• The State Tax Return Converts to an Electronic Format in 2011 - See Page 3 for Details •

December 2010

Volume 17, Number 4

State Tax Return

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

Winning an "Essence of the Transaction" Case in Texas

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Jones Day recently won a significant "essence of the transaction" sales tax redetermination hearing against the Texas Comptroller of Public Accounts before the State Office of Administrative Hearings. At issue was whether Taxpayer, a major automobile customer lead-generation company, was liable for Texas sales tax on its customer referral services involving direct-mail advertising.

Following a contested hearing, the SOAH administrative law judge agreed with our contention that the "essence of the transaction" was a nontaxable customer referral service rather than a taxable direct-mail advertising service. The ALJ ruled in favor of Taxpayer on all contested issues, and the Comptroller adopted the ALJ's opinion. The entire contested assessment was subsequently reduced to zero. *See* Texas Comptroller Hearing No. 46,579, SOAH Docket No. 304-10-1028-26 (2010).

Background

Automobile dealers often hire the Taxpayer at issue to solicit referrals of potential automobile purchasers meeting certain credit criteria, using internet, television, and direct-mail advertising packages. The hearing challenged the treatment of the Taxpayer's referral method that involved the Taxpayer's use of targeted direct-mail advertising to solicit leads.

Based on credit criteria, location, and number of direct-mail letters selected by automobile dealers, the Taxpayer acquires a targeted mailing list from a credit-reporting agency and contracts with a direct-mail vendor to print and mail letters to Taxpayer's designated recipients. The dealers do not take possession of the letters and do not know the names of the letter recipients. In most, if not all, instances, the dealers are not mentioned in the letters. The letters direct the recipients to call the Taxpayer if they are interested in purchasing a vehicle. If a potential automobile purchaser meets a dealer's criteria, the Taxpayer refers the recipient to the respective dealer. The Taxpayer charges dealers for the referral service according to the number of direct-mail letters selected—the number of referrals is not guaranteed.

The Texas Comptroller maintained that the Taxpayer provides a taxable direct-mailing/printing service to dealers, and it assessed the Taxpayer for uncollected Texas sales tax. The ALJ rejected the Texas Comptroller's position and agreed with the Taxpayer's contention that the essence of the transaction was a nontaxable customer referral service. The ALJ reached his decision in part because the direct-mail letters were never in the possession or control of dealers and the letters directed potential automobile customers to call the Taxpayer (not the dealers). In reaching his decision, the ALJ held that the evidence presented by Jones Day was "compelling" that the essence of the service provided was not direct-mail advertising.

Analysis

The Taxpayer had a compelling story—dealers did not purchase a direct-mailing service; they purchased qualified customer referrals. Winning this "essence of the transaction" case turned in large part on how the facts and evidence were presented to support the story.

As in most cases, not all facts were helpful to the Taxpayer's case. The contracts were unclear. Limited materials were available from the audit period. The dealer order forms and invoices stated the number of letters ordered and the charges per letter, which led the auditor to conclude that the Taxpayer was providing a direct-mailing service.

There were important facts in the Taxpayer's favor, however. The Taxpayer used an external vendor to print and mail the letters. The customers were not simply buying direct mail services. The Taxpayer charged its customers substantially more than the printing and mailing costs to the Taxpayer. The letters themselves did not mention a dealer's name, but rather directed the recipient to call the Taxpayer if he or she was in the market to purchase a car. These facts all indicated that the Taxpayer was not simply providing a direct-mailing service to the dealers.

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To support the Taxpayer's position that it provides a nontaxable lead-generation service to dealers, the Taxpayer produced samples of the advertising materials it sends to the dealers. Although the advertising materials were dated after the audit period, they showed the intent of the parties and supported the position that the essence of the transaction was the generation of qualified referrals, not the production of direct mailers. The Taxpayer also produced an affidavit by an employee who walked through Taxpayer's services and the evidence produced in detail.

While the limited amount of evidence may have discouraged some from contesting the issue, we are happy to report that the Taxpayer was ultimately rewarded for standing its ground. The ALJ, swayed by the story and evidence that the Taxpayer presented, granted a 100 percent victory on the contested issues.

The hearing shows what some hard work and creative thinking can do. Who says taxpayers cannot win at SOAH? Sometimes the argument just needs to be "compelling."■

Fast, Efficient, and Environmentally Friendly State Tax Developments . . . The *State Tax Return* (*Green Edition*)

Yes, the *State Tax Return* printing press is retiring! Enjoy this final print publication in the old black-and-white format. As promised for the past year, the *State Tax Return* is "Going Green." Most of our readers have already converted to the electronic version, and the feedback has been very positive. The newsletter is delivered must faster, contains helpful links, and can be more easily shared with others. If we have received your email address, you should have received the electronic version sent via email by:

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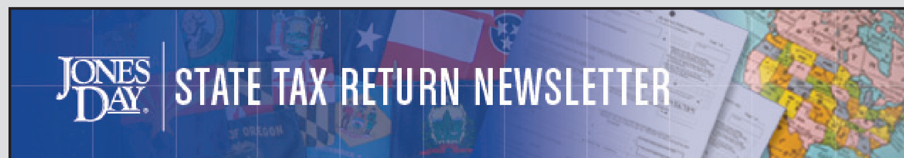

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Georgia Court-Validated Bond Transactions Challenged in Tax Valuation Case Involving Sale-Leaseback Transactions

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Introduction

On November 1, 2010, the Georgia Supreme Court issued its opinion in *Sherman v. Fulton County Board of Assessors*,[1] in which it allowed an individual taxpayer to challenge the Georgia practice of using sale-leaseback bond transactions to encourage real estate development. This longstanding tax abatement mechanism is one of the very few incentives available under Georgia law to attract local development, and cities and counties throughout the state have for decades relied upon the availability of this business development tool.

The trial court initially dismissed Mr. Sherman's challenge for failing to state a viable claim upon which relief could be granted. On appeal, however, the Georgia Supreme Court reversed, holding that the appropriate method for valuing the leasehold estates underlying the sale-leaseback transactions was an issue of fact and the defendants had failed to establish that their proposed valuation methodology was reasonable.

The Sale-Leaseback Bond Transaction

A sale-leaseback bond transaction arises from an agreement between a local development authority, in this case the Development Authority of Fulton County ("DAFC"), and a private developer of real property (the "Developer"). The arrangement is designed to lower property taxes on new developments for a fixed period of years. If set up properly, the transaction leaves DAFC and the Developer in the same substantive positions (other than a reduced tax burden on the Developer) that each was in before entering into the agreement. In other words, DAFC realizes no net change in its revenue or expenses and the Developer enjoys the same use of its property.

Here's how it works. The Developer wants to build commercial improvements on certain real property that he owns. DAFC, in accordance with its redevelopment powers, buys the property from the Developer and pays for this purchase by issuing revenue bonds to the Developer equal to the purchase price. The Developer then leases back the property from DAFC, which uses the lease payments to pay the principal and interest due on the revenue bonds. As a tax-exempt entity, DAFC does not pay *ad valorem* tax on its fee simple interest in the property.

The Developer, however, is not tax-exempt and therefore remains subject to tax on his leasehold interest in the property. The amount of his tax obligation depends on the assessed value of the lease. As part of the transaction, the parties typically agree that the leasehold interest will be valued at a certain percentage of the fair market value of the property's fee simple estate. The assessed leasehold value then increases by an agreed-upon percentage per year so that, after 10 years, it is valued at 100 percent of the property's fair market value. At the end of the lease, the revenue bonds are paid down or retired and, pursuant to the terms of their agreement, the Developer repurchases the property from DAFC for a nominal sum.

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[1] No. S10A0924, 2010 WL 4273347 (Ga. November 1, 2010).

Case Issues and Relief Sought

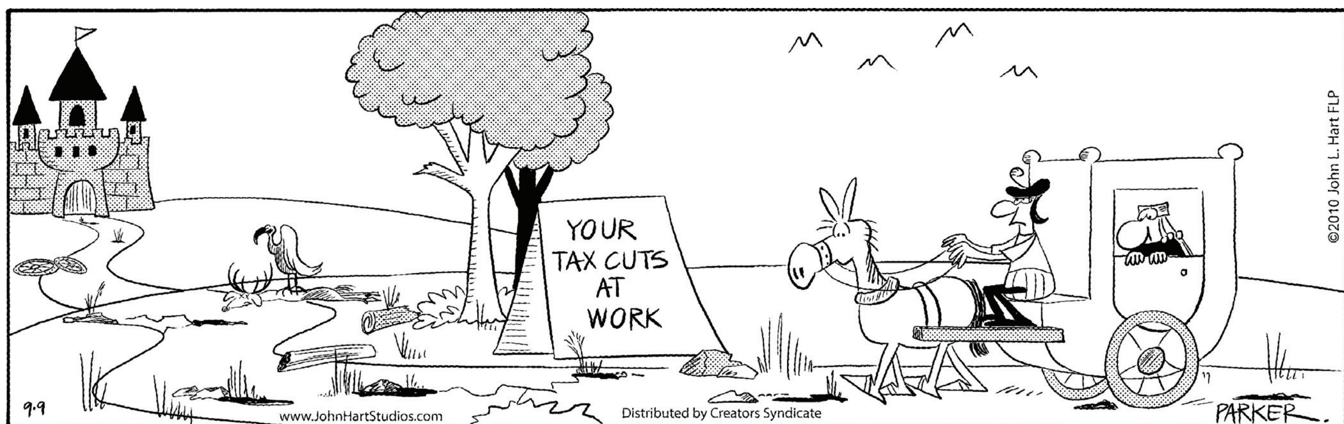
In the *Sherman* case, DAFC's bond transaction, including its agreement with the Developer, was "validated" by a Fulton County superior court, a statutory procedure used in Georgia to prevent future collateral attacks of bond issuances. Historically, DAFC assumed that the validation process rendered the entire transaction bulletproof. Therefore, the threshold issue in this case was whether allowing a taxpayer to challenge the leasehold valuation method amounted to a prohibited collateral attack on the entire validated bond transaction.

DAFC asserted that, because the leasehold valuation was part of the overall transaction that was validated by the superior court in a public proceeding, it could not be subject to collateral challenge. The superior court agreed and dismissed Mr. Sherman's lawsuit. On appeal, however, a majority of the Georgia Supreme Court justices disagreed, reasoning that while the superior court validated the issuance of the bonds, it did not specifically address and validate the leasehold valuation methodology contained within the sale-leaseback agreement. The majority stated that the valuation formula could be protected from future attack only if the superior court specifically addressed and ruled upon it when it validated the bond transaction.

Mr. Sherman alleged that the agreed-upon valuation methodology was invalid because it was illegal, unconstitutional, *ultra vires*, and constituted a failure of the Fulton County Board of Assessors ("FCBOA") to perform its duty to ensure that property is assessed at fair market value. As a Fulton County resident and taxpayer, he claimed standing to seek the following relief on behalf of himself and all others similarly situated:

- A declaration that the valuation methodology was unconstitutional under, among other sections, Georgia's uniformity of taxation provision (Art. VII, § 1, Para. 3);
- An injunction preventing FCBOA from using the methodology in this transaction; and
- A writ of mandamus ordering FCBOA to accurately determine, for property tax purposes, the values of all past and future leasehold estates.

The Supreme Court only reversed the superior court's dismissal and it remanded the case with



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direction that the superior court specifically examine and rule upon the validity and reasonableness of the proposed valuation methodology.

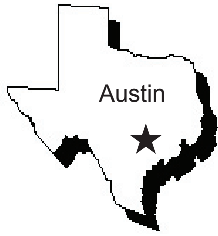
The Decision's Implications

While Mr. Sherman purports to seek a tax increase upon real estate developers, his litigation, if successful, may ironically result in a net decrease in tax collections within Fulton County. If the superior courts in Fulton County begin to question and invalidate sale-leaseback bond transactions, one of the only incentives available in Georgia for attracting new businesses, there could be a chilling effect upon future development within Fulton County. Without the property tax abatement incentives that accompany such transactions, developers may look elsewhere to find more tax-friendly jurisdictions in which to invest. Alternatively, Fulton County may have to start paying out of pocket to entice developers to undertake new projects.

While higher leasehold valuations increase tax revenue, at least in theory, and if all other circumstances stand unchanged, development is less likely to occur in the jurisdictions in which the developers face rising property tax costs. All else being equal, development decreases in response to higher tax burdens. If Fulton County winds up losing new development opportunities as a result of the *Sherman* decision, then the resulting lost tax revenue could easily exceed any net tax revenue gained from imposing higher leasehold valuations on current and future developments.

And even if Mr. Sherman is ultimately unsuccessful in getting the proposed methodology invalidated, the Supreme Court's decision may nonetheless have an indirect impact upon Fulton County's future development and tax revenue. Mr. Sherman is the first plaintiff to make a successful attack on the sale-leaseback bond transaction concept. Now that such a challenge has been allowed to proceed, albeit on a narrow issue, there may be an added element of risk to both the developer and the Development Authority in future transactions. Such an increase in risk can increase a project's anticipated cost and may make it less likely to go forward.

On the other hand, the Supreme Court's ruling provides that parties may protect themselves from such challenges by ensuring that future bond validation proceedings include a request for a ruling specifically on the methodology used to value the leasehold estates. Since the *Sherman* opinion, the DAFC has sought such specific rulings in order to insulate new sale-leaseback transactions from future attack. It has requested express findings in the bond validation orders that the formulas used to value leasehold estates are reasonable and nonarbitrary. So, while the *Sherman* ruling allowed a challenge to past transactions, its language may ultimately afford a means of increased security for future agreements between the DAFC and private developers.■



Tax-Saving Tips for the Texas Manufacturing Exemption

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The Austin Court of Appeals recently ruled that the manufacturing process does not include packaging of finished items received from another manufacturer when the physical properties of those items are not changed in some way, even if the purchase is by a manufacturer.[1] The court held that the manufacturing exemption does not apply to the purchase of materials used to package items that the taxpayer does not fabricate, process, alter, or assemble.[2] In essence, the court held that the manufacturing process ended when Home & Garden Party, Ltd. (HGP), purchased the items from the initial manufacturer and that it was not revived or continued by the activities of HGP. The decision illustrates how the courts sometimes resolve tension between the statutes and the Comptroller rules where the statute favors the taxpayer but the rule may not. The case also provides a good opportunity to reiterate some important tips and traps associated with the Texas manufacturing exemption.

Home & Garden Case

In addition to manufacturing some items itself, HGP purchased bulk-packaged items that it then repackaged prior to shipping but did not alter or assemble in any way.[3] HGP claimed this packaging operation was integrated with the packaging of the items manufactured internally and asserted that the packaging materials were exempt property used in manufacturing.[4]

The Comptroller argued that HGP merely repackages the majority of the items it sells, an activity that does not qualify for the manufacturing exemption because it does not make or cause a physical change in the items themselves.[5] Acknowledging that manufacturing in some cases includes packaging, the Comptroller suggested that once an item has the physical properties, including packaging, it possesses when transferred from the manufacturer to another, the manufacturing process has ended and subsequent repackaging by another does not qualify for the manufacturing exemption.[6] The court agreed that a distinction exists between manufacturers that package items for transfer and wholesalers that repackage them for sale, ruling that materials used by the latter in repackaging are taxable, even if the wholesaler engages in manufacturing other items.[7]

Tension Between Statute and Comptroller Rules

The HGP case illustrates just one example of the tension that exists between items qualifying for the manufacturing exemption under the statute and those allowed by the Comptroller's administrative

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[1] *Combs v. Home & Garden Party, Ltd.*, No. 03-09-00673-CV, 2010 Tex. App. LEXIS 8875 (Tex. App. – Austin Nov. 3, 2010, no pet. hist.).

[2] *Id.* at *16.

[3] *Id.* at *2.

[4] *Id.* at *2–3.

[5] *Id.* at *10.

[6] *Id.*

[7] *Id.* at 15.

rules. The statute exempts tangible personal property used or consumed in the manufacturing of tangible personal property when sold, leased, rented to, stored, or used by a manufacturer.[8] Under the statute, the manufacturing process ends "with the completion of tangible personal property having the physical properties (including packaging, if any) that it has when transferred by the manufacturer to another."[9] While the exemption statute itself does not define "manufacturer," the attendant rule defines "manufacturer" as "a person who is engaged in manufacturing."[10] Under the statute, there was no doubt that HGP was a manufacturer and that the items being sold by HGP to its customers were not complete until the packaging materials at issue were used.

Under the Comptroller's rules,[11] however, a business may purchase all of its packaging supplies tax-free only if it *primarily* manufactures tangible personal property for sale.[12] The rules have an added requirement – that the business be primarily engaged in manufacturing. To complicate matters for unfamiliar taxpayers, this requirement is not found in the rule attendant to the manufacturing exemption, but in the rule dealing with wrapping, packing, and packaging supplies. There exist numerous other examples of discrepancy between the manufacturing-exemption statute and the applicable rules, as well as traps for taxpayers not well versed in Texas sales and use tax law. A pretty good gauge for the chance of succeeding in an exemption claim is whether both the statute unequivocally supports the taxpayer and the Comptroller's rule either supports the taxpayer or at least does not directly contradict the taxpayer's position.

Planning Tips Related to the Manufacturing Exemption

Planning can sidestep a number of these issues and take fuller advantage of the manufacturing exemption. Here are some examples to keep in mind.

New Construction of Manufacturing Plant – Use Separated Contract

Perhaps the biggest risk of loss of the manufacturing exemption lies in new construction. The manufacturing exemption does not apply to the purchase of otherwise exempt manufacturing equipment if the contractor and the manufacturer/customer use a lump-sum contract. Under a lump-sum contract, the contractor is treated as the consumer and end user of all goods used in construction, and because the manufacturing exemption applies only to purchases by the manufacturer, neither the contractor nor the manufacturer can claim the manufacturing exemption on otherwise qualifying manufacturing equipment.[13] Under a separated contract, the contractor is treated as a reseller of materials physically incorporated into the realty, in which case the contractor's purchase of manufacturing equipment qualifies for the resale exemption, while the subsequent sale to the manufacturer qualifies for the manufacturing exemption.[14] The contract must state separate amounts for qualifying and nonqualifying materials.[15] A manufacturer hiring a contractor to build a manufacturing plant and

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[8] Texas Tax Code § 151.318(a) (2010).

