporation with its principal offices and headquarters in Denver, Colorado. Quark does not own property in New Jersey, but it employed a regional sales representative in New Jersey that sold Quark's products and held educational sessions. Quark developed and copyrighted a desktop publishing computer program. Its products, the disks containing the program, were shipped from a fulfillment center to locations around the world.

6. The Director found that Quark's licensing of software to New Jersey customers, while retaining title to such software, constituted "doing business" in New Jersey. The Tax Court also held that Quark sold tangible personal property and did not license intellectual property to New Jersey customers. However, because Quark's regional sales representative in New Jersey traveled to stores in New Jersey that sold Quark's products, Quark was "doing business" in New Jersey for CBT purposes at the minimum tax because P.L. 86-272 otherwise prohibited taxation of Quark.

<u>BIS LP, Inc. v. Division of Taxation</u>,
CCH 91 401-457 (N.J. Tax Ct. July 30, 2009).

1. BISYS Group, Inc. provides information processing and technology outsourcing services for its clients. It reorganized its banking information solutions division, creating a limited partnership, known as BISYS Information Solutions ("Solutions"), which was in the data processing business. BISYS, a wholly owned subsidiary of BISYS Group, transferred the assets and liabilities of its data processing business to Solutions. BISYS and BIS LP, Inc., the plaintiff in this case and a wholly owned subsidiary of BISYS, entered into a

limited partnership agreement, whereby BISYS was the general partner of Solutions with a 1% interest and BIS was the limited partner with a 99% interest.

2. BIS did not have a place of business in New Jersey; it did not have employees, agents, or representatives; and did not own property in New Jersey. BIS' sole interest in New Jersey was its limited partnership interest in Solutions, a New Jersey partnership. However, the Division of Taxation issued a corporation business tax (CBT) assessment of $1,008,537 to BIS on the basis that it had a unitary relationship with the business conducted by Solutions, giving BIS enough of a constitutional presence in New Jersey to subject it CBT.

3. The Tax Court, on the other hand, found that Solutions and BIS were not integrally related. Rather, BIS was a passive investor in Solutions, and BIS had no control or potential for control in the limited partnership. It was not in the same line of business. A foreign corporation that simply holds a limited partnership interest in a New Jersey partnership and is not part of the unitary business of the partnership is not subject to CBT.

NEW MEXICO

An out-of-state drop shipper was declared immune from New Mexico's gross receipts tax because it had no physical presence nexus in New Mexico. The Department of Revenue deemed it critical that the drop shipper never had physical possession of its customers' merchandise – it had gross receipts but no nexus.

1. Administrative Ruling, No. 401-09-05, CCH ¶ 401-258 (N.M. Taxation and Revenue Dept. Dec. 3, 2009).

2. The New Mexico Taxation and Revenue Department considered a set of hypothetical facts to determine whether a out-of-state taxpayer would be liable under the gross receipts tax and/or the compensating tax for sales to New Mexico customers. In the hypothetical, an out-of-state "Company X" sells property to New Mexico customers by drop shipment. In such transactions, the customers order merchandise from Company X. Company X then purchases the property from vendors and has the property delivered to New Mexico customers by common carrier without Company X ever taking physical possession of the property.

3. Company X has no equipment, offices, warehouses, employees, advertising or other contacts with New Mexico. It contracts with customers in a way that Company X retains title in the property from the point in time when customers order the property to the time when the customer receives the property from Company X via common carrier. Based on these facts, Company X asked the New Mexico Taxation and Revenue Department whether it or its vendors were subject to New Mexico's gross receipts tax and/or the state compensating tax.

4. The Revenue Department determined that Company X was not subject to

the gross receipts tax because it lacked a nexus with New Mexico. In its analysis, the Department first determined that the drop shipments to customers in New Mexico were gross receipts from the selling of property in New Mexico. However, the brief ownership by Company X of the property, without ever taking physical possession, was not sufficient ownership to establish nexus. Without other physical ties — equipment, offices, warehouses, etc. — Company X did not have sufficient tax nexus with New Mexico.

