STATE TAX RETURN NEWSLETTER

Volume 17 Number 3 September 2010

New York's Budget Bill is Finally Done!

The sun set many times on the Empire State between April 1, when the Budget is constitutionally required to be passed, and August 11, when Governor Paterson finally signed Chapter 57 of the Laws of 2010 into effect. The good news is that, despite a strained economy, and despite (or because of?) an unruly Legislature, the damage inflicted by the 2010 tax legislation, while painful to those affected, was not as bad as it could have been. More...

2010 California Tax Policy Conference

More...

Amnesty Alert—Programs Ending September 30!

As previously reported in the State Tax Return, state and local taxing jurisdictions have been increasingly adopting tax amnesty programs to generate revenue in response to budget shortfalls. These programs offer taxpayers significant opportunities (and in some cases pitfalls) for coming forward and remitting past due tax liabilities. We return to this space once again to update you on the major state tax amnesty programs slated for the fall of 2010. The recurring trends this season appear to be September deadlines, and a waiver of interest in addition to the standard penalty waiver. More...

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Case" Finally on Track

When Ohio first adopted a controversial "bright-line presence" nexus standard for its new commercial activity tax ("CAT") back in 2005, few taxpayers would have guessed that more than five years later, the constitutional questions surrounding the aggressive new standard would still remain unresolved. But until just a few weeks ago, no clear "test case" was on track to challenge the statute and address these issues. All of this changed on August 10, 2010, when the Ohio Department of Taxation (the "Department") issued its first public-record decision on CAT nexus to L.L. Bean, Inc., affirming assessments issued to a retailer that has significant sales to Ohio customers but no physical presence within Ohio. More...

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DMA Challenges Colorado's Non-Collecting Retailer" Notice and Reporting Regime

As previously reported in the *State Tax Return*, the Colorado General Assembly recently enacted new notice and reporting requirements for retailers that sell goods to Colorado purchasers but do not collect sales or use tax. The Colorado Department of Revenue (the "Department") was quick to promulgate regulations that impose significant penalties for noncompliance. The Direct Marketing Association is now challenging the constitutionality of these sweeping changes. More...

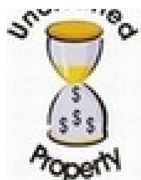
The Marcellus Shale Formation: Pennsylvania's Natural Gas Severence Tax Debate

Pennsylvania has a long history of producing natural gas from a large number of conventional shallow low-production wells, principally for domestic household use. Only Texas has more currently active wells. Pennsylvania ranks 15th in natural gas production among U.S. states, and it is the largest producer without a severance tax. More...

Michigan Legislation Reinstates SBT Conformity With Federal "Check the Box" Election for Federally Disregarded LLCs

The Michigan Legislature took action this session to amend MCL 205.27(a) in order to swiftly limit the effect of the 2009 Michigan Court of Appeals decision in *Kmart Michigan Property Services v. Michigan Department of Treasury*. That decision rejected conformity with federal "check the box" election for purposes of the (now repealed) Michigan Single Business Tax ("SBT"). In the absence of the legislative "fix," the *Kmart* decision would have required entities that are "disregarded" for federal income tax purposes to file separately for SBT purposes. More...

Changes in Unclaimed Property Laws Provide a Financial Windfall



to New Jersey and New York, Administrative Review Passes in Delaware, and Pennsylvania Offers Amnesty

In an effort to close next year's budget gaps, New Jersey and New York recently changed their unclaimed property laws to increase state revenue. These changes, in addition to Pennsylvania's offer of amnesty and Delaware's passage of an administrative review law, are discussed below. More...

NEXUS: Update On Recent Developments

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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Volume 17 Number 3 September 2010

New York's Budget Bill is Finally Done!

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The sun set many times on the Empire State between April 1, when the Budget is constitutionally required to be passed, and August 11, when Governor Paterson finally signed Chapter 57 of the Laws of 2010 into effect. The good news is that, despite a strained economy, and despite (or because of?) an unruly Legislature, the damage inflicted by the 2010 tax legislation, while painful to those affected, was not as bad as it could have been.

Credits Deferred

For businesses, one of the most significant changes is the temporary deferral of tax credits. New Tax Law § 33 provides that, for tax years beginning on or after January 1, 2010 and before January 1, 2013, only $2 million of credits can be claimed in any tax year. The $2 million is pro rated among the various types of credits to which a taxpayer may be entitled. The excess is carried forward and freed up beginning in 2013 – assuming of course the limitation is not further extended. The new legislation further added provisions specifying that, in the case of biofuels and incubator facility credits earned in a pass-through entity, the dollar limitations imposed on those particular credits are to be measured at the entity level, not at the member level.[1]

Stewardship Rewarded

Another significant change, and a rare improvement for

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businesses, is a loosening of the circumstances under which the New York activities of an affiliated entity can create sales tax nexus for an out-of-state entity. The law had generally provided that an out-of-state seller with no New York contacts will nonetheless have nexus to New York if an affiliated vendor, measured by a 5% common ownership threshold, uses the same trademarks, service marks or trade names in New York, or engages in activities inuring to the benefit of the out-of-state entity in the development or maintenance of a market in New York. The 2010 legislation now carves out of the latter category the provision of accounting or legal services, and directing the activities of the out-of-state entity, for example in making decisions about strategic planning, marketing, inventory, staffing, distribution or cash management. Stewardship-type activities carried on by an affiliate in New York thus will no longer taint the out-of-state seller with nexus.[2]

Welcome Robert Waldow!

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REITs Captured

Captive REITs have been addressed yet again in the 2010 legislation. The new law has eliminated the clause that automatically excluded any publicly-traded REIT from captive REIT status. Thus, a captive REIT is now any entity that is more than 50% owned by an association classified as a corporation. "Listed Australian Property Trusts" and certain qualified foreign entities have, however, been excluded from the category of owner that causes captive status. Furthermore, and perhaps not surprisingly, the sunset provision that had been negotiated in enacting the captive REIT provisions a few years ago, under which the entire captive REIT regime was to disappear for taxable years beginning after January 1, 2011, has now been repealed. Thus, the captive REIT rules, as they have changed from year to year since their 2007 enactment, do not seem to be going away any time soon.[3]

Factored Sales Tax Credits Repealed

On the sales tax front the 2010 legislation contained bad news for private label credit cards and similar structures. The legislation repealed a relatively recently enacted rule that had allowed certain factors and similar lenders to claim sales tax credits for bad debts when the purchaser/debtors whose obligations they had acquired defaulted on payment. This relief provision had been enacted to provide some equity, where tax has been remitted in respect of a sale but the customer ultimately fails to pay the bill. With the repeal of this provision we return to an unfortunate mismatch between the taxes paid to New York and the tax dollars ultimately actually collected from customers.[4]

Tourism Taxed for Remarketing

"Room remarketers," including online travel companies, also got stung by the new legislation. They are now treated as subject to sales tax on the "margin" earned for providing travel booking services. In addition, the New York City Hotel Occupancy Tax was directly amended to authorize the imposition of that tax on the margins earned by room remarketers, and to conform the City's tax to the new sales tax.[5]

Carried Interest Comes and Goes

Perhaps the biggest news in the budget legislation is the tax that wasn't. As originally enacted, the 2010 budget bill included "carried interest" provisions, which would have recharacterized, for both corporations and individuals, that portion of a distributive share of partnership income attributable to their provision of "investment management services." New York has sought for some time now to get out ahead of the federal income tax on the treatment of carried interests, and for a while it appeared they might. However, the day after passing the Budget Bill that included the carried interest provisions, the New York Legislature passed a second bill repealing that portion of the Budget Bill, and the Governor signed both, meaning that the carried interest rules came and went at the same time. Interesting approach to legislating!

338(h)(10) Reinstated Retroactively for S Corps

For individuals the 2010 legislation included some expensive changes. Nonresident S corporation shareholders had enjoyed a favorable Tax Appeals Tribunal decision that essentially undid section 338(h)(10) elections, treating them as selling stock, and also favorably treating their collections on installment notes distributed by an S corporation. The recent legislation undoes this, retroactively for all open years. The good news on that front, however, is that buyers of S corporations in § 338(h)(10) transactions, who might have been concerned that they no longer had the treatment they had bargained for, can now be assured that, for all open years, their intended treatment is assured.[6]

Nonresidents to Share More Income

Nonresidents also now face tougher rules for sourcing income derived under covenants not to compete, termination agreements, and the like. The exact contours of these new rules remain to be seen, but nonresidents, and those responsible for withholding in respect of nonresidents, need now to take this new statute into account in quantifying their tax exposures.[7]

Deductions Slashed and Rates Increased for Top Earners

Nonresidents are not, however, the only ones feeling new pain. Itemized deductions have now been all but eliminated from the Personal Income Tax for those with incomes over $1,000,000. Between $1 million and $10 million of income, the only itemized deduction still allowed is 50% of charitable deductions. Over $10 million the charitable deduction is cut back to 25%. In addition to eliminating itemized deductions for high-income earners, the top tax rate on New York City residents was increased from 3.2% to 3.4%. And for all New York State filers the modifications to deductions allowed (where itemized deductions are still relevant) now excludes from deductible amounts any federal deduction claimed for sales taxes in lieu of state income taxes.[8]

Failure-to-File Felonies and Other Refined Print

In addition to the rather varied tax law changes described above, the newly enacted budget legislation included some additional items of note. A new provision has been enacted making it a Class E felony for individuals and corporations to fail to file New York returns for 3 successive years, unless it is shown no tax is due. New reporting provisions

have been enacted to mirror the federal provisions of Internal Revenue Code § 6050W, requiring reporting in respect of the settlement of payment card and third party network transactions. There have been changes to the film production credit and low income housing credit rules; changes to the QEZE and IDA rules; tighter sales tax rules for transfers of vessels and aircraft; and a shortening to three years of the period after which unclaimed amounts for services not rendered or goods not delivered will be considered abandoned.

All in all, it could have been worse. We are now deep into campaign season, and certain to have a new Governor, and perhaps a differently oriented Legislature. Our government never seems to get smaller. So unless, in particular, personal income tax and sales tax revenues have rebounded from the recession, keep a watchful eye on New York for more revenue raisers.

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[1] N.Y. Tax Law §§ 28(a), 210-G(f). ^TOP
[2] N.Y. Tax Law § 1101(b)(8)(i)(I). ^TOP
[3] N. Y. Tax Law § 2(9); Ch. 57, L. 2008, Part FF-1, § 18. ^TOP
[4] N.Y. Tax Law § 1132-e, repealed. ^TOP
[5] N.Y. Tax Law § 1101(c), N.Y.C. Admin Code Chapter 25. ^TOP
[6] N.Y. Tax Law §§ 632, 631(b)(1)(E-1). ^TOP
[7] N.Y. Tax Law § 631(b)(1)(F). ^TOP
[8] N.Y. Tax Law §§ 615(g)(1), 615(c)(1), 1304. ^TOP

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JONES DAY STATE TAX RETURN NEWSLETTER

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Amnesty Alert—Programs Ending September 30!

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As previously reported in the *State Tax Return*,[1] state and local taxing jurisdictions have been increasingly adopting tax amnesty programs[2] to generate revenue in response to budget shortfalls. These programs offer taxpayers significant opportunities (and in some cases pitfalls) for coming forward and remitting past due tax liabilities. We return to this space once again to update you on the major state tax amnesty programs slated for the fall of 2010. The recurring trends this season appear to be September deadlines, and a waiver of interest in addition to the standard penalty waiver.