[9] *Id.* § 151.318(d).

[10] Comptroller Rule § 3.330(a)(8) (2010).

[11] 34 Texas Administrative Code.

[12] Comptroller Rule § 3.314(e) (emphasis added).

[13] Texas Tax Code § 151.056(a); Comptroller Rule § 3.330(i).

[14] Comptroller Rule § 3.330(i).

[15] *Id.*

purchase and install the equipment should use a separately stated contract with the contractor.

Labor and Service Charges

Generally, the repair, remodeling, maintenance, or restoration of tangible personal property is a taxable service.[16] However, services performed on tangible personal property that would be exempt from sales tax if sold at the time the service is performed are exempt.[17] Accordingly, installation charges for exempt manufacturing equipment are not taxable. Likewise, repairs, remodeling, maintenance, and restoration charges relating to exempt manufacturing equipment are exempt, so long as the equipment has not been incorporated into realty such that it has lost its characterization as tangible personal property at the time the service is performed. Repair or remodeling of real property is a taxable service.[18] The manufacturing exemption does not apply to repairs of real property.

Even when manufacturing machinery and equipment have lost their characterization as tangible personal property, making repairs or remodeling services taxable, opportunities for tax savings still exist. The Comptroller's rules provide that maintenance on real property is not taxable.[19] To qualify as maintenance, the services must be scheduled and periodic.[20] That is, services cannot be requested and performed on an as-needed basis. Certain types of repairs, replacements, and modifications become nontaxable when performed as part of scheduled maintenance.[21] Further, the scheduled shutdown or turnaround of a manufacturing or processing plant is considered to be maintenance.[22] Manufacturers and processors can realize significant tax savings by performing certain repair, remodeling, and restoration activities during scheduled shutdowns, turnarounds, or outages.

Gas and Electricity Used in Manufacturing

Gas and electricity used to power exempt manufacturing equipment or used to light, cool, and heat the actual manufacturing area during the manufacturing process is exempt.[23] Gas and electricity used to power exempt manufacturing equipment is exempt even if the equipment has been incorporated into realty.[24] When gas or electricity is used for both exempt and taxable purposes, the Comptroller applies a predominant-use test.[25] Under the predominant-use test, gas and electricity billed under a single meter is totally exempt or taxable based on the predominant use as measured by that meter.[26] Taxpayers claiming the predominant-use exemption must perform a utility study to establish predominately exempt use for 12 consecutive months.[27]

Taxpayers who use gas and electricity in manufacturing can realize tax savings by performing a predominant-use study to determine whether the use of gas and electricity is predominately exempt.

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[16] Texas Tax Code § 151.0101(a)(5); Comptroller Rule § 3.312(c)(1).

[17] Texas Tax Code § 151.3111(a).

[18] *Id.* § 151.0101(a)(13).

[19] Comptroller Rule § 3.357(a)(7).

[20] *Id.*

[21] *Id.* § 3.357(a)(11), (12), (14).

[22] *Id.* § 3.357(a)(7)(C).

[23] Texas Tax Code § 151.317(a)(2), (3).

[24] Comptroller Rule § 3.295(c)(4)(A).

[25] Texas Tax Code § 151.317(e).

[26] Comptroller Rule § 3.295(e)(1).

[27] *Id.* § 3.295(f)(1).

Taxpayers who cannot establish predominately exempt use can nonetheless realize tax savings by having an additional meter installed, directing all exempt use of gas and electricity through the second meter. As the predominant-use test is performed on a meter-by-meter basis, all gas and electricity billed under a single meter will be exempt so long as 51 percent of the gas or electricity billed under the meter is exempt. Thus, taxpayers should also maximize taxable use of electricity through the second meter, so long as use under the meter remains predominately exempt.

Use of Equipment During Manufacturing

Taxpayers should take steps to ensure that equipment is used during the manufacturing process. Under the statute, the manufacturing process begins with the first stage in production.[28] The Comptroller's rule limits this to the first stage of actual production, excluding acts in preparation for production.[29] The statute provides that the manufacturing process ends with the completion of all physical properties the item has when transferred by the manufacturer to another.[30] Items that would otherwise be exempt will not qualify if used before or after the manufacturing process. For example, quality-control machinery is eligible for the manufacturing exemption but must be used during the manufacturing process.[31] Taxpayers can realize tax savings by performing quality-control tests prior to products having all complete physical properties (including packaging) whenever possible.

Direct Use in Manufacturing

In addition to being used during the manufacturing process, to qualify for the exemption, an item must either: (i) become an ingredient or component part of the manufactured item, or (ii) directly make or cause a chemical or physical change to the product being manufactured or to an intermediate or preliminary product that will become an ingredient or component part of the product being manufactured.[32] Items that are "one step removed" from the manufacturing process may not qualify, as they do not directly make or cause a physical change to the product being manufactured. For example, suppose a taxpayer manufactures cast-iron pipes using molds made from specially treated sand.[33] The mold itself would be exempt because it directly forms steel into the proper shape for the product being manufactured – the pipes. However, items used to make the mold would not be exempt. The product ultimately being manufactured is the pipe, and the items used to make the mold do not become component parts of the pipe, nor do they directly make or cause a physical change to the pipe.

Taxpayers can avoid loss of the exemption on "one step removed" items through the use of multiple entities. In the example above, the taxpayer would create a drop-down subsidiary to manufacture the molds. As the molds are the product manufactured by the subsidiary, any items becoming ingredients or component parts of the molds, or causing a direct change to the

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[28] Texas Tax Code § 151.318(d).

[29] Comptroller Rule § 3.330(a)(9).

[30] Texas Tax Code § 151.318(d).

[31] *Id.* § 151.318(a)(8).

[32] *Id.* § 151.318(a).

[33] These facts are borrowed from *Sharp v. Tyler Pipe Industries, Inc.*, where the court ruled that materials used to make the molds were exempt. 919 S.W.2d 157 (Tex. App. – Austin 1996, writ denied). *Tyler Pipe Industries* was superseded by statute when the legislature added the direct-use requirement to section 151.318(a)(2).

molds, would be exempt. The sale of the molds to the parent would be exempt, as the molds directly make a physical change to the pipes, the product manufactured by the parent. By placing the production of items used in manufacturing, but not ultimately sold, in a separate entity, taxpayers can avoid the "one step removed" issue, maximizing tax savings.

Other Nuances

There are numerous other nuances of the manufacturing exemption of which taxpayers should be aware, including general qualifications, lease and rental provisions, and the divergent-use exception. As noted above, to qualify for the exemption, an item must become an ingredient or component part of the manufactured item, or be "necessary or essential" to the manufacturing process and directly make or cause a physical change.[34] Neither the statute nor the Comptroller's rule defines the terms "necessary" or "essential," and much litigation focuses on these terms. Knowledge of the Comptroller's positions and case law can be helpful in determining whether an item is likely to qualify for the exemption.

Leases and rentals of qualifying manufacturing equipment may also be exempted.[35] However, the leases or rentals must be for a period of one year or greater.[36] The Comptroller's Office looks only to the actual term of the lease or rental to determine whether an item qualifies. Thus, an item rented on a month-to-month basis will not be exempt even if the lease is renewed for 12 consecutive months or more.[37] Manufacturers renting their manufacturing equipment should ensure that the term of the lease is for a year or more. An item rented or leased for a full year that is removed from manufacturing prior to the completion of the contract is not taxable, unless it is moved or put to a nonmanufacturing use, in which case the divergent-use exception applies.[38]

The divergent-use exception applies when property that qualified for the manufacturing exemption is put to a nonqualifying use within

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[34] Texas Tax Code § 151.318(a).

[35] *Id*.

[36] *Id.* § 151.318(d); Comptroller Rule § 3.330(c)(2).

[37] Letter No. 200402378L, Texas Comptroller of Public Accounts, Feb. 7, 2004.

[38] Letter No. 200402378L, Texas Comptroller of Public Accounts, Feb. 7, 2004.

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four years of purchase.[39] When applicable, a fraction of the tax that would have been due at the time of purchase is imposed based upon the percentage of divergent use during that month.[40] No tax is due if the divergent use during a single month does not exceed 5 percent.[41]

Alternative Tax-Saving Possibilities

Taxpayers whose activities meet the intent of the manufacturing exemption, if not the explicit requirements, may want to take proactive steps in an attempt to have the exemption broadened.

Favorable Legislation

The exemption has been amended roughly every three years since inception and has been expanded to include items such as semiconductor fabrication cleanrooms and equipment,[42] photographic props used in printing,[43] and pharmaceutical biotechnology cleanrooms and equipment.[44] We have assisted industry groups who were successful in obtaining some of these provisions.

Rulings and Other Options

There are other ways for taxpayers to confirm that the manufacturing exemption applies to their activities. For example, taxpayers can request rulings from the Comptroller confirming the applicability of the exemption, such as our August 26, 2003, ruling that the exemption covers production and testing machinery used during the early or initial stages of manufacturing before optimum production is achieved (*i.e.*, in implementing a new manufacturing process).[45] Taxpayers are sometimes forced to litigate whether their equipment qualifies for the exemption. Taking up the fight can pay off. We have successfully argued at the administrative hearing level that equipment used during the manufacturing process to move, store, and sequence the manufactured product qualified for the exemption, including the outer walls, ceiling, and frame.[46]

The above examples show only some of the tax-saving tips relating to the Texas manufacturing exemption. Requirements to qualify for the exemption are nuanced and complex, and taxpayers will benefit from advice and counsel from those well versed in Texas sales and use tax law. Jones Day has helped numerous taxpayers work through Texas tax issues and maximize savings.■

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[39] Texas Tax Code § 151.3181.

[40] *Id.* § 151.3181(c).

[41] *Id.* § 151.3181(d).

[42] *Id.* § 151.318(b)(2); S.B. 640, 1995 Leg., 74th Sess. (Tex. 1995).

[43] Texas Tax Code § 151.318(t); S.B. 1125, 2001 Leg., 77th Sess. (Tex. 2001).

[44] Texas Tax Code § 151.318(b)(3); H.B. 2425, 2003 Leg., 78th Sess. (Tex. 2003).

[45] Texas Comptroller of Public Accounts Letter August 26, 2003.

[46] Texas Comptroller Hearing No. 44,798 (May 23, 2006).

New Jersey U.S. District Court Temporarily Enjoins Enforcement of Portions of the State's New Unclaimed Property Law

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As we previously reported, several states have recently sought new ways to increase unclaimed property collections.[1] Perhaps the most controversial of these efforts is New Jersey Assembly Bill No. A3002. Assem. No. 3002, 214th Leg. Sess. (N.J. 2010); 2010 N.J. Laws Chapter 25 (hereafter "Chapter 25").

Chapter 25 attempts to retroactively extend the state's unclaimed property law to "stored value cards" ("SVCs"),which were previously exempt, and imposes onerous reporting and record-keeping requirements on card issuers. In Chapter 25, New Jersey also seeks to create and enforce a place-of-purchase presumption that provides that if the purchaser's or owner's name and address are not maintained by the SVC issuer, the address "shall assume the address of the place where the SVC was purchased or issued and shall be reported to New Jersey if the place of business where the SVC was sold or issued is located in New Jersey." Chapter 25, Section 5c.

Several lawsuits challenging Chapter 25 are pending in the United States District Court for the District of New Jersey. On November 13, 2010, the court issued a preliminary injunction enjoining the defendants – the New Jersey State Treasurer and the New Jersey Unclaimed Property Administrator – from enforcing portions of Chapter 25. The Chapter 25 amendments, the challenges filed in district court, the court's preliminary injunction, and New Jersey's response are discussed below.

Amendments to New Jersey's Unclaimed Property Law Applicable to SVCs

Chapter 25 was signed into law on June 30, 2010. The bill, which was fast-tracked by the New Jersey Legislature, was introduced on June 24, 2010, and referred to and reported out of the Assembly Budget Committee that same day. The bill passed in both the New Jersey Assembly and Senate on June 28, 2010, with an effective date of July 1, 2010. As introduced, the new law was expected to increase state revenues by almost $80 million in fiscal year 2011 alone. *See* Assembly Budget Committee Statement to Assembly, No. 3002, June 24, 2010.

Chapter 25 adds "stored value card" to the definition of "property" for purposes of New Jersey's unclaimed property law. *See* N.J. Stat. Ann. § 46:30B-6(r) (2010). "Stored value card" is broadly defined as:

> a record that evidences a promise, made for monetary or other consideration, by the issuer or seller of the record that the owner of the record will be provided, solely or a combination of, merchandise, services, or cash in the value shown in the record, which is pre-funded and the value of which is reduced upon each redemption.

Id. SVCs include, among other things, gift certificates, gift cards, electronic gift cards, rebate cards, stored value cards, and store cards. *Id*.

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[1] *See* Julie Kaplan, *Changes in Unclaimed Property Laws Provide a Financial Windfall to New Jersey and New York, Administrative Review Passes in Delaware, and Pennsylvania Offers Amnesty,* Jones Day State Tax Return (September 2010).

By specifically including SVCs in the definition of "property," Chapter 25 supersedes a 1998 New Jersey court case and considerably alters the state's treatment of unclaimed gift cards. *See 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).

Chapter 25 creates a two-year presumption of abandonment for SVCs. See N.J. Stat. Ann. § 46:30B-42.1(5)(a). The reportable proceeds of an SVC are the value of the card, in money, on the date the SVC is presumed abandoned. Id. at § 46:30B-42.1(5)(b).

Notably, New Jersey's two-year dormancy period is shorter than the expiration-date requirements of the federal Electronic Fund Transfer Act (the "EFT Act"), which, unless certain conditions are satisfied, generally prohibits the issuance of gift certificates or cards that expire in less than five years. See 15 U.S.C. § 1693l-1(c)(2) (2010). As a result, companies issuing cards in New Jersey will be required under federal law to honor an SVC presented by a customer after the unused balance has been remitted to New Jersey. In an attempt to protect issuers that find themselves in this situation, Chapter 25 permits issuers to seek reimbursement from the state after an owner uses a card that the issuer has already escheated to New Jersey. See id. at § 46:30B-62. Chapter 25 also prohibits all dormancy charges on SVCs. See id. at § 46:30B-43.1(37).

In addition to the reporting requirements, Chapter 25 imposes burdensome record collection and retention requirements on SVC issuers. Under the new law, issuers are required to obtain the name and address of the purchaser or owner of each SVC issued or sold and must, at a minimum, maintain a record of the owner's or purchaser's ZIP Code. See id. at § 46:30B-42.1(5)(c). If the issuer does not maintain the name and address of the purchaser or owner, Chapter 25 creates a presumption that the owner or purchaser "shall assume the address of the place where the SVC was purchased or issued and shall be reported to New Jersey if the place of business where the SVC was sold or issued is located in New Jersey." Id.

Notably, this "place of purchase" presumption seems to apply when the issuer maintains ZIP Codes (which appears to be all that is required under the amended statute) but fails to maintain names and addresses (which is not specifically required). Chapter 25 does not apply to an SVC that is distributed by the issuer under a promotional or customer-loyalty program or a charitable program for no monetary or other consideration or to an SVC issued by any issuer that in the past year sold SVCs with a face value of $250,000 or less.[2]

Guidance Issued by the New Jersey Treasurer

Chapter 25, as enacted, had an effective date of July 1, 2010. The New Jersey Treasurer subsequently issued a series of announcements, or guidelines, delaying the application of the new law until November 15, 2010, "in the interest of sound administration."[3]

In addition to delaying the application of Chapter 25, the guidances also addressed several aspects of the new law. Significantly, in Treasury Announcement FY 2011-03 (September 23, 2010), the Treasurer expounded on the record collection and retention requirements and provided that: (a) if the issuer obtains the name and address of the purchaser or owner of any SVC issued or sold in

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[2] See id. at § 46:30B-42.1(5)(e). For purposes of this subsection, sales of SVCs by businesses that operate either: (1) under the same trade name as, or under common ownership or control with, another business or businesses in the state, or (2) as franchised outlets of a parent business, will be considered sales by a single issuer.

[3] On July 1, 2010, the Treasurer announced a temporary exemption from Chapter 25 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 Treasurer extended this exemption to October 1, 2010. State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-02 (Aug. 26, 2010). On September 23, 2010, the Treasurer extended the exemption until October 31, 2010. State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-03 (Sept. 23, 2010). The exemption was finally extended until November 15, 2010. State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-04 (Oct. 26, 2010).

New Jersey in the normal course of its business, then the issuer shall continue to maintain that information; (b) if the issuer requires the registration of the SVC by the purchaser or owner before initial use, the name and address must be obtained at that time and maintained by the issuer; and (c) except as provided above, issuers and holders will be exempt from the requirement to maintain the name and street address of the purchaser if the purchaser's ZIP Code is obtained. The Treasurer further provided that "it is mandatory that all businesses obtain and maintain the zip code of the purchaser's address. Maintenance of the zip code information shall be sufficient to satisfy the address requirement of the amended Statute." Announcement FY 2011-03.

Announcement FY 2011-03 also explains the Treasurer's interpretation of the application of the place-of-purchase presumption. Announcement FY 2011-03 essentially provides that SVCs issued prior to September 23, 2010 (the date of the announcement), should be reported in a manner consistent with the federal priority rules of *Texas v. New Jersey*, 379 U.S. 674 (1965). If the issuer is domiciled in New Jersey, the guidance provides that any unredeemed balances of cards issued prior to September 23, 2010, where the purchasers' or owners' names and addresses or ZIP Codes were not recorded should be reported to New Jersey. If the issuer is not domiciled in New Jersey, any unredeemed balances of cards issued prior to September 23, 2010, where the purchasers' or owners' names and addresses or ZIP Codes were not recorded should be reported to the state in which the issuer is domiciled. The Treasurer then states:

> If the issuer is not domiciled in New Jersey and the issuer's state of domicile exempts this type of property from its unclaimed property statute, any unredeemed balances of stored value cards issued prior to [September 23, 2010] where the names and addresses or zip code of the purchasers or owners were not recorded must be reported to New Jersey if the cards were issued or sold in New Jersey. In these instances, the issuer must maintain the address of the business where the stored value card was purchased or issued.