5. The Department did not thoroughly analyze nexus considerations regarding the vendors, but noted that the vendors were eligible for certain deductions under state law should nexus be found.

6. For statutory reasons, such as the resale exemption, the Department found Company X and the vendors could be exempt from the compensating tax if the statutory requirements were satisfied by Company X and the vendors.

<u>NEW YORK</u>

Every decade or so, a taxpayer wins a use tax case on an aircraft. Here, unusual facts about a World War II P-51 Mustang fighter plane resulted in a finding that mere ownership of the P-51 Mustang did not constitute "doing business" in New York for tax purposes.

Advisory Opinion, Petition No. 821342, CCH ¶406¬033 (N.Y. Dept. of Tax & Fin. Apr. 18, 2008) aff'd In re Rochester Amphibian Airways, Inc., CCH T 406-484 (N.Y. Tax App. Trib. Aug. 6, 2009).

1. On appeal, the Tax Appeals Tribunal affirmed the Division of Tax Appeals' decision involving a use tax assessment against a Delaware corporation that owned two vintage World War II aircraft. The Tribunal held that the corporation's ownership and maintenance of the aircraft, purchased in another state, did not constitute doing or carrying on a business in New York.

The method and location of the ultimate delivery of asphalt controlled the New York sales tax consequences of initial railcar delivery in Albany. This is a good reminder of basic nexus rules.

Advisory Opinion, Petition No. S090206A, CCH T 406-471 (N.Y. Dep't of Tax & Fin. July 14, 2009).

1. Petitioner is one of the largest asphalt refiners and marketers in the United States. Petitioner's product comes into the railway terminal in Albany, New York in railroad cars in a "heated" and "wet" condition. The asphalt is delivered to customers at the terminal by loading it into tractor-trailer (tanker) combinations or tank trucks. These vehicles may be owned by the customer or may be owned and operated by a third-party carrier contracted and paid directly by the customer.

2. Many of Petitioner's customers are out-of-state entities that are not doing business in New York. The customers may subject the asphalt to further processing and either resell the asphalt or use it in fulfillment of construction projects. These customers all assert that the asphalt is not for use in New York. Petitioner requested an advisory opinion as to whether its asphalt sales are subject to sales tax.

3. The Opinion stated that if Petitioner relinquishes possession of the asphalt directly to the custody of a common carrier, Petitioner is required to collect New York sales tax only on deliveries made to locations in New York, unless otherwise exempt. However, any delivery of the asphalt to an agent, representative, or employee of the customer was a taxable transfer of the possession of the asphalt to the customer in New York.

SOUTH CAROLINA

This extensive guidance includes nexus creating activities and is a useful reference to those planning to do business with South Carolina customers.

Revenue Ruling 09-9, South Carolina Department of Revenue, CCH ¶400-488 (June 16, 2009).

1. The South Carolina Department of Revenue released a notice that explains when a retailer with Commerce Clause nexus in South Carolina has sufficient minimal connection with a jurisdiction in order to subject it to sales and use taxation.

2. If a retailer with Commerce Clause nexus purposefully avails itself of a jurisdiction's economic market or has purposefully directed its efforts towards the jurisdiction's residents, it may be subject to the authority of that jurisdiction and will be required to submit taxes on deliveries into that jurisdiction. A retailer's physical presence within a jurisdiction is not necessary. A retailer with nexus in South Carolina must remit a jurisdiction's sales and use tax when it delivers property into a jurisdiction using its own vehicles or a contract carrier. A retailer is also subject to a jurisdiction's taxes when it uses a common carrier for deliveries and Due Process nexus has been established with the jurisdiction. Examples of Due Process nexus include advertising using media located in the jurisdiction, maintenance of property within the jurisdiction, and placing agents or employees within the jurisdiction.

VIRGINIA

Sometimes a state removes an affiliate from a consolidated return on a "no nexus" basis.

Ruling of Commissioner, P.D. 09-121,
CCH ¶205-049 (Virginia Department of Taxation, August 7, 2009).

