



State Corporate Income and Franchise Tax Developments

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Ernst & Young LLP

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Recent State Corporate Income and Franchise Tax Developments
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I. NEXUS

A. National Debate Over Nexus Standards

Federal—Proposed bill (H.R. 1083) would establish physical presence as the nexus standard for all state business activity taxes and "modernize" P.L. 86-272. Specifically, H.R. 1083 would provide that "[n]o taxing authority of a State shall have the power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such a person's activities in interstate commerce unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed." Physical presence would be established in a state if the taxpayer:

- (1) was physically in the state or assigned at least one employee in the state;
- (2) used the services of an agent (excluding an employee) to establish or maintain the market in the state, if such agent does not perform business services in the State for any other person during the taxable year; or
- (3) leased or owned tangible personal property or real property in the State.

Under a *de minimis* rule, physical presence would not include presence in a State for less than 15 days in a taxable year, or presence in a State to conduct limited or transient business activity. The bill would define "other business activity tax" as "any tax in the nature of a net income tax or tax measured by the amount of, or economic results of, business related activity conducted in the State." The term would not include sales/use tax or other similar transaction taxes imposed on the sale or acquisition of goods or services, whether or not the tax was for the privilege of doing business.

In addition, H.R. 1083 would remove certain limitations on the application of P.L. 86-272 and extend its protections to all business activity taxes and to solicitation of sales of services and all other forms of property (under current law the provisions of P.L. 86-272 apply only to net income tax and sales of tangible personal property). If enacted as currently drafted, these provisions would be effective for taxable periods beginning on or after Jan. 1, 2009. H.R. 1083 was introduced on Feb. 13, 2009. Similar measures (H.R. 5267 and S. 1726) have been considered in prior years.

B. Nexus Under P.L. 86-272

Public Law 86-272—Public Law 86-272, codified at 15 U.S.C. §381, prohibits a state, and any of its political subdivisions, from imposing a net income tax on an out-of-state seller if the seller’s “only business activities” within the state consist of “the solicitation of orders by such person, or his representative...for sales of tangible personal property...which...are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State.”

Multistate Tax Commission (MTC)—A revised “Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272” (Phase II) was adopted by the MTC on July 29, 1994. Originally adopted in 1986, this guideline sets forth the MTC signatory states’ interpretation of those in-state activities conducted by or on behalf of a corporation that would and would not establish corporate income tax nexus under the provisions of P.L. 86-272.

The guideline was revised in response to the decision in *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 112 S. Ct. 2447 (1992), in which the U.S. Supreme Court held that “solicitation” includes not only actual requests for purchases; but also other activities that are entirely ancillary to the request so long as the activities “serve no independent business function apart from their connection to the solicitation of orders.” It is not enough to facilitate sales—an activity must facilitate the requesting of sales. The Court also concluded that, absent language to the contrary, P.L. 86-272 incorporates a *de minimis* standard. Activities that constitute a trivial additional connection with the taxing state will be considered *de minimis*.

The 1994 Phase II Statement makes clear that only solicitation to *sell* personal property is protected. Leasing, renting, licensing of tangible personal property are not protected activities. Transactions involving *intangibles*, such as franchises, patents, copyrights, and trademarks, are not protected activities. The sale or delivery and the solicitation for the sale or delivery of *services* is not protected unless it is either (1) ancillary to solicitation or (2) one of the few activities enumerated in the list of protected activities included in this statement. Finally, in-state activity must be limited solely to solicitation (except for *de minimis* activities and those protected activities conducted by independent contractors).

Other revisions include the addition of delivery as an unprotected activity, clarification that protection is not lost by registration or qualification to do

business in the taxing state, and application of the Statement's standards to business activities in foreign commerce.¹ The Phase II Statement also provides that in determining whether the activities of any company fall beyond the protection of P.L. 86-272, the "Joyce Rule" applies. As such, *only those in-state activities that are conducted by or on behalf of said company* would be considered for purposes of determining protection under P.L. 86-272. Activities that are conducted by any other person or business entity, whether or not said person or business entity is affiliated with the company, will not be considered attributable to said company, unless such other person or business entity was acting in a representative capacity on its behalf. *Appeal of Joyce, Inc.*, (Cal. SBOE 11-23-66).

The Phase II Statement was sent to the states in September 1994. There are at least 17 signatory states—Alabama, Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Illinois², Louisiana, Montana³, New Jersey, New Mexico, North Dakota, Oregon, Rhode Island, and Utah. With the exception of Alabama, Arizona, Arkansas, California, New Jersey, Oregon, Rhode Island and Utah, the above-named states adopted the Statement verbatim.⁴

In response to the position of a number of states that utilization of a seller's trucks, whether owned or leased, to make deliveries of its goods into the taxing state is a protected activity under P.L. 86-272,⁵ the MTC amended its 1994 Phase II Statement to delete the delivery of a company's products in company trucks from the list of unprotected activities under P.L. 86-272 (section IV.A.20).⁶ Deletion of this provision has the effect of protecting this activity under P.L. 86-272 so long as delivery occurs from outside the taxing state.

Federal Legislation—Proposed bill (H.R. 1083) would establish physical presence as the nexus standard for all state business activity taxes and "modernize" P.L. 86-272. Specifically, H.R. 1083 would remove certain limitations on the application of P.L. 86-272 and extend its protections to

¹ See Cal. Franchise Tax Bd., Legal Ruling 99-1, Jan. 6, 1999 (sales of tangible personal property shipped from California to Puerto Rico must be thrown back to California if the seller's activities in Puerto Rico are limited to solicitation of orders. Although the seller is taxable in Puerto Rico under U.S. constitutional standards, commerce between Puerto Rico and the fifty states constitutes interstate for purposes P.L. 86-272).

² Ill. Dept. Rev., Reg. §100-9720.

³ Mont. Dept. Rev., ARM 42.26.501 through 42.26.511, April 12, 2004.

⁴ Multistate Tax Commission, *Updated Status Report Regarding State Adoption of "Phase II" Revision of Public Law 86-272* (May 3, 1996). Arkansas, California, Rhode Island did not adopt the foreign commerce provision. Ark. Reg. 2.26-51-702, *et seq.*; R.I. Reg. CT 95-2.

⁵ These states include Alabama, Arizona, Illinois, Maine, Massachusetts, Nebraska, New Jersey, New York, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas and Virginia. Two states—Florida and Indiana—issued rulings that delivery of goods into the state in company-owned vehicles by an out-of-state seller exceeded the mere solicitation of orders.

⁶ Resolution of the Multistate Tax Commission Amending the MTC Statement of Information Concerning Practices of the MTC and Signatory States under Public Law 86-272, July 27, 2001.

all business activity taxes and to solicitation of sales of services and all other forms of property (under current law the provisions of P.L. 86-272 apply only to net income tax and sales of tangible personal property). If enacted as currently drafted, these provisions would be effective for taxable periods beginning on or after Jan. 1, 2009. H.R. 1083 was introduced on Feb. 13, 2009. Similar measures (H.R. 5267 and S. 1726) have been considered in prior years.

Arizona—Public Law 86-272 does not preclude the state of Arizona from including an out-of-state partnership's revenues in the numerator of the apportionment formula of an Arizona consolidated return. The taxpayer, a newspaper company that elected to file a consolidated return in Arizona with its affiliates, owned a partnership interest in a Washington general partnership that sold newsprint across the U.S. The partnership solicited sales of newsprint in Arizona, but otherwise conducted no business in the state. As a result, the partnership would have qualified for protection under PL 86-272. The taxpayer argued that by including the partnerships sales in the numerator of the sales factor, the state would be taxing the income of an entity that qualified for PL 86-272 protection. As a result, the taxpayer argued that the income passing through to the partner should also be protected from taxation since the partnership would be protected if subject to tax itself. The court, however, stated "We do not interpret PL 86-272 as creating a class of tax-exempt income for sales in interstate commerce." Instead, the court noted that the income would retain its character as business income and that a partner that is independently subject to tax in the jurisdiction must include the income from the partnership because the limitations of PL 86-272 do not apply to that company. *Arizona Dept. Rev. v. Central Newspapers*, No. 1 CA-TX 07-0016 (Ariz. Ct. App., Div. 1, Nov. 03, 2009).

California—An out-of-state media company had nexus with California based on the activities of its employees operating in California. The employees solicited orders for advertising in magazines that were shipped to California customers from points outside the state. The company argued that it was not subject to tax because the employees merely solicited orders for magazines, orders were approved or rejected outside the state, neither the company nor the employees maintained or used an office in California, and the activities were protected under P.L. 86-272. The State Board of Equalization rejected these arguments, finding that by continuously soliciting advertising within California from businesses located in the state, the company "was afforded substantial and enduring benefits and protections of the state to enable [it] to generate business advertising revenue." The Board also determined that the company's sales activities did not fall within the protection of P.L. 86-272, because the solicitation was for sales of service, not sales of tangible personal property. *Appeal of Personal Selling Power, Inc.*, No. 380557 (Cal. St. Bd.

of Equal. March 16, 2009).

Massachusetts—New law (H. 4904) amends the prior law to impose the net worth / property measure of the corporate excise on corporations whose activities in Massachusetts are limited to the solicitation of sales of tangible personal property. Such companies will remain protected from the net income tax by Public Law 86-272. This measure will take effect for the 2009 tax years. Under prior law, Massachusetts afforded Public Law 86-272 protection to both the net income and net worth / property measures of the corporate excise even though the Public Law applies only to net income taxes. Mass. Laws 2008, H. 4904, enacted July 3, 2008.

Wisconsin—New law (A.B. 75) clarifies the "doing business in this state" provision to incorporate the limitations imposed by P.L. 86-272 and that a taxpayer doing business in Wisconsin for any part of the taxable year is considered to be doing business in Wisconsin for the entire taxable year. Wis. Laws 2009, Act 28 (A.B. 75), enacted June 29, 2009.

C. Nexus Premised Upon In-State Use of Intangibles or Economic Nexus

Geoffrey, Inc. v. South Carolina Tax Commission—The South Carolina Supreme Court held that the licensing of a trade name or trademark, coupled with the receipt of royalties from an in-state licensee, creates sufficient nexus between an out-of-state licensor and the state to meet both the "minimum connection" standard required by the Due Process Clause and the "substantial nexus" requirement of the Commerce Clause. The court further found that Geoffrey had intangible properties—a franchise (license of a trademark and a trade name) and an account receivable generated by sales—in the state, the presence of which also satisfied the "minimum connection" due process requirement. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

Recently issued advisory opinion addresses some of the common questions regarding the implications of the 1993 *Geoffrey*. The advisory opinion provides examples of activities or relationships that will not, by themselves, create income tax nexus with South Carolina. Topics covered by the advisory deal with authors, celebrities, subsidiaries, bank accounts, debts, sales of tangible personal property (including Internet sales), employee activities, printers, personal property, seminars, meetings, and other similar visits. For instance, the advisory opinion states that nexus is not created when "a North Carolina corporation that does not do any business in South Carolina owns a subsidiary that is incorporated in and transacts an unrelated, non-unitary business in South

Carolina." Another example explains that a Kentucky company will not have nexus if it temporarily sends its business records to the state for use by its independent auditors. S.C. Dept. of Rev., Revenue Ruling #08-1 (Jan. 11, 2008) (this Revenue Ruling clarifies Revenue Ruling #98-3).

Application of Economic Presence Tests in Other States—The following states have been identified as formally adopting (via statute, regulation or court determination) an economic nexus standard: Alabama, Arizona, Arkansas, California (effective 1/1/2011), Connecticut Florida, Idaho, Indiana, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, New Hampshire, New York State and City (limited to certain credit card transactions), New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee,⁷ West Virginia and Wisconsin (effective 1/1/2009).

Some states via statute and/or regulation or administrative pronouncement have adopted an economic nexus standard for corporations or with respect to certain industries, such as financial institutions. For example Kentucky's economic nexus statute for financial institutions provides, "A financial institution is presumed to be regularly engaging in business in this Commonwealth if during any taxable year it obtains or solicits business with twenty (20) or more persons within this Commonwealth, or if receipts attributable to sources in this Commonwealth... equals or exceeds one hundred thousand dollars (\$100,000)." New York's new economic nexus statute applies to certain banking corporations that issue credit cards. In a non-industry specific context, New Jersey's economic nexus statute provides, "Every domestic or foreign corporation which is not hereinafter exempted shall pay an annual franchise tax for each year, as hereinafter provided, . . . for the privilege of deriving receipts from sources within this State"⁸ (Emphasis added).

A state also is considered to adopt an economic nexus approach if the state follows the rationale of the South Carolina Supreme Court's ruling in *Geoffrey*.⁹ In *Geoffrey*, the court held that the licensing of a trade name or trademark, coupled with the receipt of royalties from an in-state licensee, creates sufficient nexus between an out-of-state licensor and the state to meet both the "minimum connection" standard required by the Due Process Clause and the "substantial nexus" requirement of the Commerce Clause. In addition to South Carolina, other states that have "Geoffrey" type precedent include Louisiana, New Jersey, New Mexico, North

⁷ Although Tenn. Code §§67-4-2105(e)(1) and (e)(2) and 67-4-2004(9)(A) and (B) contain economic presence language, the Tennessee Appeals Court in *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal denied* (Tenn. Sup. Ct. May 8, 2000), *cert. denied*, *Johnson v. J.C. Penney National Bank*, 531 U.S. 927 (2000), interprets "substantial nexus" to require physical presence.

⁸ See N.J.S.A. 54:10A-2.

⁹ *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

Carolina, and Oklahoma.

States adopting the MTC's Factor Presence Nexus Standard similarly reflect the application of an economic nexus standard. Under the MTC "Factor Presence Nexus Standard," an out-of-state taxpayer doing business in a state will have substantial nexus with the state and be subject to the state's franchise and income tax if any of the following thresholds are exceeded in the state during the tax period:

- (1) \$50,000 or 25% of the total property;
- (2) \$50,000 or 25% of the total payroll; or
- (3) \$500,000 or 25% of the total sales.

Ohio (as part of the CAT) and California (effective Jan. 1, 2011) are the only states that have adopted a "factor presence nexus standard".

California—Currently, a taxpayer is "doing business" in California if it is actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. Effective for tax years beginning on or after January 1, 2011, California joins other states in adopting a "bright line" economic nexus standard. Under this test, in addition to the historic definition of engaging in transactions in the state, taxpayers will be deemed to be "doing business" in California and, therefore, subject to corporate income and franchise tax, if:

- They are organized or commercially domiciled in California; or
- Any of the following conditions are met:
 1. Sales of the taxpayer in California exceeds the lesser of \$500,000 or 25% of its total sales;
 2. Property (real and tangible personal) of the taxpayer in California exceeds the lesser of \$50,000 or 25% of its total property; or
 3. Payroll of the taxpayer in this state exceeds the lesser of \$50,000 or 25% of its total payroll.

For purposes of applying these provisions, a taxpayer's sales, property, and payroll is deemed to include its pro rata share of such factors from pass-through entities, specifically partnerships and S corporations.

Further, for purposes of determining whether a sale is allocated to California for purposes of determining if the taxpayer has nexus in California, the newly adopted rules for assigning sales under CR&TC §§25135 and 25136 apply (note that these new rules take effect January 1, 2011).

It should be noted that the Franchise Tax Board has the authority to

annually adjust these threshold amounts in line with changes in inflation rates. Cal. Laws 2009, Ch. 17 (S.B. X3 15), signed by the Governor on Feb. 20, 2009.

Colorado—Proposed amendment to Regulation 39-22-301.1 would adopt a factor presence nexus standard for determining when an out-of-state entity is doing business in Colorado. Under this standard an entity would have substantial nexus with Colorado if, in any tax period, the property, payroll or sales of the business in Colorado exceeds:

- (1) \$50,000 of property, or;
- (2) \$50,000 of payroll, or;
- (3) \$500,000 of sales, or;
- (4) 25% of total property, total payroll or total sales.

For taxpayers subject to special apportionment methods under Colorado Special Regulations for Allocation and Apportionment of Corporate Income, the property, payroll and sales for measuring against the nexus thresholds would be defined as they were defined for tax periods before Jan. 1, 2008, for apportionment purposes under those regulations.

Financial institutions subject to an apportioned income or franchise tax would determine property, payroll and sales for purposes of the nexus threshold in the same manner as it is determined under the financial institutions special regulation. Pass-through entities would determine threshold amounts at the entity level. If the threshold level is exceeded, the members, partners, shareholders or beneficiaries of the pass-through entity would be subject to tax on the portion of income earned in Colorado and passed-through to them. Further, in order to clearly reflect the activity of a taxpayer in Colorado, the Executive Tax Director would have the authority to combine the payroll, property or sales of two or more entities within a combined group "if the payroll, property or sales of those entities have been manipulated in order to artificially fall within the safe harbors of [this rule]." The Department of Revenue will hold a hearing on this proposed regulation on Oct. 7, 2009.

Connecticut—New law (H.B. 6802) adopts economic nexus provisions for determining whether an out-of-state company has a "substantial economic presence" or a partnership or S corporation is "doing business in the state" and as such is subject to Connecticut corporation or individual income taxes. A company, partnership, or S corporation "has a substantial economic presence within the state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of [its] economic contacts with this state, without regard to physical presence, and to the extent permitted by the Constitution of the United States...." This provision takes effect Jan. 1,

2010. Ct. Laws 2009, Pub. Act 09-3 (H.B. 6802), became law without the Governor's signature on Sept. 8, 2009

Hawaii—On June 30, 2009, Governor Lingle filed a notice of intent to veto H.B. 1405, provisions of which would establish an economic nexus standard. In her veto message, Governor Lingle said that H.B. 1405 "is legally defective in that it violates...the Hawaii State Constitution regarding the subject matter each bill can include within its scope."

Indiana—In *MBNA America Bank*, the Indiana Tax Court held that the Commerce Clause does not require an out-of-state credit card bank to have physical presence in Indiana in order to be subject to the state's Financial Institutions Tax, rather the bank's economic presence is sufficient to establish substantial nexus with the state. In reaching this conclusion, the court found that the U.S. Supreme Court has not extended the physical presence standard set forth in *Bellas Hess*¹⁰ and *Quill*¹¹ beyond sales and use taxes. *MBNA America Bank, N.A. & Affiliates v. Indiana Dept. of Rev.*, No. 49T10-0506-TA-53 (Ind. Tax Ct. Oct. 20, 2008).

Iowa—An out-of-state fast-food restaurant chain that entered into franchise agreements with third party Iowa franchisees has economic nexus with the state because it receives royalty income from restaurants in Iowa. Under Iowa law, tax is imposed on corporations doing business in or deriving income from sources within Iowa, which includes income from real, tangible, or intangible property located or having a situs in this state. Intangible property is located or situated within Iowa if it belongs to a corporation with its commercial domicile in the state or, if belonging to a noncommercially domiciled corporation, it has become an integral part of some business activity occurring regularly in Iowa. On appeal, an Administrative Law Judge (ALJ) of the Iowa Department of Inspections and Appeals found that the restaurant chain was deriving income from sources inside Iowa. In addition, the chain restaurant relies on local services such as police and fire for the continued remuneration it enjoys from sales of its franchised stores in Iowa. Turning to the constitutionality of the tax as it applies to the chain restaurant, the ALJ found that the state's economic nexus standard "appeared logical" and as applied to the taxpayer did not discriminate against interstate commerce. The ALJ reasoned that "[a]n income tax on funds derived from the sources in a state is not an undue burden; rather, it is a payment to the government that provides the economic climate for the business to prosper." *KFC Corporation v. Iowa Department of Revenue*, No. 07DORFC016 (Iowa Dept. of Inspections and App., ALJ, Aug. 8, 2008).

¹⁰ *National Bellas Hess v. Illinois Dept. of Rev.*, 386 U.S. 753 (1967).

¹¹ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Massachusetts—The Massachusetts Supreme Judicial Court affirmed the Appellate Tax Board's ruling in *Geoffrey* that an out-of-state intangible holding company that does not have a physical presence in Massachusetts has substantial nexus with the commonwealth because it "purposefully sought to reap economic benefits from the Massachusetts retail marketplace by licensing its assets for use in Massachusetts by [related entities]." In reaching this conclusion, the court concluded that substantial nexus can be established when a company carries on business in another state through the licensing of its intangible property that generates income for the taxpayer. During the tax years at issue, the holding company engaged in business activities with a substantial nexus in Massachusetts. For instance, the company entered into licensing agreements with related entities that permitted these entities to use its trademarks exclusively in Massachusetts. In addition, the company encouraged Massachusetts consumers to shop at these related entities, and it reviewed licensed products and materials that would be sold in the Commonwealth to ensure company standards were maintained. The court also upheld the imposition of penalties for failure to file timely returns and failure to pay taxes. In upholding the penalties, the court rejected the company's argument of reasonable cause based on its reliance on *Quill's* physical presence nexus standard. *Geoffrey, Inc. v. Commissioner of Revenue*, No. SJC-10106 (Mass. Sup. Jud. Ct. Jan. 8, 2009), *cert. denied*, Dkt. No. 08-1207 (U.S. Sup. Ct. June 22, 2009).

Massachusetts—The Massachusetts Supreme Judicial Court affirmed the Appellate Tax Board's ruling in *Capital One* that two out-of-state credit card banks' activities in Massachusetts created substantial nexus with the Commonwealth for purposes of imposing the Financial Institution Excise Tax (FIET), despite the fact that the banks had no physical presence in the Commonwealth during the tax years at issue. In reaching this conclusion, the court found the physical-presence nexus standard established by the U.S. Supreme Court in *Quill* is limited to sales and use taxes. *Capital One Bank v. Commissioner of Revenue*, No. SJC-10105 (Mass. Sup. Judicial Ct. Jan. 8, 2009), *cert. denied*, Dkt. No. 08-1169 (U.S. Sup. Ct. June 22, 2009).