Announcement FY 2011-03.

Finally, Announcement FY 2011-03 provides that prepaid phone cards redeemable for minutes are exempted from the requirements of Chapter 25 pending further study. Other SVCs issued by the telecommunications industry (*e.g.*, cards redeemable for prepaid services, cash, or merchandise) are not exempt.

The Treasurer issued two additional guidances, Treasury Announcement FY 2011-05 (November 23, 2010) and Treasury Announcement FY 2011-06 (November 24, 2010), to inform issuers of current reporting obligations under Chapter 25 following the issuance of the temporary injunction by the district court. These guidances are discussed below as responses to the court's injunction.

Challenges Filed by Retailers

The passage of Chapter 25 has raised a number of concerns within the business community. Of primary concern are the administrative burdens placed on SVC issuers and the potential conflict among states created by the place-of-purchase presumption, which creates a situation in which the issuer may face two states (*e.g.*, New Jersey and the holder's state of incorporation) that both lay claim to the same dormant SVC.

American Express Prepaid Card Management Corporation, American Express Travel Related Services Company, the New Jersey Retail Merchants Association, and the New Jersey Food Council (and others) (collectively, the "Plaintiffs") filed lawsuits in U.S. District Court challenging Chapter 25.[4] The Plaintiffs claim, among other things, that Chapter 25 is unconstitutional and violates the Supremacy, Takings, Contracts, and Due Process Clauses of the U.S. Constitution and similar provisions of the New Jersey Constitution.

The Plaintiffs also claim that Chapter 25 is preempted by federal law, including the EFT Act and the priority rules established by the Supreme Court in *Texas v. New Jersey*, 379 U.S. 674 (1965). The Plaintiffs seek a declaration that Chapter 25 is void as a matter of law and also ask the court to issue preliminary and permanent injunctions enjoining New Jersey from enforcing the amended laws.

The District Court Has Enjoined New Jersey From Enforcing Certain Provisions of Chapter 25 During the Pendency of the Cases

On November 13, 2010, the U.S. District Court for the District of New Jersey issued a consolidated Opinion and Order granting in part and denying in part all of the Plaintiffs' requests for a preliminary injunction and temporarily enjoining New Jersey from enforcing certain provisions of Chapter 25. Specifically, New Jersey is enjoined from enforcing the place-of-purchase presumption and from enforcing Chapter 25 retroactively against issuers of SVCs with existing contracts that require issuers to redeem the cards solely for merchandise or services. However, the court denied relief based on the Plaintiffs' argument that the EFT Act preempted Chapter 25 or that Chapter 25 violated substantive due process or the Commerce Clause. The court rejected the Plaintiffs' arguments that enforcing Chapter 25 on a prospective basis (enforcement on SVCs issued after the effective date of Chapter 25) would violate the Contracts Clause or the Takings Clause of the U.S. Constitution.[5] The court also denied New Jersey's motion to dismiss on abstention and immunity grounds.

For each of the Plaintiffs' motions to preliminarily enjoin the implementation of the portions of Chapter 25 relating to SVCs, the court considered whether: (i) the Plaintiffs would be irreparably harmed if denied injunctive relief due to the cost burden of implementing a potentially unconstitutional statute, (ii) granting relief would cause greater harm to the state, and (iii) granting a preliminary injunction was in the public interest. Finally, the court had to examine whether the Plaintiffs showed a reasonable probability of success on the merits of their claims.

First the court addressed whether Chapter 25 violated the priority rules created by the Supreme Court in *Texas v. New Jersey*, 379 U.S. 614 (1965). Under the priority rules established in *Texas*, unclaimed property should escheat to the state of the owner's last known address (the first-priority rule) or, if the owner's address is unknown, to the holder's state of incorporation or domicile (the second-priority rule).

The court determined that New Jersey, by creating and enforcing a place-of-purchase presumption that applies when the purchaser's or owner's name and address are not maintained by the issuer of an SVC, is seeking to implement a third-priority rule based on transaction location. The court concluded that this third-priority rule is unconstitutional because it contradicts the federal common law established in the *Texas* line of cases and thus is preempted. The court cited several examples showing that the Supreme Court intended the first- and second-priority rules "to be exclusive and exhaustive" and that it "is not the province of New Jersey to create [a third-priority] rule." The court stated, notably, that "a state may serve as a 'temporary custodian' only where the holder is incorporated in that state. In other words, there is no room for a third priority position. If the

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[4] *See American Express Prepaid Card Management Corp. v. Sidamon-Eristoff*, Dkt. 3:10-cv-05206-FLW-DEA (D. N.J. filed Oct. 11, 2010); *New Jersey Food Council v. New Jersey*, Dkt. 3:10-cv-05123-FLW-LHG (D. N.J. filed Oct. 5, 2010); *New Jersey Retail Merchants Association v. Sidamon-Eristoff*, Dkt. 3:10-cv-05059-FLW-LHG (D. N.J. filed Sept. 30, 2010); *American Express Travel Related Services Company, Inc. v. Sidamon-Eristoff*, Dkt. 3:10-cv-04890-FLW-LHG (D. N.J. filed Sept. 23, 2010).

[5] In its November 13 Opinion and Order, the district court refused to issue an injunction related to Chapter 25's reduced dormancy period on travelers' checks being challenged by American Express because it determined that American Express did not demonstrate a likelihood of success on any of its claims. On November 14, 2010, American Express filed a notice of appeal to the Third Circuit Court of Appeals and sought an injunction. On November 15, a judge in the Third Circuit granted temporary injunctive relief, enjoining New Jersey from enforcing Chapter 25 to the extent it shortens dormancy periods for travelers' checks, until a full panel of the court has the opportunity to review and consider the American Express motion. *See American Express Travel Related Services Company, Inc. v. Sidamon-Eristoff*, Dkt. No. 10-4328 (3rd Cir. Nov. 15, 2010).

secondary-rule state does not escheat, the buck stops there." The court's decision suggests that the third priority is unconstitutional categorically and not simply as applied in Chapter 25.[6]

Since the place-of-purchase presumption is based on an impermissible third-priority rule, the court concluded it violates federal common law established in *Texas*. The court granted a preliminary injunction against both the retroactive and the prospective application of the presumption, stating that the presumption would do exactly what the Supreme Court sought to prevent by permitting "New Jersey to fabricate an interest where it otherwise does not have one . . . and by usurping the right of the [issuer's] state of incorporation to rule over the [issuer]." Essentially, the presumption ignores the right of the issuer's state of domicile to escheat (or to choose not to escheat) the unclaimed SVCs if the owner's last known address is not maintained.

Next, the court addressed the Plaintiffs' Contracts Clause claims. The Contracts Clause prohibits states from passing laws that impair the obligation of contracts. U.S. Const. Art. I § 10. In determining the likelihood of success of the Plaintiffs' Contracts Clause claim, the court analyzed the existence of a contractual relationship, the potential of Chapter 25 to impair the contractual relationship, and whether any impairment would be substantial. The court found the requisite contractual relationship between issuers who sold SVCs redeemable solely for merchandise or services and the card purchasers. The court determined that Chapter 25 substantially impairs the issuers' right to earn and retain profits from the sale of SVCs under these contracts by forcing the issuers to transfer the entire face value, including profits, to state custody. The court did not find a similar contractual relationship between Plaintiffs who sold SVCs redeemable solely for cash and their customers, and thus it determined that these Plaintiffs had not demonstrated a likelihood of success on a Contracts Clause claim.

Under its Contracts Clause analysis, the court enjoined only the retroactive application of Chapter 25, stating that the Contracts Clause provides protection for existing contracts, not for future contracts. In the court's view, after the effective date of Chapter 25 (November 15, 2010), issuers may choose to alter their contracts or cease to issue SVCs in New Jersey as a remedy.

The court applied a similar analysis relating to the Plaintiffs' Takings Clause claim. The Takings Clause prevents states from taking private property for public use without just compensation. U.S. Const. Amend. V, XIV. The court analyzed whether Chapter 25 affected a legally cognizable property interest and determined that it does by depriving issuers of SVCs redeemable for merchandise or services of their contractual right to earn profits in connection with the sale of the cards.

Finally, the court rejected the Plaintiffs' argument that the EFT Act preempts Chapter 25. The EFT Act is a federal consumer protection law that governs electronic fund transactions, including gift cards. The court determined that it is possible for an issuer to comply with both the EFT Act and Chapter 25 by honoring the SVC for five years as required by the EFT Act and seeking reimbursement from the state. The court also determined that Chapter 25 affords consumers greater protection than does the EFT Act. Thus, the court concluded that the Plaintiffs have not demonstrated a likelihood of success on the preemption claim.

The court also denied the Plaintiffs' substantive due-process claims based on a rational basis review. The court decided that New Jersey put

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[6] Both the 1981 and the 1995 Uniform Unclaimed Property Acts, as well as a number of states, include a third-priority rule in their unclaimed property statutes. The district court's Opinion would appear to call the validity of those provisions into question. Uniform Unclaimed Property Act § 4.6 (1995); Uniform Unclaimed Property Act § 3.6 (1981).

forth a conceivable rational basis for changing its unclaimed property laws, and the fact that these changes also happen to substantially increase state revenue does not run afoul of any substantive due-process concerns. The court rejected the Plaintiffs' Commerce Clause arguments as well, because the Plaintiffs did not show how Chapter 25 would impede interstate commerce or how Chapter 25 regulates the sale of SVCs in other states.

New Jersey Issues New Guidance in Response to the Injunction

In response to the preliminary injunction, the Treasurer issued Treasury Announcement FY 2011-05 (November 23, 2010) and Treasury Announcement FY 2011-06 (November 24, 2010) to inform issuers of current reporting obligations under Chapter 25.[7] The Treasurer recognized that the court "temporarily enjoined" it from applying the place-of-purchase presumption and from retroactively collecting SVCs redeemable solely for merchandise or services. The Treasurer also indicated that should the injunction be lifted, the state will waive any interest or penalties that would otherwise attach relating to cards that should have been reported but for the injunction. The Treasurer, however, indicated that SVCs issued prior to July 1, 2008, and redeemable solely for cash must be reported to New Jersey if: (1) the address of the purchaser is known and is in New Jersey, or (2) the address of the purchaser is unknown and the issuer is domiciled in New Jersey.

In addition, the Treasurer restated the data collection and retention requirements outlined in Announcement FY 2011-03. The Treasurer also stated that the issuer is required to immediately begin obtaining and maintaining the owner's ZIP Code for all cards sold in New Jersey.

If the issuer does not have a system or process in place to record and retain this information, the Treasurer states that the issuer is given until January 3, 2011, to install and implement any necessary systems or processes. The announcement also asserts that the Treasury may conduct audits to ensure compliance with these record-keeping requirements.[8]

Guidance for Holders – The Current Status of Chapter 25

The district court's decision to grant in part and deny in part the Plaintiffs' claims has resulted in a somewhat convoluted patchwork of enforceable and unenforceable pieces of Chapter 25. What is clear from the court's lengthy decision is that New Jersey is temporarily enjoined from enforcing the place-of-purchase presumption set out in Chapter 25 and the Treasury guidances both retroactively and prospectively. New Jersey is also temporarily enjoined from collecting as unclaimed property SVCs issued prior to November 15, 2010 (the effective date of Chapter 25) that are redeemable solely for merchandise and services.

While these aspects of Chapter 25 and the Treasury's guidance are among the most controversial for holders, the decision does leave the state free to enforce a number of other burdensome provisions from Chapter 25. Notably, the district court did not enjoin New Jersey from collecting SVCs that are redeemable for cash, whether issued before or after the effective date of Chapter 25. Under Chapter 25, the full unredeemed value of cards that fall into this category is reportable if the cards have been inactive for more than two years (currently cards issued June 30, 2008, and earlier). New Jersey is, of course, currently prohibited from applying a place-of-purchase presumption in all cases. Thus, SVCs redeemable for cash for which the dormancy period has lapsed appear to be reportable to New Jersey if under the federal priority rules: (1) the address of the owner or purchaser is known

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[7] State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-05 (Nov. 23, 2010); State of New Jersey, Office of the State Treasurer, Treasury Announcement FY 2011-06 (Nov. 24, 2010).

[8] The New Jersey Food Council filed a letter with the district court on November 24, 2010, asking the court to strike or enjoin Treasury Announcement FY 2011-05. As of the date of this article, the court has not yet responded to this request.

and is in New Jersey, or (2) the address of the owner or purchaser is unknown and the issuer is domiciled in New Jersey.

Similarly, because the district court determined that going forward, the Plaintiffs could modify their contracts to account for the impact of Chapter 25 or simply stop selling cards in New Jersey, the court did not enjoin New Jersey from prospectively applying Chapter 25 to SVCs that are redeemable solely for merchandise or services. Thus, as it now stands, these types of cards apparently will be reportable to New Jersey in conformity with the federal priority rules after the two-year dormancy period lapses. Presumably a decision will be reached on the constitutionality of the place-of-purchase presumption before cards issued after Chapter 25 became effective need to be reported.

Finally, the district court did not enjoin New Jersey from enforcing the address and ZIP Code collection and retention requirements of Chapter 25.[9] As discussed above, the Treasurer has announced that it will still require holders to collect and retain address and/or ZIP Code information and may conduct audits to ensure compliance.

In response to Announcements FY 2011-05 and FY 2011-06, American Express Prepaid Cards, Food Council, and the Retail Merchants Association filed individual motions on December 8, 2010, that all seek an order from the district court construing the November 13 Order and enjoining New Jersey from enforcing all provisions of Chapter 25 and the corresponding Treasury guidances or, in the alternative, an injunction pending appeal pursuant to Federal Rule of Civil Procedure 62(c). Such an injunction would presumably prevent New Jersey from enforcing the January 3, 2011, ZIP Code collection deadline from Announcement FY 2011-06.

On December 7, 2010, New Jersey appealed the preliminary injunction to the Third Circuit Court of Appeals in the American Express Prepaid Cards, Food Council, and Retail Merchants cases.[10] Between issuing the two Treasury announcements and seeking an interlocutory appeal, New Jersey seems intent on enforcing Chapter 25, despite the fact that the district court identified serious constitutional concerns with the statute.■

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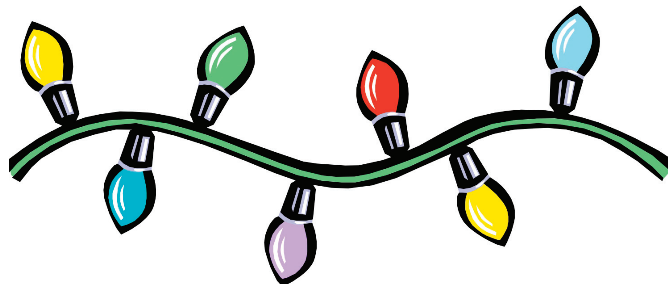
[9] It appears that the Legislature and Treasurer included the ZIP Code retention requirements in Chapter 25 and the Treasury guidances to serve as evidence of the place-of-purchase presumption, which the court has initially rejected. The connection with the presumption has led to some confusion in the district court's decision regarding the state's ability to enforce these requirements. The court's Order does state that New Jersey is enjoined from enforcing all of Section 5c of Chapter 25, which includes the ZIP Code retention requirement. In its opinion, however, the court never specifically addressed the validity of the ZIP Code retention requirement. It is likely that the court did not feel it was necessary to do so at this stage in the proceeding. Until the court rules on the December 7, 2010, motions to enjoin all enforcement of Chapter 25, the more prudent reading of the court's Order and Opinion is to limit the injunction to the place-of-purchase presumption as stated in the Opinion, leaving the ZIP Code retention requirement enforceable.

[10] *American Express Prepaid Card Management Corp. v. Sidamon-Eristoff*, Dkt. 10-4553 (3rd Cir. Dec. 7, 2010); *New Jersey Food Council v. New Jersey*, Dkt. 10-4552 (3rd Cir. Dec. 7, 2010); *New Jersey Retail Merchants Association v. Sidamon-Eristoff*, Dkt. 10-4551 (3rd Cir. Dec. 7, 2010).



Texas 82nd Regular Legislative Session Preview

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The Texas Legislature is set to convene for the 82nd regular session on January 11, 2011. Budget deficit projections are reaching as high as $25 billion, and Texas' constitutionally mandated balanced budget will create difficult decisions as to how to meet spending commitments. The Comptroller has stated that cash collections for fiscal year 2010 were down 6.5%, or $2.5 billion.[1] While redistricting may be the forefront concern for some legislators, revenue creation will certainly be a major issue. Governor Perry may well use his executive power to call special sessions focusing on revenue creation.

Even before the deficit projections ballooned up to $25 billion, revenue creation was a concern for the 82nd session. During the legislative interim, the House Ways and Means Committee was tasked to study certain tax topics, including monitoring the performance of the revised franchise tax; examining major sales/use and other tax exemptions to determine how costs and benefits comport with original objectives; studying the tax structure applicable to cable television service, with consideration of competitive fairness; and identifying ways to improve the quality and uniformity of property tax appraisals.[2]

The following is a preview of some of the topics expected to be addressed in the upcoming session, as well as an example of the significant goals that can be accomplished from taxpayer involvement.

- **Margin Tax Underperforming** – The Texas margin tax has raised about $1.5 billion a year less than anticipated when it was enacted in 2006. One major reason cited for the underperformance is that more businesses are claiming the cost of goods sold deduction than anticipated, so the dollar value of that deduction is greater than expected. Businesses have taken varying views and the controlling guidance does not address all of the various costs that may properly be includable in the deduction. Expect the Legislature to take a close look at the definition of "cost of goods sold," perhaps considering simplification by adopting the federal definition of cost of goods sold or creating a cap on the deduction.
- **Increased Sales Tax Rates** – Until sales tax rates become so high that spending decreases or the pressure for unreported transactions results in diminishing tax revenue, raising rates on existing sales/use taxes is often cited as a quick fix. Expect legislation to propose increasing the sales tax rate and the ceiling on local tax rates, may be proposed during the 82nd session.
- **Reducing or Eliminating Existing Exemptions** – The Legislature is considering alternatives to increase tax collections by

[1] Susan Combs, *State of Texas Annual Cash Report* v (2010).