Current Programs Expiring Soon

Several jurisdictions are currently administering amnesty programs that are set to expire soon. Notably, the District of Columbia, Florida, Nevada, and New Mexico are all administering tax amnesty programs that will expire at the end of this month. Kansas follows closely behind with a tax amnesty program that expires in mid-October. The Maine Tax Receivables Initiative will run through the end November. Taxpayers with unreported or underreported liabilities in these jurisdictions need to act quickly to determine whether they are eligible for,

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and interested in participating in, these programs.

District of Columbia: Expires September 30, 2010

Pursuant to the authority set forth in the Fiscal Year 2010 Budget Support Act of 2009,[3] District of Columbia's Chief Financial Officer recently launched a tax amnesty program that covers all taxes delinquent prior to December 31, 2009, except real property taxes and the ball park fee.[4] Taxpayers that pay qualifying delinquent taxes and applicable interest by September 30, 2010, are eligible to receive a waiver of penalties and collection fees and avoid criminal penalties.

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Florida: Expires September 30, 2010

Florida is also conducting a tax amnesty program that is set to expire September 30, 2010.[5] The Florida program applies to all taxes administered by the Department of Revenue, except unemployment tax and Miami-Dade County Lake Belt Fees, to the extent such taxes were originally due prior to July 1, 2010. The program may also apply to local-option taxes for those localities participating 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 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 an eligible tax liability are entitled to a waiver of penalties and 50 percent of the interest that would otherwise be due upon remittance of that tax. Taxpayers currently under audit or investigation by the Department of Revenue 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 for any taxpayer.

Those taxpayers that have liabilities that are the subject of a pending administrative or judicial proceeding may participate in the program but must withdraw the pending administrative or judicial claims. Participating taxpayers will also forfeit the right to protest any assessments paid or request refunds for any amounts paid under the program.

Nevada: Expires September 30, 2010

Nevada is currently administering an amnesty program that expires on September 30, 2010.[6] The Nevada amnesty program applies broadly to all taxes, including sales and use and modified business taxes, fees, and assessments that were originally required to be paid to the Department of Taxation before July 1, 2010. Eligible taxpayers are entitled to a waiver of *all* penalties and interest if the underlying tax is paid in full during the amnesty period. The program does not apply, however, 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. Taxpayers that participated in Nevada's 2008 tax amnesty program are not prohibited from participating

in the current amnesty program.

New Mexico: Expires September 30, 2010

New Mexico is also conducting an amnesty program that ends on September 30, 2010.[7] The amnesty program applies to all taxes owed and administered under the state's Tax Administration Act, including corporate income and gross receipts taxes, and due prior to January 1, 2010. A taxpayer that has been contacted by the Taxation and Revenue Department regarding the commencement of an audit is ineligible for the New Mexico amnesty program with respect to that tax; however, other unreported taxes of the taxpayer may be eligible.

The terms of the amnesty program 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 within 180 days of any issued assessment. Taxpayers opting to participate in the amnesty program waive their rights to protest the amnesty assessment.

Kansas: Expires October 15, 2010

The Kansas Department of Revenue is overseeing an amnesty program that runs from September 1, 2010 through October 15, 2010.[8] The Kansas program applies to a number of taxes administered by the Department of Revenue, including corporate income, sales, privilege, and withholding taxes, to the extent such taxes are due on or before December 31, 2008. Taxpayers with unreported or underreported liabilities may receive a waiver of *all* penalties and interest if the tax and applicable collection fees are paid in full by October 15, 2010.

Taxpayers are not eligible to participate in the amnesty program if, on or after September 1, 2010, they have an audit in progress, receive notice of a commencement of an audit, or receive notice of an assessment due to an audit. Furthermore, taxpayers under any criminal investigation or any civil or criminal litigation related to a Kansas tax may not participate. Tax payments received through the amnesty program are not eligible for a refund or credit, and participating taxpayers forego their administrative and judicial appeal rights.

Maine: Expires November 30, 2010

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 run through November 30, 2010.[9] 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 are 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.

Upcoming Tax Amnesty Programs

In addition to those states discussed above, several other jurisdictions have considered adopting amnesty programs in the future. At this time, Illinois is the only state that has enacted legislation providing for an upcoming amnesty program, though we can expect additional states to do so in the not too distant future.

Illinois: October 1, 2010 through November 8, 2010

The Illinois General Assembly recently enacted amnesty legislation that provides for the waiver of penalties and interest on all taxes collected by the Department of Revenue, except motor fuel tax, to the extent such taxes were due after June 30, 2002, and prior to July 1, 2009.[10] Eligible taxpayers that remit the qualifying taxes between October 1, 2010, and November 8, 2010 will be entitled to a waiver of *all* penalties and interest. Eligible taxpayers that fail to participate, however, will have their penalty and interest charges doubled.

Taxpayers under any criminal investigation or involved in any civil or criminal litigation for nonpayment, delinquency, or fraud related to an Illinois tax may not participate in the amnesty program.

Tax payments received as part of the amnesty program are not eligible for credit or refund; however, participation in the program does not preclude a taxpayer from seeking a refund of overpaid taxes on an issue unrelated to the issues for which the taxpayer claimed amnesty or based upon certain federal adjustments. The Department of Revenue is expected to release emergency regulations soon.

Michigan

The Michigan Legislature has considered amnesty legislation in recent legislative sessions, but none of these measures were ultimately adopted. In her recent budget proposal, however, Michigan Governor Jennifer Granholm proposed a tax amnesty program that, if approved, would occur in 2011. Specifically, the Governor's proposal calls for a program running from May 15, 2011 to June 30, 2011 that would allow taxpayers with delinquent tax liabilities prior to December 31, 2009, to settle their delinquent liabilities with all penalties waived if paid in full prior to the end of the amnesty period.

To Amnesty or Not To Amnesty?

With the adoption of amnesty programs by so many states, taxpayers with unpaid liabilities are increasingly provided with the opportunity to pay delinquent tax while avoiding penalties and, in many cases, interest. While these programs may seem

favorable to taxpayers in general, there are certain considerations that need to be taken into account before deciding whether to participate in a tax amnesty program.

An important consideration for many taxpayer is the ability to challenge the underlying tax at issue. In many states, the taxpayer may be required to forego their rights to protest the underlying tax or seek a refund of any tax paid pursuant to an amnesty program. Similarly, taxpayers with an ongoing administrative or judicial proceeding may be required to withdraw their pending administrative or judicial claim. These parameters could be unattractive to a taxpayer with questionable or uncertain liabilities.

Taxpayers need to keep in mind, however, that significant failure-to-participate penalties could be imposed on those taxpayers who fail to act now. Given the rapidly-approaching expiration dates of several current amnesty programs, taxpayers must quickly evaluate the relative benefits and burdens of each program.

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[1] *See Karen H. Currie & Justin R. Thompson, Amnesty Programs Continue—Taxpayers With Unreported or Underreported Pennsylvania Taxes, Act Quickly!*, JONES DAY STATE TAX RETURN (June 2010); Karen H. Currie, *Amnesty! Amnesty! Amnesty!*, JONES DAY STATE TAX RETURN (September 2009); Karen H. Currie, *Tax Amnesty Update*, JONES DAY STATE TAX RETURN (June 2009); Carolyn Joy Lee et al., *Alert: State Tax Amnesty Programs*, JONES DAY STATE TAX RETURN (April 2009). ^TOP

[2] 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

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

[4] Details of the D.C. tax amnesty program are available at http://www.dctaxamnesty.com/. ^TOP

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

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

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

[8] *See* S.B. 572, 2010 Leg., Reg. Sess. (Kan. 2010). ^TOP

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

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

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STATE TAX RETURN NEWSLETTER

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Breaking News: Ohio's First CAT Nexus "Test Case" Finally on Track

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When Ohio first adopted a controversial "bright-line presence" nexus standard for its new commercial activity tax ("CAT") back in 2005, few taxpayers would have guessed that more than five years later, the constitutional questions surrounding the aggressive new standard would still remain unresolved. But until just a few weeks ago, no clear "test case" was on track to challenge the statute and address these issues. All of this changed on August 10, 2010, when the Ohio Department of Taxation (the "Department") issued its first public-record decision on CAT nexus to L.L. Bean, Inc., affirming assessments issued to a retailer that has significant sales to Ohio customers but no physical presence within Ohio.

L.L. Bean is a traditional catalog and internet seller based in Maine. While it has retail stores in several other states, it has no stores or other physical presence in Ohio. L.L. Bean's annual sales to customers in Ohio exceeded $500,000 during each of the periods at issue. When L.L. Bean failed to register for the CAT, the Department assessed it; L.L. Bean responded by filing a petition for reassessment to administratively challenge the tax.

Because L.L. Bean met the statutory "bright-line presence" test (which defines nexus solely on the

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basis of annual sales to Ohio residents in excess of $500,000), it is not surprising that the Department concluded that L.L. Bean was subject to tax. The Department's final determination in *In re L.L. Bean, Inc.* thus squarely tees up the nexus question for resolution by Ohio courts. While still in the very early stages of the appeals process, the issue presented in *L. L. Bean* is a fairly straightforward one: Must a taxpayer have some physical presence in Ohio before it can be constitutionally required to pay the CAT, or is the statutory requirement of economic presence alone enough?

Welcome Robert Waldow!

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Resolution of the question will turn on whether the United States Supreme Court's longstanding "physical presence" requirement applies to the Ohio CAT. At the heart of the issue is the application of the Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). There, the Court unequivocally held that a mail-order seller lacked substantial nexus under the Commerce Clause—and therefore could not be constitutionally required to collect and remit sales and use tax—because it had no physical presence in the taxing state. Since *Quill*, state courts have differed in their views as to whether *Quill's* physical-presence nexus test is limited solely to sales and use taxes. Despite a split of authority among the states, the U.S. Supreme Court has not agreed to review the issue, and the Ohio Supreme Court has not squarely resolved it either. At its core, therefore, the L.L. Bean case will ultimately force the Ohio Supreme Court to determine whether *Quill* applies to the CAT. If the Department prevails in its view that it does not, L.L. Bean (and countless other out-of-state businesses) will face the curious result of being forced to pay a direct tax measured by the gross amount of sales to its Ohio customers (the CAT), while at the same time being constitutionally protected from any obligation to collect and remit sales tax on those same sales.

The Ohio CAT Nexus Standard and Its Conflict With *Quill*

The CAT has been in effect since July 1, 2005, when the State of Ohio imposed this broad-based gross receipts tax "on each person with taxable gross receipts for the privilege of doing business in this state." R.C. 5751.02. Under the terms of the statute, any business with "substantial nexus"—defined to include companies that merely have "taxable gross receipts" from sources in Ohio totaling at least $500,000—is required to register and pay the CAT. R.C. 5751.02(A), 5751.01(H), (I).[1] The statute calls this "bright-line presence."