Michigan—For purposes of the new Michigan Business Tax, which is effective January 1, 2008, a taxpayer has nexus with the state if, the taxpayer:

- i. has a physical presence in Michigan for a period of more than one day during the tax years; or
- ii. actively solicit sales in Michigan and have gross receipts of \$350,000 or more sourced to the state.

The term "physical presence" is defined as "any activity conducted by the

taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity." The term does not include activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in Michigan. Mich. Laws 2007, Pub. Act 36 (S.B. 94), signed by the governor on July 12, 2007.

The Department of Treasury issued a bulletin to provide guidance on the nexus standards of the Michigan Business Tax (MBT). Under the MBT, a taxpayer other than an insurance company has nexus with the state if it: (1) has a physical presence in Michigan for a period of more than one day during the tax year; or (2) "actively solicits" sales in Michigan and has gross receipts of \$350,000 or more sourced to the state.

The term "physical presence" means "any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity." It does not include activities of a professional providing service in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in the state. Physical presence is determined on a facts and circumstances basis. In addition, the bulletin provides guidance as to when a taxpayer will have a physical presence in the state. In regard to the economic nexus standard, the Department defined "actively solicits" as "purposeful solicitation of persons within Michigan.

Solicitation means: (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order. Solicitation is purposeful when it is directed at or intended to reach persons within Michigan or the Michigan market." The term "active solicitation" includes solicitation via mail, telephone, e-mail, advertising (i.e., print, radio, Internet, television, and other media), and maintenance of an Internet site where sales transactions occur with persons in Michigan. In determining whether the solicitation is sufficient to establish "active solicitation", the Department will look at the quality, nature, and magnitude of the activity on a facts and circumstances basis. The guidance also discusses the application of P.L. 86-272 and which activities are protected and unprotected. Mich. Dept. of Treas., RABs 2007-6 (Dec. 28, 2007) and 2008-4 (Oct. 21, 2008).

New Jersey—In *AccuZIP Inc.* and *Quark Inc.*, the New Jersey Tax Court found that nexus with the state will not be established for out-of-state companies if their only connection to New Jersey is the in-state presence of licensed copyrighted computer software programs to which it retains

title. While one of the taxpayers was doing business in the state for the period in which it had a New Jersey sales representative, the taxpayer was liable for the minimum tax, not a tax based on income, because the representative limited activities in the state were protected under P.L. 86-272. Further, the tax court declined to adopt the significant economic presence test set forth in *MBNA* to determine whether the out-of-state companies had a substantial nexus with the state to satisfy commerce clause requirements. *AccuZip, Inc. v. Director, Division of Taxation*, No. 005744-2003 (N.J. Tax Ct. Aug. 13, 2009) and *Quark Inc. v. Director, Division of Taxation*, No. 004692-2002 (N.J. Tax Ct. Aug. 13, 2009).

While ostensibly the holding in the opinions may seem at once narrowly defined by the immediate facts, there may be broader implications in the Court's rejection of the "significant economic presence test" as articulated by the West Virginia Supreme Court's *MBNA* decision. *Tax Comm'r of W. Va. v. MBNA Am. Bank*, 640 S.E.2d 226 (W.Va. Sup. Ct. Nov. 21, 2006), *cert. denied*.

Background: Two separate out-of-state software companies license copyrighted canned software, for which it retains title, to customers in New Jersey. Neither company owned or rented property in New Jersey. AccuZIP did not have employees in New Jersey and it marketed its software by placing advertisements on the Internet and in trade magazines. Customers place orders for the software via telephone, email or fax, and the orders are received and accepted by an employee located in California. Technical support for the software is provided customers from its California office. The second taxpayer -- Quark -- is a Colorado company whose copyrighted, desktop computer program is sold in pre-packaged shrink-wrapped boxes to distributors and resellers who resell the product to the end users. Unlike AccuZIP, Quark had a regional sales representative who solicited orders from resellers in New Jersey from August 1992 through April 1994. In addition to soliciting orders, the sales representative conducted educational sessions and distributed "valueless demo disks". The representative did not perform agency stock checks, pick up or replace damaged software, or return software to the company.

The Division of Taxation ("DOT") assessed corporation business tax on both companies, arguing that the companies were "doing business" in New Jersey because they retained title to software licensed to New Jersey customers. On appeal, the tax court rejected this argument and found that AccuZIP is not doing business in New Jersey, but Quark is doing business in the state because it had an employee in the state.

Doing Business in New Jersey: Factors to be considered in determining whether a foreign corporation is "doing business" in New Jersey, include: (1) the nature and extent of the activities of the corporation in New Jersey;

(2) the location of its offices and other places of business; (3) the continuity, frequency and regularity of the activities of the corporation in New Jersey; (4) the employment in the state of agents, officers and employees; and (5) the location of the actual seat of management or control of the corporation. Further, case law establishes that “the State may tax income generated in the State by intangible property, even where the assessed corporation, itself, lacks a physical presence in the State.”¹²

The DOT argued that the companies are similar to the intangible holding company taxpayer in *Lanco* in that they are licensing intangible property. In rejecting this argument, the court distinguished the software companies from the taxpayer in *Lanco*, most notably finding that the software companies are selling tangible property, not intangible property. The court found instructive the state’s sales and use tax law which treats prewritten computer software (including software delivered electronically) as tangible personal property, and federal law which treats the sale of prewritten software as tangible property even when the parties characterize the transaction as a license. Moreover, unlike the intangible holding company in *Lanco* neither software company is affiliated with a corporation that has a physical presence in New Jersey, neither company’s intellectual property is displayed in New Jersey stores to generate sales, and neither company receives royalty payments or licensing fees for its products but instead generate fees from the single sale of its software and software updates.

The court also rejected the DOT’s argument that the software companies had nexus because the language in their licensing agreements evidence ownership of property in New Jersey. Federal law¹³ specifically distinguishes ownership of copyright from ownership of material objects in which work is embodied, and provides that “transfer of ownership of any material object...does not of itself convey any rights in the copyrighted work embodied in the object; nor, in the absence of an agreement, does transfer of ownership of a copyright or of any exclusive rights under a copyright convey property rights in any material object.” In this case, neither company is selling their ownership rights in their intellectual property, the retention of this right does not mean that they own property in New Jersey. To find otherwise, the court noted “would lead to illogical results.”

While the court found that both AccuZIP and Quark were selling tangible property and did not own property in New Jersey, it concluded that only AccuZIP was not doing business in New Jersey and, as such, was not subject to the state’s corporate income tax. The presence of a sales

¹² *Praxair Tech., Inc. v. Director, Division of Taxation*, 404 N.J. Super. 287, 291 (App. Div. 2008), appeal pending, Dkt. No. 63,664 (N.J. Sup. Ct.), citing *Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 380 (2006), *cert. denied*, 551 U.S. 1131 (2007).

¹³ 17 U.S.C.A. §202.

representative in New Jersey compels a finding that Quark was doing business in the state, but only for the 20 month period the representative was working in the state. Further, because the employee's activities did not go beyond mere solicitation, they are protected under P.L. 86-272, and as a result of this protection, Quark is only subject to the minimum tax and will not be liable for any tax measured on its income.

In reaching this conclusion, the court rejected that DOT's attempt to informally adopt MTC guidance¹⁴ that provides only solicitation to sell personal property is protected under P.L. 86-272 and the licensing of tangible property or transactions involving intangibles such as franchises, copyrights and the like are not protected activities. The court explained that since New Jersey is only a sovereignty member of the MTC, it "is not bound by the group's position" and that while the Director of the DOT may agree with this position, "[t]he Director may not informally adopt the MTC's rules without notice." The allowance of "the Director's determination would have a wide coverage as it would apply to all out of state companies that license tangible personal products or intangibles such as copyrights and trademarks." The court noted that adoption of this position, must be done so via the formal rule making process.

Lastly, the court declined to adopt the significant economic presence test¹⁵ set forth in *MBNA* for determining whether substantial nexus exists for Commerce Clause purposes, stating that this test "is not binding....."

New Jersey—In reversing a lower court ruling, the New Jersey Supreme Court ruled that an out-of-state intangible holding company that conducted all business, and whose offices were located, outside New Jersey had taxable nexus in years prior to adoption of an amendment to the doing business regulation that added an out-of-state intangible holding company example. On Nov. 6, 1996, the regulation at issue -- N.J.A.C 18:7-1.9(b) -- was amended to include out-of-state intangible holding companies receiving licensing fees for use of trademarks in New Jersey as an example of doing business in the state. The company argued that without the 1996 intangible holding company example, the "doing business" statute would not have applied to it for tax years 1994-1996. In rejecting this contention, the court found that the example falls within the true meaning of the statute and merely clarifies and explains the statute by presenting a hypothetical situation under which a taxpayer would be subject to taxation. Further, the court found the nature and extent of the

¹⁴ Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272.

¹⁵ This test is based on the "frequency, quantity, and systematic nature of a taxpayer's economic contacts with the state." *Tax Comm'r of W. Va. v. MBNA Am. Bank*, 640 S.E.2d 226 (W.Va. Sup. Ct. Nov. 21, 2006), *cert. denied*, *FIA Card Services, fka MBNA Am. Bank v. Tax Comm'r of W.Va.*, Dkt. No. 06-1228 (U.S. Sup. Ct. June 18, 2007).

company's business activities in New Jersey to be "obvious". Since the company licensed its intellectual property for use in the manufacture and sale of products in New Jersey, the company's property was brought into and used in New Jersey to create income. Even though the company did not have offices or employees in the state, the court found that these "absences do not overcome the irrefutable import of [company's] activities: that [company] was deriving income directly from New Jersey-based activities." In addition, the court found that the company's argument that it was only subject to tax after the example was added to the regulation "is premised on a fallacy, an unspoken but nonetheless incorrect assumption that tax liability somehow can flow from a regulatory change. That assumption flies in the face of the exclusive constitutional authorization to the Legislature of the power to tax." *Praxair Technology Inc. v. Division of Taxation*, No. A-91/92-08 (N.J. Sup. Ct. Dec. 15, 2009).

New York—New law (A. 9807C /S.6807C) establishes an economic nexus standard for certain banking corporations that issue credit cards (i.e., credit card includes bank, credit, travel and entertainment cards). Under the new provision, a banking corporation is doing business in New York if:

- (1) it has issued credit cards to 1,000 or more customers who have a mailing address within New York as of the last day of its taxable year;
- (2) it has merchant contracts with merchants and the total number of locations covered by the contracts is 1,000 or more New York locations to whom the banking corporation remitted payments for credit card transactions during the taxpayer year;
- (3) it has receipts of \$1 million or more in the taxable year from customers who have been issued credit cards by the banking corporation and have a mailing address within the state;
- (4) it has receipts of \$1 million or more arising from merchant customer contracts with merchants located in New York; or
- (5) the sum of customers described in (1) plus the number of locations described in (2) equals 1,000 or more, OR the amount of its receipts describe in (3) and (4) equals \$1 million or more.

For purposes of this provision, receipts from processing credit card transactions for merchants include merchant discounts fees received by the banking corporation. The bill also codifies the customer sourcing rules for credit card receipts contained in the current regulations. N.Y. Laws 2008, Ch. 57 (A. 9807C/S.6807C), signed by the Governor on April 23, 2008. See also N.Y. Dept. of Taxn. & Fin., TSB-M-08(7)C (June 9, 2008).

New York City—New law (A. 8867) adopts numerous measures to conform the New York City tax law to recent changes made by New York

State. Establish, effective for tax years beginning on and after January 1, 2011, economic nexus provisions for certain credit card banks by requiring them to file a New York City banking corporation tax return if they have:

1. 1,000 or more customers with mailing address in New York City;
2. 1,000 or more merchant customer contracts with merchants located in New York City;
3. \$1 million or more of receipts from credit card customers with mailing address in New York City;
4. \$1 million or more of receipts relating to merchant contracts from merchants located in New York City; or
5. The sum of customers described in (1) plus the number of locations described in (2) equals 1,000 or more, OR the amount of its receipts describe in (3) and (4) equals \$1 million or more.

N.Y. Laws 2009, ch. 201 (A. 8867), enacted July 11, 2009

Oregon—New rule (OAR 150-317.010) defines "substantial nexus" to clarify that for purposes of the corporation excise or income tax a taxpayer does not need a physical presence in Oregon in order to have a "substantial nexus" with the state. Substantial nexus exists "where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state." In determining whether a taxpayer has substantial nexus, the Department of Revenue may consider whether the taxpayer:

- (1) maintains continuous and systematic contacts with Oregon's economy or market;
- (2) conducts deliberate marketing to or solicitation of Oregon customers;
- (3) files or is required to file reports with Oregon regulatory bodies;
- (4) receives significant gross receipts attributable to customers in the state;
- (5) receives significant gross receipts attributable to the use of the taxpayer's intangible property in Oregon; or
- (6) receives state provided benefits, such as laws providing protection of business interests or regulatory consumer credit; access to courts and judicial process to enforce business rights; access to the state's transportation systems for transportation of the taxpayer's goods or services; access to the educated workforce in Oregon; or police or fire protection for property in Oregon that displays the taxpayer's intellectual or intangible property.

Since the aforementioned list is not exclusive, the Department may consider any other relevant facts and circumstances. In addition, these

provisions must be applied in determining whether the taxpayer has substantial nexus in other states. The examples discuss nexus creation for taxpayers providing credit card lending service via the Internet and mail, *de minimis* sales of an Internet sales company, a company registered with a government agency, and a Delaware intangible holding company. The new rule is effective upon filing. On its Website, the Department of Revenue indicated that it filed the rule on May, 5, 2008. Or. Dept. of Rev., OAR 150-317.010, effective May 5, 2008.

Wisconsin—Effective for tax years beginning on or after January 1, 2009, the state adopts an economic nexus standard for determining whether a taxpayer is “doing business” in Wisconsin. Specifically, the definition of “doing business in this state”¹⁶ is expanded to include:

- (1) regularly selling products or services of any kind or nature to customers in Wisconsin that receive the product or service in this state;
- (2) regularly soliciting business from potential customers in Wisconsin;
- (3) regularly engaging in transaction with customers in Wisconsin that involve intangible property and result in receipts flowing to the taxpayer from within this state; and
- (4) holding loans secured by real or tangible personal property located in Wisconsin.

Wis. Laws 2009, Ch. 2 (S.B. 62), enacted Feb. 19, 2009.

D. Nexus Based on Affiliate’s Activities In-State

Maryland—An intangible holding company subsidiary lacked economic substance and had nexus with the state through the activities of its parent corporation. The Talbots, Inc. transferred all of its trademarks, tradenames, and other intellectual property (collectively, “marks”) to a wholly owned Dutch subsidiary. Prior to an initial public offering of Talbots in 1993, a wholly owned subsidiary -- The Classics Chicago, Inc. -- acquired the marks from the Dutch subsidiary. Following the acquisition, Talbots and Classics entered into a licensing agreement that allowed Talbots to use the royalties owned by Classics. Relying on *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399 (Md. 2003) *cert. denied* 540 U.S. 984 and 540 U.S. 1090 (2003), the tax court evaluated whether the subsidiary had “real economic substance as a separate business entity.” In finding that the subsidiary lacked economic substance, the tax court noted that it had minimal operating expenses, with little or no expenses for compensation for officers or other salaries and wages, and minimum expenditures for travel, maintenance, professional services, service charges, directors’ fees, and rent. The tax court also noted that the

¹⁶ Wis. Stat. §71.22(1r).
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transactions generating the royalty income were all intercompany charges and that the income was subsequently repaid to the parent as a dividend. As a result, the court held that the subsidiary had no real economic substance as a separate business entity and consequently it should be viewed through the activities of its operating parent. In affirming this ruling the Court of Special Appeals found the tax court did not err in holding that substantial nexus existed between Classics and Maryland. *The Classics Chicago Inc. v. Comptroller of the Treasury*, No. 2047 (Md. Ct. Special App. Jan. 4, 2010).

Maryland—The Tax Court held that out-of-state intangible holding companies that lack economic substance have substantial nexus with Maryland, because their activities are considered to be the activities of their parent company. In reaching this conclusion, the court explained that the test to be applied when determining nexus for out-of-state affiliates is whether affiliates had real economic substance as separate business entities, and not the sham doctrine, which examines the transactions involved and invalidates those designed solely to avoid income taxes. *Nordstrom, Inc. v. Comptroller of the Treasury*, No. 07-IN-OO-0317 (Md. Tax Ct. Oct. 24, 2008); *NIHC, Inc. v. Comptroller of the Treasury*, No. 07-IN-OO-0318 (Md. Tax Ct. Oct. 24, 2008); and *N2HC, Inc. v. Comptroller of the Treasury*, No. 07-IN-OO-0319 (Md. Tax Ct. Oct. 24, 2008).

E. Other State Nexus Developments

Colorado—A company that hires an administrative support employee who performs his duties out of his home in Colorado will likely have nexus with the state for corporate income tax purposes. The company provides analytical support to the US military and, as such, the majority of its employees are based overseas. The new employee would not perform any direct duties related to revenue generating activity, but instead would provide administrative support to the company and would be based out of his home in Colorado. The Department of Revenue stated that "a company that has an employee residing in Colorado will generally have nexus for income tax purposes" and that "if a company's only cost in generating service income is the labor cost of its employees, and only one of its employees is located in Colorado, then the company's service income will be apportioned to Colorado in proportion to the cost of the one Colorado employee to the total cost of all its employees." Colo. Dept. of Rev., General Information Letter 2009-010 (Feb. 24, 2009).

Kentucky—In affirming in part a lower court ruling, the Kentucky Court of Appeals held that foreign corporations with no physical presence in the state had taxable nexus with Kentucky due to the receipt of a distributive share of income from partnership entities doing business in the state. For

the tax years at issue (1993-1996), KRS 141.206(5) provided that a nonresident corporation which is a partner in a partnership doing business within and without Kentucky is taxable on its distributive share of income attributable to business done in the state. Because KRS 141.206 recognizes the flow-thru nature of partnerships, income tax is not owed by the partnership, rather it owed by the partners. Further, subjecting the corporation to tax based on KRS 141.206 does not violate the Commerce Clause. Even though the appellate court found the applicability of *Quill's* physical presence standard to taxes other than sales/use taxes "unclear", it concluded that "even if a substantial nexus requires a physical presence in Kentucky...the Corporations in fact have such a nexus." In support of this conclusion the appellate court explained that at times the corporations owned up to a 99% limited and/or general partnership interest in, and received distributive shares of partnership income from the profits of, a partnership doing business in Kentucky. The partnership received protection and benefits from Kentucky, which enabled the partnership to distribute income to the corporations. This connection, the court concluded, "gives rise to a substantial nexus with, and/or physical presence within, Kentucky." The appellate court, however, reversed the lower court's finding that the income should be apportioned to Kentucky based on a three factor (payroll, property, sales) factor apportionment formula, concluding that the use of a single sales factor method proposed by the Revenue Cabinet does not infringe on the corporation's constitutional rights. *Kentucky Revenue Cabinet v. Ashworth Corp.*, Nos. 2007-CA-002549 and 2008-CA-000023-MR (Ky. Ct. App. Nov. 20, 2009).

II. FILING OPTIONS

A. Recent Combined Reporting/Consolidated Return Legislation

Currently twenty-four states require combined reporting by corporations that are members of a unitary group: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York State and City (only if significant intercompany transactions), North Dakota, Ohio (for CAT and only if consolidated filing is not elected) Oregon, Texas, Utah, Vermont, West Virginia, and Wisconsin. The District of Columbia has adopted for tax years beginning after December 31, 2010.

Multistate Tax Commission (MTC)—On August 17, 2006, the MTC approved a model statute for combined reporting, with a water's edge election. Under the model combined reporting statute, a taxpayer engaged

in a unitary business with one or more other corporations is required to file a combined report, which includes the income and apportionment factors (as specified by the statute) of all corporations that are members of the unitary business, and such other information as required by the state tax commissioner. Taxpayers meeting specified requirements may elect to determine each of their apportioned shares of the net business income or loss of the combined group pursuant to a water's-edge election. A water's-edge election, once made, is binding for a ten-year period.

The state tax commissioner, by regulation, has the authority to require that the combined report include the income and associated apportionment factors of any person not included pursuant to the mandatory combined reporting provisions, but that are members of a unitary business, in order to reflect proper apportionment of the entire unitary businesses. Under this discretionary provision, the commissioner has the authority to require combination of persons that are not subject to the state's tax, or would not be subject to the state's income tax if doing business in the state.

Further if the state tax commissioner determined that the reported income or loss of a taxpayer engaged in a unitary business with any person not included in the unitary business represents an avoidance or evasion of tax, the commissioner may require all or any part of the income and associated apportionment factors of such person be included in the taxpayer's combined report. In addition, with respect to inclusion of associated apportionment factors, the commissioner may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors, or the employment of any other method in order to fairly represent the taxpayer's business activity in the state.

The statute discusses in detail how taxpayers should determine taxable income or loss using a combined report. More specifically, the statute addresses the following: (A) components of income subject to tax in the state; application of tax credits and post apportionment deductions; (B) determination of taxpayer's share of the business income of a combined group apportionable to the state; (C) determination of business income of the combined group; (D) designation of surety; and (E) water's-edge election, initiation and withdrawal.

Alabama—The 2009 legislature considered, but did not approve, a proposed bill (H.B. 865) that would have required corporations to file a combined return.

Connecticut—The 2009 legislature considered, but did not approve, a proposed bill (S.B. 807) that would have adopted mandatory combined reporting provisions.

District of Columbia—New law (B18-433, B18-203) makes clear the Council's intention to require reporting for tax years 2011 and thereafter. The bill provides little detail as to how combined reporting would be implemented and, in its entirety, the provision reads: "The Council orders that for tax years beginning after December 31, 2010, the D.C. Official Code shall have been amended to require that all corporations taxable in the District of Columbia shall determine the income apportionable or allocable to the District of Columbia by reference to the income and apportionment factors of all commonly controlled corporations organized within the United States with which they are engaged in a unitary business." The Office of Tax and Revenue will provide recommendation for statutory language. D.C. Laws 2009, B18-433, B18-203.