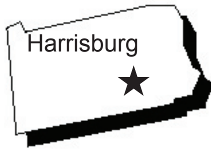
[2] See Bill Kidd, *Texas House Panel to Study Franchise Tax, Property Appraisal Issues*, State Tax Today, Nov. 23, ____ 2009.

scaling back or eliminating some existing sales/use and other tax exemptions. No doubt this will raise the debate of whether decreasing the scope of exemptions such as the *manufacturing exemption,* may hurt jobs or otherwise reduce in-state business with longer term negative effects on the state's economy.

- **Expanding the Sales Tax Base** – In addition to scaling back exemptions, the Legislature is considering additional types of items (generally services) that might be subjected to the sales tax. Expect the list of *taxable services* to be a topic of debate.
- **Streamlined Sales Tax Project** – Having failed to implement the project in the past, the Legislature may once again consider renewed attempts at implementation in the upcoming session. Now that the Streamlined Sales and Use Tax Agreement (SSUTA) permits more flexibility on local sourcing rules, expect discussion of whether and how other states have benefitted from the SSUTA.

With revenue statutes at the forefront of the upcoming session, taxpayers should take proactive steps to ensure their voice is heard regarding tax legislation likely to affect them. We closely monitor legislative matters in consultation with several taxpayer groups and have years of experience in evaluating and assisting in drafting favorable provisions[3] and in successfully opposing negative legislative changes.■

[3] *See, e.g.*, S.B. 640, 1995 Leg., 74th Sess. (Tex. 1995) (adding semiconductor fabrication cleanrooms and equipment to the sales and use tax manufacturing exemption, codified at Texas Tax Code § 111.318,).



The Marcellus Shale Formation: Pennsylvania Lawmakers Face Severance Tax Hurdle

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Editor's Note: Many thanks to Fran Muracca for sharing this informative severance tax commentary that was published in December 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.

On November 2, 2010, Pennsylvania elected Republican State Attorney General Tom Corbett as its 46th Governor, leaving Democratic Governor Ed Rendell a lame duck in the final weeks of his term. In addition, control of the House shifted to Republicans, establishing Republicans as the majority in both the Pennsylvania House and the Senate. During his campaign, Governor-elect Corbett signed the Americans for Tax Reform pledge[1] and repeatedly stated that he would not raise any taxes if elected.

Toward the end of 2010, the General Assembly, divided by party lines in a gubernatorial election year, was embroiled in a fierce debate over whether the Commonwealth should enact a severance tax on natural gas that parallels the tax imposed by other shale-gas-producing states. In Act 46, representing the Commonwealth's fiscal code for the year ending June 30, 2011, the Pennsylvania General Assembly set, but subsequently missed, an October 1 deadline to pass a natural gas severance tax. In the coming year, with Republicans in control of the General Assembly, it remains to be seen what, if any, compromise can be reached.

Pennsylvania's Severance Tax Outlook Under Newly Elected Republican Leadership

With record unemployment, a loss of public trust in state government, and major budget issues, Governor-elect Corbett assumes office on January 18, 2011 challenged to revitalize Pennsylvania's economy and reduce the size and cost of state government. Pennsylvania is facing a looming pension crisis, deficits in its Unemployment Compensation Trust Fund, declining stimulus funds, rising health care costs, and an uncompetitive business tax structure.

As part of his campaign platform, Governor-elect Corbett disclosed his views on a potential natural gas severance tax. Governor-elect Corbett believes that Pennsylvania's natural gas and renewable energy resources are critical to restoring a vibrant economy and sustainable job growth. He fully supports the exploration, distribution, and transmission of natural gas from the Marcellus Shale formation in an environmentally sound manner. "Tom Corbett believes that a punitive tax on the industry at this stage would reduce capital investment in the commonwealth and reduce the potential for new jobs, tax revenues and other economic benefits associated with the development of the Marcellus Shale."[2] While there may be room to negotiate a "nonpunitive" tax, Governor-elect Corbett is clear that any tax must not interfere with job growth related to the Marcellus Shale industry.

Based on Governor-elect Corbett's strong anti-tax statements, it remains to be seen what options are still on the table to raise state funds from the Marcellus Shale drilling activity boom. Just prior to the election, Senate Republicans outlined a severance tax proposal. With Republicans controlling both the House and the Senate when the new General Assembly reconvenes on January 4, 2011, it is possible that a tax closely mirroring this proposal could be enacted. While the proposed tax rate is substantially lower than the tax that passed the House at the end of September, it would still generate revenue to help the Commonwealth overcome its significant financial burdens.

Now that it is clear that Senate Bill 1155 will not pass the General Assembly and has no chance of clearing Governor-elect Corbett's desk, perhaps more Democrat legislators will be willing to sign on to the Senate Republican Proposal. As an added incentive, the Republican proposal includes several increased environmental and water protection measures. For example, the proposal would expand distance and duration of rebuttable presumption in cases of contamination of drinking water to reflect the expanded ranges of unconventional drilling techniques. The proposal would also increase and clarify the permitting authority of the Department of Environmental Protection ("DEP") over wells and fracturing chemicals.

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 continues to be a key point of negotiation.

At least one prominent Republican Senator, Joe Scarnati, has said he would consider creating impact fees that could be assessed in place of a severance tax. As opposed to a tax, impact fees would be charged to shale drilling companies in an effort to recoup the environmental and community costs to the localities from the drilling activity. These fees would pay to mitigate environmental impacts, widen roads, boost emergency services, and monitor air and water emissions. Impact fees would have the benefit of avoiding the "tax" label, satisfying Governor-elect Corbett's pledge. In addition, the impact fees should be limited to offsetting direct costs of the drilling, thereby satisfying demands to limit the revenue from being added to the Pennsylvania general fund. However, the question remains how the troubled budget will be balanced without help from a natural gas extraction tax.

Looking Ahead to 2011

Governor-elect Corbett has named approximately 400 people from a wide variety of industry, environmental, community, and government groups to 17 different transition committees. While it is not yet known who will emerge from these committees as the next Secretary of the DEP or the Department of Revenue, these committees, particularly the Energy & Environment Committee, will help shape Pennsylvania's natural gas industry and revitalize its economy.■

This Commentary is part II of a series dedicated to the Pennsylvania natural gas industry. A more comprehensive Jones Day Commentary on the Pennsylvania severance tax controversy is available at www.jonesday.com/marcellus_shale_formation.

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[1] The Americans for Tax Reform pledge, which Tom Corbett signed, states "I, Tom Corbett, pledge to the taxpayers of the state of Pennsylvania, that I will oppose and veto any and all efforts to increase taxes."

[2] www.tomcorbettforgovernor.com/issues/faq.

Indiana Joins the Concerning Trend -- Applying Substance-Over-Form in the Sales and Use Tax Context

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How complicated do sales and use taxes need to be? Taxing authorities are more frequently recharacterizing transactions for tax purposes. If a transaction can be structured in multiple ways, should businesses be required to pay the highest tax possible? Surely not.

There was a time not so long ago when computing taxes was much simpler. A time before Sarbanes-Oxley and FIN 48, when a taxpayer could review the law and have at least some certainty of what tax returns to file and where to file them. Taxpayers could look at the location of their property and payroll, and have a pretty good idea of where they had nexus. This was a time when sales taxes were determined by the particular form of the transaction.

Times have changed. We no longer walk uphill barefoot in the snow to and from school. But tax professionals are increasingly being left in the cold when trying to determine what taxes need to be reported and where. The form of a transaction no longer necessarily dictates tax treatment, not just in the income tax context, but increasingly in the sales or transfer tax contexts as well. Taxing authorities are increasingly looking at the substance of a transaction or series of transactions, not just the form of the transaction, in determining whether sales and use taxes will be due.

The Substance-Over-Form Doctrine

Over the past 75 years, federal courts have developed a variety of "anti-abuse" doctrines that prohibit the recognition of tax benefits in certain transactions.[1] The foundation of these "anti-abuse" doctrines is the substance-over-form doctrine. This doctrine allows courts to re-characterize transactions and overlook legal formalities when the true substance of a transaction varies demonstrably from the outward form. Substance-over-form analysis often applies in federal income tax cases involving leasing transactions, related party transactions, shareholder or employee transactions, and transfer of ownership determinations,[2] but the application of the doctrine is not limited to these types of transactions.

State and local taxing jurisdictions have widely adopted the substance-over-form doctrine with respect to income taxes.[3] There has been no consensus, however, on the appropriateness of applying the substance-over-form doctrine to other type of taxes – particularly sales and use taxes. In addition to the lack of federal precedent,

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[1] The most notable anti-abuse doctrines include economic substance, substance over form, the sham transaction doctrine, the step-transaction doctrine, and business purpose.

[2] See *Frank Lyon v. U.S.*, 435 U.S. 561 (1978); *Helvering v. Lazarus and Co.*, 308 U.S. 252 (1939); *Davis v. Comr.*, 585 F.2d 807 (6th Cir. 1978); *Teong-Chan Gaw v. Comr.*, T.C. Memo 1995-53; *U.S. v. Ingalls,* 399 F.2d 143 (5th Cir. 1968); *Higgins v. Smith*, 308 U.S. 473 (1940); *Grodt & McKay Realty, Inc. v. Comr.*, 77 T.C. 1221 (1981); *Falsetti v. Comr.*, 85 T.C. 332 91985).

[3] *See generally Syms Corp. v. Commissioner*, 765 N.E.2d 758 (Mass. 2002)(court applied sham-transaction doctrine to disallow deduction of royalty payments in a transfer-leaseback arrangement between a company and its subsidiary), *Dep't of Revenue v. Puffnstuff*, Inc., No. IT 01-18 (Ill. Dep't Revenue Office of Admin. Hearings, Oct. 5, 2001)(court applied step-transaction doctrine to qualify gain as business income), *Sherwin-Williams Co. v. Tax Appeals Tribunal* (Sherwin-Williams NY), 784 N.YS.2d 178 (N.Y. App. Div. 2004)(upheld division's determination that a combined return was required by applying the economic substance doctrine).

this lack of consensus is largely due to the fact that sales and use taxes generally have been determined based on the particular form of the specific sale transaction.[4] Historically, states did not typically look beyond the form of a transaction to the underlying objective of the transaction, even if the form of the transaction was structured to achieve tax efficiency or a tax benefit.

In recent years, however, state and local taxing jurisdictions have become increasingly aggressive in assessing all kinds of taxes. A growing number of states have begun to look beyond the form of a transaction to its ultimate purpose or goal in determining whether to assess sales or use tax. The latest taxing authority to successfully proceed down this path was the Indiana Department of Revenue, which was allowed by the Indiana Supreme Court to assess a use tax by asserting that the tax should apply under the step-transaction doctrine.[5]

The Indiana Supreme Court Opinion in Belterra

In *Belterra*, the Indiana Supreme Court concluded that a riverboat casino owner was required to pay use tax on its purchase of a riverboat, in spite of the fact that the riverboat was acquired by way of a capital contribution from its owner. The court applied the step-transaction doctrine to conclude that the ultimate substance of the transaction was the purchase of a riverboat for use in Indiana.

The taxpayer in this case had contracted with an Alabama company to manufacture a riverboat. On July 24, 2000, title to and possession of the boat was conveyed by the Alabama manufacturer to the taxpayer's parent company off the coast of Alabama, in international waters. The purchase price of the boat was approximately $35 million. Alabama sales tax was not collected and remitted because the boat was purchased outside of the state. The next day, the parent transferred the riverboat to its 97% owned subsidiary through a contribution to capital. The subsidiary moved the boat into Indiana, where it was ultimately to be used.

The Indiana Department of Revenue audited the subsidiary and concluded that the acquisition of the riverboat was subject to use tax in Indiana.[6] The subsidiary protested the assessment on the basis that the acquisition of the riverboat for use in Indiana was a contribution to capital without consideration and thus, was not subject to tax. The subsidiary's position was that the sale of the riverboat from the Alabama manufacturer to its parent was irrelevant to the transaction at hand.

The Indiana Supreme Court found that the acquisition of the riverboat by the subsidiary was a retail transaction subject to Indiana use tax. Applying the step-transaction doctrine, the court collapsed to two transactions to find the requisite consideration, looking to the original sale of the riverboat from the Alabama manufacturer to the parent.

The court looked to the end result of the purchase of the boat and subsequent contribution, concluding that the transactions were component parts of a single transaction intended from the outset to reach the ultimate result of obtaining 100% ownership of the riverboat for use in Indiana without paying Indiana use tax. The court considered the interdependence of the transactions finding that the purchase of the boat, the contribution, and the subsidiary's operation of the boat were so interdependent that it was unreasonable to conclude

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[4] *See generally Spencer Gifts, Inc. v. Bob Bullock*, Comptroller of Pub. Accts., 766 SW2d 593 (TX Ct.App. 1989)(the court emphasized the significance of stated language in a sales tax dispute); *Dep't of Rev. of the State of Ill. V. Dauntless Tenpin and 8-Ball Co*., Taxpayer, IL Admin. Hearing, No. LIT 02-1, IL Dep't of Rev. (Jan., 2001)(court was not willing to overlook the definition of "trade-in" as stated in the law to view substance of transaction); *Bank of Commerce v. Woods*, 585 SW2d 577 (TN Sip. Cr. 1979)(Bank held liable for unpaid taxes when it purchased the debtor's equity interest where it could have avoided successor liability through foreclosure).

[5] *Indiana Dep't of State Revenue v. Belterra Resort Indiana, LLC*, 935 N.E.2d 174 (Ind. Oct. 5, 2010).

[6] Under Indiana law, use tax is imposed on the storage, use, or consumption of tangible personal property if the property was acquired in a retail transaction. Indiana Code 6-2.5-3-2(a).

that the transactions would have been undertaken except to complete the entire series of transactions. According to the Indiana Supreme Court, "the substance, rather than the form, of transactions determines their tax consequences."[7]

What Does Belterra Mean for Taxpayers?

The substance-over-form analysis could become a subjective analysis about the taxpayer's intent or overall objective. Subjective determination of tax treatment inherently leads to inconsistency in application. This can be unsettling to taxpayers who seek certainty as to how a transaction is properly taxable. When substance-over-form is part of the equation, taxpayers should look at both the specific statutory guidelines applicable to each step in the transaction, and whether the substance of the transaction itself may be subjectively problematic.

Another complicating factor arises if a court simply does not like the way a transaction is structured, or its ultimate result. Again, this subjective evaluation inherently leads to a lack of consistency in application.

For example, *Belterra* leaves open the issue of whether the Indiana courts will apply the substance-over-form and step-transaction doctrines in every capital contribution case, or if this sort of scrutiny will be triggered only when sales and use taxes have not been paid in any state.

While it seems unlikely that the doctrines will be applied to every capital contribution case in Indiana, confusion remains as to the appropriate treatment of a capital contribution in the state. The court in *Belterra* looked to the surrounding transactions to find consideration attributable to the capital contribution. Because the Taxpayer's affiliate had recently paid consideration, the court concluded that the purchase and contribution was a retail transaction that could be subject to tax. Might consideration be attributed to a contribution to capital in other circumstances? As a result of *Belterra*, capital contributions should be reviewed to determine if there is sufficient consideration to classify it as a retail sale that is subject to tax.

The Trend: Application of Federal Judicial Doctrines to State Sales and Use Tax Cases

The *Belterra* decision adds to the growing trend of states that have applied the federal "anti-abuse" doctrines, once reserved for income tax cases to sales and use taxes. By adopting the substance-over-form and step-transaction doctrines for sales and use taxes, the Indiana Supreme Court calls into question the old adage that form controls over substance in sales and use tax transactions. This shift encourages the Department of Revenue to more aggressively scrutinize corporate structures and assess sales and use taxes on previously untaxed transactions.

This is not an entirely new phenomenon. The substance-over-form doctrine began to appear in the sales tax context occasionally during the past few years, most often in the context of aircraft purchases. Because of the significant tax attributed to these types of transactions, taxpayers often structure such purchases in the most tax efficient manner, triggering a higher level of scrutiny.

Texas has issued two letter rulings applying the substance-over-form doctrine to an airline purchase.[8] In these rulings the Comptroller indicated that such transactions will be scrutinized beyond the mere form to determine if the transaction was conducted to achieve a legitimate business purpose. The Comptroller reasoned that, "to permit

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[7] *Belterra* at 179. *See generally Mason Metals Co. v. Ind. Dep't of State Revenue*, 590 N.E.2d 672, 675 (Ind. Tax Ct.1992); *Bethlehem Steel Corp. v. Ind. Dep't of State Revenue*, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992).

[8] Tex. Policy Ltr. Rul. Nos. 200611755L (Nov. 15, 2006) and 200908387L (Aug. 6, 2009).

the true nature of the transaction to be disguised by mere formalisms would seriously impair effective administration of tax policy."[9]

Similarly, the Illinois Appellate Court has applied the substance-over-form doctrine to assess tax in an aircraft purchase.[10] The Tennessee courts also considered the doctrine in a related context; however, the Tennessee Supreme Court ultimately decided the case on other grounds.[11] Although the substance-over-form doctrine was ultimately determined not to apply to the Tennessee case, the court left open the possibility of future application.

Perhaps one of the earliest applications of substance over the form in the sales tax context, and one of the few instances of its application outside of the context of an airline purchase occurred in Oklahoma, where the Tax Commissioner issued an order applying the substance-over-form doctrine to conclude that a contribution of assets to a subsidiary followed by a sale of a controlling interest in the subsidiary was in reality a sale of the underlying assets and thus, subject to sales tax.[12] This type of transaction has sometimes been referred to as a "drop-kick" transaction. Interestingly, the commissioner justified the use of the doctrine by stating simply that the doctrine is "well-recognized in matters of taxation," without discussing the novel application to state sales tax matters.

Better tax policy would dictate that such changes in general tax principles should be enacted through legislation as opposed to subjective caselaw. Where states have legislated such changes, taxpayers have more certainty as to the tax treatment of transactions. Taxing authorities also benefit by lower audit costs and higher tax collections from better compliance with a more clear policy.

Death of Form over Substance?

A very wise Judge Learned Hand once stated: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[13] That precedent, while still good law, appears to have been overlooked by some taxing authorities and courts.