On the basis of this statutory standard alone, many companies traditionally immune from state taxation meet the threshold standards sufficient to trigger CAT obligations. However, the obligation to register, file tax returns, and pay state taxes is not defined solely by the applicable state tax statute. Indeed, the Commerce Clause of the U.S. Constitution (U.S. Const. art. I, § 8, cl. 3) prohibits a state from imposing tax registration, filing, and collection obligations unless the person has "substantial nexus" with the taxing state. *See, e.g., Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

More than 40 years of U.S. Supreme Court precedent supports L.L. Bean's view that nexus requires a physical presence. For example, in *National Bellas Hess, Inc. v. Illinois Dept. of Revenue*, 386 U.S. 753 (1967), the Supreme Court considered the issue of tax nexus in

the context of an out-of-state mail-order seller that, like L.L. Bean, sold merchandise to customers in the state exclusively through interstate commerce. There, the Court created a bright-line substantial nexus test by drawing a "sharp distinction" between those mail-order sellers that "do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business" and those that have an actual physical presence in the state by maintaining property, stores, or employees there. *Bellas Hess*, 386 U.S. at 758. Twenty-five years later, the Supreme Court reaffirmed this physical-presence rule in *Quill*, declaring that a "bright-line, physical presence requirement" remains the proper measure of whether a vendor has "substantial nexus" with the taxing state. *Quill*, 504 U.S. at 311, 314–15.

The "bright-line presence" standard for nexus under the CAT defines nexus solely on the basis of economic connections, without regard for physical presence. When measured against *Quill's* physical-presence test, therefore, the CAT is unconstitutional as applied to a business that is not physically present in Ohio.

Round 1: The L.L. Bean Final Determination

L.L. Bean maintained that it is not constitutionally subject to tax—irrespective of whether or not it meets the statutory definition of "bright-line presence" in Ohio—because it lacks "substantial nexus" as required by the Commerce Clause. The Department disagreed. First, it upheld the assessments simply because L.L. Bean, by conceding that its annual sales to Ohio were in excess of the $500,000 statutory thresholds, met the definition of "bright-line presence" in R.C. 5751.01(I)(3) and thus was squarely subject to the tax. Second, the Department also relied on a statutory "catchall" condition in R.C. 5751.01(H)(4), which defines CAT nexus to include a person that "[o]therwise has nexus with this state to an extent that the person can be required to remit the tax imposed under this chapter under the Constitution of the United States."

While the Department has no jurisdiction to decide the constitutional objections raised by L.L. Bean, it did reject L.L. Bean's claim that *Quill* applied and thus prevented the Department from subjecting it to CAT liabilities. The Department—like that of many other states—takes the position that *Quill* applies only to sales and use taxes, leaving the Department free to ignore the physical-presence rule when other types of taxes are at issue. Focusing on catalog mailings and L.L. Bean's more than $100 million in sales to Ohio residents during the period at issue, the Department concluded that L.L. Bean's "continuous, systematic, and significant solicitation and exploitation of the economic marketplace in Ohio is sufficient" to create substantial nexus under the Commerce Clause. Since R.C. 5751.01(H)(4) requires the CAT to be imposed to the fullest extent permissible under the Constitution, the Department relied on both "bright-line presence" and the statutory catchall provision to conclude that L.L. Bean was properly subject to tax.

While the case focuses on whether economic ties alone are enough to create CAT liability, the Department has nevertheless hedged its bets and specifically reserved its right to make a case to establish CAT nexus for L.L. Bean on traditional physical-presence-nexus grounds. Footnote 1 in the final determination notes the following:

> Given the bright-line nexus standard set forth in R.C. 5751.01(H)(3) and R.C. 5739.01(I)(3), and the "economic presence" nexus encompassed within the scope of R.C. 5751.01(H)(4), the Tax Commissioner has not investigated nor issued

> findings concerning the petitioner's assertion that it lacked a "physical presence" in this state during any of the assessed periods. In the event, however, that the Commissioner's final determination is appealed and, on appeal the reviewing tribunal or court does not ultimately sustain the Commissioner's final determination on either of these grounds, the Commissioner hereby reserves ruling on the petitioner's assertion that it lacked a "physical presence" within the state during any of the assessment periods. In such event, the Tax Commissioner would render findings on the "physical presence" issue upon remand of any such adverse ruling.

Thus, the Department has kept open the possibility of sustaining the assessments against L.L. Bean on more traditional grounds if the Department's view on economic nexus is not ultimately shared by the courts.

Round 2: An Appeal to the Ohio Board of Tax Appeals

To challenge the final determination, L.L. Bean must next file an appeal to the Ohio Board of Tax Appeals (the "BTA") within 60 days. The BTA is a quasi-judicial body empowered to hear and determine appeals from final determinations of the Tax Commissioner. *See* R.C. 5703.02. It serves as the independent trial-level tribunal for all Ohio tax matters. Further review is by direct appeal to the Ohio Supreme Court, where jurisdiction and review are mandatory rather than discretionary.

While the next level in the appeal process for L.L. Bean is the Ohio BTA, the BTA has no authority to rule on the ultimate constitutional question. As a creature of statute, the BTA has no power to determine the constitutionality of a statute or to grant equitable relief. Instead, the BTA's role is to receive evidence and rule on factual issues. It is this factual record that will serve as the basis for the Ohio Supreme Court's resolution of the constitutional question.

Indeed, the BTA's role in a constitutional case of this kind is well defined. In *MCI Telecommunications Corp. v. Limbach*, 68 Ohio St. 3d 195 (1994), for example, the Ohio Supreme Court explained that the BTA must receive the evidence that the court needs to make its constitutional findings and rule on the constitutional issue:

> The question of whether a tax statute is unconstitutional when applied to a particular state of facts must be raised in the notice of appeal to the Board of Tax Appeals, and the Board of Tax Appeals must receive evidence concerning this question if presented, even though the Board of Tax Appeals may not declare the statute unconstitutional.

See also Cleveland Gear Co. v. Limbach, 35 Ohio St. 3d 229 (1988); *Bd. of Edn. of South-Western City Schools v. Kinney*, 24 Ohio St. 3d 184 (1986). While the BTA has no power to rule on the constitutional question, it is a necessary step in the appeal process. The court has explicitly rejected a "constitutional issue" exception to the general rule that all matters must first be raised and tried before the BTA.

Conclusion

The Department's recent ruling in *L.L. Bean* is the first step toward determining whether the Ohio CAT nexus standard is constitutional. However, it will still be quite some time

before taxpayers have clear guidance on this issue. The BTA has no power to rule on the constitutional issue, and there are significant case backlogs at the BTA that could limit the parties' ability to complete the BTA process in a speedy fashion before moving on to the Ohio Supreme Court.

Stay tuned in Ohio . . . .

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[1] "Substantial nexus" for CAT purposes exists if the taxpayer: (1) owns or uses part or all of its capital in Ohio; (2) holds a certificate of compliance authorizing it to do business in the state; (3) has "bright-line presence" in the state; or (4) otherwise has nexus under the U.S. Constitution. R.C. 5751.01(H). The taxpayer has "bright-line presence" if: 1) it has at least $50,000 of property in Ohio; (2) its payroll in Ohio totals at least $50,000; (3) its annual taxable gross receipts total at least $500,000; (4) at least 25 percent of its total property, payroll, or gross receipts is in Ohio; or (5) it is domiciled in Ohio. R.C. 5751.01(I). ^TOP

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STATE TAX RETURN NEWSLETTER

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DMA Challenges Colorado's "Non-Collecting Retailer" Notice and Reporting Regime

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As previously reported in the *State Tax Return*,[1] the Colorado General Assembly recently enacted new notice and reporting requirements for retailers that sell goods to Colorado purchasers but do not collect sales or use tax. The Colorado Department of Revenue (the "Department") was quick to promulgate regulations that impose significant penalties for noncompliance. The Direct Marketing Association is now challenging the constitutionality of these sweeping changes.

The New Regime

Effective March 1, 2010, Colorado instituted notice and reporting requirements targeted at remote retailers that do not collect and remit Colorado sales tax.[2] Such "non-collecting retailers" must now give notice to all Colorado purchasers at the time of each individual purchase that use tax is owed on all nonexempt purchases (the "Transactional Notice").[3] Under the new law, any retailer that does not collect Colorado sales tax must also send each of its Colorado purchasers an annual notice via first-class mail by January 31 that summarizes the Colorado purchaser's Colorado purchases for the preceding calendar year (the "Annual Purchase Summary").[4] Furthermore, each noncollecting retailer must file an annual report with the Department on or before March 1 of each year (starting in 2011), which reports the total

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amount each Colorado purchaser paid for its untaxed purchases (the "Customer Information Report").[5] The Customer Information Report must include the name, billing address, shipping address, and total amount of purchases for each of the noncollecting retailer's Colorado purchasers.[6]

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Noncollecting retailers that had total gross Colorado sales in the prior year of less than $100,000 and reasonably expect their Colorado sales in the current year to be less than $100,000 are exempt from having to provide Transactional Notices, Annual Purchase Summaries, and Customer Information Reports.[7] An Annual Purchase Summary also need not be sent to any Colorado purchaser whose total Colorado purchases for the prior calendar year amounted to less than $500.[8] Noncollecting retailers that are not required to send any Annual Purchase Summaries are not required to file Customer Information Reports with the Department.[9]

Noncompliance with the new notice and reporting regime can lead to significant penalties. A noncollecting retailer is subject to a penalty of $5 each time it fails to provide a Transactional Notice and $10 each time it fails to send an Annual Purchase Summary, with an additional $10 for each purchaser that should have been included in the Customer Information Report if the retailer fails to file such report with the Department.[10] The regulations cap the total penalties for a given retailer at $250,000 for the first noncompliant year, but no such cap is placed on subsequent noncompliant years.[11]

Constitutionally Questionable

The Direct Marketing Association ("DMA") has filed a lawsuit in federal district court challenging Colorado's new sales and use tax notice and reporting regime.[12] DMA is asking the court to declare the statute and corresponding regulations unconstitutional and to issue an injunction preventing their enforcement, arguing that the requirements "violate both the United States Constitution and the Colorado Constitution by:

> (a) imposing discriminatory treatment on out-of-state retailers lacking any physical presence in the state;
>
> (b) trampling the right to privacy of Colorado residents, as well as certain non-residents;
>
> (c) chilling the exercise of free speech by certain purchasers and vendors of products that have expressive content;
>
> (d) exposing confidential information regarding consumers and their purchases to the risk of data security breaches; and
>
> (e) depriving retailers, without due process or fair compensation, of both the value of their proprietary customer lists and the substantial investment made to protect such lists from disclosure."[13]

As "the nation's largest trade association of businesses and nonprofit organizations

marketing products directly to consumers via mail order, telephone orders, and the Internet," DMA seeks to prevent discriminatory treatment of direct marketers under both federal and state law.[14] Accordingly, DMA claims that it has associational[15] and *jus tertii*[16] (third party) standing to bring the suit on behalf of its more than 3,000 retailer members and their respective Colorado purchasers.

DMA filed its complaint in the United States District Court for the Eastern District of Colorado due to the federal constitutional issues present in the matter[17] and originally brought related claims under Colorado law, citing supplemental jurisdiction.[18] Overall, DMA's first amended complaint contains eight separate counts: (i) Counts I and II cite facial violations of the Commerce Clause of the U.S. Constitution; (ii) Counts III and IV cite violations of Colorado purchasers' privacy rights guaranteed under the U.S. and Colorado Constitutions; (iii) Counts V and VI cite violations of both remote retailers' and Colorado purchasers' free-speech rights guaranteed under the U.S. and Colorado Constitutions; and (iv) Counts VII and VIII cite deprivations and takings of remote retailers' property without due process of law, which run afoul of both the U.S. and the Colorado Constitutions.[19]

The thrust of DMA's argument (upon which its motion for a preliminary injunction is based) is that the new notice and reporting regime contravenes the Commerce Clause under long-standing federal precedent.[20] Since retailers located in Colorado are required to collect sales tax, noncollecting retailers are, by definition, remote retailers that sell products to Colorado purchasers via interstate commerce. The notice and reporting requirements therefore apply only to retailers with no physical presence in Colorado.

