STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

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

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. More…

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

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 as a method of bringing in additional revenue. More…

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

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

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tortuous journey through the Georgia court system. More...

Uncertain Tax Positions, And The "Other Shoe"

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

Addressing an issue of first impression, the First District Court of Appeal of California, in *Franchise Tax Board v. Superior Court of San Francisco*, 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"). More...

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...

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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...

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

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. More...

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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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]

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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

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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.

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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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STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

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]

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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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JONES DAY STATE TAX RETURN NEWSLETTER

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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]

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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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STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

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.

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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

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STATE TAX RETURN NEWSLETTER

Volume 17 Number 2 June 2010

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

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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.

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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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STATE TAX RETURN NEWSLETTER

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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]

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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

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STATE TAX RETURN NEWSLETTER

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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,

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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]

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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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