As the *Belterra* case illustrates, states that have never adopted the federal income tax doctrines in the sales tax context may attempt to assert a broader application. Taxpayers will have more difficulty determining the sales tax treatment of various transactions. Going forward, taxpayers should consider the underlying substance of transactions and consider possible challenges that had not previously existed.■

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9 Tex. Policy Ltr. Rul. No. 200908387L (Aug. 6, 2009).

10 *JI Aviation, Inc. v. Department of Revenue*, 781 N.E.2d 469, 481 (Ill. App. Ct. 2002).

11 *Hutton v. Johnson*, 956 S.W.2d 484, 488-489 (Tenn. 1997).

12 Okla. Tax Comm'n Order P8900153 (1991).

13 *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

Georgia Joins the Streamlined Sales Tax Governing Board – Should You Consider Amnesty?

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On November 1, 2010, the Streamlined Sales Tax Governing Board unanimously approved Georgia's petition to join the organization. Georgia will join the Streamlined Sales and Use Tax Agreement (SSUTA) as an associate member on January 1, 2011.

Georgia passed legislation in May 2010 to conform the state's sales and use tax laws to the SSUTA. *See* House Bill 1221, L. 2010, Act 507. The state's membership, however, is contingent on the state's resolving several technological issues by January 1, 2011. Officials from Georgia have promised to satisfy those requirements before the end of the year.

Beginning on January 1, 2011, Georgia will offer the standard streamlined amnesty for uncollected or unpaid sales or use tax required of all SSUTA member states. The amnesty will preclude assessment for uncollected or unpaid sales or use tax together with penalty or interest for sales made during the period the seller was not registered in the state. O.C.G.A. § 48-8-76(a)-(b); SSUTA § 402. To qualify, a seller registered under the SSUTA to pay or to collect and remit applicable sales or use tax on sales made to purchasers in the state: (i) must not have been registered in the state in the 12-month period preceding the effective date of the state's participation in the SSUTA, (ii) must register within 12 months of the effective date of the state's participation in the SSUTA, (iii) cannot have received any notice of an audit from the state, and (iv) must continue its registration and payment or collection of applicable sales or use taxes for at least 36 months. O.C.G.A. § 48-8-76(a)-(e); SSUTA § 402.

Taxpayers should carefully consider the implications and alternatives of the Georgia amnesty. Certain taxes are covered, others are not. In some cases, a voluntary disclosure agreement (VDA) may be preferred due to the required "strings" that attach to the SSUTA amnesty provisions. For example, tax amnesty applies solely to uncollected sales or use taxes due from a taxpayer in its capacity as a "seller," and not due in its capacity as a consumer or buyer. O.C.G.A. § 48-8-76(f). Thus, tax due on items used or consumed by the seller during the course of its business on which taxes have not been paid (*e.g.*, items withdrawn from inventory) are not available for amnesty. Furthermore, the amnesty program is only available for uncollected "sales or use" taxes. A variety of state and local transfer and excise taxes do not fall within the ambit of Georgia's amnesty law. For taxpayers with these types of potential liabilities, a VDA may be the preferable option.

In addition, sellers may have sales to customers in a number of SSUTA states, but lack a significant physical presence in those jurisdictions. In such cases, sellers will have to weigh the benefits of obtaining a tax amnesty against the compliance and administrative burdens imposed by voluntarily registering in each of the 20 full-member states. If, for example, a seller has a significant physical presence only in Georgia, applying for a VDA with the Georgia Department of Revenue may be a more attractive option (*i.e.*, a less expensive option) than being registered in 20 or more states to collect and remit sales and use tax. Furthermore, taxpayers who register under the SSUTA provisions should consider that they will not receive amnesty for sales and use taxes imposed in those full-member states whose 12-month amnesty periods have expired. Thus, the expiration of the amnesty period in the full-member states may counsel against registering under the SSUTA provisions.

With its admission, Georgia becomes the 24th member of the Streamlined Sales Tax Governing Board. Other participating states include 20 full member states (Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska,

Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont, Washington, West Virginia, Wisconsin, and Wyoming) that have changed their sales tax administration law to conform to all of the requirements set forth in the SSUTA, as well as three associate member states (Ohio, Tennessee, and Utah) that have been determined by the Governing Board to have achieved substantial compliance with the terms of the SSUTA taken as a whole, but not necessarily each provision. Sellers that register under the SSUTA must collect and remit sales and use taxes for all taxable sales into the full member states. SSUTA § 401(B). Sellers may, but are not required to (unless otherwise required to by applicable law), elect to collect sales or use taxes in an associate member state. SSUTA § 801.3(B). Sellers that are registered on the Streamlined Sales Tax registration system can register with Georgia starting on January 1, 2011.■

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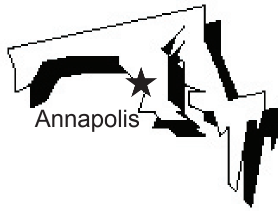
Maryland and Massachusetts Blur the Lines of Business Purpose, Economic Substance and Sham Transactions



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State and local administrative and judicial bodies have increasingly cited a lack of business purpose and/or economic substance to deny the tax benefits of what they classify as tax-motivated, sham transactions. Recently, courts in Maryland and Massachusetts expanded the reach of these amorphous concepts even further. The Maryland Tax Court upheld income tax assessments against two Delaware intangible holding companies that the court deemed to lack economic substance apart from their parent.[1] In like manner, a Massachusetts appeals court upheld the Appellate Tax Board's refusal to abate certain corporate excise taxes assessed against an in-state parent company after concluding that the parent's transfer of its world logo licensing business to a remote subsidiary constituted a sham.[2]

A Brief History

At its broadest, the issue posed by the "business purpose" and "economic substance" doctrines is whether, and, if so when, the literal language of a statute or regulation should be overridden because it leads to an inappropriate result. Courts have sometimes held that a transaction that fits within the literal language of a statute or regulation will not be respected for tax purposes, even though it may be respected for other purposes, if the transaction lacks a legitimate business purpose other than to achieve a tax objective or if the transaction lacks economic substance. Underlying these notions is the well-accepted principle of statutory construction that a statute's literal language will not be followed when it leads to an absurd result. Certain transactions, particularly intercompany transactions, have become targets for business purpose or economic substance challenges by state taxing authorities.

During the 1980s and 1990s, many corporate taxpayers took steps to manage their intellectual properties more effectively by transferring them to a so-called "intangible holding company" or "IHC." IHCs typically licensed the intellectual properties back to related companies for use in their business in exchange for royalties. Some IHCs loaned the royalty proceeds to the related companies for use in their business, generating interest expense at the related operating company level. In addition to a number of potential non-tax business purposes, the placement of intellectual properties in an IHC generally resulted in state tax savings since the related operating companies deducted the royalties and interest they incurred from their income in the states in which they did business. The IHCs, which typically limited their activities to Delaware, generally qualified for an exemption from the Delaware income tax and were commonly regarded as not being subject to taxation in any other state. States in which the related companies were doing business began challenging the use of IHCs based on a number of theories in the mid to late 1980s.

The South Carolina Supreme Court's decision in *Geoffrey, Inc. v. South Carolina Tax Commission*[3]

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[1] *See* W.L. Gore & Assocs., Inc. v. Md. Comptroller of the Treasury, Nos. 07-IN-OO-0084, 07-IN-OO-0085, and 07-IN-OO-0086 (Md. Tax Ct. Nov. 9, 2010).

[2] *See* IDC Research, Inc. v. Mass. Comm'r of Rev., No. 09-P-1533, 2010 WL 4814689 (Mass. App. Ct. Nov. 30, 2010).

[3] 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

was one of the first reported decisions involving an IHC. In *Geoffrey*, the court upheld the assessment of South Carolina income taxes against the foreign IHC.[4] Although the business purpose doctrine was not an issue in *Geoffrey*, the decision paved the way for other states to go after IHCs based on lack of business purpose and other legal theories.

Maryland—Murky Waters

Maryland courts have gradually tangled the business purpose and economic substance doctrines with unitary business and nexus principles to renounce the use of remote IHCs over the last ten years. Specifically, if a remote IHC receiving royalty income from a Maryland affiliate lacks genuine economic substance, Maryland courts have held that the Comptroller may attribute to the IHC the nexus, and where appropriate the apportionment factors, of the Maryland affiliate upon which the IHC supposedly relies for its separate existence.[5] In *SYL* and *Crown Cork & Seal*, the Maryland Court of Appeals characterized the IHCs as resembling phantom corporations with "a touch of 'window dressing' designed to create an illusion of substance."[6] The Court of Appeals concluded "[a]lthough officers of the parent corporations may have stated that tax avoidance was not the sole reason for the creation of the subsidiaries, the record demonstrates that sheltering income from state taxation was the predominant reason for the creation of SYL and Crown Delaware."[7]

Recently, the Maryland Tax Court reached a similar result as the Court of Appeals in *SYL* and *Crown Cork & Seal*, by employing a slightly different and more troubling analysis.[8] Petitioners in the matter were two Delaware IHCs wholly-owned by W.L. Gore & Associates ("WL Gore"), a manufacturer with a physical presence in Maryland. WL Gore created the two IHCs to hold and license certain patents and to invest and manage excess funds, respectively. The Maryland comptroller assessed taxes against the IHCs on the basis that neither "has an identity as a separate business entity and that the intangible income [each] receives is directly connected to Maryland activity through the unitary business conducted in Maryland" by WL Gore.[9]

The Tax court stated that "Maryland courts have consistently concluded that the basis of a nexus sufficient to justify taxation is the economic

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4 *Id.* at 19.

5 *See Md. Comptroller of the Treasury v. SYL, Inc. and Crown Cork & Seal Co.*, 825 A.2d 399 (Md. 2003); The Classics Chicago, Inc. v. Md. Comptroller of the Treasury, 985 A.2d 593 (Md. Ct. Spec. App. 2010).

6 *SYL and Crown Cork & Seal*, 825 A.2d at 415.

7 *Id.*

8 *See* W.L. Gore & Assocs., Inc. v. Md. Comptroller of the Treasury, Nos. 07-IN-OO-0084, 07-IN-OO-0085, and 07-IN-OO-0086 (Md. Tax Ct. Nov. 9, 2010).

9 *Id.*

reality of the fact that the parent's business in Maryland was what produced the income of the subsidiary."[10] Combining this so-called standard with unitary business principles, the court held that the IHCs "were passive, non-operational entities and did not have a business existence separate and apart from their parent company."[11]

In the court's eye, the facts reflected functional integration, control through stock ownership and common employees, and a reliance by the IHCs on WL Gore's personnel, office space, and corporate services.[12] The court viewed the evidence as such that substantial nexus existed between the IHCs and Maryland and upheld the assessments against the IHCs.[13] This case grants the Comptroller alarming authority to apportion a remote entity's income based upon the apportionment factors of an in-state affiliate and leaves taxpayers guessing as to what exactly constitutes economic substance.

Massachusetts—Clarity Through Codification?

The Massachusetts legislature has codified the "sham transaction doctrine." The relevant statute provides, "[T]he commissioner may, in his discretion, disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit."[14] Thus, Massachusetts law requires both a non-tax business purpose and economic substance to pass muster under a sham analysis.

These now statutorily-imposed concepts were previously developed in a series of cases in Massachusetts beginning in 2000.[15] The decisions in *Syms*, *Sherwin-Williams*, and *Cambridge Brands* made clear that the inquiry of whether or not a transaction is a sham "is, of necessity, primarily a factual one, on which the taxpayer bears the burden of proof."[16] Furthermore, in dealing with situations where remote IHCs are found to lack economic substance, Massachusetts courts have opted to deny the royalty and interest expense deductions taken by the in-state affiliates of such

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[10] *Id.* (citing *SYL* and *Classics Chicago*).

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] Mass. Gen. Laws ch. 62C, § 3A (2002).

[15] *See* Syms Corp. v. Mass. Comm'r of Rev., 765 N.E.2d 758 (2002) (disallowing royalty and interest expense deductions based upon the sham transaction doctrine); The Sherwin-Williams Co. v. Mass. Comm'r of Rev., 778 N.E.2d 504 (2002) (concluding that "[b]ecause the record in this case establishes that the reorganization and subsequent transfer and licensing transactions were genuine, creating viable businesses engaged in substantive economic activities apart from the creation of tax benefits for Sherwin-Williams, they cannot be disregarded by the commissioner as a sham regardless of their tax-motivated purpose."); Cambridge Brands, Inc. v. Mass. Comm'r of Rev., No. C259013 (Mass. App. Tax Bd. July 16, 2003), *aff'd,* 820 N.E.2d 837 (Mass. App. Ct. 2005) (unpublished) (finding that substantial evidence existed to conclude that the arrangement between the various affiliates had a business purpose).

[16] *Syms*, 765 N.E.2d at 764.

IHCs or to reallocate a portion of the IHCs' income to their in-state affiliates rather than taxing the remote IHCs directly through puzzling conceptions of nexus like their counterparts in Maryland.[17]

On November 30, 2010, a Massachusetts appeals court did just that in upholding the Appellate Tax Board's finding that a parent company's transfer of its world logo licensing business to a remote subsidiary "had no economic substance or business purpose other than tax avoidance, and therefore constituted a sham transaction."[18] International Data Group ("IDG") is a technology media company based in Massachusetts. IDG Holdings, Inc. ("IDG Holdings), a subsidiary of IDG, is an IHC based in Delaware. IDG transferred its world logo licensing business to IDG Holdings. In turn, IDG Holdings received royalty income from certain foreign affiliates in exchange for their use of the world log and loaned a portion of this income to IDG periodically. The Appellate Tax Board "concluded that the commissioner properly reallocated royalty income from IDG Holdings to IDG, based on the sham transaction and assignment of income doctrines."[19]

The appeals court agreed, finding "that IDG did not sustain its burden of proving that it was entitled to an abatement of corporate excise taxes on amounts it claimed were earned by IDG Holdings."[20] The court questioned IDG Holdings' standing as a viable entity for tax purposes, pointing out that its only activities consisted of receiving royalties, automatically investing these amounts when its account reached a certain level, and briefly leasing an office suite at its bank.[21] Moreover, though the court believed that IDG may not have transferred ownership of the world logo at all, it stated that even if the logo had been transferred, "the transactions still lacked economic substance or effect because IDG retained full use and control of the world logo and the benefits and burdens of its ownership."[22]

The Massachusetts appeals court also accepted the board's finding that there was no substantive business purpose to transfer the world logo licensing business to IDG Holdings.[23] Even with little or no direct evidence that the transaction was undertaken solely for tax avoidance, the court pointed out that the burden was on IDG to prove

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[17] *See, e.g.*, The Talbots, Inc. v. Mass. Comm'r of Rev., Nos. C266698, C271840, and C276882, 2009 WL 3162121 (Mass. App. Tax Bd. Sept. 29, 2009) (holding that the Commissioner properly reattributed to Talbots all of the royalty income and interest income earned by investment of the Talbots Marks.)

[18] IDC Research, Inc. v. Mass. Comm'r of Rev., No. 09-P-1533, 2010 WL 4814689, at *1 (Mass. App. Ct. Nov. 30, 2010).

[19] *Id.*

[20] *Id.*

[21] *Id.* at *1-2.

[22] *Id.* at *2.

[23] *Id.* at *4.

a non-tax motive.[24] The court concluded that "the control IDG maintained over IDG Holdings bore none of the hands-off features that typified its relationships with its other subsidiaries" and the transfer of the world logo licensing business was not consistent with the company's claimed goal of decentralization.[25]

Finally, the Massachusetts court refused to accept IDG's argument that the sham transaction doctrine did not apply because the licensing of the world logo constituted a new business instead of a reorganization. IDG developed and previously used the world logo and, according to the court, tax "avoidance was amply demonstrated in the record."[26]

Conclusion

While it is easy to detect a trend of state tax agencies invoking the business purpose and other doctrines in order to combat perceived state tax planning, identifying trends in how state courts react to such allegations is more difficult. Some state courts have refused to apply the business purpose and related doctrines even when faced with clear evidence of tax motive, leaving it up to the legislature to fix any perceived abuse of the system. Some state courts have searched diligently for the confines of the business purpose doctrine and applied the doctrine against the taxpayer only when compelled by clear evidence. Other state courts, including those in Maryland and Massachusetts, have arguably paid lip service to the legitimate business purpose doctrine as a basis for ruling against the taxpayer when the court felt the taxpayer was engaged in some form of tax planning.

One clear trend is that legislatures are taking a more active role in combating perceived abuse of tax systems. The U.S. Congress recently enacted a federal definition of the "economic substance doctrine." The Health Care and Education Reconciliation Act was signed into law on March, 30, 2010, and added new code section 7701(o), which states, "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (a) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position; *and* (b) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[27]

It remains to be seen whether similar state legislative attempts to codify common law doctrines such as the business purpose doctrine or attempts to disallow deductions for intercorporate payments will lead to more or less litigation. Given the current economic landscape, it seems unlikely such attempts will thwart the efforts of taxpayers to find even more creative ways of reducing state taxes. Taxpayers should take care to structure transactions that have economic substance and are at least partially motivated by a viable non-tax purpose.■

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[24] *Id.*

[25] *Id.*

[26] *Id.* at *5.

[27] I.R.C. § 7701(o) (emphasis added).

Foreign Property: What Unclaimed Property Holders Need to Know

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Editors Note: We appreciate our friends Mark Paolillo and Sam Schaunaman at Thomson Reuters sharing this article on one of the more controversial issues of unclaimed property. Expect to see more cases in the near future!

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As companies continue to expand their operations overseas, an increasingly important issue in their unclaimed property compliance program is to what extent "foreign property" may be subject to the reach of U.S. unclaimed property laws. This article consists of several parts: First, an introduction to uniform law provisions discussing foreign property; second, commentary discussing the authors view of the main types of foreign unclaimed property transactions; third, a general overview of relevant state legislation; fourth, an overview of pertinent cases in this area; fifth, a brief discussion of similar laws of other countries; and finally, some additional legal considerations will be mentioned.