Florida—The 2009 legislature considered, but did not approve, a proposed bill (S.B. 2270) that would have required members of a water's edge group to use the water's edge reporting method (i.e., combined filing) for tax years beginning on or after Jan. 1, 2010.

Iowa—The 2009 legislature considered, but did not approve, a proposed bill (S.F. 211) that would have required the net income of affiliated groups of corporations engaged in a unitary business be computed on a combined return basis for corporate tax purposes if the group meets the requirements for filing a federal consolidated return. S.F. 211 was introduced Feb. 24, 2009.

Louisiana—The 2009 legislature considered, but did not approve, a proposed bill (H.B. 754) that would have adopted the MTC's model combined reporting statute.

Maryland—The 2009 legislature adjourned without approving bills (S.B. 603 / H.B. 1244) that would have required an affiliated group of corporations engaged in a unitary business to file a combined report using a water's edge method. The state has considered similar legislation in prior sessions.

Massachusetts—New law (H. 4904) adopts a unitary tax system effective for tax years beginning on or after January 1, 2009, and provide FAS 109 relief to help mitigate the negative tax accounting implications of this change. Under the new unitary system, one or more affiliated corporations conducting related business activities are generally required to determine their corporate income tax by taking into account the income and activities of the entire group of affiliates. In this system, the income of all corporations in the group (including those not doing business in the state) is aggregated and intercompany transactions are eliminated. Aggregated income is then apportioned to the state based on the property, payroll and sales of all of the group members. The following are some of

the important features of the unitary provisions of the Bill.

Unitary Group Composition: The unitary group includes all corporations under common ownership that are engaged in a unitary business. Corporations are considered under common ownership if more than 50% of their voting stock is controlled by the same beneficial owners. A unitary business is defined broadly to include two or more corporations whose business activities are interrelated and result in mutual benefit or a sharing of value between the corporations. The Bill specifies the Legislature's intent that the term be construed to the broadest extent permissible under the U.S. Constitution.

The group includes financial institutions, S corporations, utility corporations, real estate investment trusts (REITs) and regulated investment companies (RICs) if the companies otherwise meet the definition of a unitary group. Captive insurance companies are also included. Security corporations and tax exempt organizations with UBIT will not be included in a unitary group.

Water's Edge Rule: Under the unitary system, tax will be imposed on a water's edge basis, unless a worldwide election is made. A waters edge report will include:

- (i) any member incorporated in the United States or formed under the laws of the United States, any state, or any territory or possession of the United States;
- (ii) any member, regardless of the place incorporated or formed, if the average property, payroll, and sales factors within the United States is 20% or more; and
- (iii) any member that derives more than 20% of its income from intangible property or service activity where that income is received from a group member that deducts the expenses related to the activity for federal income tax purposes.

In the case of members that are included in the group under the third prong of the definition, only the income and apportionment factors relating to their transactions with other group members are included in the unitary computation.

Worldwide Election: The worldwide election permits every member of the unitary group, wherever located, to be included in the report. The election needs to be made on a timely filed, original return and, once made, is binding for a period of 10 years.

Unitary Computation: The unitary group will determine its income on an aggregate basis, eliminating intercompany transactions. The share of the aggregated income or loss attributable to the Commonwealth will be based on the apportionment percentages of each “taxable member” of the group. A taxable member is defined as a member of the unitary group that is independently subject to tax in Massachusetts.

Each taxable member will compute the numerator of its apportionment factor based on its separate activities and its share of Massachusetts sales of non-taxable members. Each taxable member’s share of Massachusetts non-taxable member’s sales will be determined based on a ratio, the numerator of which will be the taxable member’s Massachusetts sales and the denominator will be the aggregate amount of all Massachusetts sales of all the taxable members. In addition, each taxable member will compute the denominator of its apportionment factor by aggregating the apportionment factor denominators of every member of the group. Further, a taxable member’s apportionment factor denominator will include the property and payroll factors attributable to members that are subject to single sales factor apportionment.

By attributing the sales of non-taxable members to taxable members, the Bill adopts the *Finnigan* approach to unitary apportionment. As such, the Massachusetts sales of all group members will be considered in apportioning income, regardless of whether or not any particular member of the group has Massachusetts nexus.

Apportionable income will be determined by each taxable member applying its apportionment percentage to the unitary business income received by the group members. Every member of the unitary group will be jointly and severally liable for the tax due from any member.

Special Rules Applicable Where a Unitary Group Includes Financial Institutions and Other Corporations: Where a unitary group includes both financial institutions and other corporations, the following adjustments to the apportionment rules apply:

- (i) Prior to combination, the value of intangible property included in the property factors of the financial institution members (e.g., loans) are reduced to 20% of the otherwise applicable value;
- (ii) Receipts that are includable in the sales factors of the financial institutions but not the other corporations (e.g., interest on loans) are taken into account in the denominators of the other corporations; and
- (iii) Goodwill from the sale of a business is excluded from the sales

factor of all members.

Election to Use the Federal Affiliated Group as the Reporting Group:

A taxpayer may elect, without consent of the DOR, to treat as its Massachusetts group all corporations that are members of its affiliated group, as defined under IRC §1504. This methodology will permit non-unitary companies to be included in the tax computation. The election is binding for 10 years.

DOR Regulations: The Department of Revenue (DOR) is required to promulgate other regulations necessary to implement the unitary tax system. These regulations will be required to provide for: (i) the elimination or deferral of intercompany transactions, (ii) the sharing and carryover of credits by group members, (iii) the sharing and carryover of NOLs, and (iv) the appropriate application of the intercompany interest and royalty addback provisions (which will remain in effect).

Provisions of the bill also allow publicly traded corporations a special deduction to address an increase in a deferred tax liability on the company's GAAP financial statements resulting from the shift to unitary taxation. The deduction will be available for seven years starting with taxable years beginning during calendar year 2012. The amount of the deduction for each tax year is one-seventh of the lesser of (i) the net increase in deferred tax liability that results from the switch to unitary taxation or (ii) the difference between the book basis and tax basis of the group's non-taxable members' depreciable or amortizable assets before the taxpayer becomes subject to the unitary tax regime. To claim the deduction a taxpayer needed to file a report with the DOR showing the computation of the deduction by July 1, 2009.

Massachusetts—The Department of Revenue (DOR) adopted regulation 830 CMR 63.32B.2. The regulation sets out rules for the application of the Massachusetts unitary combined reporting requirements, which took effect Jan. 1, 2009. The regulation is comprehensive in scope and discusses: (1) unitary presumptions and inferences; (2) corporations to be included in a combined report; (3) water's edge or worldwide parameters of a combined report; (4) determination of taxable income of a taxable member of a combined group; (5) apportionment of income computation, tax computation where no there is no apportionment; (6) net operating loss carry forwards; (7) credits; (8) affiliated group elections; (9) principal reporting corporation, liability; and (10) tax returns and taxable years. The new regulation was published in the Mass. Register on May 29, 2009.

Missouri—The 2009 legislature considered, but did not approve, a proposed bill (S.B. 241) that would have required a corporation doing business in Missouri that is a member of a unitary group, to file a water's

edge combined report.

New Mexico—The 2009 legislature adjourned without approving a proposed bill (S.B. 389) that would have required a corporation to file a combined return with other unitary corporations as though the entire combined net income were that of one corporation. The state has considered similar combined reporting legislation in prior years.

New York City—New law (A. 8867) adopts numerous measures to conform the New York City tax law to recent changes made by New York State. Key provisions of the bill:

- Mandate combined reporting for general corporation tax purposes when there are substantial inter-corporate transactions among related domestic corporations, regardless of the transfer price for such transactions. The legislation would also conform to New York State legislation that requires captive REITs and captive RICs to file on a combined basis with the closest controlling corporation that is subject to New York City tax. RICs and REITs included in the combined report will determine entire net income without regard to a dividends paid deduction to affiliated stockholders for tax years beginning on or after January 1, 2009.
- Conform to the New York State legislation that requires captive REITs and RICs to file on a combined basis for banking corporation tax purposes subject to certain exceptions. The legislation would allow a 25% dividends paid deduction for captive REITs and RICs for tax years beginning on and after January 1, 2009 but before January 1, 2011. A dividends paid deduction would not be allowed for tax years beginning on or after January 1, 2011.

N.Y. Laws 2009, ch. 201 (A. 8867), enacted July 11, 2009.

New York—For corporation franchise and bank franchise tax purposes, an "overcapitalized captive insurance company" is required to file a combined report with its direct parent, provided the parent is doing business in New York or is otherwise included in a combined return. If this is not the case, an overcapitalized captive insurance company then must be combined with the "closest controlling stockholder" (as measured by a greater than 50% voting stock threshold) under the same rules now applicable to certain captive REITs and RICs. In summary, this would entail identifying each tier in the structure until a corporation that meets this threshold and that is also a New York taxpayer, is identified. An overcapitalized captive insurance company is defined as a corporation: (1) that is directly or indirectly owned or controlled (as measured by a greater than 50% voting stock threshold) by a corporation not exempt from federal income taxes; (2) that is licensed as a captive insurance company under

the laws of New York or another jurisdiction; (3) whose business includes providing insurance or reinsurance covering the risks of its parent or affiliates; and (4) whose premiums do not account for more than 50% of its gross receipts for the tax year.

The bill also amends the definition of “insurance company” to specifically exclude overcapitalized captive insurance companies.

These changes are effective for taxable years beginning on or after Jan. 1, 2009; however, certain changes amend temporary provisions and as such will expire when these temporary provisions are repealed in 2011. N.Y. Tax Laws, Ch. 57 (A. 157B and S. 57B), enacted April 7, 2009.

Pennsylvania—Proposed bill (H.B. 1775 and S.B. 1069) would adopt combined reporting provisions that would apply to taxable years beginning on or after Jan. 1, 2011. Under the proposed provisions, the business income of a corporation that is a member of a unitary business of two or more corporations, at least one of which transacts its business within and without Pennsylvania, would be determined by combining the business income of either all corporations that are water's edge basis members or all corporations that are worldwide members of the unitary business. The proposed provisions list income that would be excluded, including income from a title insurance company and electric light companies. Gross receipts from intercompany transactions between included corporations would be eliminated, unless otherwise provided. H.B. 1775 was introduced on June 24, 2009. S.B. 1069 was introduced on Aug. 7, 2009.

Rhode Island—The 2009 legislature considered, but did not approve, a proposed bill (H.B. 5832) that would have required a taxpayer engaged in a unitary business with one or more corporations to file a combined report that includes the income and apportionment factors of all corporations that are members of the unitary business.

Tennessee—The 2009 legislature considered, but did not approve, a proposed bills (H.B. 1350 /S.B. 502) that would have required a taxpayer engaged in a unitary business with one or more other corporations to file a combined report that includes the income and apportionment factors of all corporations that are members of the unitary business.

Texas—Effective with the 2008 Texas franchise tax report (based on business activity incurred during the 2007 fiscal accounting year-end), the taxable capital and earned surplus components of the franchise tax are repealed and replaced with a tax based on taxable fo that is calculated on a unitary combined basis. Tex. Laws 2006, H.B. 3, enacted May 18, 2006. Specifically, provisions of H.B. 3 require taxable entities that are members of an affiliated group engaged in a unitary business (including partnerships

and disregarded entities) to file a combined group report. An affiliated group includes one or more entities in which a controlling interest is owned by common owners.

A controlling interest is considered to exist with respect to corporations when 80% or more of the combined voting power of all stock or 80% or more of the beneficial interest in voting stock is owned directly or indirectly by common owners. A controlling interest is considered to exist with respect to other entities (including partnerships) when 80% or more of the capital, profits, or beneficial interest is owned directly or indirectly by common owners.

A unitary business is defined to be a "single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."

A combined group report does not include those taxable entities that have 80% or more of their property and payroll outside the United States. If an entity does not have any property or payroll, it would not be included in a unitary group if 80% or more of its gross receipts are assigned to locations outside the United States.

A combined group must elect to deduct the cost of goods sold ("COGS") or the compensation for the entire group, and each member of the group must use the same deduction.

Intercompany transactions between members of the combined group are eliminated from the combined tax base and combined apportionment factor. The numerator of the apportionment factor for a combined group report is to be determined using a "Joyce" type approach, where the numerator includes only the receipts of a member of the group with nexus in Texas on a separate company basis (see 171.103(b) and 171.105(c); Pgs. 49 and 51). However, the elimination of intercompany receipts from the apportionment factor is not permitted for receipts when an entity with Texas nexus sells tangible personal property to a member of the combined group, if that member of the combined group does not have nexus in Texas and if that member resells the property to a purchaser in Texas without modification to the property.

Lastly, a combined group may elect to include an exempt entity that would be included in the combined group if the entity were not exempt from the tax. If such an election is made, the exempt entity would be treated as a taxable entity.

West Virginia—New combined reporting provisions, which apply to the state’s corporate net income tax, are effective for tax years beginning on and after January 1, 2009, and adopt in substantial part the provisions of the Multistate Tax Commission’s Model Statute for Combined Reporting. Specifically, any taxpayer engaged in a unitary business with one or more other corporations will be required to file a combined report that includes the income of all the corporations that are members of the unitary business, and other information required by the Tax Commissioner. If the tax commissioner determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included in the combined report represents an avoidance or evasion of tax by such taxpayer, he/she has the authority to require all or any part of the income and associated apportionment factors of such person be included in the combined report. Alternatively, the tax commissioner may require any person or corporation to make and file a separate return or to make and file a composite, unitary, consolidated or combined return in order to clearly reflect the taxable income of a corporation

Eligible taxpayers may make a water’s edge election. If a water’s edge election is made, members of a unitary group will take into account all or a portion of the income and apportionment factors of the following:

- The entire income and apportionment factors of:
 - Any member incorporated in the U.S. or formed under the laws of any state, the District of Columbia or any territory or possession of the U.S.;
 - Any member regardless of where incorporated or formed, if the average of its payroll, property and sales factors within the U.S. is 20% or more;
 - Any member which is a DISC (as described in IRC §§991 to 994), a FSC (as described in IRC §§921 to 927), or that is an export trade corporation (as described in IRC §§970 to 971);
- Any member not described above will be required to include the portion of its income derived from or attributable to sources within the U.S.;
- Any member that is a CFC (as defined in IRC §957) to the extent the income of that member is defined in Subpart F of the IRC;
- Any member that earns more than 20% of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group; and
- The entire income and apportionment factors of any member that is doing business in a tax haven.

A water’s edge election is effective only if made on a timely-filed, original

return for a tax year by every member of the unitary business subject to West Virginia corporate net income tax and is binding for a period of 10 years. The water's edge election may be withdrawn or reinstated after withdrawal only with written permission of the tax commissioner. Alternatively, the tax commissioner has the discretionary authority to disregard in whole or in part a taxpayer's water's edge election if any member of the unitary business fails to comply with the combined reporting provisions or if a taxpayer is not included in the water's edge combined report for the purpose of avoiding state income tax.

The use of a combined report does not disregard the separate identities of the members of the combined group. Rather, each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to West Virginia. Further, no credit or post-apportionment deduction earned by one member of the group, but not fully used by or allowed to that member, may be used in whole or in part by another member of the group or applied in whole or in part against the total income of the combined group. A post-apportionment deduction that is carried over into a subsequent year as to the member that incurred it will be considered in the computation of the income of that member in the subsequent year, regardless of the composition of that income as apportioned, allocated or wholly within West Virginia.

For tax years beginning on and after January 1, 2009, provisions related to making an election to file a consolidated return are null and void.

In 2008 the state's combined reporting provisions were amended. Most notably, taxpayers are allowed to elect to file a worldwide unitary combined report (if the election is not made, the taxpayer must file on a water's edge unitary combined reporting basis). An election to file a worldwide combined report is effective for 10 years (the Tax Commissioner has the authority to grant withdrawal prior to the expiration of the 10 year period). The Tax Commissioner has the discretionary authority to disregard or mandate the use of a worldwide combined report. S.B. 680 also makes clear that the income and apportionment factors of an insurance company should not be included in a combined report unless specifically required to be included by the Tax Commissioner. For purposes of determining taxable income or loss using a combined reporting, S.B. 680 clarifies that net operating loss (NOL) carryovers that were earned during a tax year in which the taxpayer filed a consolidated return may be applied as a deduction from the West Virginia taxable income of any member of the taxpayer's controlled group until the NOL carryover is used or expires. Similar provisions apply to unused and unexpired economic development tax credits that were earned during a tax year in which the taxpayer filed a consolidated return. W. Va. Laws 2008, S.B. 680, enacted on March 31, 2008.

Wisconsin—Effective for tax years beginning on or after January 1, 2009, corporations engaged in a unitary business with one or more other corporations are required to file using the combined reporting method, effective for tax years beginning on and after January 1, 2009. A “unitary business” is defined as “a single economic enterprise that is made up either of separate parts of a single business entity, of multiple business entities that are related under [IRC §§ 267 or 1563], or of a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.” Two or more business entities are presumed unitary if the businesses have unity of ownership, operation and use. Unitary business also includes any business activity of a pass-through entity owned directly or indirectly by a corporation, to the extent of the corporation’s distributive share of the pass-through entity’s income.

Foreign corporations that are members of the combined group only include income that is derived from sources within the United States. If 80% or more of a corporation’s worldwide income is active foreign business income, the income and apportionment factors(s) of the corporation are not included in the combined report, but the corporation will compute and allocate or apportion its income from the unitary business separately.

If a consolidated foreign operating corporation (CFOC) is a member of the unitary business, the combined report should include the following amounts to the extent that they are attributable to the unitary business: (1) income equal to the interest expense and intangible expenses that are paid, accrued or incurred by any combined group member to or for the benefit of the CFOC, except to the extent such amounts constitute income to the CFOC from sources outside the US under IRC §§861 to 865; (2) interest income and income generated from intangible property received or accrued by CFOC, except to the extent such amounts that constitute income to the CFOC from sources outside the US under IRC §§861 to 865; (3) dividends paid or accrued by a REIT to the CFOC, if the REIT is not a qualified REIT and the dividend income is from sources within the US under IRC §§861 to 865; (4) income of the CFOC that is equal to gains derived from the sale of real or personal property located in the US.

The Department of Revenue has the discretionary authority to include in the combined report the income and associated apportionment factor(s) of any person that is not otherwise included in a combined group but that is a member of a unitary business in order to reflect the proper apportionment of income of the entire unitary business. The Department also may include

income and associated apportionment factors of non-corporate entities. Moreover, if the Department determines that the reported income or loss of a member of the combined group engaged in a unitary business with any person not otherwise included in the group represents an avoidance or evasion of tax by the person or the combined group member, it may require the use of an alternative apportionment factor.

The business income of the combined group is the sum of the income of each member of the combined group. If the unitary business includes income from a pass-through entity, the amount included in the total income of the combined group is the member's direct and indirect distributive share of the pass-through entity's unitary business income. The statute specifies income that should be included and excluded from the combined report, for example any pre-apportionment net business loss carry-forward deductions are to be subtracted, while dividends paid by one combined group member to another are excluded to the extent the dividends are paid out of the earnings and profit of the unitary business.

Each member of a combined group is doing business in Wisconsin if any member of the combined group is doing business in Wisconsin and that business relates to the combined group's unitary business. The statute specifies how a taxpayer's share of the business income apportionable to Wisconsin of each combined group is determined, and it specifies how net business losses and loss carry-forward can be used. Generally, no tax credit, Wisconsin net business loss carry-forward or other post-apportionment deduction earned by one member of the group but not fully used by or allowed to that member, can be used in whole or in part by another member of the combined group. However, a member of the combined group may use a carry-forward of a credit, Wisconsin net business loss carry-forward or other post-apportionment deduction that was incurred by that same member in a taxable year beginning before January 1, 2009.

Each combined group must have one designated agent. Generally, the designated agent is the parent corporation of the combined group. If, however, there is no such parent corporation, the designated agent may be appointed by the members. If no member is appointed, the designated agent is the member with the most significant operations in Wisconsin.

There is a transition period during which the Department will deem as timely paid the estimated tax payments attributable to income includable in the combined report for installments that become due during a certain period, provided that such payments are paid by the next installment due date.

Note: A.B. 75 amends the recently enacted combined reporting provisions

to allow the combined reporting group's designated agent, without having to first obtain written approval from the Department of Revenue, to include in the combined group every corporation in its commonly controlled group, regardless of whether such corporations are engaged in the same unitary business as the designated agent. Such election is made on an original, timely filed combined report, and is binding for 10 years -- the taxable year for which the election is made and the subsequent nine years -- and may be renewed for an additional 10 years. The Department can disallow an election with respect to a controlled group member(s) for any year of the election period, if the Department determines that the election has the effect of tax avoidance.

In addition, A.B. 75 amends combined reporting provisions related to how credits, credit carryforwards and business loss carryforwards can be used by members of the combined group. Under the new provisions, a member of a combined group that has an unused net business loss carry-forward or business credit that was computed on a combined report for a combined group's unitary business for a taxable year beginning on or after January 1, 2009 or an R&D credit/credit carryforward generated prior to filing a combined return, can, after using the loss/credit/credit carryforward to offset its own tax liability for the year, use the remaining loss/credit/credit carryforward to offset the liability of other members of the group on a proportionate basis, to the extent the liability is attributable to the unitary business.

In addition, the Department of Revenue is authorized to promulgate rules necessary to create uniformity between the treatment of transactions entered into by members of a federal consolidated group under federal regulations and treatment of transactions entered into by members of a combined group. Wis. Laws 2009, Act 2 (S.B. 62), signed by the Governor on Feb. 19, 2009, as amended by Wis. Laws 2009, Act 28 (A.B. 75), signed by the Governor on June 29, 2009. See also emergency combined reporting regulations sections 2.60 to 2.67.