DMA contends that the statute and regulations discriminate against interstate commerce by placing a new reporting burden exclusively on remote retailers.[21] Moreover, DMA argues that the principles established in *Quill Corp. v. North Dakota*[22] prevent Colorado from imposing notice and reporting requirements on retailers with no physical presence in Colorado.[23]

Colorado filed a motion to dismiss on July 30, 2010, asserting that DMA lacks associational and *jus tertii* standing and/or failed to state a claim for relief in its first amended petition.[24] DMA responded on August 27, 2010, voluntarily agreeing to dismiss its state-law claims without prejudice.[25] So now, the DMA's case focuses on its federal law claims, including claims that the new law violates the Commerce Clause, First Amendment speech and privacy rights, and constitutes a taking of property without due process or just compensation.

Conclusion

Colorado's new notice and reporting regime targets remote retailers that have no physical presence in Colorado. Under *Quill*, Colorado is prohibited from mandating that such remote retailers collect Colorado sales and use taxes. Can Colorado do an end-run around *Quill*, by not directly requiring that remote retailers collect Colorado sales tax, but instead imposing even more burdensome obligations of excessive reporting (beyond that of instate retailers) if the remote retailers don't waive their constitutional right through voluntarily collection of Colorado's sales and use taxes? Since remote retailers are, by definition, the only retailers that must comply with the notice and reporting requirements,

the new rules appear to impose a discriminatory burden that should fail to pass constitutional muster.

The DMA's request for preliminary injunction to prevent enforcement of Colorado's notice and reporting rules as well as Colorado's motion to dismiss remain currently pending. Stay tuned for updates on the case in the next edition of the *State Tax Return*.

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[1] Laura A. Kulwicki & Allison E. Haedt, *Colorado Leads the Charge: Adopts Affiliate Nexus and New Notice and Reporting Requirements for Sales Tax and "Economic Nexus" Rules for Income Tax*, JONES DAY STATE TAX RETURN (June 2010). ^TOP

[2] *See* H.B. 1193, 67th Gen. Assem., 2d Reg. Sess. (Colo. 2010) (amending COLO. REV. STAT. § 39-21-112). ^TOP

[3] COLO. REV. STAT. § 39-21-112(3.5)(c)(I) (2010). ^TOP

[4] *Id.* § 39-21-112(3.5)(d)(I)(A). ^TOP

[5] *Id.* § 39-21-112(3.5)(d)(II)(A). ^TOP

[6] 39 COLO. CODE REGS. § 21-112.3.5(4)(a) (2010). ^TOP

[7] *Id.* § 21-112.3.5(1)(a)(iii). ^TOP

[8] *Id.* § 21-112.3.5(3)(c)(i). ^TOP

[9] *Id.* § 21-112.3.5(4)(d). ^TOP

[10] *Id.* § 21-112.3.5(2)(f)(i), (3)(d)(i), (4)(f)(i). ^TOP

[11] *Id.* § 21-112.3.5(2)(f)(ii), (3)(d)(ii), (4)(f)(ii). ^TOP

[12] *Direct Mktg. Ass'n v. Huber*, No. 10-CV-01546-REB-CBS (D. Colo. filed June 30, 2010). ^TOP

[13] First Amended Complaint, ¶ 1, *Direct Mktg. Ass'n v. Huber*, No. 10-CV-01546-REB-CBS (D. Colo. filed July 23, 2010). ^TOP

[14] *Id.* ^TOP

[15] *Cf. Hunt v. Washington State Apple Adver. Comm'n*, 432 U.S. 333 (1977) (addressing associational standing). ^TOP

[16] *Cf. Craig v. Boren*, 429 U.S. 190 (1976) (addressing *jus tertii* standing). ^TOP

[17] First Amended Complaint, *supra* note 13, ¶ 4. ^TOP

[18] *Id.*, ¶ 5. ^TOP

[19] *Id.*, ¶¶ 54–154. ^TOP

[20] Plaintiff's Motion for a Preliminary Injunction and Incorporated Memorandum of Law at 19, *Direct Mktg. Ass'n v. Huber*, No. 10-CV-01546-REB-CBS (D. Colo. filed Aug. 13, 2010). ^TOP

[21] *Id.* ^TOP

[22] 504 U.S. 298 (1992). ^TOP

[23] Plaintiff's Motion for a Preliminary Injunction, *supra* note 20, at 23. ^TOP

[24] Defendant's Motion to Dismiss Plaintiff's First Amended Complaint, *Direct Mktg. Ass'n v. Huber*, No. 10-CV-01546-REB-CBS (D. Colo. filed July 30, 2010). ^TOP

[25] Plaintiff's Response in Opposition to Defendant's July 23, 2010, Motion to Dismiss Plaintiff's First Amended Complaint, *Direct Mktg. Ass'n v. Huber*, No. 10-CV-01546-REB-CBS (D. Colo. filed Aug. 27, 2010). ^TOP

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STATE TAX RETURN NEWSLETTER

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PENNSYLVANIA

The Marcellus Shale Formation: Pennsylvania's Natural Gas Severance Tax Debate

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Editor's Note: Many thanks to Fran Muracca and Tom Zahn for sharing this informative severance tax commentary that was published in July 2010. If you would like to be added to the distribution list for our Energy Practice commentaries, please contact our administrative coordinator Christa Smith at 1.214.969.5165 or email us at statetaxreturn@jonesday.com.

Pennsylvania has a long history of producing natural gas from a large number of conventional shallow low-production wells, principally for domestic household use. Only Texas has more currently active wells.[1] Pennsylvania ranks 15th in natural gas production among U.S. states, and it is the largest producer without a severance tax.

The advancement of drilling technology and water treatment has strengthened the economic viability and long-term return on investment of extracting natural gas from the Marcellus Shale formation. Marcellus Shale is a unit of marine sedimentary rock found in eastern North America. It extends throughout much of the Appalachian Basin extending across West Virginia, western Ohio, western, central, and northeastern Pennsylvania, southwestern New York, and small

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portions of Virginia and Maryland.[2] The shale contains largely untapped natural gas reserves that, according to several studies, could conservatively supply U.S. consumption for nearly two decades.[3] The Marcellus Shale formation is estimated to be 10 times larger than the Barnett Shale formation in Texas and is attracting attention from major Texas-based natural gas production companies and big oil companies. The Pennsylvania General Assembly is now considering several proposals to enact an extraction tax that parallels the tax imposed by other shale-gas-producing states, including West Virginia, Texas, and Arkansas.

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On July 6, 2010, Pennsylvania Governor Edward G. Rendell signed Pennsylvania Act 46 into law, representing the Commonwealth's fiscal code for the year ending June 30, 2011. Under one of the terms of this Act, Pennsylvania's General Assembly committed itself to passing a severance tax on the extraction of natural gas by October 1, 2010, to be effective no later than January 1, 2011. This commitment represents the culmination of more than 18 months of debate on whether Pennsylvania should levy a tax on the extraction of natural gas from the Marcellus Shale and how that tax should be structured.

On September 20, 2010, the Pennsylvania House of Representatives will begin a long-awaited day of floor debate over the natural gas extraction tax. A key point of debate within the Democratic controlled House is how much of the severance tax revenue should be earmarked for the Commonwealth's general fund. State Senate Republican leaders have begun drafting legislation for a sweeping overall of Pennsylvania's oil and gas laws and limitations on municipal zoning authority that effects drilling. Republicans have sought input from environmentalists groups, industry officials and local government advocates. The Republican proposal includes new rules for "pooling", which could be used to force landowners under certain conditions to lease their subsurface gas rights to existing drillers in the area. The Pennsylvania Marcellus Shale Coalition hired former Pennsylvania Governor and first Director of Homeland Security Tom Ridge to sell the public and elected officials across Pennsylvania on the benefits of developing the natural gas industry in the Marcellus shale formation.

With the November 2, 2010 Pennsylvania Gubernatorial election heading into its final campaign weeks, the political environment among the candidates is drawing sharp debate. The Republican candidate for governor, State Attorney General Tom Corbett, has repeatedly said he will not raise any taxes if elected. Democratic candidate Dan Onorato, Allegheny County's elected chief executive, supports a severance tax but has not released any plan. Onorato supports a tax to raise money for environmental enforcement, maintenance of infrastructure in communities affected by the drilling and the preservation of open space. With only a few days left in the legislative session, Governor Rendell has stated that it is unlikely the lawmakers would pass a tax by the October 1, deadline.

Although 39 states currently have some type of severance tax, including taxes on both coal and natural gas, Pennsylvania, which has long been a major coal producer, has never imposed a severance tax on coal, natural gas, or any other natural resource. While this legislative agreement to pass a tax is a significant first step toward the eventual

enactment of a natural gas severance tax law, much remains to be determined during this gubernatorial election year, including the structure, rate, and exceptions to the severance tax.

The Issue in Context

A severance tax is a tax imposed on the extraction of a state's natural resources. In various states, severance taxes are charged for removal of natural resources including natural gas, coal, timber, and salt. In the case of a severance tax on natural gas, the tax is generally payable by both the gas well operator, who extracts the natural gas, as well as anyone else with a working or royalty interest in the natural gas.

The fact that significant amounts of natural gas exist underneath most of Pennsylvania has been known for some time. In 2002, the United States Geological Survey estimated that as much as 1.9 trillion cubic feet of gas existed in the Marcellus Shale. However, that gas was spread over a large area, and, until recently, the technology did not exist to profitably extract the gas. Recent advances in technology, along with anticipated future increases in natural gas prices, have significantly brought down the real and perceived costs of extracting natural gas from the Marcellus Shale, leading to a speculative investment and production boom during the last few years.

Shale formations, such as the Marcellus Shale, are not unique to the northeast United States. Early advances in natural gas extraction from shale formations occurred in the Barnett Shale located in Northern Texas. Techniques developed to extract natural gas from the Barnett Shale have since been successfully employed in the Fayetteville Shale in Arkansas and the Haynesville Shale in Louisiana along with the Marcellus Shale. Drilling companies hope to expand this technology to extract natural gas from previously ignored natural gas plays around the world.

Along with the possibility of significant natural gas production in Pennsylvania comes the possibility of additional revenue for the Commonwealth. In February 2009, Governor Rendell announced that he would seek the imposition of a severance tax on natural gas produced in Pennsylvania. Since that announcement, the tax has been the source of vigorous debate.

During the current 2009–2010 legislative session, there have been numerous separate bills introduced in the Pennsylvania House and Senate proposing various forms of a severance tax. The debate has been divided along traditional lines, with environmentalists and Democrats largely supporting a higher severance tax, while industry and Republicans seek lesser or no taxation. With the passage of Pennsylvania Act 46, it seems likely that some form of tax will be imposed, and the debate has shifted to the proper structure, rate, and distribution of the tax.