Introduction

Two of the often disputed, seminal rules in this area emanate from the 1981 Uniform Unclaimed Property Act ("1981 Act"), and are also found in the 1995 Uniform Unclaimed Property Act ("1995 Act"). First, Section 3(5) of the 1981 Act provides in pertinent part that "…intangible property is subject to the custody of this State as unclaimed property if…the last known address, as shown on the records of the holder, of the apparent owner is in a foreign nation and the holder is a domiciliary…of this state…." The term "domicile" is defined in Section 1(6) of such Act to mean "…the state of incorporation of a corporation and

the state of the principal place of business of an unincorporated person."

What is the pertinent authority for this rule? Interestingly, the Commentary of the Uniform Law Commissioners to Section 3 of the 1981 Act simply states: "Paragraph (5) provides that, when the last known address of the apparent owner is in a foreign nation the state in which the holder is domiciled may claim the property. This issue was not dealt with by the Supreme Court in *Texas v. New Jersey*, but is a rational extension of that ruling." The Supreme Court has yet to agree that this unsupported extension of the court's fairly clear ruling is "rational."

Section 36 of the 1981 Act provides that: "This Act does not apply to any property held, due and owing in a foreign country and arising out of a foreign transaction." Authors of a leading treatise in this area state that "The 1995 and 1981 Uniform Unclaimed Property Acts have similar provisions and commentary relating to the escheat of foreign accounts."[1] As the authors of the BNA Treatise note, "The Uniform Acts were created by the National Conference of Commissioners on Uniform State Laws ("NCCUSL"). NCCUSL is a non-profit unincorporated association consisting of representatives appointed by state governmental authorities from all states, the District of Columbia, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands. As expressed on their website…the goal of the NCCUSL is to 'study and review the law of the states to determine which areas of law should be uniform…and to promote the principle of uniformity by drafting and proposing specific statutes in areas of the law where uniformity between the states is desirable.'…NCCUSL acts do not, however, carry the force of law and serve only as model provisions that become legally binding only upon adoption by an applicable legislative body."[2]

Since over forty states have enacted a version of the Uniform Unclaimed Property Acts, presumably many states have enacted similar provisions to those delineated above into their respective unclaimed property laws.

Principal Types of Foreign Unclaimed Property Transactions

Our experience in this area has been that three principal types of foreign unclaimed property transactions tend to arise. The first type is the "foreign to foreign" area. For example, assume a company organized under the laws of France sends a vendor check from its office in France to a business in Germany, which entity is organized under German law; the check is returned as undeliverable. There is no U.S. involvement in the transaction. This type of transaction should not be subject to the reach of U.S. state unclaimed property laws since, in addition to issues of conflicts of governing laws, the transaction falls under the "foreign to foreign" exemption delineated in Section 36 of the 1981 Act (i.e., "This Act does not apply to any property due, held and owing in a foreign country and arising out of a foreign transaction.")

The second type of transaction is the "domestic to foreign" area. For example, assume company "X", domiciled within the United States, mails a vendor check from its offices in the United States to a vendor located overseas; the check is returned as undeliverable. What result? Company X's state of domicile may claim any unclaimed funds emanating from that transaction as subject to its law, based upon the first seminal rule discussed in Part I above. Legal analysts on this subject

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[1] See Michael Houghton, et al., Unclaimed Property, 74-2nd C.P.S. (BNA-Rev. 2008), at p. A-27b. (Thomson Reuters representatives are co-authors of this treatise); see also Section 4(5) of the 1995 Act and Section 26 of the 1995 Act.

[2] See p. A-39.

[3] See Brooke Spotswood, Esq., and Sonia Walwyn, J.D., "Foreign Unclaimed Property Reporting," presented at UPPO Annual Conference (March, 2009), at p. 7.

dispute such claims stating, "[h]owever rational this provision appears to be, the question is whether or not any extension of a U.S. Supreme Court ruling, no matter how logical, is binding on property due and owing to a resident of a foreign country?"[3] Such authors note that the *Texas v. New Jersey* ruling did not deal with "…jurisdiction over an individual who is not a U.S. citizen" and note that the key issue is: "Can a state legislate beyond or outside of the *Texas v. New Jersey* guidelines?"[4]

The third principle type of transaction relates to the "foreign to domestic" area. For example, assume an entity organized under foreign law and operating overseas discovers that it owes funds to a missing individual owner whose last known address was within the United States. Is there a duty to report and remit such funds to the applicable U.S. state?

Although the treatment of U.S.-owned property held by a foreign entity may not be entirely clear, authors of a leading treatise in this area assert: "A foreign nation corporation does have a duty to report and deliver unclaimed property held to it by the state where the last known address of the person owed the property is located because a state has the power to legislate regarding the disposition of property presumed abandoned and due to its resident and exercising that power, state unclaimed property law imposes upon a holder a duty to report and deliver unclaimed property into the protective custody of the state. In a suit brought by a state to enforce this duty, a court would have personal jurisdiction over the foreign nation corporation only if that corporation has certain minimum contacts with the state such that the maintenance of the suit would not offend traditional notions of fair play and substantial justice."[5]

This third type of transaction is subject to the maxim that it applies only so long as it does not interfere with, or violate, international law (which in itself is a complex subject beyond the scope of this article). In other words, the law of the country where the foreign entity was organized would also need to be taken into account.

General Overview of State Legislation

How do the unclaimed property laws of the various states address the treatment of foreign property? In general terms, states can be divided into three categories for this purpose. The first category consists of those states that have adopted a version of either the 1981 Act or the 1995 Act, and thus presumably have incorporated into their laws the two rules regarding foreign property discussed in Part I hereof.[6] A list of the various states that have adopted a version of the 1995 Uniform Act may be found at the website for the National Conference of Commissioners on Uniform State Laws.[7]

The second category consists of those states that have not adopted a version of the 1981 or 1995 Uniform Acts, but have provided for the disposition of foreign property in their laws. Analysts indicate that states in this category are the following: California, Connecticut, Hawaii,[8] Massachusetts, Mississippi, and Texas.

A third category consists of those states that have not adopted a version of the 1981 or 1995 Uniform Acts, and also have not explicitly provided for foreign property in their unclaimed property laws. Analysts indicate that this category consists of: Delaware, Illinois, Kentucky, Missouri,

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4 Id., at p. 8.

5 See Matthew Bender, *Unclaimed Property*, Vol. 1, p.2-64.

6 The BNA C.P.S. Unclaimed Property Treatise provides a good discussion of which states have adopted "what version" of the various Uniform Acts. See Michael Houghton et al., *Unclaimed Property,* 74-2nd C.P.S. (BNA Rev. 2009), at Chapter IV.

7 See www.nccusl.org

8 See Spotswood and Walwyn, at p. 5 (A review of the website for the National Conference of Commissioners on Uniform State Laws on December 7, 2010 indicated that Hawaii has adopted the 1995 Act.).

Nebraska, New York, Ohio and Pennsylvania.[9] In discussing this category of states, analysts have noted that: "[t]hese states, to the extent they claim foreign property, utilize the articulated extension of the Supreme Court in *Texas v. New Jersey*."[10] Presenters on this topic have stated that "Delaware is one of a handful of states which did not adopt the model legislation or specifically provide for 'foreign transactions' in its statutes."[11] Such presenters then give the Delaware statutory definition of "holder", suggesting that definition may be relied upon by Delaware as support for its right to claim certain foreign property. See Delaware Code, Title 12, Sec. 1198(6).[12] Due to a paucity of case law in this area, whether Delaware's position is defensible seems to be somewhat of a "gray area".

Some of the states in this category also may assert a claim to certain foreign property under the "miscellaneous or catch all" provision found in the various state laws. This article will not cover the various provision of each state's law with regard to foreign unclaimed property. Rather, it merely notes that the treatment of foreign property has been handled differently by different states, similar to the manner in which states address other areas of unclaimed property.

Overview of Case Law

There has been a paucity of case law discussing the issue of treatment of foreign property.[13] In one of the few cases to discuss this issue, the Screen Actors Guild ("Guild") brought an action in California state court seeking a declaratory judgment that unclaimed residuals paid to it for distribution to its members were not subject to California's Unclaimed Property Law ("UPL").

The Guild was a labor union representing some 30,000 actors, stuntmen, and other performers. It negotiated collective bargaining agreements with the various performers whereby producers would transmit certain "residuals" to it for transmission to the entitled performers. The opinion of the California Court of Appeal stated that the residuals "…constitute additional compensation to it for the reruns of television programming, foreign telecasting, theatrical exhibition of television motion pictures, etc." The opinion further indicated that the Guild spent "…approximately $250,000 a year in processing residuals and in attempting to locate the performers entitled to them" and further indicated that the Guild "…deposited part of these unclaimed residuals in a savings trust account at Toronto Dominion Bank of Canada, located in Canada."

Among other arguments, the Guild cited Section 1502, Subdivision 4, of the UPL as expressly exempting "any funds held only in a foreign country." The California Court of Appeal did not agree with the Guild. It cited the definition of "holder" as meaning "any person in possession of property, subject to the UPL, belonging to another or who is a trustee in case of a trust." Applying that statutory definition of holder to the facts of the case, the court concluded "Plaintiff is in constructive possession of the funds which it has deposited in the Canadian bank. It is also quite clearly a trust with respect to the trust under

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[9] Id., at p. 5.

[10] Id., at p. 5.

[11] See Brooke Spotswood, Esq. and Brian Browdy, Esq., "Foreign Escheat", presented at 2007 UPPO Annual Conference.

[12] Based on our firm's collective audit experience, we are aware that in some situations Delaware has taken the position that there is nothing in Delaware law which prevents them from claiming foreign property (i.e., their position could be described as simply there is no exclusion or exemption in the statute for unclaimed property whose owner has a last known address in a foreign country.)

[13] Thus, in a discussion of unclaimed property cases in one treatise, under the heading "Foreign Funds", only one case was cited as discussing the issue of foreign property. See A. Andreoli and B. Spotswood, "*Guide to Unclaimed Property and Escheat Laws*", Second Edition, Vol. 1, Commonwealth Publishing Company, Inc. 1998 Supplement-discussion of "Comparative Table of Issues and Unclaimed Property Categories."

which these funds are held in the Canadian bank. Consequently the right to these funds is held in California by plaintiff, even though the funds themselves are physically located, at least in part, in Canada. In sum, the residuals on deposit in Canada are not 'funds held *only* in a foreign country.'"[14]

Another case which discussed foreign property is that of *Vondjidis v. Hewlett Packard Corporation*.[15] The facts of that case indicate that Plaintiff, a Greek citizen, was employed by Defendant Hewlett Packard Corporation ("Hewlett Packard") at their Athens, Greece office in the 1970's. He purchased shares of the company's stock through an employee stock purchase plan. Although the company was aware of Plaintiff's home address in Athens, for administrative convenience it sent periodic stock mailings to the corporate office address in Athens. After such office closed in 1982, Plaintiff ceased receiving any such mailings, despite the fact that Plaintiff maintained the same home address.

The opinion of the Court of Appeal, Sixth Appellate District, stated in pertinent part: "Vondjidis moved to Canada in 1981, but he continued to maintain the same home address in Athens and continued to receive mail that was sent to his Athens home address." In 1993, Hewlett Packard transferred Plaintiff's shares to the State of California as unclaimed property. The California Court of Appeal essentially ruled that Hewlett Packard could not rely upon the statutory immunity provision set forth in the UPL, since it had not followed the method of due diligence/ owner notification scheme prescribed by the UPL. However, for purposes of this article, the case reaffirms one of the two principles discussed in Part I hereof-namely that a "domestic to foreign" transaction can be covered under the ambit of a state's unclaimed property law.

A third case also arguably stands for the proposition that a "domestic to foreign" transaction may, at least in certain situations, be covered by a state's unclaimed property law. In the *Taylor v. Chiang* case, Plaintiffs, one of whom resided in England, alleged that the California State Controller had taken possession of, and liquidated, their securities without providing them sufficient notice. An earlier opinion in the case by the U.S. Court of Appeals for the Ninth Circuit had ruled that general newspaper advertisements advising people to check the state's website was not a constitutionally sufficient method of notice, and that the plaintiffs in the case had established a "showing of likelihood of success on the merits." On June 1, 2007 the U.S. District Court entered a preliminary injunction against the California State Controller, prohibiting the Controller from accepting or taking possession of "any property pursuant to the UPL."[16]

Unclaimed Property Laws of Other Countries

It is apparent that unclaimed property laws are increasing around the world. Analysts in this area have noted that "Foreign legislation on unclaimed property is expanding."[17] As noted on the website for the National Association of Unclaimed Property Administrators, Guam, Puerto

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[14] See *Screen Actors Guild, Inc. v. Kenneth Cory, California State Controller*, 91 Cal. App. 3d 111, 154 Cal. Rptr. 77, Court of Appeal, Second District, Division 3 (March 28, 1979).

[15] See *Vondjidis v. Hewlett Packard Corporation*, 85 Cal. Rptr. 3d 806 (Nov. 25, 2008). It is noted that the petition for review in this case was dismissed by the California Supreme Court and remanded to the California Court of Appeal, Sixth District, in light of the decision in the Azure Limited v. I-Flow Corp. case. See 217 P. 3rd 816, 100 Cal. Rptr. 3d 447.

[16] See *Taylor v. Chiang*, 2007 U.S. District Court (June 1, 2007). Note: After enactment of legislation by the California Legislature (Sen. Bill 86) which substantially addressed the constitutional defects of the earlier legislation, the injunction subsequently was dissolved by the courts.

[17] See Spotswood and Walwyn, at p. 9.

[18] See www.unclaimed.org -last reviewed on December 7, 2010. The NAUPA website has a "drop down bar" which delineates states, U.S. territories and Canadian provinces with an unclaimed property law-Guam, Puerto Rico and the Virgin Islands are all mentioned on the website.

Rico and the U.S. Virgin Islands all have a type of unclaimed property law.[18] A review of the website for the National Conference of Commissioners on Uniform State Laws indicates that the Virgin Islands adopted the Uniform Unclaimed Property Act (1995).[19] The following countries have reportedly enacted a form of unclaimed property legislation: "Australia, Belgium, Canada, France, Italy, Kenya, Germany, Hong Kong, New Zealand, and the United Kingdom."[20] The various Canadian provinces have also become increasingly active in this area. For example, Alberta enacted a comprehensive unclaimed property law, effective September 1, 2008, captioned the "Unclaimed Personal Property and Vested Property Act."[21] Analysts in this area report their understanding is that Canada's equivalent of the Uniform Law Commissioners has recommended a proposed version of the "Unclaimed Intangible Property Act", and that the proposed Canadian Act apparently has a "first priority rule: last known address plus 'nexus'".[22]

Additional Legal Considerations

Foreign property is one area where there is generally more questions than answers, due to the complexities of international law, the myriad of factual situations that can arise, and the paucity of case law in this area. Considerable uncertainty exists in this area.

First, recall that the issue of foreign property was not dealt with by the U.S. Supreme Court in Texas v. New Jersey. Rather, as the Commentary of the Uniform Law Commissioners assert, the foreign property rules are justified as "a rational extension of that ruling". However, reasonable people certainly can differ on whether that is a "rational extension". As the authors of a leading treatise in this area state: "Therefore, with foreign addressed property it is fair to say the state of the law is somewhat unclear."[23] Second, the wording of each state unclaimed property law which has adopted a version of the Uniform Act should be checked, such analysts state, since "…the legislature of a particular state may not have adopted the 'foreign property' rule exactly the same as the Uniform Acts."[24] Third, each state law should be carefully checked to see what the specific terms of that state's law provide with respect to the treatment of foreign property.

Finally, the international conflict of law provisions must be considered. In summary, the foreign property area seems likely to grow in importance for many large, multi-national corporations and for service providers who consult or practice in this area.■

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[19] See www.nccusl.org-last reviewed on December 7, 2010.

[20] Id., at pp. 12-17.

[21] A copy of such legislation can be downloaded from the above-mentioned NAUPA website.

[22] See Brooke Spotswood, Esq., and Brian Browdy, Esq., "*Foreign Escheat*", (2007).

[23] See Houghton, et al., at p. A-27(b).

[24] Id., at p. A-27(b).

Texas Misstep – Texas Court Sanctions Another Broad Texas Comptroller Nexus Position

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The Amarillo Court of Appeals recently held in *Galland Henning Nopak, Inc. v. Combs*[1] that an employee's promoting or inducing sales in Texas is sufficient to create nexus and subject an out-of-state company to the Texas franchise tax (both the earned-surplus component and the taxable capital component in effect during the audit period).[2] Following a franchise tax assessment, Galland Henning Nopak, Inc. (Nopak) filed suit, claiming it lacked substantial nexus with Texas such that imposition of the tax would violate the Commerce Clause.[3] Nopak's only connection to Texas other than common carrier and the United States mail was a regional manager employed to service the needs of distributors in several states, including Texas.[4] Nopak's regional managers were not authorized to directly solicit or take orders.[5] Rather, the regional manager did little beyond "extolling the virtues of Nopak's products to distributors and attempting to resolve customer complaints."[6]

The Texas Court of Appeals held that the employee's activities were aimed at promoting or inducing sales and were significantly associated with Nopak's ability to establish and maintain a market in Texas; thus, the assessment did not violate the Commerce Clause.[7] The court rejected Nopak's argument that any Texas activities were *de minimis*, finding that the regional manager's handling of customer complaints served an independent business function and was conducted on a regular basis. The decision highlights a number of issues, including some unique to Texas with which taxpayers may not be familiar.

Identifying Companies With Texas Nexus

The Comptroller identified Nopak as a company potentially subject to the franchise tax after discovering that Nopak was filing employee wages for its Texas-based employee.[8] Likely, the Comptroller's Business Activity Research Team (BART) requested W-2s from the Internal Revenue Service or Texas Workforce Commission reports, then compared the information to companies filing franchise tax returns. This is a method commonly used by BART to identify entities allegedly doing

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[1] 317 S.W.3d 841 (Tex. App. – Amarillo 2010, no pet. hist.).

[2] The court's decision does not specify which component of the tax was at issue; but in light of the discussion of Public Law 86-272 and the underlying Comptroller hearing, both components appear to have been considered. *See* Comptroller Hearing No. 43,503, STAR No. 200602184H (2006).

[3] *Nopak*, 317 S.W.3d at 842–43.