B. Other Consolidated or Combined Reporting Developments

California—Amended rule (18 CCR 25111) and new rule (18 CCR 25113) provide regulatory guidance for making water's edge combined return elections for tax years prior to and after 2003 statutory changes became effective. Regulation 25111 is applicable to elections entered into for taxable years beginning on or after Jan. 1, 1994 and before Jan. 1, 2003. To the extent that a taxpayer would have been required to file on water's edge basis in its first taxable year beginning on or after Jan. 1, 2003, pursuant to a water's edge election made in a prior year under CR&TC §25111 and Reg. 25111, the terms of Reg. 25111 no longer apply and

that election shall be deemed to have been made under the terms of CR&TC §25113. Note, however, that the commencement date of an election made in prior years under CR&TC §25111 and Reg. 25111 remains the commencement date of the water's edge election period for purposes of apply CR&TC §25113. Regulation 25113, applicable to tax years beginning on or after Jan. 1, 2008, provides guidance on making a water's edge election, including definitions applicable to a water's edge return, water's edge election procedures, and examples illustrating the election procedures. The regulatory changes are effective May 6, 2009. Cal. Franchise Tax Bd., Reg. 25111 and Reg. 25113.

California—The Franchise Tax Board issued draft frequently asked questions (FAQs) on the assignment of credits within the combined reporting group under CR&TC §23663. In general, credits under Chapter 3.5 can be assigned if they were generated in any taxable year beginning on or after July 1, 2008, or in taxable years before July 1, 2008 that are eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008. The assignor (i.e., the taxpayer that originally generated the eligible credit - or is allowed it as a distributive share item - and assigned the credit to an eligible assignee) can assign these credits if there is a carryover available from prior years, for example the Manufacturers' Investment Credit. An eligible assignee is any affiliated corporation that is a member of the same combined reporting group as the assignor on:

- (1) June 30, 2008 and the last day of the taxable year in which the credit was assigned to the assignee (for credits generated in taxable years beginning before July 1, 2008); or
- (2) the last day of the taxable year in which the credit was first allowed to the assignor and the last day of the taxable year in which the credit was assigned to the assignee (applies to credits generated in taxable years beginning on or after July 1, 2008).

In order to assign a credit, which is deemed to be an irrevocable election, the taxpayer must file FTB Form 3544 and attach it to the **original return** for the taxable year in which the assignment is made. Taxpayers will have to use one form per credit per assignor. Thus, if two credits are assigned, the assignor must use two forms. The draft FAQs discuss in detail whether: (1) the assignment can be made to a "division"; (2) when the assigned credits can be used to offset a tax liability of the assignee; (3) how the credits are assigned; (4) when the election has to be filed and implications of not fully complying with the rules of assignment; (5) various unitary issues, such as whether a corporation that has been assigned credits can take the credit with them if it leaves the combined group; and (6) restrictions on use of the credits, including issues related to enterprise zone credits. Comments and recommendations are due April 13, 2009.

FTB, Draft - Combined Reporting Group Credit Assignment FAQs (posted March 27, 2009).

California—The Franchise Tax Board has issued a legal ruling addressing the application of the Real Estate Mortgage Investment Conduit (REMIC) excess inclusion rules in a unitary combined reporting group. The Board explained that to avoid double taxation of a noneconomic residual interest holder's taxable income, which represents the REMIC's taxable income in multiple jurisdictions, the minimal amount the holder must take into account for California purposes based on excess inclusion rules is determined by reference to its California apportionment percentage (i.e., determined on a post-apportionment basis). Further, for California tax purposes, the minimal amount of taxable income is not included in the gross income or taxable income used to determine the amount of the net operating loss the holder can carryforward. Cal. Franch. Tax Bd., Legal Ruling 2009-01 (Jan. 26, 2009).

Colorado—Proposed new regulation 39-22-303.12(c) would clarify how to determine whether a corporation that does not have property or payroll factors is includible in a combined return. Under CRS §39-22-303(12)(c), a corporation is includible in a combined return if it has 20% of its property and payroll assigned to locations within the US. CRS §39-22-303(8) excludes a foreign corporation from inclusion in the combined report if 80% or more of its property and payroll is assigned to locations outside the US. Proposed regulation 39-22-303.12(c) would provide that when the corporation does not have payroll or property factors, determination of includibility will be made using the taxpayer's sales factor. If 80% or more of the corporation's sales are outside the US, then the corporation would not be included in the combined reporting group. In addition, if the amount of the corporation's property and payroll is de minimis (i.e., it does not contribute to the generation of revenue), it would be excluded from the payroll and property factor calculations.

Colorado—In reversing the District Court ruling, the Colorado Court of Appeals found that a corporation and its subsidiaries ("corporation") were not permitted to file an amended combined-consolidated return because the amended return was untimely and the corporation had sufficient notice that the combined-consolidated return option existed. The statutes and regulations in place during the tax year at issue establish that an affiliated group may elect a consolidated filing, and at the same time the group is required to file a combined report. Thus, both can be completed together as a combined-consolidated return. If the corporation was unclear about the statutory and regulatory scheme, the record indicated that the corporation could have availed itself of the Department of Revenue's help-line prior to the return filing deadline. Further, the corporation's substantive due process rights were not violated because the corporation

had constructive knowledge of the combined-consolidated filing option as it had a reasonable opportunity to familiarize itself with the written statutes and regulations. Also, the corporation's procedural due process rights were not violated because the Department gave proper notice that it rejected the corporation's amended returns. *Cendant Corp. v. Colo. Dept. of Revenue*, No. 08C0103 (Colo. Ct. App. Feb. 5, 2009).

Connecticut—New law (H.B. 6802), increases the combined reporting preference tax from \$250,000 to \$500,000, effective immediately. Ct. Laws 2009, Pub. Act 09-3 (H.B. 6802), became law without the Governor's signature on Sept. 8, 2009.

Idaho—Effective Jan. 1, 2009, provisions of H.B. 3 amend Idaho Code §63-3027B to revise the standards for making the water's-edge combined reporting election on behalf of members of the water's-edge combined group. For each corporation within the combined group, a water's-edge election will be deemed to have been filed and consent given upon the filing of a valid water's-edge election by any qualified taxpayer of the combined group. If during the period a water's-edge election is in effect, another corporation subject to tax by this state becomes a part of the combined group, the corporation is deemed to have made a water's-edge election and consent properly given. The amendment also provides that a taxpayer who makes a water's-edge election shall take into account the income and apportionment factors of *all* affiliated corporations in a unitary relationship with the taxpayer, other than corporations filing elections under IRC §936. Previously, *only* affiliated corporations were included. Idaho Laws 2009, ch. 2 (H.B. 3), enacted Feb. 18, 2009.

Massachusetts—The Department of Revenue issued for public comment a draft TIR explaining the FAS 109 deduction that is being allowed as a result of Massachusetts moving from a separate return state to a combined reporting state. Per FAS 109, a company is required to report the effects of income taxes resulting from transactions occurring in the current and preceding years to be reported on its financial statements for current and future years. Such reporting requirements include accounting for certain deferred tax liabilities and assets to reflect future tax consequences of events recognized on the company's financial statements or tax returns. Provisions of the 2008 Tax Fairness Bill, which adopted mandatory unitary combined reporting effective for tax years beginning on and after Jan. 1, 2009, allows certain publicly traded corporations a special deduction to offset an increase in deferred tax liabilities on a company's GAAP financial statements resulting from the shift to combined reporting. Only publicly traded corporations, including affiliated corporations participating in the publicly traded corporation's financial statements prepared in accordance with GAAP, are eligible for the FAS 109 deduction. In order to claim the deduction, taxpayers will

have to electronically file with the Department a statement using a Web-based application (not available as of April 27, 2009) on or before July 1, 2009. The statement will have to specify the total amount of the deduction the taxpayer is claiming, and it will have to include all calculations and other information used to arrive at the deduction. The draft TIR also provides a definition for net deferred tax liability, guidance on how to determine the Massachusetts tax basis modification and how to calculate the FAS 109 deduction, and discusses recordkeeping requirements. Comments are due by May 8, 2009. Mass. Dept. of Rev., Working Draft TIR 09-X (released April 24, 2009).

Oregon—New law (S.B. 180-A) requires regulated investment companies (RICs) and real estate investment trusts (REITs) that are not included in a federal consolidated return under IRC §1504(b)(6) to be included in the Oregon consolidated return filed by the affiliated group. This provision applies to tax years beginning on and after Jan. 1, 2010. Or. Laws 2009, S.B. 180-A, signed by the Governor on June 18, 2009.

South Carolina—A group of taxpayers were allowed to use combined reporting as an alternative apportionment method in order to fairly represent the extent of their business activity in South Carolina, because use of the state's standard three factor (payroll, property, sales) apportionment methodology on a separate entity basis creates distortion. Under South Carolina law (S.C. Stat. §12-6-2320) if any of the statutory apportionment provision does not fairly represent a taxpayer's business activities in the state, the taxpayer may petition or the Department of Revenue may require the use of an alternative apportionment method, including the "employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

At issue in this case is whether "any other method" allows the use of combined reporting. In finding in favor of the taxpayer, the court held that use of combined entity apportionment methodology fits the definition of "any other" apportionment method authorized by S.C. Stat. §12-6-2320 and that the Department has the statutory authority to allow the use of such method. Because application of the standard apportionment method on a separate entity basis results in an assessment that is 435% of the income tax and license fees compared to that resulting from use of combined reporting, an alternative method must be applied. In this case use of the combined entity apportionment methodology is an acceptable apportionment method as it accurately reflects the taxpayer's business activities in South Carolina. *Media General Communications v. South Carolina Department of Revenue*, No. 07-ALJ-17-0089-CC (S.C. Admin. Law Ct. May 4, 2009).

West Virginia—The Department of Revenue issued a brochure

highlighting the state's new combined reporting provisions, which apply to tax years beginning on and after Jan. 1, 2009. The brochure describes what combined reporting entails, what a combined report requires, and which taxpayers are subject to the combined reporting provisions (i.e., corporations, partnerships, financial institutions, transportation industry). W.V. Dept. of Rev., "Combined Reporting in West Virginia" (Jan. 2009).

III. COMPUTATION OF TAX BASE

A. Interest and/or Royalty Expense Addback – Recent Developments

Multistate Tax Commission (MTC)—On August 17, 2006, the MTC approved a Model Statute requiring the addback of certain related party intangible and interest expenses. Pursuant to the statute, a taxpayer is required to add back otherwise deductible intangible expenses directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members. If the related member is subject to tax in this state or another state or possession of the US or a foreign nation, or combination thereof, on a tax base that includes the intangible expenses paid, accrued or incurred by the taxpayer, the taxpayer will receive a credit against tax due in the state.

Addback is not required and the aforementioned credit does not apply in the following situations:

- A. To the portion of the intangible expense that the taxpayer establishes by clear and convincing evidence meets both of the following: (1) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member, and (2) the transaction giving rise to the intangible expense between the taxpayer and the related member was undertaken for a valid business purpose.
- B. If the taxpayer establishes by clear and convincing evidence that: (1) the related member was subject to tax on its net income in the state or another state or possession of the US; (2) the tax base for said tax included the intangible expense paid, accrued or incurred by the taxpayer; and (3) the aggregate effective rate of tax applied to the related member is no less than the statutory rate applied to the taxpayer.
- C. If the taxpayer establishes by clear and convincing evidence that: (1) the intangible expense was paid, accrued, or incurred to a related member organized under the laws of a country other than the US; (2) the related member's income from the transaction was subject to a comprehensive income tax treaty between such

country and the US; (3) the related member's income from the transaction was taxed in such country at a tax rate at least equal to that imposed by the state; and (4) the intangible expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflected an arm's length relationship.

- D. If the corporation and tax commissioner agree in writing to the application or use of alternative adjustment or computations.

Further, a taxpayer is required to add back otherwise deductible interest paid, accrued or incurred to a related member during the taxable year. If the related member is subject to tax in this state or another state or possession of the US or a foreign nation, or combination thereof, on a tax base that includes the interest expense paid, accrued or incurred by the taxpayer, the taxpayer will receive a credit against tax due in the state.

Addback is not required and the aforementioned credit does not apply in the following situations:

- A. To the portion of the intangible expense where the taxpayer establishes by clear and convincing evidence that: (1) the transaction giving rise to the interest expense between the taxpayer and the related member was undertaken for a valid business purpose, and (2) the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.
- B. If the taxpayer establishes by clear and convincing evidence that: (1) the related member was subject to tax on its net income in the state or another state or possession of the US; (2) the tax base for said tax included the interest expense paid, accrued or incurred by the taxpayer; and (3) the aggregate effective rate of tax applied to the related member is no less than the statutory rate applied to the taxpayer.
- C. If the taxpayer establishes by clear and convincing evidence that: (1) the interest expense is paid, accrued, or incurred to a related member organized under the laws of a country other than the US; (2) the related member's income from the transaction was subject to a comprehensive income tax treaty between such country and the US; (3) the related member's income from the transaction was taxed in such country at a tax rate at least equal to that imposed by the state; and (4) the interest expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflected an arm's length relationship.
- D. If the corporation and tax commissioner agree in writing to the application or use of alternative adjustment or computations.

Alabama—A manufacturer was required to add back deductions for royalties it paid to related intangible management companies (IMCs) for use of the IMC's trademarks, because it did not qualify for either the unreasonableness or “subject-to-tax” addback exceptions. At issue in the case is the validity under Alabama's add-back statute (Ala. Code §40-18-35(b)) of the Department of Revenue's disallowance of deductions for the royalty payments VFJ made to Lee and Wrangler. Per the add-back statute, corporations must add back otherwise deductible intangible/interest expenses and costs directly or indirectly paid, accrued, or incurred to one or more related members, unless certain exceptions apply. A circuit court found in favor of VFJ, holding that “because add-back in VFJ's circumstances effectively denies it a deduction for a necessary cost of doing business in Alabama, thereby resulting in a calculation of taxable income that includes income fairly attributable to other states, add-back is unreasonable and thus not required for VFJ.” In reaching this conclusion, the circuit court concluded that the two IMCs were not sham or shell corporations, VFJ had a business purposes for making the royalty payments, and the payments had economic substance.

The Court of Civil Appeals reversed this ruling, finding that the circuit court erred in interpreting the unreasonable exemption to be determined by an analysis of business purpose and economic substance. During the time period at issue, the statute provided that add-back was not required when the corporation established that the adjustments are unreasonable. The statute did not define “unreasonable”. Prior to adopting a regulation interpreting the term “unreasonable”, the Department interpreted this exception as applying when the resulting tax would be “out of proportion” to the corporation’s presence in Alabama. The Department did not consider whether the transaction had a business purpose or economic substance. In agreeing with the Department’s interpretation, the Court found that the add-back statute was not enacted to address the problems with deductions based on sham transactions (i.e., those that lack a valid business purpose or economic substance). Rather, in enacting the add-back statute the legislature evidenced its intent to eliminate certain deductions for ordinary and necessary business expenses, subject to specific exceptions.

Moreover, allowing the “unreasonable” exception to be determined based only on a showing of business purpose or economic substance would effectively render the exception provided under Ala. Code §40-18-35(b)(3) ineffective as it requires a similar showing plus a showing the related member to whom the payment was made did not have as its primary business purpose the management of intangible assets. In order for the unreasonable exception to have its own effect and not be duplicative of the (b)(3) exception, it must be interpreted not to focus on a showing of business purpose or economic substance. Accordingly, the unreasonable

exception applies when the resulting tax would be out of proportion to the taxpayer's presence in the state.

The Court also rejected the taxpayer's argument that since the IMCs paid North Carolina income tax on a portion of its royalty income, the entire amount of federal taxable income the IMCs listed on their North Carolina returns was "subject-to-tax". To qualify for this exception, the items of income must be reported by the corporation for which those payments constitute income *and* that income must be included in income for purposes of a tax on net income. The income cannot be offset or eliminated in a combined or consolidated return that includes the payor. In other words, the Court concluded that this exemption applies on a post-apportionment and not a pre-apportionment basis.

Lastly, the Court found that the state's add-back statute did not violate the federal Due Process or Commerce Clause. VFJ argued that Alabama's add-back statute "is effectively an attempt" to tax the income of the IMCs and that the state lacked sufficient nexus with the IMCs to justify the imposition of that tax. The Court disagreed with this argument, finding that the statute does not effectively impose a tax on the IMCs. Rather it disallows deductions sought by VFJ, which has sufficient nexus with Alabama to justify its paying of corporate income tax in this state. In addition, the Court rejected VFJ's assertion that the add-back statute results in a tax that is not fairly apportioned to Alabama as it attempts to tax activity beyond that which is fairly attributable to its activities in the state. The evidence presented did not demonstrate that the application of the add-back statute resulted in taxation that is out of proportion to VFJ's activities in Alabama. *Surtees v. VFJ Ventures, Inc. f/k/a VF Jeanswear, Inc.*, No. 2060478 (Ala. Civ. App. Feb. 08, 2008), *aff'd*, *VFJ Ventures, Inc. f/k/a VF Jeanswear, Inc. v. Surtees*, No. 1070718 (Ala. Sup. Ct. Sept. 19, 2008), *cert. denied*, Dk. No. 08-916 (U.S. Sup. Ct. April 27, 2009).

Note that effective for all tax years beginning after December 31, 2006, new law clarifies the exceptions to the intangible/interest expense and cost related party addback provisions. First, the "subject to a tax based on or measured by the related member's net income" exception is clarified to provide that any portion of income not attributed to the taxing jurisdiction (determined by the jurisdiction's allocation and apportionment rules or other sourcing provisions) is not included in the income for purposes of a tax on net income and, therefore, is not considered to be subject to tax. Income that is attributed to a taxing jurisdiction that has a tax on net income is considered subject to a tax even if no actual tax is paid on the income in the taxing jurisdiction. Second, a new exemption provides that the addback requirement does not apply to the portion of interest/intangible expenses and costs that the corporation can establish

was paid, accrued or incurred, directly or indirectly, by the related member during the same taxable year to a non-related third party. Ala. Laws 2008 (1st Special Sess.), Act 543 (H.B. 62), enacted on June 9, 2008.

District of Columbia—New law (B18-433; B18-203) replaces related party royalty payment add back provisions under DC Code §47-1803-03(a)(19) with new, expanded interest/intangible add back provisions (DC Code §47-1803-03(d)(8)), effective for taxable years beginning after Dec. 31, 2008. The new provisions disallow a deduction for otherwise deductible interest/intangible expenses directly or indirectly paid to, accrued or incurred by, or in connection with, one or more transactions with a related member. The deduction will be allowed to the extent that the corporation establishes that:

- (1) the transaction giving rise to the payment of the interest/intangible expense between the corporation and the related member did not have as a principal purpose the avoidance or any portion of the tax due under title;
- (2) the interest and intangible expenses was paid pursuant to arm's length contracts at an arm's length rate of interest or price; and
- (3) (a) during the same taxable year, the related member directly or indirectly paid interest expense to, or the interest/intangible expense was accrued or incurred by, a person that is not a related member; or
- (3) (b)(i) the related member was subject to a tax measured by its net income or receipts in the District, a state or US possession, or a foreign nation that has entered into a comprehensive tax treaty with the US government;
- (b)(ii) a measure of the tax imposed by the District, a state or possession of the US, or a foreign nation that has entered into a comprehensive tax treaty with US government included in the interest/intangible expenses received by the related member from the corporation; and
- (b)(iii) the aggregate effective tax rate imposed on the amounts received by the related member is equal to or greater than 4.5%, provided that a related member receiving the interest or intangible payment is not considered to be subject to a tax merely by virtue of the related member's inclusion in a combined or consolidated return in one or more states.

The definition of "intangible expense" includes a loss related to or incurred in connection with factoring transactions or discounting transactions. The legislation was enacted on an emergency basis and expires Nov. 24, 2009. In order for this provision to become permanently effective, it must be enacted as part of the regular legislative process (i.e., approved by the DC Council Committee as a Whole, approved by the mayor, and then

reviewed by congress). D.C. Laws 2009, B18-583, B18-203.

Georgia—New Regulation 560-7-3-.05 provides guidance on statutory provisions that require add back of interest/intangible expenses and costs paid to related members (“related member costs”). In general, add back of all direct and indirect related member costs is required unless the taxpayer meets one of the exceptions. Taxpayers that are required to add back related member costs must complete Form IT-Addback. The final regulation provides examples of when related member costs are indirect and when the tax commissioner has the authority to reverse in whole or in part the add back adjustments (usually where there are unusual fact patterns that are unique and produce incongruous results or the proposed allocation/apportionment method would more clearly reflect income). The regulation also addresses: (1) when the exception for income allocated or apportioned to, and taxed by Georgia or another state, applies; (2) when the exception for expenses paid, accrued or incurred to a related member that is domiciled in a foreign nation applies; and (3) when the exception for expenses to a related member that paid, accrued or incurred expenses to a non-related person applies. The regulation takes effect June 28, 2009. Ga. Dept. of Rev., Regulation 560-7-3-.05 (filed and received by the Secretary of State on June 8, 2009).

Michigan—New law (S.B. 219) adds an exception to the related party intercompany add-back provisions, which require a taxpayer to add-back any royalty, interest or other expense paid to a related person to the taxpayer by ownership or control for the use of an intangible asset if the person is not part of the taxpayer’s unitary business group. Effective Oct. 1, 2009, add-back is not required if the taxpayer can demonstrate that the transaction has a nontax business purpose other than avoidance of the Michigan Business Tax, is conducted with arm’s-length pricing, rates and terms; and the related person is organized under the laws of a foreign nation that has in-force a comprehensive income tax treaty with the United States. Mich. Laws 2009, Act 105 (S.B. 219), signed by the Governor on Oct. 1, 2009.

Oregon—New law (S.B. 181) requires taxpayers to add back intangible expenses that are not included in the same state returns as the taxpayer and that have been paid, accrued or incurred in connection with one or more direct or indirect transactions with a related member. Taxpayers are allowed a credit against tax when a related member pays tax on income required to be added back; however, the credit does not apply to any portion of the intangible expense that the related member paid, accrued or incurred to a non-related member if the transaction giving rise to the expense was undertaken for a valid business purpose. For purposes of this provision, "intangible property" includes patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade

secrets, and similar types of intangible assets, while the term "intangible expenses" includes losses related to, or incurred in connection with, factoring or discounting transactions. These provisions apply to tax years beginning on or after Jan. 1, 2010. Or. Laws 2009, S.B. 181, signed by the Governor on June 18, 2009.