1. Taxpayer was the lead corporation in an affiliated group (the "Group") that filed a consolidated Virginia corporate income tax return for the 2003 taxable

year. Under audit, the Department removed one of the entities, "X", from the consolidated return, finding that X lacked income from Virginia sources and lacked nexus to the state.

2. X was a construction contractor based outside Virginia and had no payroll or property in the state. For the 2003 taxable year, X's sole revenue resulted from a final progress billing invoice for a contract completed in a previous taxable year. In addition, X had out-of-state personnel traveling into Virginia soliciting additional contract work. The Taxpayer contested the assessment, asserting that X had nexus with Virginia for the 2003 taxable year and was properly included in the Group's consolidated return because it was actively pursuing additional work in Virginia.

3. Generally, a corporation not organized under Virginia law is subject to Virginia income tax if the corporation receives income from Virginia sources, unless exempted by Va. Code § 58.1-401 or Public Law (P.L.) 86 272. P.L. 86-272 prohibits a state from imposing a net income tax where the only contacts with a state are a narrowly defined set of activities constituting solicitation of orders for sales of tangible personal property. The Department limits the scope of P.L. 86-272 to only those activities that constitute solicitation, are ancillary to solicitation, or are de minimis in nature.

4. The Tax Commissioner concluded that X did not have nexus with Virginia for the 2003 taxable year. X did not provide contracting services in Virginia in 2003. X did have personnel traveling into Virginia to pursue potential contracts; these activities involved a bidding process that extended several months involving multiple visits to potential construction sites. The bid work was primarily conducted by a project superintendent who traveled into Virginia in a company owned truck. X was eventually granted a contract set to begin in 2004, but lack of funding caused the contract to be cancelled.

5. The Tax Commissioner found that actively pursuing business in Virginia generally includes activities included in the solicitation of orders. According to the Commissioner, "[s]uch activities cannot create nexus pursuant to P.L. 86-272." The Taxpayer provided no evidence that the project superintendent conducted any activities in Virginia that exceeded the protection afforded under P.L. 86-272. Therefore, X did not have nexus with Virginia.

After an analysis of the rules about licensing and selling software, the Tax Commissioner concluded that the out-of-state company was leasing servers in Virginia with licensed prewritten software in a sufficient quantity to create nexus.

Ruling of Commissioner, P.D. 09-169, CCH ¶205-099 (Virginia Department of Taxation, October 23, 2009).

1. The Ruling of the Commissioner discuses the application of retail sales and use tax to an out-of-state company that licenses software installed on servers shipped to customers in Virginia. The Company has an office located outside Virginia and all employees work at this office. There are no traveling

salespersons, installers, service people, subcontractors, independent contractors, agents, affiliates, or similar individuals entering Virginia on behalf of the Company. According to the Company, it creates and sells canned software, which the Company installs, configures and tests on computer servers at its office. This characterization of the Company's business was disputed by the Commissioner in this ruling. Once operating correctly, servers with installed software are shipped to customers in Virginia via common carrier. The Company pays sales or use tax on the cost of these servers in the state where its office is located. The software installed on these servers functions and receives software fixes, upgrades and patches through a link to a network with an Internet connection.

2. The facts also revealed that although the Company states that it sells a canned software product, the company actually licenses the software without passing title to the software to another person. Also, the Company treats itself as a user or consumer of the servers as it pays the sales tax on the cost price of such servers to its home state. Generally, a person engaged in personal or professional service transactions is the user or consumer of the tangible personal property used in the performance of such services. See Title 23 of the Virginia Administrative Code 10-210-4040 E and Va. Code § 58.1-609.5 1. In an attempt to respond to the issue presented, the Commissioner addresses the application of the tax using two likely scenarios.

3. (1) Service Provider. If the Company is a service provider in Virginia, then it is generally liable for the tax on all servers, software and any other tangible personal property used in Virginia for its provision of services. An exception to this rule would be for servers and software owned or leased by an Internet service provider to enable users to access proprietary and other content, information, electronic mail, and the Internet as part of a package of services sold to end-user subscribers.