Tax Structure and Rate

Pennsylvania, like many states, is facing a substantial budget deficit as a result of shrinking stimulus funds, rising pension costs and declining tax revenues. The Commonwealth needs to generate new sources of revenue or drastically cut spending to balance its budget. Both gubernatorial candidates, Corbett and Onorato, have cited wasteful spending as a principal basis for reform under new leadership. An extraction tax is one of the few options available that will not constitute an across the board tax increase

on all Pennsylvanians. A major policy question at this juncture, apart from the environmental risks, is whether or not a severance tax will negatively affect the growth of Pennsylvania's natural gas industry and the incentives for the creation of jobs, and enhance the Commonwealth's general fund. The Penn State Institute for Research in Training & Development released a study on September 13 entitled *Benchmarks For Assessing The Potential Impact Of a Natural Gas Severance Tax on the Pennsylvania Economy*. The authors conclude that a severance tax on natural gas in Pennsylvania would increase costs for gas drilling companies, but the resulting increase in spending of state revenue could yield positive, but small, impacts on the Commonwealth's economy and population.

Severance taxes are traditionally assessed based on the volume or value of gas extracted, or a combination of the two. There are advantages and disadvantages to each method.

The most simple structure is to assess a tax based on the volume of gas extracted from the ground. In this type of tax, flat rates are charge in cents per MCF (thousand cubic feet). The gas is metered through the well as it is extracted, and the well-driller pays a tax based on the amount of gas piped out of the well. The problem with this type of tax is that it does not account for the fluctuating price of natural gas. When the price of gas is relatively high, gas producers gain a windfall, while the Commonwealth is left without benefit from the higher prices. On the other hand, when prices are low, a volume-based tax can become prohibitively expensive for producers.

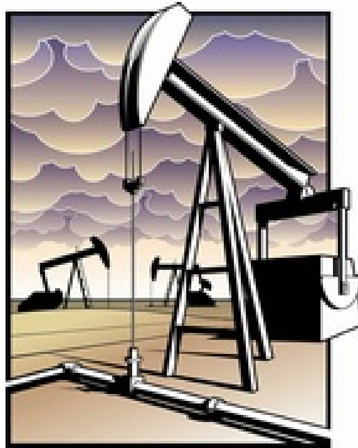
An alternative tax structure is a tax on the value of the gas extracted. These value-based severance taxes are applied to the value of the gas "at the wellhead." (This term means the value of the gas itself at the point of production, before accounting for transportation and distribution costs). This value-based severance tax fixes the problems associated with a volume-based tax, but it creates some new issues of its own. While the volume of gas extracted can be accurately predicted, revenues from a value-based tax are much more difficult for state budget-makers to forecast since the revenues collected fluctuate with the energy futures market. Value-based severance taxes are also more costly to enforce. Rather than just monitoring the well meter, as is done with a volume-based tax, regulators must monitor sales.

In an effort to balance these issues, many severance taxes represent a hybrid of the two different forms of taxation. In these hybrid tax schemes, the taxing authority charges a flat-volume tax at a relatively low rate and then charges an additional tax on the value of the extracted gas. This hybrid structure has the advantage of both allowing the legislators to make more accurate forecasts of revenues that will be collected from the tax and, at the same time, taking advantage of higher sales prices, while not overburdening producers when prices are low. The major disadvantage of a hybrid tax structure is that it is the most expensive to enforce because a taxing authority must incur all of the costs associated with both value-based and volume-based severance taxes.

The severance taxes that have been proposed in Pennsylvania are either volume-based taxes or a hybrid tax structure. The earliest proposed taxes, including Governor Rendell's proposal, were hybrid taxes. These include House Bills 325, 2435, and 2438 along with Senate Bills 905, 997, and 1254. With the exception of House Bill 325, all of these bills propose a tax of 5 percent on the wellhead value plus 4.7 cents/MCF extracted. Not coincidentally, this is the same tax rate that is imposed by the West Virginia hybrid

severance tax.[4] Pennsylvania House Bill 325 has proposed a higher rate of 8 percent on the wellhead value and 8 cents/MCF extracted.

More recently, several tax bills have been introduced that would apply a volume-based tax. House Bill 1489 was originally a hybrid structured tax when it was introduced, but it has since been amended to be a volume-based tax. Along with this bill, House Bills 2443 and 2579 have proposed a volume-based tax. The biggest variation among these bills is the base rate of tax charged. On the low end, House Bill 2443 would charge an initial base rate of 25 cents/MCF extracted while House Bills 2579 and 1489 would charge a base rate of 30 cents and 35 cents/MCF respectively.



In order to allow the Commonwealth to benefit when fuel prices are high, all of these volume-based severance taxes are adjusted based on an "Index." This Index is determined each year based on the New York Mercantile Exchange Henry Hub settled price on March 31 for the previous 12-month period, as reported by *The Wall Street Journal*. If 5 percent of the Index is greater than the base rate, then 50 percent of the difference between 5 percent of the Index and the base rate will be added to the base rate for the coming year. In no case will the tax rate fall below the base rate.

Exemptions from Taxation

Most of the Pennsylvania severance tax proposals also contain exemptions. In general, these exemptions are categorized as front-end or back-end exemptions. Front-end exemptions reduce or eliminate the tax in the initial years when the well begins production to account for the upfront costs of establishing the site and drilling the gas. Back-end exemptions reflect the fact that gas wells have a very productive period at the beginning of the life cycle and then will continue to operate for many years with much lower production rates. The back-end exemptions incentivize drillers to continue operating these older, low-producing wells rather than drilling more wells.

A common back-end exemption is known as a "Stripper Well Exemption." The Stripper Well Exemption generally eliminates severance taxes on wells producing less than 60,000 cubic feet of gas per day. All of the severance tax bills introduced in the Pennsylvania House and two of the four bills introduced in the Senate (Senate Bills 905 and 2579) contain a Stripper Well Exemption.

In another common exemption, Pennsylvania legislators generally agree that new taxes should exempt shallow wells in order to exclude many existing, small well-owners from

the new tax, which is aimed primarily at Marcellus Shale extraction. This type of exemption has led to debate in West Virginia, which currently has a severance tax with an exemption for shallow wells. Several bills currently pending in West Virginia have proposed modifying the definition of a "shallow well" in order to expand the exemption.[5] Another way Pennsylvania could exempt existing gas wells would be to base the tax rate on the year that the well was drilled, such as is done in Montana, although in Montana older wells are taxed at a higher rate.

House Bill 1489 contains an exemption designed to promote employment of Pennsylvania employees. This exemption creates a tax credit for the gas producer of $2,500 for every Pennsylvania job created, up to a maximum of $25 million annually per company. Legislators hope creative exemptions such as this will maximize the local economic growth due to Marcellus Shale.

Industry groups have been lobbying for Pennsylvania to enact front-end exemptions such as those in Texas or Arkansas. Both Texas and Arkansas impose a value-based severance tax on natural gas, with a base rate of 7.5 percent of the wellhead value in Texas[6] and 5 percent in Arkansas.[7] In Texas, natural gas production is taxed at a reduced rate when produced at new wells with higher than average development costs. This exemption is in place until the well has recouped half of the development costs from the reduced rate. The Texas severance tax also includes a reduced rate for low-producing wells, but only when natural gas prices fall below $3.50/MCF. In Arkansas, the severance tax is reduced for shale-type wells, or "high-cost gas" as defined in the Arkansas code, during the first three years of production to help offset development costs. The Arkansas rate is again reduced when production falls below 100,000 cubic feet of gas per day. Despite the industry lobby's call for help in defraying the initial costs of drilling, no Pennsylvania proposed bill to date contains any front-end exemptions. Governor Rendell has indicated that he will veto any severance tax that is not substantially similar to the West Virginia model.

Distribution of Tax Proceeds

Another area of debate within the Pennsylvania legislature is the distribution of severance tax proceeds. Governor Rendell's initial proposal was to put 90 percent of the revenues into the Commonwealth's general fund. Many Democrats and Republicans alike disagree with that plan. These legislators argue that more money should go to specific environmental programs to offset the damage caused by the increased drilling and to local municipalities to cover additional expenses such as road damage and emergency response that will accompany the new industry. This distribution debate will continue to be a hot topic in the coming months.

Next Steps

Pennsylvania Act 46 has guaranteed one thing—the debate will continue on Pennsylvania's natural gas severance tax for at least a few more months. While the Act seems to dispose of the debate over whether to apply a tax at all, plenty of argument remains over the structure, rate, and exemptions of the new tax. One way to predict what Pennsylvania may do is to compare the severance taxes of other relevant states.

Of the other Marcellus Shale states, New York, like Pennsylvania, currently does not have a severance tax on natural gas. New York does, however, have a "production tax," which

is a property-type tax assessed each year based on the amount of natural gas produced on the property.[8] Virginia also does not have a state severance tax on natural gas, but it allows counties and cities to levy a value-based tax of up to 1 percent of the fair market value of the gas.[9] As stated above, West Virginia imposes a hybrid severance tax similar to many of the Pennsylvania proposals of 5 percent of the wellhead value and 4.7 cents/MCF extracted. Originally, West Virginia only had a value-based tax, but in 2005, it added the 4.7 cent volume-based tax in order to help correct a deficit in the state's workers' compensation fund.[10]

In other major natural-gas-producing states, Texas and Arkansas, as discussed above, have a value-based tax. Louisiana, on the other hand, applies a volume-based tax rate that is indexed in a similar fashion to the current Pennsylvania volume-based proposals.[11] Historically, this indexed rate in Louisiana has varied from as low as 7 cents/MCF in 1992–93 to as high as 37.3 cents/MCF in 2006–07, following the surge in fuel prices.[12]

The Pennsylvania Senate returns from the summer recess on September 20. This leaves only a few days to hash out a severance tax by the agreed-upon deadline of October 1. To ensure a robust natural gas industry for Pennsylvania, government leaders must balance the imposition of a severance tax with the passage of favorable pooling and zoning laws. It can be expected that debate on the best way to tax the potentially lucrative production of Marcellus Shale natural gas will continue. Check back with Jones Day for updates as this debate continues.

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[1] U.S. Energy Information Administration, Number of Producing Gas Wells, www.eia.doe.gov/dnav/ng/ng_prod_wells_s1_a.htm (last visited July 14, 2010). ^TOP

[2] *Marcellus Shale—Appalachian Basin Natural Gas Play*, Geology.com, *available at* geology.com/articles/marcellus-shale.shtml. ^TOP

[3] Esch, Mary (2008-11-04), "Estimated gas yield from Marcellus shale goes up." U.S. Department of Energy (April 2009): Modern shale gas development in the United States: a primer, p. 17 ^TOP

[4] W. Va. Code §§ 11-13A-3a, 11-13V-4 (2010). ^TOP

[5] *See* W. Va. Senate Bill 369 (Mar. 3, 2010); W. Va. House Bills 4218 (Jan. 28, 2010); W. Va. House Bill 2982 (Jan. 13, 2010). ^TOP

[6] Tex. Tax Code Ann. § 201.052 (2010). ^TOP

[7] Ark. Code Ann. § 26-58-111 (2010). ^TOP

[8] N.Y. Tax Law § 9-A-210 (2010). In 2002, the Supreme Court of Pennsylvania concluded that there was no authority for imposing a real estate, or ad valorem, tax on oil and gas interests in Pennsylvania. *Indep. Oil & Gas Ass'n of Pa. v. Bd. of Assessment Appeals*, 814 A.2d 180 (Pa. 2002). ^TOP

[9] Va. Code Ann. § 58.1-3712 (2010). ^TOP

[10] W. Va. Code § 11-13V-4. ^TOP

[11] La. Rev. Stat. Ann. § 47:633 (2010). ^TOP

[12] La. Dep't. Natural Resources, Louisiana Severance Tax, *available at* dnr.louisiana.gov/sec/execdiv/

techasmt/facts_figures/la_severance_tax_rates.pdf. ^TOP

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STATE TAX RETURN NEWSLETTER

Volume 17 Number 3 September 2010

Michigan Legislation Reinstates SBT Conformity With Federal "Check the Box" Election for Federally Disregarded LLCs

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The Michigan Legislature took action this session to amend MCL 205.27(a) in order to swiftly limit the effect of the 2009 Michigan Court of Appeals decision in *Kmart Michigan Property Services v. Michigan Department of Treasury*.[1] That decision rejected conformity with federal "check the box" election for purposes of the (now repealed) Michigan Single Business Tax ("SBT").[2] In the absence of the legislative "fix," the *Kmart* decision would have required entities that are "disregarded" for federal income tax purposes to file separately for SBT purposes.