Virginia—The taxpayer was not allowed to exempt from addback 100% of the royalties paid to an affiliated entity and deducted on its federal tax return, but instead was limited to the amount of the affiliate's royalty income apportioned to each state in which the affiliate paid tax. Per Virginia law, intangible expenses and costs paid, accrued or incurred in connection with a transaction with a related member must be added back unless and to the extent an addback exception applies. One exception provides that addback is not required for any portion of the intangible expense if the corresponding item of income received by the related member is taxed by another state. The taxpayer argued that the plain meaning of the statute entitled it to exclude 100% of its royalty payments. In rejecting this argument, the Department of Taxation found that it could not reconcile this argument with the legislature's use of the limiting words "portion" and "corresponding item". The Department explained that "the exemption does not apply to the gross amount of payments that a taxpayer made to an affiliate merely because the gross amount is shown on another state's return. Instead, the exception is limited to the portion of a taxpayer's royalty payments to its affiliate that correspond to the portion of the affiliate's income subjected to tax in other states, as evidenced by the apportionment percentages shown on the affiliate's tax returns filed with other states." The Department also rejected the company's argument that Virginia's addback statute violates the Due Process and Commerce Clauses. Va. Dept. of Rev., PD 09-49 (April 27, 2009).

Virginia—A taxpayer was not entitled to a refund of tax attributable to related party intangible expenses added back to taxable income because the taxpayer's intangible holding company ("IHC") did not receive more than 70% of its gross revenue from license fees paid by independently owned franchisees. The taxpayer and franchisees entered into a licensing agreement with the IHC for the use of its trademarks and trade names. Each franchisee pays a monthly percentage of sales to the taxpayer. The taxpayer remits a percentage of this payment to the IHC. The Department of Taxation determined that these passed through revenues constituted more than 70% of the IHC's total revenues. However, had the franchisees directly remitted the royalty payments to the IHC, the unrelated entity exemption would have applied in this case. Since the sample franchise agreement is a contract between the taxpayer and franchisee, the IHC did not engage in licensing intangible property to the unrelated franchisees. Va. Dept. of Taxn., Rulings of the Tax Comm'r 09-14 (Feb. 4, 2009).

West Virginia—New law (S.B. 540) requires the add back of otherwise deductible interest/intangible expenses if the expense is directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members. Addback is not required if specific criteria is met. For example, addback of intangible expense is not required to the extent that the corporation establishes by clear and convincing evidence that: (a) the related member during the same taxable year directly or indirectly paid, accrued or incurred the intangible expense to a non-related member; and (b) the transaction giving rise to the expense between the taxpayer and the related member was undertaken for a valid business purpose. Similarly, interest expense will not have to be added back when the taxpayer establishes by clear and convincing evidence that: (a) the transaction giving rise to the interest expense was undertaken for a valid business purpose; and (b) the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship. W.V. Laws 2009 (S.B. 540), signed by the Governor on May 7, 2009.

Wisconsin—Effective for tax years beginning on and after January 1, 2009, a corporation when determining “net income” is required to add back the amount deducted or excluded for intangible expenses and management fees paid to a related entity (note that these provisions already apply to interest and rental expenses – see below for discussion of these provisions). The corporation would subtract the amount added back to the federal income of a related entity that paid intangible expenses or management fees. Addback is not required if certain conditions are satisfied, including having a business purposes other than the avoidance or reduction of state income or franchise taxes, or subsequent payments to an unrelated party (conduit exception).

For purposes of this provision, “intangible expenses” include: (1) expenses, losses, and costs for, related to, or directly or indirectly in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property; (2) losses related to, or incurred in connection directly or indirectly with, factoring or discounting transactions; (3) royalty, patent, technical and copyright fees; (4) licensing fees; and (5) other similar expenses, losses and costs.

Management fees includes expenses and cost related to accounts receivable, accounts payable, employee benefit plans, insurance, legal issues, payroll, data processing, purchasing, taxation, financial matter, securities, accounting or reporting and compliance matters. Wis. Laws 2009, Ch. 2 (S.B. 62), enacted Feb. 19, 2009.

Interest and Rental Expenses and Costs Addback Provisions

New law (A.B. 1) creates related entity addback provisions for franchise and corporate and individual income tax purposes. Specifically, a taxpayer is required to addback the amount deducted or excluded under the IRC for interest expenses and rental expenses that are directly or indirectly paid, accrued or incurred to, or in connection with one or more direct or indirect transactions with a related entity. Addback is not required if certain conditions are satisfied, including having a business purposes other than the avoidance or reduction of state income or franchise taxes. The term "rental expense" means gross amounts that would otherwise be deductible for the use of, or the right to use, real property and tangible personal property in connection with real property, including services furnished or rendered in connection with such property, regardless of how reported for financial accounting purposes and regardless of how computed. Interest expense is defined in the bill as interest otherwise deductible under IRC §163 and Wisconsin tax law. These provisions are effective for taxable years beginning on or after January 1, 2008. Wis. Law 2008 (March 2008 Special Session), A.B. 1, enacted May 19, 2008.

The Department of Revenue issued guidance on its new addback provisions. The guidance provides a description of the transactions affected by the new provisions, defines "related entity", discusses the requirements that must be met in order to deduct related party interest or rent expenses, and provides details and examples of what is considered a "related entity". Wis. Dept. of Rev., Release: Addback of Related Party Interest and Rent Expense (June 19, 2008).

The Department of Revenue recently issued responses to frequently asked questions regarding the new related entity interest and rental expenses addback provisions, which are effective for taxable years beginning on or after Jan. 1, 2008. The answers provide insight as to which taxpayers are subject to addback, what expenses are subject to addback, what conditions are necessary in order for a taxpayer to be able to deduct expenses added back, and what constitutes nondeductible related entity expenses. Wis. Dept. of Rev., Wis. Tax Bulletin 158 (Oct. 2008).

The Department of Revenue recently released instructions for the 2008 Schedule RT, which is filed by a taxpayer or pass-through entity which claims a deduction on a Wisconsin income or franchise tax return for certain expenses paid, accrued, or incurred to a "related entity" if those expenses exceed \$100,000. The Schedule RT applies to tax years beginning on or after Jan. 1, 2009. Those taxpayers that fail to timely file a Schedule RT are not permitted to take a Wisconsin deduction for related entity interest expense or rental expense. Those taxpayers and pass-through entities required to file a Schedule RT include individuals, corporations, S corporations, partnerships, LLCs, insurance companies, and fiduciaries. Those entities which pay, accrue, or incur expenses to a

related entity must complete a Schedule RT. The partners, members, shareholders, or beneficiaries of these entities, however, are not required to file the Schedule RT for their share of the related entity expenses. The Schedule RT is necessary because a new law provides that a taxpayer or pass-through entity that directly or indirectly pays, accrues, or incurs interest expense or rental expense to a related entity and deducts the expense on a federal income tax return must make an addition to Wisconsin income to reverse out the expense. For expenses that are added back in this manner, the taxpayer or pass-through entity must then file the Schedule RT to obtain a Wisconsin deduction for those expenses. In addition, the instructions define "related entity", list factors for related entity expenses in general, list factors specific to related entity interest expenses, and highlight issues regarding transactions involving REITs. Wis. Dept. of Rev., Instructions for 2008 Schedule RT (Dec. 2008). See also Wis. Dept. of Rev., "Additional Guidance for Disclosing Related Entity Expenses," (March 4, 2009).

B. States' Decoupling from Specific Federal Provisions

In general, states may approach this federal conformity in one of several ways. Some states define "state taxable income" as federal taxable income plus or minus certain additions or subtractions, while other states may define certain terms, like income, deduction, etc. as being the same as defined in the IRC. In either event, states adopt a "federal conformity date" in order to determine which federal provisions apply for state tax purposes. Currently twenty-one states¹⁷ adopt a "rolling" conformity date and, as such, automatically conform to the IRC as enacted. Accordingly, these states have adopted federal changes and, if so desired, would have to specifically decouple from federal changes. In contrast, another twenty-one states¹⁸ use a fixed or static IRC conformity date, only incorporating changes to the IRC that occurred as of a certain date. Thus, in order for these states to adopt a federal law change to the IRC, these states would have to update their IRC conformity date. The remaining five states¹⁹ with an income tax use a selective approach and adopt only specific provisions of the IRC.

Below are recently enacted federal law changes that states have decoupled from.

¹⁷ States with a rolling conformity date are: Alabama, Alaska, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Rhode Island, Tennessee, and Utah,

¹⁸ States with a fixed or static IRC conformity date are: Arizona, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, New Hampshire, North Carolina, Ohio, Oregon, South Carolina, Texas, Vermont, Virginia, West Virginia, and Wisconsin.

¹⁹ States with a selective conformity are: Arkansas, California, Mississippi, New Jersey, and Pennsylvania.

American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009, provides a 50% bonus depreciation deduction for assets purchased during the 2009 calendar year (IRC §168k), extends the increased expensing limit of \$250,000 and the phase-out of \$800,000 in qualified purchases in 2009 contained in IRC §179, and allow companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010 (IRC §108(i)).

States that decouple from the provisions of the ARRA

Connecticut—New law (S.B. 2001) decouples the state's income tax provisions from IRC §108(i). Under IRC §108(i) companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Conn. Laws 2009 (Special Session), S.B. 2001, signed by the Governor on June 26, 2009.

District of Columbia—New law (B18-433, B18-403) decouples from IRC §108(i). Under IRC §108(i) companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Provisions of the bill require computations of discharge of indebtedness income under §108(i) be excluded when computing District income tax. The legislation was enacted on an emergency basis and expires Nov. 24, 2009. In order for this provision to become permanently effective, it must be enacted as part of the regular legislative process (i.e., approved by the DC Council Committee as a Whole, approved by the mayor, and then reviewed by congress). D.C. Laws 2009, B18-433, B18-403.

Florida—New law (S.B. 2504) updates the state's conformity to the IRC by adopting the IRC as amended and in effect on Jan. 1, 2009. Provisions of the bill, however, decouple from the 2009 bonus depreciation provisions under IRC §168(k), the increased expense limitations under IRC §179, and the deferral of the recognition of cancellation of indebtedness income on debt instruments reacquired in 2009 or 2010 under IRC §108(i), enacted as part of the American Recovery & Reinvestment Act of 2009. These provisions apply retroactively to Jan. 1, 2009. Fl. Laws 2009, Ch. 192 (S.B. 2504), signed by the Governor on June 16, 2009.

Hawaii—New law (S.B. 971) conforms state income tax laws to the IRC as amended as of Dec. 31, 2008, but decouples from the 2008 bonus depreciation under IRC §168(k) and increased expense limitations under IRC §179, enacted under the Emergency Economic Stabilization Act of

2008 (EESA). In addition, due to the date the state conforms to the IRC, it does not adopt the provisions enacted as part of the American Recovery & Reinvestment Act of 2009. Further, the provision of the EESA that allows the sale or transfer of certain preferred stock in Fannie Mae and Freddie Mac to be treated as an ordinary loss are not operative for state income tax purposes. Rather, the sale or exchange of such stock is to be treated as a sale of a capital asset. Provisions of the bill take effect July 1, 2009. Haw. Laws 2009, Act 133 (S.B. 971), enacted on June 18, 2009.

Indiana—New law (H.B. 1001) updates the date of conformity to the IRC to the IRC in effect on Feb. 17, 2009, but decouples from various provisions, including the 2008 and 2009 bonus depreciation (IRC §168(k)) and increased expensing (IRC §179) provisions enacted under the Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2009 (ARRA), and the five year NOL carryback for small businesses enacted under the ARRA. Additionally, the state decouples from IRC §108(i), which allows companies (regardless of whether they are insolvent or in bankruptcy) to make an election to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Ind. Laws 2009 (special session), Pub. Law 182 (H.B. 1001), enacted June 30, 2009.

Maine—New law (L.D. 353) updates the date of conformity to the IRC from Feb. 13, 2008 to Feb. 17, 2009, but decouples from various provisions enacted as part of the federal American Recovery and Reinvestment Act of 2009. Specifically, the state decouples from the bonus depreciation under IRC §168(k) for property placed in service after 2008, and, for tax years 2009 and 2010, the deferred discharge of indebtedness provisions under IRC §108(i). Maine Laws 2009, Ch. 213 (L.D. 353), signed by the Governor on May 28, 2009.

Maryland—New law (H.B. 101) decouples from recently enacted provisions under the federal American Recovery and Reinvestment Act of 2009. Specifically, provisions of the bill decouple from the bonus depreciation provisions under IRC §168(k), the increased expense provision under IRC §179, the five year net operating loss carryback election under IRC §172, and the deferral of discharge of indebtedness income under IRC §108(i). Decoupling applies for both corporate and individual income tax purposes. MD Laws 2009, Ch. 487 (H.B. 101), signed by the Governor on May 19, 2009.

Massachusetts—New law (H. 4129) decouples the state's income tax provisions from IRC §108(i). Under IRC §108(i) companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt

instruments reacquired in 2009 or 2010. Mass. Laws 2009, H. 4129, signed by the Governor on June 29, 2009.

Minnesota—New law (H.F. 1298) updates the date of conformity to the IRC from Dec. 31, 2008 to March 31, 2009, but decouples from certain provisions enacted under the federal American Recovery and Reinvestment Act of 2009. Specifically, provisions of the bill decouple from the bonus depreciation provisions and increased expense limitation, requiring taxpayers to add back 80% of the bonus depreciation allowed under IRC §168(k) and 80% of the increased expenses allowed under IRC §179. The bill also decouples from the IRC §108(i), which allows companies (regardless of whether they are insolvent or in bankruptcy) to elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Minn. Laws 2009, Ch. 88 (H.F. 1298), signed by the Governor on May 16, 2009.

New Jersey—New law (A.B. 4105) decouples from IRC §108(i), which allows companies (regardless of whether they are insolvent or in bankruptcy) to elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Taxpayers are required to report this income in the year that it is earned, and will be able to exclude this income from New Jersey taxable income when it is recognized for federal tax purposes. N.J. Laws 2009, A.B. 4105, signed by the Governor on June 29, 2009.

North Carolina—New law (S.B. 202) updates North Carolina's conformity to the IRC's personal and corporate income tax rules in effect as of May 1, 2009 with certain exceptions. Specifically, North Carolina decouples from the bonus depreciation in IRC §168(k) and the disaster-related property bonus depreciation in IRC §168(n). Taxpayers must add back 85% of bonus depreciation claimed on the federal return, but can make an adjustment equal to 20% of the bonus depreciation added back over the first five taxable years beginning on or after Jan. 1, 2009. Provisions of S.B. 202 also decouples the state's income tax provisions from IRC §108(i). Under IRC §108(i) companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Lastly, the bill decouples from IRC §163(e)(5)(F), and requires the add back of the amount allowed as a deduction for an original issue discount on an applicable high yield discount obligation. N.C. Laws 2009, Sess. Law 2009-451 (S.B. 202), signed by the Governor on Aug. 7, 2009.

Oklahoma—New law (S.B. 318) decouples from certain provisions enacted under the American Recovery & Reinvestment Act (ARRA) of 2009, specifically those related to net operating loss (NOL) carrybacks,

bonus depreciation, and increased expense limitation. For tax years beginning after Dec. 31, 2007 and ending before Jan. 1, 2009, NOLs can be carried back two years (the ARRA provides for a five year carryback for small businesses). For tax years thereafter, the amount of time an NOL can be carried back will be determined solely by reference to IRC §172. Provisions of the bill also decouple from the 2009 bonus depreciation under IRC §168(k), for assets placed in service before Jan. 1, 2010. In addition, for tax years beginning on or after Jan. 1, 2009 and ending on or before Dec. 31, 2009, taxpayers are required to add to Oklahoma taxable income any amount in excess of \$175,000, which has been deducted as a small business expense under IRC §179. Ok. Laws 2009, S.B. 318, signed by the Governor on May 26, 2009.

Oregon—New law (H.B. 2078) updates Oregon's conformity date to the IRC from Dec. 31, 2008 to May 1, 2009 with certain exceptions. Specifically, Oregon decouples from the bonus depreciation under IRC §168(k) and the increased expense deduction under IRC §179, enacted under the ARRA. Provisions of H.B. 2078 also decouple the state's income tax provisions from IRC §108(i). Under IRC §108(i) companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. Or. Laws 2009, H.B. 2078, enacted Aug. 5, 2009.

Rhode Island—New law (H.B. 5983A - Art. 16) decouples state income tax provisions from IRC §108(i). Under IRC §108(i) companies (regardless of whether they are insolvent or in bankruptcy) can elect to defer until 2014 recognition of cancellation of indebtedness (COD) income on debt instruments reacquired in 2009 or 2010. For Rhode Island tax purposes, such income is added back to federal income in the year it occurred. When claimed as income on a future federal return, said income is reported as a modification decreasing federal income to the extent it had been added back. R.I. Laws 2009, H.B. 5983A, signed by the Governor on June 30, 2009.

Vermont—New law (H. 441) moves forward the date of the state's conformity to the IRC to the IRC in effect for taxable year 2008. Thus, Vermont does not adopt the federal changes enacted under the American Recovery and Reinvestment Act of 2009. This change applies to taxable years beginning on or after Jan. 1, 2008. Vt. Laws 2009, H. 441, enacted over governor's veto on June 2, 2009.

Wisconsin—New law (A.B. 75) adopts the IRC in effect Dec. 31, 2008, but not adopt various federal acts including the Economic Stimulus Act of 2008, the Emergency Economic Stabilization Act of 2008, or the American Recovery & Reinvestment Act of 2009. Wis. Laws 2009, Act 28 (A.B. 75),

signed by the Governor on June 29, 2009.

States that conform to provisions of the ARRA

Idaho—New law (H.B. 281) moves forward Idaho's conformity to the IRC from Jan. 1, 2009 to Feb. 17, 2009. Accordingly, the state adopts provisions of the American Recovery and Reinvestment Act of 2009 (ARRA), including the election to defer recognition of cancellation of indebtedness income on debt instruments repurchased in 2009 or 2010 under IRC §108(i), the extension of the 50% bonus depreciation provision under IRC §168 for property placed in service in 2009 and the increased expense limitations under IRC §179, the increase exclusion for capital gains from the sale of certain small businesses, and the temporary reduction of S Corporation built-in gain recognition period. This provision is retroactively effective to Jan. 1, 2009. Idaho Laws 2009, Ch. 228 (H.B. 281), signed by the Governor on April 23, 2009.

Ohio—New law (H.B. 1) moves forward Ohio's conformity date to the IRC from Dec. 30, 2008 to July 17, 2009. Taxpayers with a taxable year ending after Dec. 30, 2008 but before July 17, 2009 may elect to apply the federal law as it existed before Dec. 30, 2008. If the taxpayer files a report or return that incorporates the provisions of the IRC or other laws of the U.S. applicable for federal income tax purposes for that taxable year but does not include any adjustments to reverse the effects of any differences between those provisions and the provisions that would otherwise apply, the taxpayer will be deemed to have made an irrevocable election for that taxable year. Ohio Laws 2009, H.B. 1, enacted July 17, 2009.

West Virginia—New law (S.B. 329 and S.B. 410) updates the state's conformity to the IRC and adopts the federal law in effect after Dec. 31, 2007 but before Feb. 18, 2009. Thus, West Virginia adopts federal legislation enacted in 2008 and early 2009, including the Emergency Economic Stabilization Act of 2008, the Worker, Retiree, and Employer Recovery Act of 2008, and the American Recovery and Reinvestment Act of 2009 (which contains the bonus depreciation and delayed recognition of certain cancellation of debt income provisions). These changes are retroactive to the extent allowable under federal law. No amendments to the laws of the U.S. made on or after Feb. 18, 2009 will be given any effect. W. Va. Laws 2009, S.B. 329 and S.B. 410, signed by the Governor on April 1, 2009.

Economic Stimulus Act of 2008

The Economic Stimulus Act of 2008 ("2008 Act"), provides a 50% bonus depreciation deduction on purchases of certain assets and would double the Section 179 expensing limit to \$250,000. Both provisions apply only for eligible assets purchased during calendar 2008.

States disallowing the bonus depreciation deduction include: Alabama, the District of Columbia, Georgia, Hawaii, Iowa, Maine, Michigan, Minnesota, New Jersey, New York, Rhode Island, South Carolina, Utah, and Vermont.

Other states have recently enacted legislation which requires a certain percentage of the amount deducted be added back. **North Carolina** requires that 85% of the bonus depreciation deduction be added back, while both **Minnesota** and **Oklahoma** require that 80% be added back. **Connecticut** requires that the taxpayer add-back the amount of the stimulus depreciation deduction, and subtract the difference between the amount of MACRS depreciation allowed for state corporation business tax purposes and the amount allowed for federal purposes. **Florida** requires an initial add back but then allows the deductions to be taken over a seven year period.

States allowing the bonus depreciation deduction include: Arizona, Idaho, Louisiana, Ohio, and West Virginia.

American Jobs Creation Act of 2004

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (P.L. 108-357 (H.R. 4250)), provisions of which allow a deduction for domestic manufacturing activities (IRC §199).

The following states have decoupled from, or do not conform to, IRC §199: Arkansas, California, Connecticut, District of Columbia (decoupled in 2008), Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Michigan (2008), Mississippi, Minnesota, New Hampshire, New Jersey, New York (decoupled in 2008), North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Texas, West Virginia, and Wisconsin.

The following states have coupled to, or effectively conform to, IRC §199: Alabama, Alaska, Arizona, Colorado, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Michigan (provided that the taxpayer elects to use the IRC in effect for the current tax year), Missouri, Montana, Nebraska, New Mexico, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, and Virginia.