4. (2) Lessor or Renter. If the Company is engaged in transactions for the lease or rental of tangible personal property in Virginia and does not use the servers, software and other tangible personal property in the provision of exempt information services, then it is engaged as a dealer in Virginia, pursuant to Va. Code §58.1-612 B 5. Under these circumstances, an examination of the Company's activities in Virginia is required to determine whether the Company has sufficient activity in Virginia pursuant to Va. Code § 58.1-612 C 9 to require it to register for use tax collection duties.

5. According to the Commissioner, the facts presented suggest that the Company satisfies the criteria of Va. Code § 58.1-612 C 9 as a "dealer." When the Company engages in the retail or lease of servers with licensed prewritten software to Virginia customers, it maintains a continuous physical presence in Virginia that regularly and intentionally makes use of the Virginia marketplace. The software and server fees are also not incidental nor of immaterial value. Moreover, the Company's physical and economic presence on an ongoing basis in Virginia is not a de minimis presence in Virginia but a significant one. Thus, the Commissioner found that the Company's leasing presence in Virginia from 2002 through 2006 is sufficient to require registration for the collection of the sales or use tax on the server and

software charges imposed on Virginia customers.

WASHINGTON

It's hard to defeat a Seattle B&O tax assessment, but this Limited Partnership prevailed. Its office in Seattle and the passive receipt of royalty income from 1947 trademarks and other intangibles was not "doing business" for B&O tax purposes.

Blistex Bracken v. City of Seattle, No. 62006-1-I (unpublished opinion), Washington Court of Appeals, Division One (September 21, 2009).

1. The minimal business activities of a family's limited partnership in Seattle were insufficient to justify the city's assessment of business and occupation ("B&O") tax on the royalty income the family received from licensing trademarks. Affirming the trial court, the Washington Court of Appeals held that the city's imposition of B&O tax violated Due Process.

2. Since 1947, the family had licensed the trademarks it owned for lip balm and skin care products to an Illinois corporation. To avoid probate and re-registering the trademarks each time an heir died, the family formed a limited partnership ("LP") to hold the trademarks the family owned and to receive the royalty payments from the Illinois corporation. A family member who was the general partner rented an office in downtown Seattle to store the LP's records and receive mail. Royalty payments the LP received were either mailed or sent by wire transfer to a banking account in Seattle, and an accounting firm prepared the federal tax return.

3. Although the city conceded the LP was an estate planning mechanism, the city contended that under its municipal code, the LP was engaged in business activities by owning, managing, and maintaining the trademarks. The court found, however, that the fact that the LP received royalties did not make that income taxable; the LP had to be engaged in business activities that generated the sales and royalty income. The corporation, not the LP, developed, manufactured, marketed, licensed, and sold products using the trademarks, and generated the royalty income. The LP's maintenance of an office, use of banking services, and hiring of accountants to prepare federal tax returns were not a determining factor in deciding the tax issue.

WISCONSIN

"Doing business" in Wisconsin now includes new "economic nexus" activities like solicitation of Wisconsin customers.

Wis. Stat. § 71.255 (2009).

1. Wisconsin passed this new legislation, which will be effective for tax years beginning on or after January 1, 2009. Under the new legislation, the definition of "doing business in this state" has been expanded to incorporate a variety of economic nexus concepts. Activities considered to constitute doing

business in Wisconsin, and hence, subject corporations to the Wisconsin corporation income tax, will now include: (1) regularly selling products or services of any kind or nature to in-state customers that receive the product or service in Wisconsin; (2) regularly soliciting business from potential customers in Wisconsin; (3) regularly performing services outside Wisconsin for which the benefits are received in Wisconsin; (4) regularly engaging in transactions with in-state customers involving intangible property and resulting in receipts flowing to the taxpayer from within Wisconsin; and (5) holding loans secured by real or tangible personal property located in Wisconsin.

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