The amendment, which was contained in House Bill 5937 and signed into law as 2010 PA 38 on March 31, 2010, was passed in response to the announcement by the Michigan Department of Treasury (the "Department") of its intent to give full retroactive effect to the court's decision. Under the new law, the Department will not require any disregarded entity to file a separate SBT return and will not assess additional tax, interest, or penalties—or reduce an overpayment—as a consequence of including a disregarded entity on its SBT return. Likewise, the new law prohibits a taxpayer from claiming a refund of SBT on the ground that it filed a separate return for

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any disregarded entity.

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Effect of Federal "Check the Box" Election for Single-Member LLCs in Michigan

The federal government does not recognize "limited liability companies" ("LLCs") as a separate classification for income tax purposes. Federal Treasury Regulations (the "check the box" regulations) set forth the rules applicable for classifying organizations for federal income tax purposes.[3] These rules allow an LLC to elect to be taxed as a separate entity or as a "disregarded entity." Under Treasury Regulation § 301.7701-3, an unincorporated entity such as an LLC with at least two members must elect to be classified either as a corporation or, by default, as a partnership for federal income tax purposes. An LLC with only one member can elect to be classified as an association taxable as a corporation or disregarded as an entity separate from its owner.[4] An LLC classified as a corporation files its own income tax return, whereas a "disregarded" LLC is treated as a division of its owner; thus, its deductions, gains, losses, and credits are reported on its owner's income tax return.[5]

In Revenue Administrative Bulletin 1999-9 (Nov. 29, 2009) ("RAB 1999-9"), the Department described its guidelines regarding the impact of federal "check the box" entity classification election for purposes of Michigan taxes, including the SBT. RAB 1999-9 provides for conformity with the federal election, concluding that a taxpayer which elects entity classification at the federal level shall file its Michigan STB return on the same basis and reflect the same tax consequences. Thus, the Department's position is that if a single-member LLC "is disregarded as an entity separate from its owner (a tax nothing) at the federal level[,] it is treated as a branch, division, or sole proprietor for SBT purposes."

The Michigan Court of Appeals' Decision in *Kmart Michigan Property Services v. Michigan Department of Treasury*: Conformity With Federal "Check the Box" Election Not Required for SBT Purposes

The Department's position on federal conformity was challenged and struck down in the Michigan Court of Appeals' 2009 decision in *Kmart*. In that case, a single-member LLC that was wholly owned by Kmart Corporation ("Kmart")—Kmart Michigan Property Services, LLC ("KMPS")—elected to file its federal income tax returns as a disregarded entity. For SBT purposes, however, KMPS filed a separate SBT return for the 1998 tax year. As part of a larger Kmart audit, the Department determined that it would not accept KMPS's separate SBT filing for tax year 1998. The Department concluded that KMPS should not have filed a separate SBT return but instead should have submitted its income, deductions, credits, assets, and liabilities with Kmart's because KMPS had elected to be a "disregarded entity" for federal income tax purposes.

KMPS appealed the Department's decision, arguing that because it met the SBT's definition of "person," it was therefore eligible to file a separate SBT return for the period at issue. The Department maintained that because KMPS had elected to be a disregarded entity for federal income tax purposes in 1998, it could not choose to be recognized as a separate entity for purposes of its SBT filing. As for RAB 1999-9 and its conformity rule, KMPS argued that the Department lacked authority to retroactively apply RAB 1999-9—

which was issued one year *after* the 1998 tax year in question. It further argued that RAB 1999-9 conflicted with the SBT statutes and was therefore invalid.

The Michigan Tax Tribunal ultimately found that, although it was logical for the Department to assert that taxpayers should be categorized under the SBT according to the classification they elected for federal income tax purposes, "[t]his rationale . . . is not the same as a legal requirement." Thus, KMPS's federal tax status was not determinative of whether it qualified as a "person" for purposes of the SBT.

The Michigan Court of Appeals agreed. Although the Department's policies were reflected in RAB 1999-9, the court found that KMPS was not legally required to follow them because they were "explanatory guidelines" only and as such were not legally binding. However, the court went even further. It found that the Department's legal rationale, as expressed in RAB 1999-9, "is inconsistent with the plain language of the [SBT Act]." The court went on to state that "[n]either the [SBT Act] nor the federal regulations require an entity to be consistent in its self-classification with respect to its state and federal tax filings for a given year."[6]

Ultimately, the court concluded that KMPS was required to file an SBT return because, as KMPS asserted, it was a "person" doing business in Michigan under the SBT Act (the "SBTA"):

> Looking simply at the provisions of the SBTA, KMPS was required to file an SBT return, regardless of its classification as a disregarded entity for federal tax purposes, because KMPS fit within the statutory definition of a "person" conducting business activity and the SBTA required all persons conducting business activity in the state to file an SBT return. Therefore, the SBTA does not support the requirement of RAB 1999-9 that an organization that is a disregarded entity for federal tax purposes for a given taxable period must also file as a disregarded entity for state tax purposes.

238 Mich. App. at 655–56.

The Legislature Responds: Amendment to MCL 205.27(a)

Prior to the *Kmart* decision, Michigan's policy (as articulated in RAB 1999-9) had been that LLCs considered "disregarded entities" for federal income tax purposes should not file separate SBT returns. After the decision, LLCs that elected to be federal "disregarded entities" were nonetheless *required* to file separately for state SBT purposes. They could even be required to retroactively file separate SBT returns for years when they had been included in the tax filings of larger entities. The Department's announcement that it would retroactively apply the *Kmart* decision caused significant controversy in the taxpayer community.

2010 PA 38, which amended MCL 205.27(a), was passed in response. It was specifically intended to restore the tax-filing responsibilities for LLCs under the former SBT to the state of affairs that existed before the *Kmart* decision.[7]

> The amendment, which is retroactive, provides that:

- Any taxpayer that filed an SBT return which included a "disregarded entity" for federal income tax purposes shall not be assessed an additional tax or have any overpayment reduced because it included a "disregarded entity."

- "Disregarded entities" that were included in an owner's SBT return are not required to file separate SBT returns.

- Any taxpayer that filed an SBT return which included a "disregarded entity" cannot claim a refund based on the entity's filing a separate return as a distinct taxpayer.[8]

In a notice issued on April 12, 2010, the Department announced that it was rescinding its prior notice to taxpayers regarding its application of *Kmart*, due to the passage of the new law. The Department stated that 2010 PA 38 "is curative, shall be retroactively applied, and is intended to correct any misinterpretation concerning the treatment of an entity disregarded for federal income tax purposes . . . under [the SBT] that may have been caused by the [*Kmart* decision]." That is, "2010 PA 38 reinstates the law governing disregarded entities under the SBT in effect prior to *Kmart*." Thus, returns, assessments, refunds, and voluntary disclosure agreements involving disregarded entities will all be administered consistent with RAB 1999-9, so as to conform SBT treatment with federal "check the box" election.

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[1] 283 Mich. App. 647, 770 N.W.2d 915 (Mich. App. 2009). ^TOP

[2] Michigan's Single Business Tax was repealed and replaced by the new Michigan Business Tax beginning January 1, 2008. ^TOP

[3] 26 CFR 301.7701-1 through 301.7701-3. ^TOP

[4] 26 CFR 301.7701-3(a). ^TOP

[5] *Taxation of Limited Liability Companies*, Publication 3402, Department of the Treasury, Internal Revenue Service, Rev. March 2010, available at www.irs.gov/pub/irs-pdf/p3402.pdf (web sites herein last visited Aug. 30, 2010). ^TOP

[6] *Kmart Michigan Property Services v. Michigan Department of Treasury*, 283 Mich. App. at 655, 770 N. W.2d at 919–20. ^TOP

[7] HB 5937 Legislative Analysis, available at www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-5937-3.pdf. ^TOP

[8] MCL 205.27(a)(8) and (9). ^TOP

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JONES DAY STATE TAX RETURN NEWSLETTER

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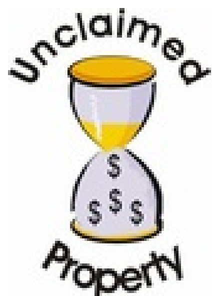

Changes in Unclaimed Property Laws Provide a Financial Windfall to New Jersey and New York, Administrative Review Passes in Delaware, and Pennsylvania Offers Amnesty

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In an effort to close next year's budget gaps, New Jersey and New York recently changed their unclaimed property laws to increase state revenue. These changes, in addition to Pennsylvania's offer of amnesty and Delaware's passage of an administrative review law, are discussed below.

New Jersey Includes Gift Cards as Escheatable Property

New Jersey recently passed an unclaimed property law that will improve next year's state budget by almost $80 million, according to the Assembly Budget Committee.[1] On June 30, 2010, the New Jersey Governor signed Bill A3002 into law, thereby considerably altering the state's treatment of unclaimed gift cards.[2] The bill supersedes a 1998 New Jersey court case, which held that unclaimed property laws do not apply to gift certificate balances, [3] by making unused balances on stored value cards subject to escheat. Bill A3002 broadly defines "stored value cards" to include paper gift certificates, records that contain microprocessor chips or magnetic stripes, gift cards, electronic gift cards, and rebate cards, and it establishes a two-year dormancy period for this property. To avoid conflict with the Electronic Fund

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Transfer Act, which states that a gift card shall be valid for a minimum of five years,[4] the bill creates a holder-reimbursement process for owners who claim already escheated stored value cards. The bill also prohibits holders from charging dormancy fees on unused card balances.

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More significantly, the new law creates potential conflicts with other states' unclaimed property laws. United States Supreme Court decisions establish the rules of priority for how unclaimed property escheats to states.[5] First, unclaimed property should escheat to the state of the property owner's last known address (the first-priority rule). If the holder does not have the owner's address, the property escheats to the holder's state of incorporation (the second-priority rule). While most unclaimed property is disbursed through the first- or second-priority rule, not all states claim all types of property. In the last several years, some states have introduced laws to capture this excluded property (the third-priority rule). Third-priority-rule laws, such as Bill A3002, assert that property escheats to the state where the transaction that created the property occurred.

Bill A3002 requires a holder to obtain the name and address of the purchaser of the stored value card and to maintain in its records the purchaser's ZIP Code. If the holder does not maintain owner records, which is a common practice with stored value cards, the card shall "assume the address" of the store where it was purchased and shall escheat accordingly. The bill does not provide any conflict-of-law provisions; *i.e.*, it does not contain language similar to "the stored value card will assume the address of the store where it was purchased only if the holder is incorporated in a state not having in effect a statute under which such amount is escheatable to the state."