C. Net Operating Loss Deductions

Federal—New Law (H.R. 3548), the Worker, Homeownership, and Business Assistance Act of 2009, expands the net operating loss (NOL) carryback period to five years for 2008 or 2009 losses. The American Reinvestment and Recovery Act of 2009 extended the carryback period for 2008 NOLs from two years to five years for "eligible small businesses".

The new law expands that benefit by generally permitting companies, regardless of size, to elect to carry back "applicable net losses" up to five years, rather than the current two. For companies carrying an applicable NOL back five years, the bill limits the carryback amount to 50% of the company's taxable income for that year. The limit is not permanent, however, so companies can carry the remaining NOL forward. No limit applies to applicable NOLs carried back four or less years. The deadline for making the election is the extended due date of a company's federal income tax return for the last tax year beginning with 2009 (e.g., Sept. 15, 2010, for calendar-year corporations). Once made, the election is irrevocable. Further, Fannie Mae, Freddie Mac, companies benefitting from TARP, and members of the same affiliated group as those companies (as well as former members that were part of the affiliated group in 2008 or 2009) are not eligible to elect the five year carryback. Currently 29 states do not provide for an NOL carryback. Of the states that allow NOLs to be carried back, only six follow the federal carryback period. H.R. 3548 was signed by President Obama on Nov. 6, 2009.

Arizona—The Department of Revenue (DOR) has published guidance explaining that the state does not conform to the federal net operating loss (NOL) carry back provisions contained in the American Recovery and Reinvestment Act of 2009 (ARRA). The DOR noted that because the fixed conformity date only includes changes made in 2008, the ARRA provisions are not incorporated and that inclusion of the ARRA provisions will likely not be considered until the spring of 2010. The DOR suggested that individuals who amended their federal returns "hold off" on filing any Arizona amended returns for the carry back of the NOL until the Arizona legislature decides whether to adopt the ARRA. Taxpayers that do not want to wait may file Arizona amended returns based on the Internal Revenue Code in existence at the end of 2008 (i.e. the 2 year federal carryback period). Ariz. Dept. of Rev., *Treatment of 2008 Federal Net Operating Losses Carried Back Based on the American Recovery and Reinvestment Act of 2009* (Sept.17, 2009).

California—New law (A.B. 1452) suspends for two years the deduction for net operating losses (NOLs), but following the suspension those provisions are amended so that they conform to federal carry-back and carry-forward rules. A deduction for NOLs would not be allowed for any tax year beginning on or after Jan. 1, 2008 and before Jan. 1, 2010. The carryover period for any NOL, or NOL carryover that is not allowed due to the suspension, would be one year for losses incurred in tax years beginning on or after Jan. 1, 2008 and before Jan. 1, 2009, and two years for losses incurred in tax years beginning before Jan. 1, 2008.

These provisions do not apply to taxpayers with less than \$500,000 of net

business income for the tax year.

In addition, NOLs attributable to tax years beginning on or after Jan. 1, 2008, could be carried forward 20 years following the year of the loss (for tax years 2000 through 2007, NOLs may be carried forward for 10 years). NOL carrybacks would not be allowed for any NOLs attributable to tax years beginning before Jan. 1, 2011. NOLs attributable to tax years beginning on or after Jan. 1, 2011, could be carried back two years; however, for 2011 the amount of the carryback would be limited to 50% of the NOL. The amount of the carryback would be increased to 75% for 2012, with 100% allowable in 2013. NOLs could not be carried back to any tax year beginning before Jan. 1, 2009. Cal. Laws 2008, A.B. 1452, enacted Sept. 30, 2008.

Florida—Adopted amendments to Fla. Admin. Code § 12C-1.013 repeal provisions providing for a Florida separate return limitation year. These provisions were declared invalid in *Golden West Financial Corp.*, as they were an “invalid exercise of delegated legislative authority” because they “enlarged, modified, or contravened the specific provisions of law....” Also repealed are examples of how SRLY net operating loss carryovers are used in consolidated tax returns when members of the consolidated group apportion their income within and without Florida. The amended rule takes effect April 14, 2009. Fla. Dept. of Rev., Fla. Admin. Code § 12C-1.013, filed March 25, 2009.

Illinois—Taxpayers are required to reduce net loss and net operating loss carryovers (collectively NOLs) for state income tax purposes if they are required to reduce the federal NOL carryover because of excluded discharge of indebtedness income under IRC §108(b)(2)(A). The amount of the state reduction depends on the amount required to be reduced under 108(b)(2)(A) to the federal NOL carryover that is allocable to Illinois. The amount allocable to Illinois is determined by multiplying the federal reduction by the percentage of the taxpayer's total excluded discharge of indebtedness income that would have been allocated or apportioned to Illinois if the income had not been excluded. Ill. Dept. of Rev., IT 09-0028-GIL (Sept. 9, 2009).

Iowa—New law (S.B. 483) repeals net operating loss (NOL) carryback provisions, effective for tax years beginning on or after Jan. 1, 2009. For years beginning before Jan. 1, 2009, NOLs can be carried back for two years (three years if the NOL is incurred in a presidentially declared disaster area by a taxpayer engaged in a small business or in farming). NOLs can be carried forward 20 years. Iowa Laws 2009, S.B. 483, signed by the Governor on May 22, 2009.

Maine—New law (L.D. 353) suspends temporarily NOL deduction for tax

years 2009, 2010, and 2011. Taxpayers unable to deduct NOLs as a result of this suspension will be able to deduct the NOLs in any tax year beginning after Dec. 31, 2011, but only to the extent that the requirements for claiming a Maine NOL are met and the taxable year is within the allowable federal period for NOL carry-over plus the number of years that the NOL carry-over adjustment was not deducted as a result of the restriction. Maine Laws 2009, Ch. 213 (L.D. 353), enacted May 28, 2009.

Maine—New law (L.D. 2305) requires taxpayer when computing income to include 10% of the absolute value in excess of \$100,000 of any net operating loss (NOL) that pursuant to IRC §172 is being carried over for federal income tax purposes to the taxable year by the taxpayer. A subtraction in the amount equal to the value of any prior year addition is allowed to the extent that Maine taxable income is not reduced below zero, the taxable year is within the allowable federal carryover period plus one year, and the amount has not been previously used as a modification under this provision. This change applies to tax years beginning in 2008. Maine Laws 2008, P.L. Ch. 700 (L.D. 2305), enacted April 24, 2008.

The Maine Revenue Services recently issued guidance related to the state's modifications related to federal net operating losses for C-corporations. The guidance provides direction for addition and subtraction modifications for tax year 2000 (and earlier years) losses, tax year 2001 losses, and tax year 2002 (and subsequent years) losses. Finally, the guidance illustrates accounting for carryovers and recaptures in tax year 2008 and subsequent years. The guidance provides detailed examples. Maine Rev. Services, Guidance Document: "Maine Modifications Related to Federal Net Operating Losses – Examples" (Revised Dec. 2008).

New Jersey—New law (S. 2130) amends NOL provisions by increasing the carryover period from seven to 20 years. Specifically S. 2130 provides that an NOL for any privilege period ending after June 30, 2009 is an NOL carryover to each of the 20 privilege periods following the period of the loss. This change brings the state carryforward period in-line with the federal period as well as that of many other states. N.J. Laws 2008, P.L. 2008, c. 102 (S. 2130), enacted Nov. 24, 2008.

North Carolina—The Department of Revenue has indicated that it does not conform to the revised and expanded five year federal net operating loss carryback provisions enacted in November under the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA). The state's current IRC conformity date is May 1, 2009 and, as such, it does not include IRC provisions enacted on Nov. 6, 2009. Because there is a difference in federal and state law, the Department said it "will hold all amended returns filed under the provisions of the WHBAA pending the General Assembly's decision regarding the revised carryback provisions

for 2008 and 2009 NOLs." Taxpayers' claiming the NOL need to write at the top center of the amended return the federal provision the NOL is being claimed under -- either ARRA (the American Recovery and Reinvestment Act, provisions of which allowed small business to carryback NOLs from 2008 for up to five years) or WHBAA (the expanded provisions). N.C. Dept. of Rev., Important Notice on State Tax Treatment of 5-Year Carryback on 2008 and 2009 NOLs as Provided in the WHBAA (Nov. 23, 2009).

North Carolina—The Department of Revenue (DOR) issued a release reminding taxpayers that the recent update to the state's IRC conformity adopts the federal five-year net operating loss (NOL) carryback provisions contained in the American Recovery and Reinvestment Act of 2009 (ARRA) for 2008 NOLs. The DOR is now processing amended returns where the three, four, or five-year carryback election was made for both federal and state purposes. Taxpayers who filed amended returns where the entire 2008 NOL was carried back to tax years 2006 and 2007 for North Carolina purposes but the three, four, or five-year carryback election was made for federal purposes must file amended returns to carry the NOL to the same tax year as that elected for federal purposes as well as revising the previously filed 2006 and 2007 amended State returns. N.C. Dept. of Rev., Update on State Tax Treatment of 5-Year Carryback of 2008 NOL for Eligible Small Businesses (Aug. 14, 2009).

Pennsylvania—New law (H.B. 1531) expands the NOL limitation cap as follows:

- For tax years beginning on or after January 1, 2007 and before January 1, 2009, the cap is the greater of \$3 million or 12.5%;
- For tax years beginning after December 31, 2008 and before January 1, 2010, the cap is the greater of \$ 3 million or 15% of taxable income,
- For tax years beginning after December 31, 2009 and thereafter, the cap is the greater of \$3 million or 20% of taxable income.

Pa. Laws 2009, H.B. 1531, enacted Oct. 9, 2009.

Virginia—The Department of Taxation has clarified that while Virginia allows net operating losses (NOLs) be carried back two years, it does not conform to the five year NOL carryback provisions that were part of the American Recovery and Reinvestment Act (ARRA) of 2009. Currently, Virginia's date of conformity to the federal law is Dec. 31, 2008. Since the ARRA was not adopted until 2009, Virginia law does not recognize the extended carryback. Va. Dept. of Taxn., VATAXeSubscription Notice (Nov. 9, 2009).

Virginia—Net operating loss (NOL) generated by a taxpayer during the acquisition year or prior years are not subject to the separate return limitation year ("SRLY") limitations in determining amounts available for carry forward to a Virginia consolidated return. The taxpayer, a corporate parent of an affiliated group, acquired all of the stock of a company that had nexus in Virginia. The acquired company had been filing separate Virginia returns prior to the acquisition. In the year of acquisition, it filed a short year separate federal return, upon which it had a taxable loss. In years prior to the date of acquisition, the company filed as part of the taxpayer's federal consolidated return. Because neither the taxpayer nor any affiliated companies had nexus with Virginia in the year of acquisition, the acquired company filed a separate Virginia short year return that reflected NOL for the same post-acquisition period as the taxpayer's federal consolidated return.

The post-acquisition NOL generated by the acquired company in the post-acquisition short year are not subject to the SRLY limitations under Treas. Reg. sec. 1.1502-21(c) in determining the amount available as a carryforward to the taxpayer's Virginia consolidated return. In general, federal regulations provide that NOL carryovers and carrybacks of a member of an affiliated group arising in a SRLY may not exceed the amount of consolidated taxable income contributed by the entity generating the loss for the taxable year. SRLY limitations apply only to NOL carryovers and carryback in a SRLY year.

Thus, post-acquisition NOL generated by the acquired company are not subject to SRLY limitations in determining the amounts available for carry forward to a Virginia consolidated return because the acquired company satisfied the ownership requirements to be a member of the taxpayer's group. Moreover, because SRLY limitations apply to the corporation that had the ownership change, the SRLY limitation would apply to NOL carryovers of the acquired company and not the taxpayer. Va. Dept. of Taxn., Rulings of the Tax Commissioner PD 09-126 (Aug. 7, 2009).

D. Intercompany Transactions

Multistate—During its July 30-31, 2008 meeting, the Multistate Tax Commission gave final approval to its model statute on taxation of captive REITs. The statute provides that the dividends paid deduction allowed under federal law in computing net income of a REIT subject to federal income tax is added back in computing the tax imposed by "STATE X" if the REIT is a captive REIT. A captive REIT is defined as a REIT whose shares or beneficial interests are not regularly traded on an established securities market, and more than 50% of the voting power or value of the beneficial interests or shares are owned by or controlled, directly or

indirectly, or constructively, by a single entity that is: (1) treated as an association taxable as a corporation under the IRC; and (2) not exempt from federal income tax under IRC §501(a). Further, a REIT that is intended to be regularly traded on an established securities market and that satisfies certain federal requirements will not be deemed a captive REIT within the meaning of this provision. Keep in mind that MTC model statutes are only recommendations. In order for the statute to become effective in a state, a state must formally adopt it.

Arkansas—New law (H.B. 1480) requires a captive REIT to add back to Arkansas taxable income the amount of the dividends-paid deduction allowed for federal purposes. A captive REIT means a REIT the shares or beneficial interests of which are not regularly traded on an established securities market and more than 50% of the voting power or value of the beneficial interest or share of which are owned or controlled, directly or indirectly, or constructively, by a single entity that is: (1) treated as an association taxable as a corporation under the IRC, and (2) not exempt from federal income tax under IRC §501(a). For purposes of this provision, entities that are not considered an association taxable as a corporation under the IRC include: (1) a REIT other than a captive REIT; (2) a qualified REIT subsidiary, other than a qualified REIT subsidiary of a captive REIT; (3) a listed Australian property trust; and (4) a qualified foreign entity (i.e., a corporation, trust, association or partnership organized outside the jurisdiction of the US that meet certain criteria). This change is effective for tax years beginning on and after Jan. 1, 2009. Ark. Laws 2009, Act 372 (H.B. 1480), enacted March 10, 2009.

California—State law requires taxpayers to annually disclose deferred intercompany stock account (DISA) transactions. Generally, dividends between members of the same unitary combined reporting group (“unitary group”) that are paid from income included in the unitary combined report are eliminated for California tax purposes. There are, however, issues that may arise when there are distributions between members of the same unitary group. One issue relates to DISA. Regulation 25106.5-1 sets forth the manner in which a distributee corporation that is a member of the combined group must report and track non-dividend distributions in excess of its adjusted basis in the stock of the distributing subsidiary corporation. Disclosure of DISA account balances is accomplished through the filing of a completed Form 3726, which must be included with the 2008 original return and every year thereafter. Failure to make such disclosure gives the FTB the discretionary authority to require amounts in the undisclosed DISA accounts to be taken into account, in part or whole, in any year of such failure. Taxpayers that have not properly disclosed the DISA account balances for years 2001 through 2007, can meet the compliance requirements by submitting a Form 3726 for each of these years by May 31, 2009. Cal. FTB, Notice 2009-01 (Feb. 20, 2009).

Colorado—New law (H.B. 1093) adopts the Multistate Tax Commission's definition of real estate investment trust (REIT), captive REIT, regulated investment company (RIC) and captive RIC. A captive REIT/captive RIC is defined as a REIT/RIC which shares or beneficial interests are not regularly traded on an established securities market and which more than 50% of the voting power or value of the beneficial interest or shares are owned or controlled, directly, indirectly, or constructively, by a single entity that is: (1) treated as an association taxable as a corporation under the IRC; and (2) not exempt from federal income tax under IRC §501(a). Provisions of the bill also clarify that the net income of a REIT is the real estate investment trust taxable income of the REIT as computed for federal income tax purposes, and that the net income of a RIC is "investment company taxable income" of such corporation. These provisions took effect April 2, 2009. Colo. Laws 2009, H.B. 1093, signed by the Governor on April 2, 2009.

Georgia—New law (H.B. 379) requires the add-back of expenses and costs directly or indirectly paid, accrued, or incurred to a captive REIT. Add-back is required pre-apportionment or allocation. The amount required to be added back will be reduced, not below zero, to the extent the corresponding expenses and costs are received as income in an arm's length transaction by a captive REIT, and to the extent such income is allocated or apportioned and taxed by Georgia or another state that imposes a tax on or measured by the income of the captive REIT. A captive REIT is defined as a real estate investment trust, the shares or beneficial interests of which are not regularly traded on an established securities market, and more than 50% of the voting power or value of the beneficial interests or shares of the REIT are owned or controlled, directly, indirectly, or constructively, by a single entity that: (1) is treated as an association taxable as a corporation under the IRC; and (2) is not exempt from federal income taxation under IRC §501(a). For purposes of this provision, an association taxable as a corporation does not include a REIT other than a captive REIT, a qualified REIT subsidiary under IRC §856 other than a qualified REIT subsidiary of a captive REIT, a listed Australian property trust, or a qualified foreign entity. If a REIT does not become regularly traded on an established securities market within one year of the date on which it first became a REIT, it will be deemed not to have been regularly traded on an established market, retroactive to the date it first became a REIT. This provision is effective for taxable years beginning on or after Jan. 1, 2010. Georgia Laws 2009, Act 170 (H.B. 379), signed by the Governor on May 5, 2009.

Illinois—New law provided that for taxable years beginning after Dec. 31, 2008, the deduction for dividends paid to a corporation by a captive REIT must be added back. This provision is expanded by S.B. 783 to apply to

any shareholder as opposed to a corporation. In addition, S.B. 783 amends the dividend subtraction modification to make it clear that the dividend subtraction only applies with respect to a dividend from a captive REIT. S.B. 783 did not add any exceptions to the addition modification. As defined in 35 ILCS 5/1501(a)(1.5)²⁰, a captive REIT means a corporation, trust, or association:

- (1) that is considered a REIT for the taxable year under IRC §856;
- (2) the certificate of beneficial interest or shares of which are not regularly traded on an established market; and
- (3) of which more than 50% of the voting power or value of the beneficial interest or shares, at any time during the last half of the taxable year, is owned or controlled, directly, indirectly or constructively, by a single person.

In general, a captive REIT does not include a corporation, trust, or association of which 50% of the voting power or value of the beneficial interest or shares is owned or controlled by:

- A REIT other than a captive REIT; and
- A person exempt from tax under IRC §501 and who is not required to treat income received from the real estate investment trust as unrelated business taxable income under IRC §512.

Certain other entities, including listed Australian property trusts that meet specified criteria, are also excluded from the definition of captive REIT.

For purposes of this provision, the constructive ownership rules prescribed under IRC §318(A), as modified by §856(D)(5), apply in determining the ownership of stock, assets, or net profits of any person. Ill. Laws 2007, Pub. Act 95-0233 (S.B. 1544), enacted Aug. 16, 2007, as amended by Ill. Law 2008, Pub. Act 95-0707 (S.B. 783), enacted Jan. 11, 2008.

Indiana—New law amends the definition of captive REIT to provide that a captive REIT does not include a listed property trust or other foreign REIT that is organized in a country that has a tax treaty with the federal government governing the tax treatment of these trusts. Ind. Laws 2009 (special session), Pub. Law 182 (H.B. 1001), enacted June 30, 2009.

Massachusetts—A multistate company doing business in Massachusetts was not liable for excise tax on dividend income a subsidiary received in connection with "off-balance sheet" internal financing performed in preparation for an intercompany financing transaction and interest income received in connection with the third-party financing transaction. While the

²⁰ This definition of captive REIT includes the changes made by S.B. 783.

subsidiary has nexus with Massachusetts, the dividend and interest income it received does not have a sufficient connection with the subsidiary's in-state activities. Rather, the dividend and interest income were used to pay off third-party creditors in order to improve the company's financial credit rating, which in turn would reduce its borrowing costs. Taxation of this income would "lead to the taxation of extraterritorial values." *W.R. Grace & Co. v. Commissioner of Revenue*, No. C271787 (Mass. App. Tax Bd. April 6, 2009).

New Jersey—In response to the New Jersey Tax Court's decision in *UNB Investment Co., Inc., v. Director, Division of Taxation*, 21 N.J. Tax 354 (Tax 2004), in which the court agreed with the tax division's interpretation that dividends received from a REIT may not be deducted, but concluded that the Division could not deny taxpayers the dividends received deduction from REITs until regulations were promulgated which reflected this policy, the New Jersey Division of Taxation has promulgated such regulations. Specifically, the Department has amended Corporation Business Tax (CBT) regulation 18:7-5.2(i) and (ii) to provide that dividends received from a qualified REIT are not allowed to be included in a corporation's dividends received deduction (DRD). Thus, in conformity with federal law, REIT distributions are subject to the CBT. The amended rule became effective February 6, 2006 and does not apply to dividends paid before that date. **The rule expires September 1, 2009.**

Further, it should be noted that in response to a number of public comments, the Division removed language that would have taxed dividends received "directly or indirectly" from a REIT.²¹ The Division noted that as a result of this deletion, "taxpayers will not be required to trace REIT distributions through multiple tiers of an ownership chain."

New York—New law (A. 9807C /S.6807C) disallows the deduction for dividends paid by a captive REIT/RIC to any member of the affiliated group that includes the corporation that directly or indirectly owns over 50% of the voting stock of the captive REIT/RIC. This disallowance applies to taxable years beginning on or after January 1, 2008. **Note** that these provisions take effect immediately and apply to taxable years beginning after 2007 and before 2011, and ***are deemed to be repealed for taxable years beginning on or after January 1, 2011.*** N.Y. Laws 2008, Ch. 57 (A. 9807C/S.6807C), enacted April 23, 2008.

²¹ Specifically, the deleted language stated: "Any dividend received "directly or indirectly" from a REIT, for the taxable year in which the dividend is paid, is not treated as a dividend and is not included as part of the dividends received deduction otherwise available to the taxpayer in determining net income derived from business carried on in New Jersey. For purposes of this sub-subparagraph, "directly or indirectly" means whether or not the dividend passes through a subsidiary or affiliate of the taxpayer, the amount of the REIT distribution may not be included in the dividends received deduction, at any level."

North Carolina—The Department of Revenue has the authority to combine the earnings of taxpayer's retail stores with those of a wholly owned property company and a real estate investment trust (REIT) in order to present the "true earnings" of the taxpayer in North Carolina. The taxpayer - Wal-Mart Stores East, Inc.- operates retail stores in North Carolina. It wholly owned Wal-Mart Property Company, which owned all of the voting units of Wal-Mart Real Estate Business Trust. The trust leased the property it held to the taxpayer's retail stores. On its North Carolina tax return, the taxpayer deducted rent paid to the trust and subtracted amounts received as dividends from the property company. Trust on its North Carolina tax return deducted dividends it paid to the property company, consistent with the federal tax treatment of REITs.