[4] *Id.* at 844.

[5] *Id.* at 845.

[6] *Id.* at 846.

[7] *Id.* at 845.

[8] *Id.* at 842.

business in Texas. Accordingly, taxpayers would be well advised to consider W-2s and state filings in evaluating the level of nexus with the state.

Texas Nexus Test

The *Nopak* court held that an employee's indirectly promoting sales in Texas created substantial nexus,[9] applying the physical-presence test in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and the "maintain a market" holding in *Tyler Pipe Indus. Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987). Activities aimed solely at establishing or maintaining a market in Texas were deemed sufficient to create nexus; taking orders or making sales was not required. The court held that helping resolve customer complaints was sufficient to establish nexus for the franchise tax, notwithstanding the language to the contrary in the United States Supreme Court's decision in *Wisconsin Dep't of Revenue v. William Wrigley Jr., Co.*[10]

Thankfully, at the same time, the court reiterated that an out-of-state entity must have some physical presence in Texas in order to have nexus for the franchise tax.[11] To date, the Texas courts have not held that an entity can establish nexus through volume of sales in Texas, or economic nexus, as other states have alleged. The leading Texas case on this issue is *Rylander v. Bandag Licensing Corp.*,[12] a case involving one of the authors. In Bandag, the Austin Court of Appeals held, for a variety of good reasons, that the physical-presence test announced in Quill and other cases applies to the Texas franchise tax. Later Texas decisions have cited that holding with approval and the Texas courts have opted to follow the physical-presence test established by the U.S. Supreme Court, rather than creating an alternative, economic presence test as some other state have done in recent years.[13]

Jurisdictional and Procedural Issues

Travis County district courts have exclusive original jurisdiction over all state tax suits brought against the Comptroller.[14] Jurisdiction for any appeal from a Travis County district court lies with the Austin Court of Appeals. Texas tax cases can be fairly nuanced, but substantively and procedurally. While centralized jurisdiction in Texas means that judges in the Austin Court of Appeals are more likely to be familiar with issues unique to tax law, it can also lead to an overload of cases in the Austin Court of Appeals and, increasingly, the assignment tax cases to other courts of appeal. Accordingly, *Nopak* was heard by the Amarillo Court of Appeals. Taxpayers should be aware that Texas appellate justices outside Austin are less likely to be familiar with tax issues. Briefing of tax cases and presentation of arguments may need to be adjusted accordingly.

Interestingly, the *Nopak* case may involve procedural error. The court of appeals referenced, and the trial court appears to have admitted, the holding of the administrative law judge (ALJ), as well as testimony elicited during the ALJ hearing.[15] Under the Texas Government Code, a court conducting a *de novo* trial "may not admit in evidence the fact of prior state agency action

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9 *Id.* at 845.

10 505 U.S. 214, 231 (1992)(ruling sales representative's actions to resolve customer complaints was ancillary to solicitation activities protected from income-based taxation under Public Law 86-272).

11 The holding would apply to the newer Texas margin tax as well.

12 18 S.W.3d 296 (Tex. App. – Austin 2000, pet. denied).

13 *See*, *e.g.*, Conn. Gen. Stat. § 90 (2010) ("Any company that derives income from sources within this state, or that has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, without regard to physical presence, and to the extent permitted by the Constitution of the United States, shall be liable for the tax imposed under chapter 208 of the general statutes.").

14 Texas Tax Code § 112.001 (2010).

15 *Nopak*, 317 S.W.3d at 843.

or the nature of that action except to the limited extent necessary to show compliance with statutory provisions that vest jurisdiction in the court."[16] As all district court tax suits are reviewed *de novo*,[17] the references to the administrative evidence are questionable.[18]

De Minimis Presence and Ancillary Services

As the *Nopak* court notes, citing the U.S. Supreme Court's decision in *Wrigley*,[19] substantial nexus requires more than a *de minimis* contact with the state.[20] The *Nopak* court relies on *Wrigley* for the proposition that an activity is more than *de minimis* if it serves an independent business function, separate from requesting orders, in which the company would wish to engage, regardless of whether it had a sales force.[21] The court then cites a Comptroller rule[22] listing "investigating, handling, or otherwise assisting in resolving customer complaints" as an example of an independent business activity and concludes that the frequency with which the regional manager handled customer complaints made his presence more than *de minimis* and justified the assessment.

In *Wrigley*, the U.S. Supreme Court addressed *de minimis* activity, as well as activities ancillary to solicitation of orders and immune from state taxation under 15 U.S.C. § 381 (Public Law 86-272).[23] One service at issue was a regional manager's intervention in credit disputes.[24] The Court held that intervening in credit disputes was ancillary to the solicitation of orders and thus protected by Public Law 86-272, reasoning:

It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other

16 Texas Government Code § 2001.173 (2010).

17 Texas Tax Code § 112.054.

18 The deaths of the taxpayer's primary witnesses following the administrative hearing but before trial may have played a role in admitting these administrative actions.

19 505 U.S. 214, 231 (1992).

20 *Nopak*, 317 S.W.3d at 845.

21 *Id.*

22 Comptroller Rule § 3.554(d)(7).

23 505 U.S. 214.

24 *Id.* at 232.

employee – some company ombudsman, so to speak – if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases.[25]

The *Wrigley* Court's discussion of what constitutes an independent business function was in the context of services ancillary to solicitation of sales, not *de minimis* activity, and thus the *Nopak* court's discussion of whether it is *de minimis* seems beside the point.[26] Further, *Wrigley* held that intervening in customer disputes was not an independent business activity but an ancillary service and therefore protected by Public Law 86-272.[27]

Still, the *Nopak* court did not rely directly on *Wrigley*, but on a Comptroller rule that attempts to construe the *Wrigley* holding as narrowly as possible. The full text of the rule provides that "investigating, handling or otherwise assisting in resolving customer complaints, *other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer*" constitutes doing business in Texas.[28] The Comptroller interprets the holding in *Wrigley* to mean that any involvement with a customer complaint beyond mediation is no longer ancillary to solicitation of sales and thus not protected by Public Law 86-272. Such an interpretation is overly restrictive, as it limits the intervention in customer complaints allowed in *Wrigley* to nothing more than mediation.

In construing Public Law 86-272, the *Wrigley* Court utilized a middle approach in determining the extent of the protected activities, rejecting the narrow interpretation suggested by Wisconsin and the broad interpretation suggested by the taxpayer.[29] In Rule 3.554(d)(7), the Comptroller turns the decision in *Wrigley* on its head by taking what was already a middle (reasonable) approach and construing it as narrowly as the words would literally permit. Such an aggressive approach in the area of nexus is not unusual for the Comptroller.[30] Out-of-state companies should beware and be well advised.■

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25 *Id.* at 235.

26 *Id.*

27 *Id.*

28 Comptroller Rule § 3.554(d)(7) (2010) (emphasis added). The Rule also allows that such *de minimis* activity will not constitute doing business. *Id.*

29 *Wrigley*, 505 U.S. at 228–29.

30 As an example, the Comptroller claims that sending an out-of-state employee into Texas for a single day to attend an educational conference where no orders are offered, taken, or accepted creates nexus for the out-of-state company for the next four years. *See Colonial Surgical Supply, Inc. v. Combs*, No. D-1-GN-07-1968 (Travis Cty., Tex., Dist. Ct. 2009); *Colonial Surgical Supply, Inc. v. Combs*, No. D-1-GN-07-1967 (Travis Cty., Tex., Dist. Ct. 2009).

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 third 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 long-awaited first Ohio CAT nexus determination, in which the Ohio Department of Taxation affirmed assessments issued to out-of-state retailer L.L. Bean to tee up the test case for economic nexus in Ohio; a trio of rulings on in-state personnel, illustrating that this area remains one of the most highly-fact sensitive nexus areas; a recent decision upholding New Jersey's "throw out" rule; and a Tennessee ruling finding that use of waterways in that state created nexus. State legislators have been busy as well, as Washington adopts "economic nexus" and trailing nexus for its B&O tax, and Colorado and Oklahoma passed expansive new "affiliate nexus" statutes and impose significant new reporting and customer notification requirements on retailers that have no sales tax nexus in those states.

IN-STATE PERSONNEL

Three more decisions on telecommuters and nexus -- Employees working from home did not create nexus in Indiana and Virginia, but a Texas Appellate Court found that a regional manager who lived in Texas and occasionally handled complaints from distributors in a 7 state region did create nexus. The key is whether the employee's activities promote sales and are directed to in-state customers.

INDIANA

An out-of-state business with employees who worked out of their homes but did not service or sell to Indiana customers was not required to collect sales tax. This is an important reminder to always check the state statute first – there is no need to reach the issue of constitutional nexus if the state nexus statute doesn't apply!

Letter of Findings No. 09-0939, Indiana Department of Revenue, June 23, 2010.

1. Taxpayer was an out-of-state company engaged in computer software sales. Taxpayer provided documentation that its Indiana-based employees were sales staff and technical advisors who worked from their homes, served regional, non-Indiana clients, and did not engage in selling to Indiana customers.
2. The Department of Revenue's initial assessment determined that Taxpayer should have collected sales tax on certain sales, and the Department levied assessments and penalties against Taxpayer. The Taxpayer protested, arguing that the sales did not take place in Indiana and that it was not engaged in business in Indiana as defined in the statute.
3. The Department of Revenue reversed its original assessment and ruled that because Taxpayer's Indiana-based employees did not service or sell to customers in Indiana, it was not a retail merchant "engaged in business in Indiana" under IC 6-2.5-3-1(c). Therefore, the Department of Revenue reversed the initial assessment and ruled that Taxpayer was not required to collect sales tax because it did not

have nexus as defined in the state's statute.

TEXAS

A Texas-based regional manager created nexus, even though he did not directly solicit sales, because his customer service activities were to "promote or induce sales" and were not de minimis. On a positive note – the court reaffirmed that physical presence is required to create franchise tax nexus in Texas.

Galland Henning Nopak, Inc. v. Combs, Tex. Tax Rep. (CCH) ¶403-620, No. 07-09-00250-CV, 2010 Tex. App. LEXIS 5546 (Tex. Ct. App. July 14, 2010)

1. Taxpayer, a Wisconsin corporation that manufactured and sold pneumatic and hydraulic cylinders and valves, maintained no offices in Texas and claimed that it did not have contacts sufficient to subject it to the Franchise Tax.

2. Taxpayer did file employee wages for its one Texas-based employee, who was regional manager for a seven and one-half state area. The manager was a liaison with distributors of the company's products in his region and his primary job was "investigating, handling or otherwise assisting in resolving customer complaints." His job included answering questions about the product line, but did not include soliciting or taking orders.

3. Administrative Law Judge found that the regional manager's activities created substantial nexus.

4. The Court of Appeals affirmed. In doing so, it applied a physical presence standard. It held that the constitutionality of the imposition of the Texas franchise tax depends on whether the Taxpayer had a physical presence in Texas, and expressly noted that a corporation has a physical presence if it has a sales force in the state.

5. Acknowledging that the regional manager did not solicit sales, the court nevertheless concluded that his Texas activities were to "promote or induce sales" and thus were sufficient to create physical presence nexus.

6. The court rejected the Taxpayer's claim that the physical presence was not substantial enough to create nexus, finding that Taxpayer's contacts with the state were more than *de minimis* because the contacts "[served] an independent business function" and designed to ensure that the Taxpayer had a continuous presence with its distributors.

VIRGINIA

An executive that lived and worked out of his home in Virginia and performed administrative and management tasks did not create nexus.

Ruling of Commissioner, P.D. 10-154, Va. Tax Rep. (CCH) ¶205-271, (Va. Dep't. of Tax., July 28, 2010).

1. Taxpayer, a company based outside the United States that produced and distributed online video games, requested an advisory opinion as to whether it was subject to the Business, Professional and Occupational License tax in Virginia because one of its executives lived and worked out of his home in Virginia.

2. The Commissioner found that the BPOL tax is imposed on the privilege of doing business in Virginia and requires that the taxed gross receipts be attributed to the "exercise of a privilege subject to licensure at a definite place of business." Va. Code § 58.1-3703.1 A 3 a.

3. The Commissioner ruled that because the Taxpayer performed only administrative and management tasks and was not

holding itself out as a business that operates from the employee's home, there was no continuous course of business conducted or directed in Virginia and Taxpayer was not liable for the tax. Since sales solicitation did not occur at the home office, nor was it directed or controlled from there, there were no receipts attributable to Virginia.

ECONOMIC NEXUS

CONNECTICUT

Connecticut Department of Revenue announces new "bright-line" nexus standard to implement its economic nexus statute.

Connecticut Department of Revenue Services Informational Publication IP 2010(29) (September 23, 2010)

1. On September 8, 2009, Connecticut adopted a new economic nexus standard for its corporate income tax, effective for tax years beginning on or after January 1, 2010. *See* Act 3 (H.B. 6802), Laws 2009, June Special Session §§ 90 and 91 (amending Conn. Gen. Stat. § 12-726 and adding new statute to be codified as Conn. Gen. Stat. § 12-216a). Under the statute, companies, partnerships and S corporations that derive income from Connecticut or have a substantial economic presence within Connecticut, attributable to the purposeful direction of business activities toward Connecticut, are subject to tax.

2. On September 23, 2010, the Connecticut Department of Revenue Services (the "Department") issued an informational publication, setting forth guidance as to the standards the Department will apply.

3. The statutory standard indicates that the economic nexus standard of "purposeful direction" will be evaluated based on the frequency, quantity and systematic nature of the business's economic contacts in Connecticut. Although not codified or noted anywhere in the statutory language or legislation itself, the Department's Informational Publication expressly adopts a "bright line test" for determining if nexus exists. According to the Department, an entity does not have economic nexus if it has less than $500,000 attributable to Connecticut sources during the taxable year.

4. The Informational Publication also describes the conditions under which the licensing of intangible property rights in Connecticut creates economic nexus and when transactions between related members gives rise to economic nexus.

5. Income arising from a passive investment activity shall not be considered as a basis for finding that a company, partnership or S corporation has economic nexus in Connecticut.

OHIO

Ohio Issues First CAT Nexus Determination to L.L.Bean

In the Matter of L.L. Bean, Inc. Ohio Department of Taxation Final Determination, Assessment Nos. 17200629735266, et al. (August 10,2010)

1. On August 10, 2010, the Ohio Tax Commissioner (the "Commissioner") affirmed Commercial Activity Tax ("CAT") assessments issued to L.L. Bean, Inc., a retailer that has significant sales to Ohio customers but no physical presence within Ohio. The L.L. Bean Determination is the first administrative decision to address the CAT's "bright line" economic nexus standard.

2. L.L. Bean is a traditional catalog and internet seller based in Maine. It has no stores, property, employees, solicitors or other physical presence in Ohio.

It conducts its business exclusively through interstate commerce from outside the State of Ohio. It did, however, make online and catalog sales to customers in Ohio in excess of $500,000 during each of the periods at issue.

3. Under the CAT statutes, companies with "bright line presence" – defined to include merely having at least $500,000 in taxable receipts from Ohio sources – are subject to the CAT. 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.

4. L.L. Bean asserts that it is not subject to tax in Ohio because it lacks "substantial nexus" under the Commerce Clause. It also asserts that it is not "doing business" in the state as required by R.C. 5751.02 because it engages in no commercial activity in Ohio and does not own or lease property, directly or indirectly, in Ohio.

5. The Commissioner rejected these arguments and upheld the tax. The Determination concludes that L.L. Bean had a "bright line presence" in Ohio, as defined by R.C. 5751.01(I)(3), because it received taxable gross receipts from Ohio of at least $500,000 during each of the calendar years in issue.

6. The Determination also concluded that, while no physical presence had been shown, L.L. Bean's "continuous, systematic and significant solicitation and exploitation of the economic market place in Ohio" was sufficient to satisfy the "substantial nexus" requirement of the Commerce Clause. The Commissioner therefore relied on the statutory "catch all" nexus provision in R.C. 5751.01(H)(4), which defines "substantial nexus" under the CAT to include nexus to the fullest extent permissible under the U.S. Constitution.

7. L.L. Bean appealed the Commissioner's Determination to the Ohio Board of Tax Appeals on October 8, 2010.

OKLAHOMA

Oklahoma Adopts New Business Activity (Gross Receipts) Tax and Adopts Factor Presence Standards

Okla. Stat. Tit. 68 Section 1218(H)

1. In June, Oklahoma enacted a new Business Activity Tax effective for tax years beginning on or after January 1, 2010. "Doing business" for purposes of this new gross receipts tax is based on the MTC factor presence standards. As a result, $500,000 in sales to Oklahoma customers or receipts generated from Oklahoma will be enough to trigger new tax obligations. *See* Okla. Stat. Tit. 68 Section 1218(H).

WASHINGTON

Washington adopts economic nexus and "trailing nexus" standards for B&O tax.

Wash. Rev. Code §§ 82.04.066, 82.04.067, as Added by Ch. 23 (S.B. 6143), Laws 2010, 1st Sp. Sess. (Effective June 1, 2010); Wash. Admin. Code Rules 458-20-19401 and 458-20-19402 (Adopted on an emergency basis effective October 1, 2010).

1. Washington adopted "factor presence" economic nexus standards for certain classes of taxpayers under its Business and Occupation ("B&O") tax. Effective for gross income generated after June 1, 2010, persons engaged in "apportionable activities" are deemed to have substantial nexus in Washington if property or payroll in Washington exceeds $50,000, Washington receipts exceed $250,000, or at least 25% of the person's total property, payroll, or receipts are in Washington. *See* Wash. Rev. Code §§ 82.04.066 and 82.04.067; Wash. Admin. Code Rules 458-20-19401 and 458-20-19402.

2. The term "apportionable activities" is defined

to include a variety of service activities. It includes businesses receiving advertising, royalty, licensing fees or other types of income, but does *not* include retailers or wholesalers. Thus, two different nexus standards currently apply to the B&O tax. For businesses engaged in "apportionable activities," merely having Washington receipts in excess of $250,000 will be enough to create B&O tax nexus. For other businesses that are not engaged in "apportionable activities," such as retailing and wholesaling, nexus continues to be based on the business having a physical presence in Washington.