Holders, therefore, could face a potential conflict if two states (New Jersey and the holder's state of incorporation through the second-priority rule) lay claim to the same dormant stored value card. For example, if a bookstore incorporated in Delaware but operating in New Jersey sells a gift card in its Newark store without recording the purchaser's name and address, and the gift card becomes dormant, both New Jersey and Delaware could claim the unused balance. However, if the bookstore is incorporated in a state that exempts gift cards from escheatment, such as Indiana or Ohio, the gift card would not be subject to competing states' interests.

The bill applies to all holders who issue or sell stored value cards except those whose sales of such cards in the prior year totaled less than $250,000, face value. For the purpose of the $250,000 sales threshold, sales of stored value cards by businesses that operate (1) under common ownership or control or under the same trademark within New Jersey or (2) as franchised outlets of a parent business shall be considered the sales of a single holder. The bill also allows the State Treasurer the discretion to grant exemptions from the stored value card provisions if a holder applies for one and shows good cause. In addition, the bill does not apply to any stored value card distributed under a promotional or loyalty program or as part of a charitable program if no money has been tendered by the owner.

Besides affecting stored value cards, Bill A3002 reduces the dormancy period for travelers' checks and money orders to three years, precludes the imposition of dormancy fees on travelers' checks and money orders for 12 months following the date of sale, and limits

dormancy fees to no more than $2 per month thereafter.

Bill A3002 became effective July 1, 2010, but, according to a temporary Treasury exemption, holders will not have to start recording owners' information until October 1, 2010.[6] Holders will have to remit stored value cards, travelers' checks, and money orders outstanding on and after July 1, 2010, including cards issued from July 1, 2003, to June 30, 2008, with outstanding balances.[7] Since the bill is retroactive, holders will likely see increased reporting obligations in the next reporting cycle to account for newly dormant property that did not previously need to be escheated. The New Jersey Unclaimed Property Administration has already stated that holders that fail to report stored value cards in an accurate and timely manner will face an increased risk of audit with a look-back period greater than five years.[8] Any property uncovered in an audit could be subject to penalties and interest.

Holders will not need to perform due diligence (giving notice to owners prior to escheatment), nor will they be able to aggregate balances under $50 into a single entry for reporting purposes. As can be surmised from the "no due diligence" provisions and the question posed by State Treasurer Andrew Sidamon-Eristoff—since a holder currently "gloms onto" unclaimed balances, "why should we not want to keep the money for New Jersey?"[9]—Bill A3002 was not created to reunite specific owners with their specific lost property. Instead, the bill will serve as a boon to all New Jersey citizens by allowing the state to capture and then utilize unused stored value card balances for the public good.

New York Reduces Dormancy Periods

On August 11, 2010, the New York Governor signed Bill A09710 into law, effective immediately. The bill relates to the 2010–2011 budget, and among other items, it reduces the dormancy period for unclaimed money orders from seven years to five and the dormancy period for unclaimed amounts related to services not rendered or goods not delivered from five years to three. With the two-year reduction in dormancy periods for both property types, New York expects to see an increase in reported funds for 2010 and 2011 due to accelerated remittances. New York also is considering another bill, A11586, which would reduce the dormancy period from five years to three on banking property such as unclaimed deposits and bank-held bond and mortgage property.

Pennsylvania Offers Amnesty

The Pennsylvania Treasury is granting companies with delinquent unclaimed-property-reporting obligations in Pennsylvania amnesty from penalties and interest if they come into compliance. Companies may enter the amnesty program between now and October 31, 2010. The program is open to first-time filers as well as any company with gaps in its reporting history. To qualify for the amnesty program, companies must contact the Pennsylvania Bureau of Unclaimed Property and complete an electronic questionnaire. The Treasury will then direct companies on the best course of action to pursue amnesty. All companies are eligible to participate, except those currently under an unclaimed property audit or self-audit.

The Treasury recommends that interested companies email the Unclaimed Property Bureau at upamnesty@patreasury.org to request a questionnaire. Companies may also contact the bureau via telephone, 1-800-379-3999.

Delaware Passes Administrative Review Law

In the last edition of the *State Tax Return*, we reviewed Delaware S.B. 272, 145th Gen. Assem. (Del. 2010), which creates an administrative review process following an unclaimed property audit and a limited exemption from the definition of "unclaimed property" for noninvoiced payables between merchants. Governor Jack Markell signed the bill into law on July 23, 2010, effective immediately.

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[1] *Statement on Assem. No. 3002 to Assem.*, 2010 214th Leg. Sess. (N.J. 2010) (statement of Assem. Budget Comm.). ^TOP

[2] Assem. No. 3002, 214th Leg. Sess. (N.J. 2010). ^TOP

[3] *Matter of Nov. 8, 1996, Determination of State, Dept. of Treasury, Unclaimed Property Office*, 309 N.J. Super. 272, 706 A.2d 1177 (N.J. Super. Ct. App. Div. 1998). ^TOP

[4] 15 U.S.C. § 1693l-1(c)(2) (2010). ^TOP

[5] *See Delaware v. New York*, 507 U.S. 490 (1993); *Pennsylvania v. New York*, 407 U.S. 206 (1972); *Texas v. New Jersey*, 379 U.S. 674 (1965). ^TOP

[6] On July 1, 2010, the Treasury announced a temporary exemption from Bill A3002. Holders will not have to record owners' names and addresses and maintain in their records the owners' ZIP Codes until September 1, 2010. State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-01 (July 1, 2010). On August 26, the Treasury extended this exemption to October 1, 2010. State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-02 (Aug. 26, 2010). ^TOP

[7] State of New Jersey, Unclaimed Property Administration, Letter to Holders of Unredeemed Travelers Checks, Money Orders, Stored Value Cards and Similar Instruments (Aug. 18, 2010). ^TOP

[8] *Id.* ^TOP

[9] Tom Hester Sr., *N.J. wants to profit from money left on gift cards*, NEWJERSEYNEWSROOM.COM (Apr. 21, 2010, 12:18 p.m.), www.newjerseynewsroom.com/economy/nj-wants-to-profit-from-money-left-on-gift-cards (web site last visited Sept. 10, 2010). ^TOP

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STATE TAX RETURN NEWSLETTER

Volume 17 Number 3 September 2010

NEXUS: Update On Recent Developments

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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 second quarter of 2010. Organized by the kind of activity that tends to give out-of-state entities nexus-planning and litigation difficulties, it includes the following: the determination that a Maryland company had nexus in New Jersey because of a telecommuting employee who relocated to New Jersey because her spouse had done so; the decision that hiring an independent contractor to develop business created nexus in New Mexico; a New Mexico advisory that web-site advertising links, with commissions, did not create "web nexus" with the state; the State of Washington's usual very broad view of what creates B&O tax nexus for mail-order pharmacy sales; and a very sensible private letter ruling from the Utah State Tax Commission that out-of-Utah repair services did not create nexus.

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NEW JERSEY

A Maryland business had CBT nexus in New

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Jersey because it had a telecommuting employee who worked out of her home in New Jersey after moving to the state because her spouse had relocated there.

a. *Telebright Corporation, Inc. v. Director, Division of Taxation, No. 011066-2008, CCH ¶401-501 (N.J. Tax Ct. Mar. 24, 2010).*

1. The New Jersey Division of Taxation successfully sought to tax a Delaware corporation with offices in Maryland ("Telebright") under the New Jersey Corporation Business Tax Act ("CBT"). Telebright's employee telecommuted from her home in New Jersey, where she regularly received and carried out her assignments, was supervised by Telebright, and began and ended her workday by checking in electronically or by phone. Furthermore, Telebright employed property in the state by providing her with a laptop on which to complete her assignments and by withholding New Jersey gross (personal) income tax from the employee's wages.

2. Based on the above-mentioned contacts through its employee, Telebright was found to be "doing business" in the state under N.J.A.C. 18:7-1.9(b).

3. Telebright's tax liability under the CBT did not violate the Due Process Clause because the corporation had sufficient minimum contacts with New Jersey. The court also found that, based on the manner in which it chose to conduct its business, Telebright had "fair warning" that its employment relationship could subject it to the laws of the state.

4. The employee's daily presence in the state for purposes of carrying out responsibilities for Telebright satisfied the substantial-nexus requirement of the Commerce Clause because the corporation enjoyed the benefits of the state's labor market. The fact that Telebright did not further take advantage of New Jersey's markets by hiring additional employees or soliciting customers did not substantiate its constitutional claims. Defending its decision, the tax court noted that the CBT has safeguards (an apportionment formula and allowance of adjustments to account for unusual circumstances) to ensure that the tax is imposed only on income attributable to New Jersey. According to the court, the CBT's application is consistent with the Commerce Clause and does not unduly burden interstate commerce.

Welcome Robert Waldow!

Save the Date - State Tax Seminars

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INDEPENDENT CONTRACTORS, SALES REPRESENTATIVES, AND MANUFACTURING REPRESENTATIVES

NEW MEXICO

The New Mexico Taxation and Revenue Department advised that service calls made on an infrequent basis did not create nexus, but hiring an independent contractor to develop new business created nexus for the out-of-state manufacturer of high-tech products.

a. Administrative Ruling, Ruling No. 401-10-1, CCH ¶401-265 (New Mexico Taxation and Revenue Department, Apr. 9, 2010).

1. The New Mexico Taxation and Revenue Department considered two sets of hypothetical facts to determine whether an out-of-state taxpayer would be liable under the Gross Receipts and Compensating Tax Act.

2. In the first set of hypothetical facts, an out-of-state company, "Company X," is engaged in the business of manufacturing optical and electro-optical systems, geodata systems, and large airborne and spaceborne deformable mirrors for the United States government. These contracts require some servicing in New Mexico, but performance of these services by Company X's employees amounts to less than 2.5 percent of the total time required to perform the services under each contract.

3. In the second set of facts, Company X plans to engage an independent contractor to develop business in New Mexico by gathering information and making informal pre-proposal customer contact, but will not engage in direct solicitation. This independent contractor will dedicate approximately eight hours per week to Company X's business.

4. Regarding the first set of facts, the New Mexico Taxation and Revenue Department determined that "[b]rief and occasional visits to New Mexico by X's employees to attend briefings concerning the progress of activity under X's contracts with the United States do not establish a sufficient level of presence necessary to determine that X is engaging in business in New Mexico[.]" According to the Department, no nexus exists because "the cumulative amount of time spent in New Mexico by X's employees is less than two and one-half percent (2 1/2%)" of the total effort dedicated by Company X to the contracts.

5. Regarding the hiring of the independent contractor to develop business, however, the Taxation and Revenue Department would find nexus because, under the facts, Company X causes "activity to be carried on within New Mexico for X's direct benefit through the activity of the independent contractor."

WEB NEXUS

NEW MEXICO

A Nevada retailer with its web server in Ohio did not have New Mexico nexus because of web "affiliate partners" in New Mexico.

a. Administrative Ruling, Ruling No. 401-10-7, CCH ¶401-271 (New Mexico Taxation and Revenue Department, Apr. 9, 2010).

1. The New Mexico Taxation and Revenue Department considered a set of hypothetical facts to determine whether an out-of-state taxpayer, "Company

X," would be liable under the Gross Receipts and Compensating Tax Act for entering into web-site advertising linkage and commission arrangements with its "affiliate partners" that maintain web sites on servers in New Mexico. The decision had little "substantial nexus" analysis but dealt with common nexus issues under the New Mexico statute.

2. The Taxation and Revenue Department found that Company X is not subject to the tax because it is not "engaging in business" per the definitions of the Gross Receipts and Compensating Tax Act. The web-site advertising linkage and commission arrangements between Company X and its affiliated partners "do[] not make those entities 'a branch or unit' of X's enterprises" under the statute.