Following an audit, the Department of Revenue assessed additional tax after it combined the earnings of the taxpayer with those of the property company and the trust. In making the assessment, the Department asserted that the income tax returns filed by the taxpayer did not disclose its true earnings, since it deducted rent it paid to its trust and reported dividends in a manner that lowered its state tax liability. The taxpayer challenged the assessment, arguing that the Department did not have the authority to force combine its earnings with those of the property company and of the trust.

In affirming a lower court ruling, the Court of Appeals found that N.C. Gen. Stat. §105-130.6 gives the Department the authority to combine entities if it finds that a report filed by a corporation does not disclose the true earning of the corporation on its business carried on in North Carolina. The court also rejected the taxpayer's arguments that the assessments violated various state and federal constitutional provisions. Lastly, the court upheld the imposition of the 25% penalty on understatements of tax liability because the taxpayer's understatement of tax was greater than 25 percent. *Wal-Mart Stores East v. Hinton*, No. COA08-450 (N.C. App. Ct. May 19, 2009).

North Dakota—New law (S.B. 2089) requires the add-back of the dividends paid deduction otherwise allowed under IRC §857 for captive REITs. A captive REIT means a real estate investment trust, the shares or beneficial interests of which are not regularly traded on an established securities market, and more than 50% of the voting power or value of the beneficial interests or shares of the REIT are owned or controlled, directly, indirectly, or constructively, by a single entity that is: (1) treated as an association taxable as a corporation under the IRC; and (2) not exempt from federal income taxation under IRC §501(a). For purposes of this provision, an association not taxable as a corporation includes a REIT other than a captive REIT, a qualified REIT subsidiary under IRC §856, a listed Australian property trust, and a qualified foreign entity. Note that if a

REIT does not become regularly traded on an established securities market within one year of the date on which it first became a REIT, it will be deemed not to have been regularly traded on an established market, retroactive to the date it first became a REIT. Such REITs are required to file an amended return reflecting the retroactive designation for any tax year or part-year occurring during its initial year of status as a REIT. This provision is effective for taxable years beginning after Dec. 31, 2008. N.D. Laws 2009, S.B. 2089, enacted April 22, 2009.

North Dakota—New law (H.B. 1392) allows an interest charge domestic international sales corporation (IC-DISC) without economic substance owned by individuals or pass-through entities to take a deduction for actual or deemed distributions to its owners. For purposes of this provision "without economic substance" means in that an IC-DISC subject to IRC §992 has elected to use intercompany pricing rules of IRC §994 instead of the rules under IRC §482. Pass-through entities include S corporations, cooperatives, general partnerships, limited partnerships, limited liability partnerships, trusts, or limited liability companies that for the application year are not taxed as corporations. This provision is effective for taxable years beginning after Dec. 31, 2008. N.D. Laws 2009, H.B. 1392, signed by the Governor on April 21, 2009.

Oklahoma—New law (S.B. 2034) requires a taxpayer to add back otherwise deductible rent and interest expenses paid to a captive REIT. For purposes of this provision, a captive REIT is defined as a REIT, the shares or beneficial interests of which are not regularly traded on an established securities market and more than 50% of the voting power or value of the beneficial interests or shares of which are owned or controlled, directly or indirectly, or constructively by a single entity that is treated as an association taxable as a corporation under the IRC and is not exempt from federal income tax under IRC §501(a). Provisions of S.B. 2034 specifies entities that are not "associations taxable as a corporation". Such entities include any REIT other than a captive REIT, any qualified REIT subsidiary under IRC §856(i) other than a qualified REIT subsidiary of a captive REIT, any listed Australian Property Trusts, and any qualified foreign entity. These provisions became effective on Jan.1, 2008. Okla. Laws 2008, Ch. 395 (S.B. 2034), enacted June 3, 2008.

Note: New law (S.B. 916) expands Captive REIT provisions enacted in 2008 by requiring the add-back of the dividends paid deduction otherwise allowed under federal law in computing net income of a captive REIT. A captive REIT is a real estate investment trust, the shares or beneficial interests of which are not regularly traded on an established securities market, and more than 50% of the voting power or value of the beneficial interests or shares of the REIT are owned or controlled, directly, indirectly,

or constructively, by a single entity that: (1) is treated as an association taxable as a corporation under the IRC; and (2) is not exempt from federal income taxation under IRC §501(a). For purposes of this provision, an association taxable as a corporation does not include a REIT other than a captive REIT, a qualified REIT subsidiary under IRC §856 other than a qualified REIT subsidiary of a captive REIT, a listed Australian property trust, or a qualified foreign entity. Note that if a REIT does not become regularly traded on an established securities market within one year of the date on which it first became a REIT, it will be deemed not to have been regularly traded on an established market, retroactive to the date it first became a REIT. Such REITs are required to file an amended return reflecting the retroactive designation for any tax year or part-year occurring during its initial year of status as a REIT. This provision is effective Jan. 1, 2010. OK Laws 2009, S.B. 916, enacted May 11, 2009.

Oregon—New rule 150-314.295 clarifies the situations in which a deduction for intercompany transactions will be disallowed. Per rule 150-314.295, the user of the intangible assets must add back the royalty or other intangible expense to federal taxable income and the owner of the intangible asset must subtract the royalty or other income from federal taxable income, when:

- (1) the intangible asset is owned by one entity and used by another for a royalty or other fee;
- (2) both the owner and the user are owned by the same interests;
- (3) the owner and the user are not included in the same Oregon return;
- and
- (4) the separation of ownership of the intangible asset from the user of the intangible asset results in either tax evasion or a computation of Oregon taxable income that does not clearly reflect Oregon business income.

Rule 150-314.295 took effect July 31, 2009.

Tennessee—New law (H.B. 2275/S.B. 2318) amends family owned noncorporate entity (FONCE) provisions to limit its applicability by redefining "passive income" to include only rents from residential property or farm property. Residential property includes any property leased or rented for residential purposes that includes not more than four residential units. "Farm property" does not include acreage used for recreational purposes. For excise tax purposes, taxpayers are required to add to their net earnings or net losses any amount in excess of reasonable rent that is paid, accrued or incurred for the rental, leasing, or comparable use of industrial and commercial property owned by an affiliate that is exempt from excise tax as an obligated member entity or FONCE. If the failure to make this adjustment is due to negligence, a penalty equal to 50% of the

amount of the adjustment will be imposed. For purposes of this provision, the term "reasonable rent" means rent that does not exceed 2% per month of the appraised value of the property. Tenn. Laws 2009, H.B. 2275/S.B.2318, signed by the Governor on June 25, 2009.

Virginia—New law (H.B. 2504/ S.B. 1147) requires captive real estate investment trusts (REITs) to add back the federal dividends paid deduction for the purpose of calculating Virginia taxable income. The add back is phased in over a two year period, with 50% of the deduction being added back in tax years 2009 and 2010, and the full add back applying for taxable years beginning on and after Jan. 1, 2011. A captive REIT is defined as a REIT that: (1) is not regularly traded on an established securities market; (2) more than 50% of the voting power or value of beneficial interests or shares of which, at any point in the last half the of the taxable year, is owned or controlled (directly or indirectly) by a single entity that is: (i) a corporation or an association taxable as a corporation under the IRC, and (ii) not exempt from tax under IRC §501(a); and (3) more than 25% of its income consists of rents from real property as defined in IRC §856(d). The following entities are not deemed to be a corporation or an association taxable as a corporation: any REIT that is not treated as a captive REIT; any REIT subsidiary under IRC §856 other than a qualified REIT subsidiary of a captive REIT; any listed Australian Property Trust; or any qualified foreign entity. Va. Laws. 2009, Ch. 426 (H.B. 2504) and Ch. 558 (S.B. 1147), enacted March 27, 2009.

West Virginia—New law (H.B. 4420) imposes the corporate net income tax on a RIC's/REIT's net income that is subject to federal income tax. In addition, the dividend paid deduction otherwise allowed by federal law in computing net income of a RIC/REIT must be added back when computing corporate net income tax unless the RIC is a qualified RIC or the REIT is either a qualified REIT or publicly traded REIT. A qualified RIC/qualified REIT is defined as any regulated company/REIT where no single entity owns or controls, directly or indirectly, constructively or otherwise, 50% or more of the voting power or value of the beneficial interests or shares of the company / trust, if the single entity is: (1) subject to the provisions of subchapter C; (2) not exempt from federal income tax under IRC §501; and (3) not a RIC as defined in section 3 of the Investment Company Act / a REIT as defined in this section or a qualified REIT under IRC §856(i). These provisions are effective Jan. 1, 2009. W. Va. Laws 2008, H.B. 4420, enacted March 28, 2008.

Note: New law (S.B. 540) replaces REIT/RIC dividend paid deduction addback provisions enacted in 2008 with new provisions and provides definitions for a captive REIT. These provisions apply to tax years beginning on and after Jan. 1, 2009, as do combined reporting provisions enacted in 2007. W.V. Laws 2009 (S.B. 540), enacted May 7, 2009.

E. Treatment/Classification of Alternative Taxes (i.e. CAT, MBT, Margins)

California—In Notice 2009-06 the California Franchise Tax Board (FTB) provides general guidance on whether the Texas Margin Tax is eligible for an Other State Tax Credit (OSTC) or allowed as a deduction when computing California franchise and income tax. The taxpayer's characterization of the Margin tax as a gross receipts tax, a gross income tax, or a net income tax will determine whether the Margin tax qualifies for an OSTC, which is intended to alleviate double taxation, or is deductible for state tax purposes. This determination will be made on a case-by-case basis. Cal. FTB, Notice 2009-06 (July 20, 2009).

Kansas—A recently released opinion letter provides guidance on the deductibility of certain items for corporate income tax purposes. Per KSA §79-32,138(b), state and local taxes imposed on or measured by income or fees in lieu of income tax are not deductible for Kansas corporate income tax purposes. To the extent these taxes are deducted on the federal return, they must be added back to the state corporate income tax return. According to the Dept. of Rev., the following taxes **are deductible**: (1) the net worth portion of the Ohio Franchise Tax; (2) the Ohio CAT; (3) the modified gross receipts portion of the Michigan Business Tax (MBT); and (4) the Texas Franchise Tax.

The following taxes, however, **are not deductible**: (1) the income based portion of the Ohio Franchise Tax; (2) the income based portion of the MBT; and (3) the Texas Revised Margins Tax if determined by deducting cost of goods sold or compensation from gross receipts. Kan. Dept. of Rev., Opinion Letter No. O-2009-005 (March 24, 2009).

Kansas—The Department of Revenue in response to an opinion letter has determined that the **new revised Texas Franchise Tax (i.e., the Margins Tax)** is based on income and, therefore, is "in the nature of an income tax." Accordingly, the Margins Tax is an addback modification for Kansas corporate income tax purposes and can also be claimed as a credit for taxes paid to another state. Kan. Dept. of Rev., Individual Income Tax Opinion Letter O-2008-004 (Sept. 2, 2008).

Massachusetts—A Massachusetts taxpayer is not entitled to the income tax credit allowed under G.L. c. 62 §6(a) for gross receipts based taxes paid to another jurisdiction because these taxes are based on gross receipts, not on net income. Examples of gross receipts based taxes include the Washington Gross Receipts Tax, the Texas Gross Margin Tax, and the Ohio CAT. Mass. Dept. of Rev., Directive 08-7 (Dec. 18, 2008).

A Massachusetts resident taxpayer who is a sole proprietor or a shareholder, partner or member of a pass-through entity is entitled to a credit against Massachusetts personal income tax for income taxes paid by the sole proprietor or the entity to another jurisdiction, provided the requirements of G.L. c. 62 §6(a) are met. The credit is allowed for an income tax, and not for other types of taxes, such as excise, property, or franchise taxes not in the nature of an income tax. If, however, the out-of-state tax computation begins with gross income as defined for federal income tax purposes, the tax is generally determined to be an income tax rather than a gross receipts tax. Further, a Massachusetts shareholder of an S corporation may claim the credit if the S corporation pays, or is obligated to pay an out-of-state tax, if the following additional conditions apply: (1) the tax is imposed by another state, territory or possession of the U.S or Canada; (2) the tax is measured by income earned by the S corporation, the distributive share of which is required to be included in the shareholder's Massachusetts gross income; (3) the S corporation does not deduct any portion of the tax from its income in computing net income available for distribution to shareholders; and (4) the tax is otherwise allowable as a credit under G.L. c. 62 §6(a). The credit will be allowed whenever an entity-level tax is paid in another state, if certain criteria are met. Finally, where an entity-level income tax based on an item of Massachusetts gross income is paid in another state by a partnership or pass-through entity and meets these same conditions, a credit will be allowed to the Massachusetts partners or members. Mass. Dept. of Rev., Directive 08-6 (Dec. 18, 2008).

Minnesota—State law requires an addition to federal taxable income for taxes based on net income paid to another state. Regarding taxes based on net income, taxes paid to another state that are not based on net income do not qualify for the credit under Minn. Stat. §290.06, subd. 22, nor the addition to federal taxable income under Minn. Stat. §290.01, subd. 19a(4) or subd. 19c(1). It is the Department of Revenue position that neither the Ohio CAT nor the Texas Margins Tax are taxes based on net income. Accordingly, these taxes do not qualify for the credit or addition. Minn. Dept. of Rev., Revenue Notice No. 08-08 (July 21, 2008).

South Carolina—In a recently released revenue ruling, the Department of Revenue provides guidance on taxes that are not allowed to be deducted in determining South Carolina taxable income. Taxes not allowed as a deduction and thus required to be added back when include: state/local income-based taxes imposed by South Carolina, other states, and out-of-state local governments; the District of Columbia Unincorporated Business Tax; the business income tax portion of the Michigan Business Tax; the New Hampshire Business Profits Tax; and the Texas Margin Tax. Taxes allowed as a deduction include: state franchise taxes based on capital

stock or net worth; state gross receipts taxes; Kentucky License Tax; the modified gross receipts tax portion of the Michigan Business Tax; the Ohio Commercial Activity Tax; and the Washington and West Virginia B&O taxes. S.C. Dept. of Rev., SC Rev. Ruling 09-10 (July 17, 2009).

Virginia—A corporation in computing its Virginia taxable income is not required to addback the new Texas Margin Tax. Virginia's modification provision requires an addition for net income taxes as well as taxes based on, measured by, or computed with reference to net income. The Department determined that the Margin Tax is not a tax based on, measured by or computed with reference to net income because it excludes most normal business expenses usually permitted in determining net income. Va. Dept. of Taxn., PD 08-169 (Sept. 11, 2008).

Wisconsin—A taxpayer when computing Wisconsin franchise or income tax may not deduct any component of either the Michigan Business Tax (MBT) or the Texas Margin Tax. These taxes, however, qualify for the credit for net income taxes paid to another state if the other requirements of the credit set forth in Wis. Stat. §71.01(7) are met. For the MBT, both the business income and modified gross receipts qualify for the credit. In regard to the Margin Tax, the credit applies regardless of which computation is used to compute the "margin". In addition, a Wisconsin resident shareholder, partner or member of a pass-through entity may claim a credit for his/her pro rata share of MBT or Margin Tax paid by the entity, provided that the income taxed by Michigan or Texas is considered income for Wisconsin. Wis. Dept. of Rev., Release "Wisconsin Tax Treatment of the New Michigan Business Tax and Texas Margin Tax" (Feb. 26, 2008).

F. Other Modifications

Alabama—In response to *AT&T Corp. v. Surtees*, the Department of Revenue (DOR) has published a proposed regulation that would eliminate the business privilege and corporate shares tax deduction for investments in entities doing business in Alabama. In *AT&T Corp. v. Surtees*, the Alabama Circuit Court held that the business privilege and corporate shares tax deduction statutes, which allow a deduction for investments in entities doing business in Alabama but not for investments in entities doing business in states other than Alabama, are facially discriminatory because the state could not show sufficient justification for the statutes. While the court found that the taxpayer was entitled to a deduction for its equity investments in all corporations and limited liability entities, and not just those doing business in Alabama, the DOR action would completely remove the deduction rather than allow taxpayers to take the deduction for all equity investments in corporations. A hearing will be held on Proposed Regulation 810-2-8-.08 on Oct. 13, 2009 at 10:00 am (ET).

Connecticut—New law (H.B. 6802), for tax years 2009 through 2011, imposes a 10% corporation surcharge, which is calculated without reduction for any credits against the tax. The surcharge is not imposed on companies whose corporation tax liability does not exceed the \$250 minimum tax, or on any companies whose gross income for the tax year was less than \$100 million. This \$100 million exception does not apply to companies filing a combined or unitary return. The surcharge is due and payable as part of each company's total tax for the year and applies to companies that pay tax on their net income and well as those that pay tax on their capital base. Ct. Laws 2009, Pub. Act 09-3 (H.B. 6802), became law without the Governor's signature on Sept. 8, 2009.

Delaware—New law (H.B. 267) increases the franchise tax by raising the tax from \$250 per \$1,000,000 of assumed capital value to \$350 per \$1,000,000 of capital value and raises the maximum tax from \$165,000 to \$180,000. The maximum tax on RICs is raised from \$75,000 to \$90,000. Additionally, the new law raises several fees payable to the Secretary of State. The franchise tax increases are effective for tax years beginning on or after Jan. 1, 2009. Del. Laws 2009, S.B. 267, enacted July 2, 2009.

Georgia—Gain realized by an out-of-state S corporation as a result of the deemed sale of its assets pursuant to an IRC §338(h)(10) election is subject to Georgia's corporate income tax. In reaching this conclusion, a Georgia Court of Appeals found that the S corporation had Georgia taxable income from the deemed sale because it received a tax benefit of a stepped-up basis in its assets which in turn allowed it to claim increased depreciation and amortization deductions, thereby reducing its Georgia tax liability. *Georgia Dept. of Rev. v. Trawick Construction Co.*, No. A08A2323 (Ga. Ct. App. Feb. 23, 2009), *cert. granted*, No. S09C1045 (Ga. Sup. Ct. June 29, 2009).

Illinois—Electricity is tangible personal property and, therefore, a public utility's sale of electricity qualifies it as a retailer for purposes of the personal property replacement income tax investment credit. Illinois allows a taxpayer to claim a credit against the personal property replacement income tax for investments in "qualified property", which includes property used in Illinois by a taxpayer primarily engaged in retailing (i.e., selling tangible personal property). A public utility engaged in the production and sale of electricity applied for the credit, asserting that the electricity is tangible personal property. Citing the Illinois Supreme Court's ruling in *Farrand Coal* an ALJ found that the general assembly did not intend to include electricity within the meaning of tangible personal property. An appellate court found the ruling in *Farrand Coal* dispositive and upheld the denial. In reversing the lower court's ruling, the Illinois Supreme Court held that electricity is tangible personal property and, as

such, the utility's business of selling electricity constitutes retailing, thereby qualifying it for the credit. In reaching this conclusion, the court stated that its analysis in *Farrand Coal* did not apply to this matter, because any conclusions regarding electricity in that case were pure dicta. *Exelon Corp. v. Illinois Dept. of Rev.*, No. 105582 (Ill. Sup. Ct. Feb. 20, 2009).

On July 15, 2009, the Illinois Supreme Court modified its opinion in *Exelon Corp.* to provide that the holding applies prospectively to taxes incurred, or tax credits sought, for the tax year 2009 and thereafter. The Court explained that "[r]etroactive application of this decision could cause uncertainty in state tax law in general and as applied to Exelon. Conversely, limiting this decision to an entirely prospective application permits the legislature to provide direction on the meaning of the statutory phrase 'tangible personal property.'" *Exelon Corp. v. Illinois Dept. of Rev.*, No. 105582 (Ill. Sup. Ct. modified July 15, 2009).

Note: New law (S.B. 256) effectively reverses the ruling in *Exelon Corp.* Under S.B. 256 the term "tangible personal property" has the same meaning as used in the Retailers' Occupation Tax Act, and for taxable years ending after Dec. 31, 2008, does not include the generation, transmission or distribution of electricity. Ill. Laws 2009, Pub. Act 96-0115 (S.B. 256), signed by the Governor on July 31, 2009.

Louisiana—New law (Act 476) eliminates the \$10 minimum corporate franchise tax for all existing corporations. The minimum tax is replaced with a \$10 initial tax for every newly taxable corporation. The provision is effective for franchise tax periods beginning on or after January 1, 2010. La. Laws 2009, Act 476 (H.B. 618), enacted July 9, 2009.

Louisiana—New law (S.B. 10) accelerates the phase-out of the debt-portion of the corporation franchise tax base by one year. Legislation enacted in 2004 phased out the debt-portion of the franchise tax base by 2012, but the new law does so by 2011. The portion of debt included in the taxable base for calendar year taxpayers will now be phased-out as follows:

- 2005 income/2006 franchise tax return -- 86% of total debt included;
- 2006 income/2007 franchise tax return -- 72% of total debt included;
- 2007 income/2008 franchise tax return -- 58% of total debt included;
- 2008 income/2009 franchise tax return -- 44% of total debt included;
- 2009 income/2010 franchise tax return -- 30% of total debt

- included;
- 2010 income/2011 franchise tax return and after -- no debt included.

In general, these provisions are effective for all taxable periods beginning on or after July 1, 2008. La. Laws 2008, 2nd Extraordinary Session, Act 10 (S.B. 10), enacted March 24, 2008.