3. The new rules also include a "trailing nexus" provision, under which nexus continues for as long as the taxpayer meets the nexus standards, plus the following tax year. This rule applies to *all* taxpayers – irrespective of whether the particular nexus test applied is based on the new factor presence standards or on more traditional physical presence. Thus, a person who stops the business activity that created nexus in Washington will now have nexus for the remainder of that calendar year plus one additional calendar year. *See* Wash. Admin. Code Rule 19401(9), (10).

4. The new trailing nexus rule applies only to nexus for the B&O tax. The trailing nexus period for retail sales tax remains at four years, plus the current year, under Wash. Admin. Code 458-20-193 (Rule 193). *See* Washington Department of Revenue Special Notice (Sept. 10, 2010).

AFFILIATE NEXUS

COLORADO

***Colo. Rev. Stat. § 39-26-102(3) (effective March 1, 2010*)**

1. Colorado's recently enacted "affiliate nexus" statute provides that an out-of-state retailer is "presumed" to be "doing business" in Colorado if it is part of a controlled group of corporations that has a member that is a retailer with physical presence in Colorado.

    a. The retailer can rebut the presumption by demonstrating that the member with physical presence in Colorado did not engage in any constitutionally sufficient solicitation on behalf of its out-of-state affiliate.

2. In addition, a retailer is deemed to be "doing business" in Colorado, and thus is responsible for collecting and remitting sales and use tax, if the retailer maintains an office, distribution house, salesroom, warehouse, or other place of business in Colorado, either directly or indirectly through a subsidiary. A retailer is also "doing business" in Colorado where it solicits business from persons residing in Colorado, through either direct or indirect representatives

OKLAHOMA

Okla. Stat. tit. 68, § 1401(9)(eff. July 1, 2010)

1. Under a new Oklahoma affiliate nexus statute, a retailer has nexus for sales/use tax purposes if the retailer holds a substantial ownership interest in, or is owned by, a retailer that has a place of business in Oklahoma and (1) the retailer sells the same or substantially similar products under the same or a substantially similar name as the Oklahoma retailer or (2) the Oklahoma retailer's employees or facilities are used to promote sales for the retailer.

2. Affiliate nexus is also established if the retailer holds a substantial ownership interest in or is owned by a business that has a distribution house, sales house, warehouse or other place of business in Oklahoma that delivers the retailer's property to consumers

3. Like the Colorado statute, the new affiliate nexus statute also contains an expansive statutory presumption of nexus based on affiliation. The statute provides that an out-of-state retailer is "presumed" to be "doing business" in Oklahoma if it is part of a controlled group of corporations that has a member that is a retailer with physical presence in Oklahoma.

4. The retailer can rebut the presumption by demonstrating that the member with

physical presence in Oklahoma did not engage in certain activities on behalf of its out-of-state affiliate.

5 A remote seller also has nexus if it has a contractual relationship with an entity to provide or perform installation or maintenance services for the remote seller's purchasers in Oklahoma.

NEW "NON-COLLECTING RETAILER" CUSTOMER NOTICE AND REPORTING LAWS

Colorado passes aggressive new notice and reporting laws for remote sellers that lack nexus and imposes significant penalties for failure to comply; Oklahoma follows suit, but has not yet adopted a penalty regime.

COLORADO

Colo. Rev. Stat. § 39-21-112.3.5 (June 18, 2010)

1. Effective March 1, 2010, the Colorado Legislature amended § 39-21-112 of the Colorado Revised Statutes. Under the amended law, retailers that do not collect Colorado sales tax are required to notify their in-state customers twice that they have to pay Colorado sales or use tax — once at the time of purchase and then again at the end of each calendar year beginning in 2010. Retailers also must file an annual report with the Colorado Department of Revenue ("Department"), reporting the total amount paid for Colorado purchases and detailing other information to the Department.

2. Regulation 39-21-112.3.5, adopted on June 18, 2010, sets forth detailed requirements and imposes significant penalties for noncompliance.

3. Any retailer that sells goods to Colorado purchasers but does not collect Colorado sales or use tax is considered a "non-collecting retailer" subject to the new notice and reporting rules.

   a. Sellers of services and retailers that exclusively sell downloadable digital goods or software are not subject to the rules

   b. *De Minimis* Exception: Retailers with annual Colorado sales under $100,000 need not comply.

4. Customer Notification at Time of Purchase

   a. Retailers must notify customers at the time of purchase that the retailer does not collect Colorado sales or use tax, that the purchase is not exempt from Colorado sales or use tax because it was made over the Internet, and that the purchaser must file a sales and use tax return and pay all applicable taxes.

   b. A $5 penalty is imposed for every failure to provide notice at the time of purchase.

5. Annual Customer Notification

   a. Notice must be sent by first-class mail by January 31 of each year that sales or use tax is due on taxable purchases made from the retailer. The mailing must say "Important Tax Document Enclosed" and must include dates of the purchases, a description of the items purchased, and the dollar amounts of the purchases.

   b. *De Minimis* Exception: The annual notice need not be provided to any customer whose total Colorado purchases for the year amounted to less than $500.

   c. A $10 penalty is imposed for every failure to send a required annual customer notification.

6. Annual Report to the Department of Revenue

   a. Non-collecting retailers must file a report with the Department on

or before March 1 of each year showing the total amount each of its Colorado customers paid to the retailer during the preceding calendar year

b. Retailers that are not required to send any annual customer notifications at all (*i.e.* because no single customer exceeded the $500 threshold in annual sales) are not required to file an annual report with the Department. If, however, a non-collecting retailer has even one Colorado purchaser who exceeds the $500 threshold, the retailer must file an annual report with the Department and that report must include *all* Colorado purchasers, even those whose total Colorado purchases were less than $500.

c. Retailers that fail to provide a required annual report to the Department are subject to a penalty in the amount of $10 times the number of purchasers that should have been included in the report.

OKLAHOMA

The Oklahoma law imposes customer notice requirements but as of yet contains no penalties for non-compliance.

Okla. Stat. tit. 68, § 1406.1 (eff. October 1, 2010)

1. Oklahoma also passed use tax notice law and Emergency Regulations that went into effect on October 1, 2010.

2. Retailers that sell merchandise for use in Oklahoma but do not collect tax must provide a readily visible notice — on its website or catalogs and also on its invoices — that Oklahoma use tax is imposed and must be paid to the state. Okla. Stat. tit. 68, § 1406.1; Emergency Regulation 710:65-21-8.

   a. Retailers that have less than $100,000 in total gross sales in Oklahoma in the previous year and reasonably expect the same in the current year are considered *de minimis* and need not comply with the notice law.

3. Website and Catalog Notices

   a. The website notice must appear on "a page necessary to facilitating the applicable transaction," although it shall be sufficient if the retailer provides a prominent linking notice that reads: "See important Oklahoma sales tax information regarding the tax you may owe directly to the State of Oklahoma."

   b. For catalogs, the notice must be included on the order form, although a linking notice using the language set forth above may be used.

4. Invoice Notices

   a. For online orders, the notice must be on the electronic order confirmation sent to the consumer. This can be done through a linking notice as described above. If no electronic order confirmation is provided, the full text of the notice must appear "on the purchase order, bill, receipt, sales slip, order form, or packing statement." Alternatively, internet retailers can place the notice on the "check out" page of their websites. This fulfills both the website and invoice notice requirements.

   b. For catalog orders, the full text of the notice must appear "on the purchase order, bill, receipt, sales slip, order form, or packing statement."

5. At this time, there are no penalties

imposed for non-compliance under either Okla. Stat. tit. 68, § 1406.1 or the Regulation.

TEMPORARY IN-STATE PRESENCE

TENNESSEE

***Teco Barge Line, Inc. v. Wilson*, Tenn. Tax Rep. (CCH) ¶401-362, No. M2009-01675-COA-R12-CV, 2010 Tenn. App. LEXIS 435 (Tenn. Ct. App. July 9, 2010).**

1. Tennessee Court of Appeals upheld the assessment of an ad valorem tax on the personal property of Taxpayer, an interstate shipper, who uses both the Mississippi and Tennessee Rivers to transport goods.

2. Tax was assessed on the boats and barges used by the company when it shipped through Tennessee's waters, according to Tenn. Code Ann. § 67-5-1301, which authorizes such tax.

3. The Court refused to accept Taxpayer's claim that only vessels which commonly use the state's ports were subject to the tax, finding that simply using a state's waterways was enough to create nexus.

DOING BUSINESS IN THE STATE

NEW JERSEY

***Whirlpool Properties, Inc. v. Division of Taxation*, No. A-1180-08T2, CCH ¶ 401-518 (N.J. Sup. Ct. App. Div. July 12, 2010).**

1. Two Corporations, Whirlpool Properties, Inc. and Pfizer, Inc. (collectively, the "Plaintiffs"), facially challenged the constitutionality of New Jersey's "Throwout Rule," a statutory scheme designed to remove non-taxing states (states not charging corporate income or franchise tax) from the denominator in New Jersey's apportionment calculation for its Corporation Business Tax ("CBT"). By excluding income of non-taxing states from the sales fraction's denominator, the Throwout Rule thus made "a larger amount of [a corporation's] income taxable by the CBT." The Throwout Rule was repealed prior to the Court's decision in this case, but the Court noted that the "decision by the Legislature [played] no role in [its] opinion."

2. Emphasizing that the Plaintiffs were merely challenging the Throwout Rule on facial grounds, the Court upheld the Rule under Due Process, Commerce Clause, and Supremacy Clause analyses.

3. Regarding the Due Process challenge, the Court concluded that although "the Throwout Rule may result in tax liability," the Plaintiffs were incorrect to argue that "it violated the Due Process Clause by taxing transactions that did not reflect a sufficient degree of in-state business activity." The court noted that "[p]laintiffs do not contest that they had a nexus with New Jersey that was independent of their unitary business, and they do not contest that their sales to non-taxing states were part of that business. Those were the only conditions needed for New Jersey to have a constitutionally sufficient nexus to those sales."

4. Looking to the Commerce Clause challenge, the Court similarly held that the Plaintiffs did not establish that the Throwout Rule was facially unconstitutional. A tax is facially discriminatory against interstate commerce when it subjects income on sales outside the state to a greater taxation than income on intrastate transactions. Here, the court relied on its Due Process analysis and found that the rule does not expose any income to multiple taxation, and it does not tax in-state and out-of-state sales in a discriminatory manner. Although the Throwout Rule "might reduce or

eliminate the relative financial benefit to the taxpayer of sales in nontaxing states compared to sales in taxing states, it does not make them less remunerative."

5. The Court also held that the Throwout Rule did not facially violate the Supremacy Clause because it could avoid conflict with federal law in some instances. Because plaintiffs failed to establish that the rule could not operate constitutionally under any circumstances, the Tax Court correctly found that their facial challenge to the rule on Supremacy Clause grounds failed.

TEXAS

Receipts from construction contracts performed outside Texas were properly taxable as receipts from business done in Texas because Taxpayer was physically present in Texas and hired its in-state affiliate to perform engineering services in Texas for the out-of-state construction contract.

***In Re: * * *, Comptroller's Decision, Hearing No. 47,979*, Tex. Tax Rep. (CCH) ¶20100830019 (Tex. Cmptr. Pub. Acct. June 30, 2010) available at http://aixtcp.cpa.state.tx.us/opendocs/open32/201006867h.html**

1. Taxpayer is a Delaware corporation headquartered in Texas. Taxpayer petitioned for tax credit after paying franchise tax for receipts it paid as a general contractor on several non-US construction projects. Taxpayer claims that because it did not perform any construction services in Texas, and its only action in Texas was purchasing services from the subcontractor, it did not have sufficient nexus with Texas and receipts from the projects should not be subject to the Franchise Tax.

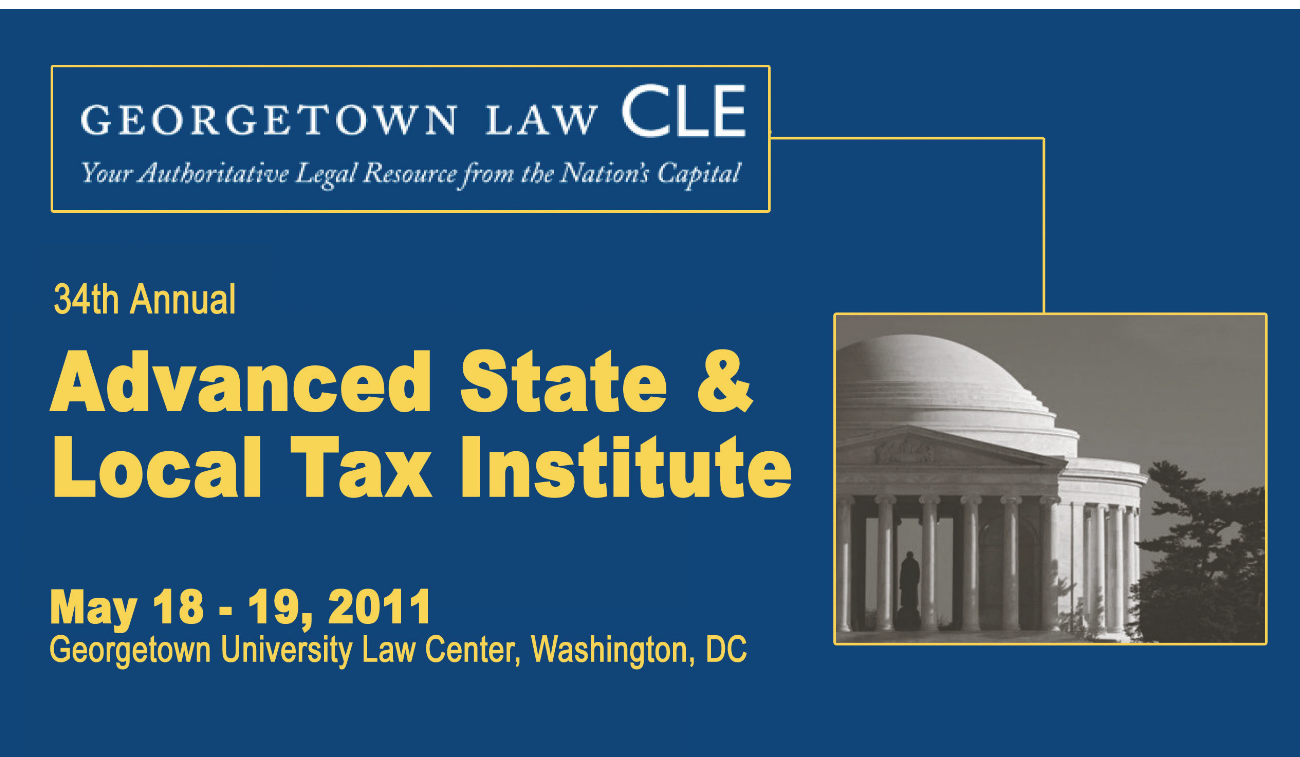
2. The Comptroller upheld the denial of tax credits because some engineering services for the projects were performed in Texas by an affiliated company that was a subcontractor, and this is taxable as service procurement. Tex. Admin. Code § 3.557(e)(34).

3. The Comptroller also found that sufficient nexus was created because both the Taxpayer and subcontractor were physically located in Texas.■

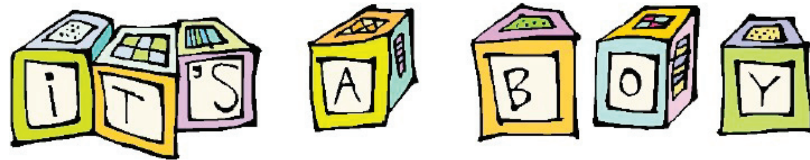
▶ Save the Date - State Tax Seminars

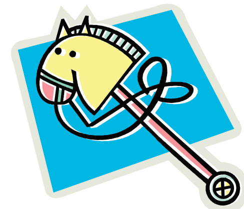
Date	Event	Location	Presenter(s)
Jan. 28, 2011	20th Annual Ohio Tax Conference - Nexus	Columbus, OH	Laura Kulwicki
March 7, 2011	UPPO National Conference - Legislative Updates, Emerging Issues, GOV Watch	San Antonio, TX	Charolette Noel
March 23, 2011	IPT Tax School - FIN 48, FAS 5 and Uncertain Positions - What Must Be Disclosed to IRS and States About Tax Liabilities	New Orleans, LA	John Allan
May 12-13, 2011	FICPA/Florida Bar State Tax Conference - Nexus	Orlando, FL	Laura Kulwicki
June 9, 2011	University of Wisconsin-Milwaukee 15th Annual Multitstate Tax Institute - Nexus	Milwaukee, WI	Laura Kulwicki

▶ Save the Date



▶ New Arrival





Congratulations to
Stella and Dennis Rimkunas (New York Office)
the proud parents of
Ethan Samuel Rimkunas
born at 2:55 pm on October 20, 2010 - 7 lbs 3 oz, 19 inches long.

Mom, Dad and baby Ethan are doing great!

Further Information: For further information on items covered in the *State Tax Return*, please contact any of the following Jones Day attorneys:

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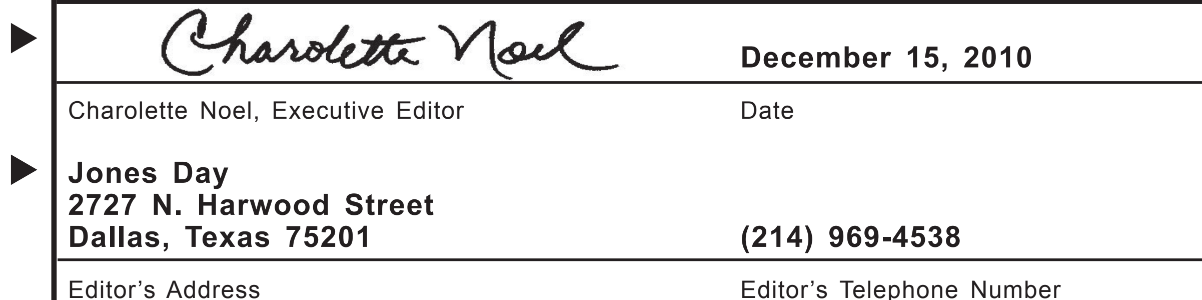

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