3. The Department of Taxation and Revenue declined to address the question of whether the arrangements with the affiliates created jurisdiction to impose income taxes, but it noted that the "substantial nexus" decision of Quill "was careful to note it had never extended such a requirement to the imposition of income-based taxes."

AFFILIATE NEXUS

WASHINGTON

B&O tax was affirmed against an out-of-state mail-order pharmacy because of in-state marketing and advertising on its behalf by an insurance-company affiliate.

a. Tax Determination No. 08-0158ER, Washington Department of Revenue, 29 WTD 10, CCH ¶203-104 (Mar. 25, 2010).

1. Taxpayer is an out-of-state pharmacy, licensed to do business in Washington and with a nonresident pharmacy license in the state. Taxpayer fills mail-order prescriptions for an affiliated in-state insurance company, "B." Taxpayer is a wholly owned subsidiary of a larger corporation and objects to paying taxes in the state.

2. The corporation offers its products nationwide through various subsidiaries, many of which are licensed to do business in Washington or to sell insurance in the state. One particular subsidiary, "A," is wholly owned by the company and has employees who market health insurance in the state. This subsidiary shares officers, but not employees, with Taxpayer.

3. Taxpayer provides services to another subsidiary, "B," "on behalf of itself and its Affiliate," which is defined as "any corporation, partnership or other legal entity . . . directly or indirectly owned or controlled by, or which owns or controls, or which is under common ownership or control with," B. The Department of Taxation found that this bound Taxpayer to A and B. Taxpayer is the sole provider of mail-order pharmacy services to B's customers.

4. A has employees in Washington to distribute brochures about the parent

corporation of A, B, and Taxpayer, which direct customers to the corporation's web site, where there is more information available about Taxpayer as well as other pharmacies. The corporation provides plan documents that disclose that "[w]ith the exception of [taxpayer], all participating . . . health care providers are independent contractors."

5. Taxpayer claims that it pays no fees to A for marketing and thus should be considered no different from the other pharmacies that are independent contractors. The Washington Department of Revenue found that A's marketing activities caused Taxpayer to have nexus with Washington because those activities are significantly associated with Taxpayer's ability to do business in the state. The Department of Revenue was not persuaded that A's marketing of Taxpayer was purely for the benefit of A.

6. Washington's business and occupation tax is assessed on goods originating outside the state only if the goods are received by the purchaser in the state and the seller has nexus. Nexus is established when activities go beyond pure mail order and there is "demonstrably more than the slightest presence in the state," which includes "any activity performed in the state on behalf of the seller that is significantly associated with the seller's ability to establish and maintain a market" in the state. Here, because A is acting as Taxpayer's agent in Washington and that activity is significantly associated with Taxpayer's ability to maintain a market in Washington, there is sufficient nexus.

DOING BUSINESS IN THE STATE

UTAH

A Utah service provider was not required to collect Utah sales tax on repairs performed outside Utah, although payment for the service took place in Utah.

a. Response Letter, PLR 09-007, Utah State Tax Commission, Sept. 22, 2009, CCH ¶400-663 (released May 2010).

1. Taxpayer is a dealer located in Utah, with no contacts to other states, that sells and services the products of a national manufacturer. Taxpayer asks hypothetically whether it should collect a sales tax from either a business that hires it to service a product or from a manager who must approve the dealer's work on the business's product and make the payment. The manager is located in Utah, and the business has regional operations in Utah but is headquartered out of state. The dealer contracts with the manufacturer to do the actual repairs out of state.

2. The Utah State Tax Commission found that the dealer did not need to collect sales tax from the manager because under Utah Code Ann. §59-12-211, "the location of the transaction is the location where the purchaser takes receipt of the . . . service."

3. In this case, the service, consisting of the repairs, was happening outside Utah. Moreover, the product was being serviced in another state and returned to the business in a different state before coming back through Utah in the stream of commerce.

4. The Utah State Tax Commission found that there is no substantial nexus to the State of Utah when the service occurs outside the state. Mere payment for the service inside the state does not create substantial nexus.

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JONES DAY STATE TAX RETURN NEWSLETTER

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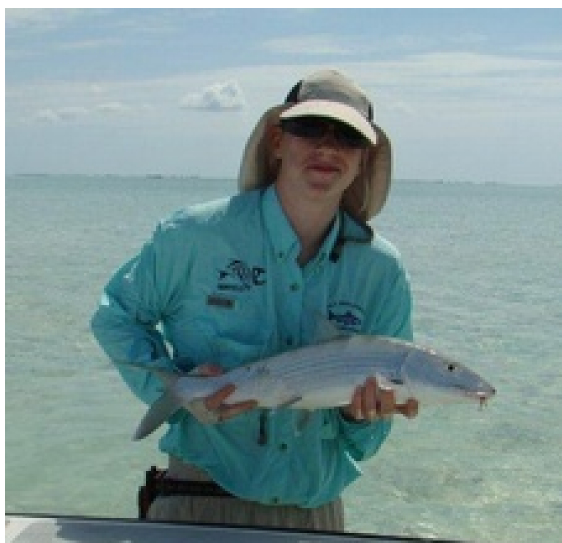
Spotlight on Jones Day Kids

Amy Atwood
On June 6, 2010, the ten year old daughter of Roy Atwood made her Carnegie Hall debut. Amy Atwood was part of a 180 member children's choir that performed in a memorial concert for Mattie Stepanek, who suffered from muscular dystrophy. Mattie lived only 14 years, but in that time became a best-selling author, publishing six collections of poetry and one collection of peace essays. The choir performed the world premier of "Heartsongs," a selection of Mattie's poetry set to music by composer Joseph Martin, to a full house. To learn more about Mattie please visit www.mattieonline.com



Jasper Lee
Earlier this year, the high school son of Carolyn Joy Lee was featured on the "Kids Are Heroes" website. Jasper Lee is an avid fly fisherman who began the sport at the age of 3. He uses his passion for fly-

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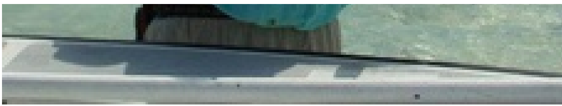

fishing to help provide relaxation and stress relief to soldiers as they re-acclimate from their tours of duty. Jasper is a volunteer for Veteran Anglers of New York ("VANY") , which is associated with the nationally recognized program Project Healing Waters. You can see a great picture of Jasper with his soldier trainee and read the interview of Jasper posted by Gabe O'Neill at www.justgabe.com/2010/02/01/fly-fishing-for-soldiers. To learn more about Project Healing Waters, which is dedicated to the physical and emotional rehabilitation of disabled active military service personnel and veterans through fly fishing and fly tying education and outings, please visit www.projecthealingwaters.org.

Welcome Roburt Waldow!

Save the Date - State Tax Seminars

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JONES DAY | STATE TAX RETURN NEWSLETTER

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WELCOME Roburt Waldow!

The State Tax Team is very excited to welcome Robурт Waldow as our newest state tax partner in California. Robert, who recently joined Jones Day as a partner in our Irvine office, is widely recognized for his extensive experience in state and local tax controversy matters, from audit through litigation. His practice also encompasses a broad variety of planning, including providing advice on state franchise, income, sales and use, and local property and miscellaneous business tax matters in the contexts of business formations, operations, debt and equity financings, mergers, acquisitions, dispositions, and dissolutions.

Roburt is currently the chair of the Banking and Savings Institutions Committee of the ABA Tax Section. He is a contributing author to the CCH *California Tax Analysis: Corporation Tax* (2d ed.); has authored articles published in the *Journal of Taxation and Regulation of Financial Institutions*, Tax Analysts' *State Tax Notes*, and BNA's Tax Management series; and has served as a panelist on state tax matters for the California State Bar Tax Section, California Tax

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Policy Conference and at meetings of the Banking and Savings Institutions Committee of the ABA Tax Section. Roburt earned his J.D. from Duke University School of Law, his LL.M. from New York University School of Law, and his B.S., magna cum laude, from the University of the Pacific. Before joining Jones Day, he was a partner at McDermott Will & Emery in their Silicon Valley office.

Welcome Roburt Waldow!

Save the Date - State Tax Seminars

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The Waldow family is looking forward to moving to sunny Southern California. During the transition, Roburt will split his time between our Silicon Valley and Irvine offices. Pictured above are Roburt and Kristin on a recent house-hunting trip checking out the sand castle options at Laguna Beach for Elise (12) and Grant (9). When Roburt is not reading state tax advance sheets or engineering sand castles, he enjoys jogging, biking, weight lifting, and high performance driving – whether on a track, in the carpool lane, or chauffeuring the kids to their activities. YES, another "muscle car" enthusiast on the State Tax Team.

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Date	Event	Location	Presenter(s)
Fri., Sept. 10, 2010	COST JD Midwestern Regional Seminar	Columbus, Ohio	Laura Kulwicki Maryann Gall
Mon. through Wed., Sept. 26 - 29, 2010	IPT 2010 Sales Tax Symposium - Nexus Update Brochure and Registration Information	Indian Wells, CA	Laura Kulwicki Maryann Gall
Wed. through Fri., Oct. 20-22, 2010	2010 COST 41st Annual Meeting – **Nexus Update** Brochure and Registration	Phoenix, AZ	Charolette Noel
Thurs. through Sat., Nov. 4-6, 2010	2010 California Tax Policy Conference **Mergers, Acquisitions & Dispositions –** **A Multi-Tax Review of Issues and Today's** **State Tax Woes for the Energy Sector** Brochure and Registration	San Diego, CA	David Cowling Carolyn Lee
Thurs. and Fri., Nov. 4-5, 2010	Austin TSCPA – **Unclaimed Property** Brochure and Registration	Austin, TX	Stephen Harris
Tues. through Thurs., Nov. 8-11, 2010	IPT Advances Sales and Use Tax Academy - **Internet and Other Remote Seller Taxation - Constitutionally Permitted?** Brochure and Registration	Miami, FL	Laura Kulwicki Maryann Gall

Tues. through Thurs., Nov. 8-11, 2010	IPT 2010 Income Tax Symposium Economic Nexus, Flow-Through Nexus, Agency Nexus, Affiliate Nexus: **"Where Don't I Have To File?"** Brochure and Registration	Miami, FL	Laura Kulwicki
Tues. through Thurs., Nov. 9-11, 2010	Hartman Tax Institute - **Nexus Update** Brochure and Registration	Nashville, TN	Maryann Gall
Fri., Nov. 12, 2010	Jones Day/TEI Annual Tax Seminar Brochure and Registration	Dallas, TX	Jones Day Dallas
Fri., Dec. 3, 2010	TSCPA Expo 2010 – Unclaimed Property – **Reporting and the Risks of Noncompliance**	San Antonio, TX	Stephen Harris
Tues., Dec. 7. 2010	TSCPA Expo 2010 – Unclaimed Property – **Reporting and the Risks of Noncomplianc**	Houston, TX	Stephen Harris
Fri., Dec. 10, 2010	TSCPA Expo 2010 – Unclaimed Property – **Reporting and the Risks of Noncompliance**	Arlington, TX	Stephen Harris
Thurs., Dec. 9, 2010	Economic Nexus Standards in State Taxation	Teleconference	Maryann Gall Laura Kulwicki Charolette Noel
Mon., Dec. 13, 2010	NYU State & Local Tax Institute - Nexus Update	New York, NY	Maryann Gall

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September 15, 2010

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