Massachusetts—In affirming a Appellate Tax Board ruling, the Massachusetts Supreme Judicial Court held that a tax-free liquidation of a subsidiary corporation by its parent under IRC §332 did not result in a disposition of assets for purposes of the investment tax credit (ITC) under Mass. G.L. c. 63, §31A(e). Per §31A(e) when property for which ITC is to be taken is disposed of or ceases to be in qualified use prior to the end of the taxable year in which the credit will be taken, the ITC generated is subject to reduction. If, however, the ITC has already been claimed, it is subject to recapture. At issue in this case is whether there was a "disposition" for purposes of §31A following a §332 transaction. In finding in favor of the taxpayer, the Court held that in order for there to be a disposition, the taxpayer must "get rid of something... [there is a] transfer of property from one to another." In this case there was not a transfer of property to a third-party. Rather, the parent was merely continuing the subsidiary's activities with respect to the assets at issue. Because there was not a disposition of assets, the taxpayer is not required to recapture ITC previously taken and is entitled to have the proposed \$4,812,418 tax assessment abated. *Commissioner of Revenue v. The Gillette Company*, No. SJC-10298 (Ma. Sup. Judicial Ct. June 11, 2009).

Massachusetts—New law (H. 4904) adds a new provision (M.G.L. c. 63, §31M) that will require an adjustment for gain and loss to reflect the disparities between federal tax basis and Massachusetts tax basis. Effective for tax years beginning on or after January 1, 2009, this adjustment to the calculation of Massachusetts gross income would occur if federal taxable income contained any items of gain or loss related to disposals of property. Federal gross income would be increased by the excess of federal adjusted basis over the Massachusetts adjusted basis. Likewise, federal gross income would be decreased by the excess of Massachusetts adjusted basis over federal adjusted basis.

Such variances between state and federal tax basis may result from items such as bonus depreciation and differences in filing methodologies (*i.e.*, separate return vs. consolidated return). Prior law did not explicitly provide for an adjustment to federal taxable income for disparities in federal tax basis and Massachusetts tax basis. Thus, from a practical perspective, the new rule will require companies to keep closer track of the state basis of assets. Mass. Laws 2008, H. 4904, enacted July 3, 2008.

Michigan—Proposed bill (H.B. 5529) would repeal the Michigan Business Tax surcharge, which is 21.99% of the pre-credit, MBT tax liability, not to exceed \$6 million for any taxpayer in a single year. An alternative surcharge is imposed on financial institutions in the amount of 23.4% for tax years ending after December 31, 2008. For financial institutions the surcharge is not capped. The repeal would only be effective if the bills to expand the sales/use tax to include services (H.B. 5527 and H.B. 5528) are enacted. H.B. 5529 was introduced on Oct. 20, 2009.

Michigan—New law (S.B. 1038) amends and expands the list of items excluded from the definition of gross receipts to include certain proceeds, interest income, royalties, dividends, taxes, fees, surcharges and hedging transactions. These provisions are retroactively effective and apply to taxes levied on and after Jan. 1, 2008. Mich. Laws 2008, PA 433 (S.B. 1038), signed by the Governor on Jan. 9, 2009.

Michigan—H.B. 5408 imposes an annual surcharge on a taxpayer's Michigan Business Tax (MBT) liability. The surcharge is 21.99% of the pre-credit, MBT tax liability, not to exceed \$6 million for any taxpayer in a single year. An alternative surcharge is imposed on financial institutions in the amount of 27.7% for tax years ending after Dec. 31, 2007 and 23.4% for tax years ending after Dec. 31, 2008. For financial institutions the surcharge is not capped. The surcharge sunsets on Jan. 1, 2017 provided that in any of the three calendar years immediately preceding the 2017 year, the "Michigan personal income growth" exceeds 0%. Insurance companies are not subject to the surcharge. In addition, taxpayers subject to the financial institutions tax will not be subject to the surcharge if they are only authorized to exercise trust powers. Mich. Laws 2007, PA 145 (H.B. 5408), enacted Dec. 1, 2007.

Missouri—New law (H.B. 191) increases the outstanding shares and surplus threshold amount used to calculate the annual franchise tax from \$1 million to \$10 million, effective for taxable years beginning on or after Jan. 1, 2010. As of said date, the annual franchise tax equals one-thirtieth of one percent of the corporation's outstanding shares and surplus if the outstanding shares and surplus exceed \$10 million. If the corporation's outstanding shares and surplus do not exceed \$10 million, the corporation must state this fact on its annual report. Mo. Laws 2009, H.B. 191, signed by the Governor on June 4, 2009.

New Jersey—In affirming a Tax Court ruling, the appellate court held that the gain generated from the sale of stock under an IRC §338(h)(10) election was not operational income and was, therefore, not subject to taxation by New Jersey. The taxpayer—a Delaware corporation with a

commercial domicile and principal place of business in California—was a wholly owned subsidiary of McKesson Corporation (Parent) and engaged in the selling of bottled drinking water. Parent sold all of the stock of the taxpayer and made an IRC §338(h)(10) election to treat the sale of stock as a sale of assets. In ruling that the taxpayer was not required to include the gain as New Jersey income, the Court looked to other state decisions regarding "nonbusiness" income under UDITPA, since it believed that the New Jersey provisions on operational income were similar to the UDITPA definition of "business income". In this case, the gain from the sale of stock does not constitute operational income because no operational function of the taxpayer continued after the deemed sale of assets and liquidation. Further, Parent did not invest the proceeds of the sale in a business similar to that conducted by the taxpayer. *McKesson Water Products Company v. Director, Division of Taxation*, No. A-5423-06T3 (N.J. Ct. App. July 16, 2009).

New Jersey—A 4% surtax on Corporation Business Tax (CBT) liabilities (not on New Jersey allocated income). For periods ending on or after July 1, 2006 and before July 1, 2010 (previous sunset date of July 1, 2009), taxpayers must pay a surtax equal to 4% of the amount of the franchise tax liability remaining after the application of credits allowed against that liability other than credits for installment payments, estimated payments made with a request for an extension of time for filing a return, or overpayment from prior periods. N.J. Laws 2006, A. 4706, as amended by N.J. Laws 2009, A.B. 4105, signed by the Governor on June 29, 2009.

New York—Nonresident shareholders' gain from the sale of stock of the S corporation pursuant to an IRC §338(h)(10) deemed asset sale is not included in the nonresident's income for New York income tax return purposes. The nonresident shareholders of an S corporation sold their shares of stock in the S corporation to another corporation through an IRC §338(h)(10) deemed asset sale. The nonresident shareholders claimed the deemed asset sale on their New York nonresident income tax returns, which resulted in a loss due to basis offset. Following an audit, the Division of Taxation concluded that the nonresidents had improperly offset their gains from the deemed asset sale by their losses recognized upon the deemed liquidation of the S corporation. The Division subsequently issued notices of deficiency to each of the nonresident shareholders. On appeal, the New York Tax Appeals Tribunal found that the deemed asset sale is not valid at the state level and, as such, the gain from the deemed asset sale may not be included in the entire net income of the New York S corporation for purposes of determining its state franchise tax under Article 9-A. Because the deemed asset sale cannot be included in the entire net income of the S corporation, it may not be passed through, pro rata, as New York source income to the shareholders of the S corporation. Accordingly, the taxpayers' gain from the sale of stock in the S corporation

is not included as New York source income to them, since they are nonresident individuals. *In re: Petition of Gabriel S. and Frances B. Baum*, Nos. 820837 and 820838 (N.Y. Tax App. Trib. Feb. 12, 2009).

New York—New law reduces the Art 9-A corporation franchise tax rate imposed on the capital base from .178% to .15%, and also increases the current \$1 million tax liability cap for non-manufacturing corporations to \$10 million. Provisions of the bill retain the \$350,000 liability cap for manufactures, but limit its applicability to “Qualified New York manufacturers”. The increase in the tax liability cap for non-manufacturing corporations applies to taxable years beginning on or after January 1, 2008 but before January 1, 2011. The \$1 million cap is restored for tax years beginning on or after January 1, 2011. N.Y. Laws 2008, Ch. 57 (A. 9807C/S.6807C), enacted April 23, 2008.

New York City—New law (A. 8867) adopts numerous measures to conform the New York City tax law to recent changes made by New York State. Key provisions of the bill: (1) increase the capital tax ceiling (amount of tax computed on allocated business and investment capital for general corporation tax purposes) from \$350,000 to \$1 million, effective for tax years beginning after 2008; and (2) replace the \$300 fixed dollar minimum tax with a scaled rate based on New York City receipts. Effective for tax years beginning after 2008, the amount of tax would range from \$25 for New York City receipts of less than \$100,000 and \$5,000 for receipts over \$25 million. Effective for tax years beginning on or after Jan. 1, 2009. N.Y. Laws 2009, ch. 201 (A. 8867), enacted July 11, 2009.

North Carolina—New law (S.B. 202) imposes a surtax on corporate and personal income taxes for tax years 2009 and 2010. The corporate income surtax is imposed at a rate of 3% and is based on the amount of tax payable by the corporation. Tax payable is calculated by multiplying apportioned North Carolina taxable income by the North Carolina corporate income tax rate (currently 6.9%). The surtax is not imposed on North Carolina corporate franchise tax. The personal income surtax is imposed at the following rates: 2% for joint returns with income between \$100,000 and \$250,000 or single filers with income between \$60,000 and \$150,000. The surtax is increased to 3% for those with incomes above \$250,000 (joint return) and \$150,000 (single). There are additional threshold amounts for heads of households and married filing separately. The surtax expires for taxable years beginning on or after Jan. 1, 2011. N.C. Laws 2009, Sess. Law 2009-451 (S.B. 202), enacted Aug. 7, 2009.

Oregon—New law (H.B. 3405) amends the corporate minimum tax provisions and raises the corporate excise tax rate. Effective for tax years beginning on or after Jan. 1, 2009, the corporate minimum tax imposed on C corporations ranges from \$150 (for corporations with Oregon sales of

less than \$500,000) up to \$100,000 (for corporations with \$100 million or more in Oregon sales). If the corporation is an S corporation, the minimum tax is \$150. In addition, a \$150 minimum tax is imposed on each partnership transacting business in Oregon. For tax years 2009 and 2010, the corporate excise tax rate is 6.6% of the first \$250,000 of taxable income and 7.9% of any amount in excess of that amount (decreased to 7.6% for 2011 and 2012). Beginning in 2013 the tax rate is 6.6% of the first \$10 million of taxable income and 7.6% of any amount in excess of that amount. Or. Laws 2009, H.B. 3405, enacted July 20, 2009.

Pennsylvania— Effective for taxable years beginning after December 31, 2009, the definition of “capital stock value” is amended by increasing its fixed formula valuation deduction from \$150,000 to \$160,000. Provisions of H.B. 1531 also decelerate the phase-out of the Capital Stock and Foreign Franchise Tax, which was scheduled to sunset in 2011. Beginning January 1, 2009, the tax rate will remain at 2.89 mills instead of reducing to 1.89 mills. The 2.89 mills rate will apply through Dec. 31, 2011, and then it will decrease until it is completely phased out in 2014.

The new phase-out schedule is as follows:

- January 1, 2008 through December 31, 2011 - rate of 2.89 mills
- January 1, 2012 through December 31, 2012 - rate of 1.89 mills
- January 1, 2013 through December 31, 2013 - rate of 0.89 mills
- January 1, 2014 and thereafter - no tax.

Pa. Laws 2009, H.B. 1531, signed by the Governor on Oct. 9, 2009.

Texas—The Comptroller of Public Accounts explained that a taxable entity that contracts with an unrelated third party to manufacture goods to its specification, will not be able to include in its costs of goods sold the costs directly related to the production of goods usually allowed a producer (e.g., research, engineering, design, etc.). When an entity enters such a contract with an unrelated third party, it is not considered a producer of the goods. Tex. Comp. of Pub. Accts., Tax Policy News (Oct. 2009).

Texas—New law (H.B. 4765) increases the small business margin tax exemption from \$300,000 to \$1 million, effective for 2010 and 2011. After 2011, the exemption is reduced to \$600,000. Tex. Laws 2009, H.B. 4765, signed by the Governor on June 16, 2009.

Vermont—New law (H. 441) imposes on business entities that qualify, or elect to be taxed, as a digital business entity an annual franchise tax equal to: (1) the greater of .02% of the current value of the tangible and intangible assets of the company or \$250; or (2) where the authorized

capital stock does not exceed 5,000 shares, \$250 (increased to \$500 when the authorized capital stock is more than 5,000 but less than or equal to 10,000, and further increased by \$250 on each 10,000 shares or part thereof). The tax for a full taxable year cannot be less than \$250 or more than \$500,000. Entities that have been in existence for less than a full year will prorate the tax. Provisions of the bill define "digital business entity" as a business entity which during the entire taxable year: (1) was not a member of a Vermont affiliated group; did not have payroll, sales, or property and did not perform activities in the state which would constitute doing business for income tax purposes; and (2) used mainly computer, electronic and telecommunications technologies in its formation and in the conduct of its business meetings and other formal requirements. Corporations that qualify and elect to be taxed as a digital business entity will not be subject to the state's corporate income tax. These provisions are effective on Jan. 1, 2010. Vt. Laws 2009, H. 441, enacted over governor's veto on June 2, 2009.

West Virginia—New law (S.B. 680) phase-out the business franchise tax, with its repeal effective for taxable years beginning on or after January 1, 2015. The rate of reduction is as follows:

- .48% for tax years after 2008;
- .41% for tax years after 2009;
- .34% for tax years after 2010;
- .27% for tax years after 2011;
- .21% for tax years after 2012;
- .10% for tax years after 2013;
- 0% for tax years after 2014.

In addition, S.B. 680 gradually reduces the rate of the corporate net income tax as follows:

- 8.5% for taxable periods beginning on and after January 1, 2009;
- 7.75% for taxable periods beginning on and after January 1, 2012;
- 7.0% for taxable periods beginning on and after January 1, 2013;
- and
- 6.5% for taxable periods beginning on and after January 1, 2014.

W. Va. Laws 2008, S.B. 680, enacted on March 31, 2008.

Wisconsin—New law (A.B. 75) makes various changes to the state's income tax laws. Key changes: (1) reduce the long-term capital gains exclusion from 60% to 30%; (2) allow for taxable years beginning after Dec. 31, 2010, a claimant to subtract from federal taxable income up to \$10 million of a long-term capital gain if the taxpayer takes specific action, including investing, within 180 day after the sale of the assets, the

proceeds in a qualified new business venture; and (8) impose a higher personal income tax rate of 7.75% on single filers with taxable income exceeding \$225,000 and joint filers with taxable income exceeding \$300,000. Wis. Laws 2009, Act 28 (A.B. 75), enacted June 29, 2009.

IV. ALLOCATION AND APPORTIONMENT

A. UDITPA Revision

On June 30, 2009, a Uniform Law Commission study committee voted to recommend that the project to revise the Uniform Division of Income for Tax Purposes Act (UDITPA) be abandoned. Despite this decision, the Multistate Tax Commission Executive Committee voted to continue with its review the portion of the Multistate Tax Compact that incorporates UDITPA. This review process will be undertaken by the MTC's Uniformity Committee. State Tax Today 2009 STT 145-2 (July 31, 2009).

B. Business/Nonbusiness Income

Under the Uniform Division of Income for Tax Purposes Act (UDITPA), business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's trade or business operations. This provision has been interpreted as encompassing two tests, either of which would satisfy the definition of business income. Under the "transactional test," income is classified as business income if it arises in the regular course of the taxpayer's trade or business. Income from tangible and intangible property is classified as business income under the "functional test" if the acquisition, management, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Differing standards have been used in applying the functional test and some courts have chosen not to recognize that a separate functional test exists.²² Nevertheless, many states take the position that the disposition of assets used in the business gives rise to business income, even if the income is derived from an occasional or extraordinary transaction. Rather than focusing on a particular transaction, the "functional test" focuses on the utilization of the property in the business.

²² See, e.g., *Appeal of Chief Industries Inc.*, 875 P.2d 278 (Kan. 1994), and *Phillips Petroleum Co. v. Iowa Dept. of Revenue and Finance*, 511 N.W.2d 608 (Iowa 1993). See also *Laurel Pipe Line Company v. Commonwealth*, 642 A.2d 472 (Pa. 1994)(gain on sale of pipeline running between Aliquippa, Pennsylvania and Cleveland, Ohio that had been idle for the previous three years was nonbusiness income). But see *Texaco-Cities Service Pipeline Co. v. Department of Revenue*, No. 93 L 50312 (Ill. Cir. Ct. 1995) (gain from the sale of pipeline assets located partly in Illinois constituted business income under the functional test).

Several states have amended their laws to expand the definition of business income. For example, Alabama adopted a broader definition of “business income” in a bill that expressly overruled the state supreme court’s decision in *Uniroyal Tire Co. v. Alabama Dept. of Rev.*²³ Mississippi²⁴ and Kansas²⁵ have expanded their definitions to specifically include both a transactional and functional test, while Ohio has adopted a business/non-business classification similar to the UDITPA definition.²⁶ Other states, including Illinois and Kansas, allow taxpayers an election to treat all income as business income.²⁷ New Jersey law has been changed to assign 100% of a taxpayer’s “nonoperational income” to the taxpayer’s headquarters state to the extent permitted under the U.S. Constitution.²⁸ Illinois, West Virginia, North Carolina and the District of Columbia define “business income” to mean all income that is apportionable under the U.S. Constitution.²⁹ Pennsylvania has amended its law to include “income arising from transactions in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if either the acquisition, the management or the disposition of the property constitutes an integral part of the taxpayer’s regular trade or business operations. This term includes all income that is apportionable under the U.S. Constitution.”³⁰ Utah recently amended its regulation to define business income as any income from activities that meet the requirements under either the transactional test or the functional test.³¹

Montana—The definition of “business income” found in Mont. Code Ann. §15-31-302(1) includes both a transactional test and a functional test for purposes of determining whether income is business or nonbusiness

²³ Effective for taxable years beginning after December 31, 2001, Ala. Code §40-27-1.1 defines “business income” as “income arising from transactions or activity in the course of the taxpayer’s trade or business; or income from tangible or intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer’s trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of real property or of tangible or intangible personal property, if the property while owned by the taxpayer was operationally related to the taxpayer’s trade or business carried on in Alabama or operationally related to sources within Alabama, or the property was operationally related to sources outside this state and to the taxpayer’s trade or business carried on in Alabama; or gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer’s trade or business carried on in Alabama while the stock was owned by the taxpayer.”

²⁴ Miss. Code Ann. §27-7-23(2), effective for taxable years beginning on or after January 1, 2001.

²⁵ Kan. Laws 2008, H.B. 2434, enacted May 22, 2008.

²⁶ Ohio Laws 2003, Am. Sub. H.B. 95, effective for tax years beginning on or after June 26, 2003. Under prior law, certain specified items of income were allocated and all remaining items of income were apportioned. In addition, the new law creates a “look-through” mechanism allowing nonbusiness gains or losses to be situated to Ohio based upon the percent of physical assets of the *entire affiliated group* of which the investee is a member.

²⁷ 35 ILCS 5/1501(a)(1), as amended by Ill. Laws 2002, Pub. Act. No. 92-0846 (S.B. 2212), effective for each taxable year beginning on or after January 1, 2003 and Kan. Laws 2002, S.B. 472, effective July 1, 2002.

²⁸ N.J. Laws 2002, Pub. L. No. 2002, c. 40 (A. 5201), effective January 1, 2002.

²⁹ N.C. Gen Stat. §105-130.4(a)(1), amended by N.C. Ch. 2002-126 (S.B. 1115), effective for tax years beginning on or after January 1, 2002. D.C. Budget Bill approved by the City Council on May 14, 2004 and presented to U.S. Senate Appropriations Subcommittee on May 19, 2004. 35 ILCS 5/1501(a)(1) amended by Ill. Laws 2004 (S.B. 2207), effective July 30, 2004.

³⁰ Pa. Laws 2001, Act 23 (H.B. 334), effective retroactively to tax years beginning after December 31, 1998.

³¹ Utah Admin. R. R865-6F, effective Sept. 9, 2008

income. Montana uses UDITPA's definitions to divide all corporate income into two categories --- business income and nonbusiness income. Per §15-31-302(1), business income is defined as "income arising from the transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The parties in this case requested the District Court to rule on the State Board of Appeal's construction of §15-31-302(1) as containing two separate tests for business income. On appeal the District Court and then the Montana Supreme Court affirmed the Board's conclusion that the definition of business income includes both a transactional test and functional test when determining business income. *Gannett Satellite Information Network, Inc. v. Montana Dept. of Rev.*, No. DA 08-0026 (Mt. Sup. Ct. Jan. 13, 2009).

Tennessee—In affirming a lower court ruling, the Tennessee Court of Appeals found that interest on investments in U.S. Treasury securities earned by an out-of-state corporation is allocable nonbusiness income because the interest income was not put back into the corporation for operational and working capital needs. In reaching this conclusion, the court found that the corporation's automotive activities in Tennessee are wholly unrelated to its investment activities in Missouri and that the securities interest earned served an investment function, not an operational function. The taxpayer provided evidence showing that the income it earned from the investment in Treasury securities was not used to fund the automotive operations in Tennessee or to acquire businesses related to, or for the purpose of expanding, the Tennessee automotive operations. Further, the evidence established that the investment income was not needed by the automotive operation since it generated sufficient income from its activities to fund its own operations. Accordingly, the court found the assessment unconstitutional since the income earned from the investment in Treasury securities did not bear a relation to the Tennessee automotive operations. The court noted that the "The Department's speculative contention that [the taxpayer] used the income earned from the investment in Treasury securities in the operation of the [automotive operations] is not sufficient to create an actual relation between the use of the income and the operations conducted in Tennessee." *Siegel-Robert, Inc. v. Johnson*, No. M2008-02228-COA-R3-CV (Tenn. Ct. App. Oct. 28, 2009).

Tennessee—Capital gain realized by the taxpayer as a result of its parent company's redemption of outstanding stock held by the taxpayer was not subject to Tennessee's excise tax, because the taxpayer and the parent

were not part of a unitary business. The outstanding stock was received by the taxpayer as part of a reorganization of a group of entities that manufacture and distribute ice cream. The parent's redemption of the outstanding stock resulted in capital gain to the taxpayer, which the taxpayer treated as nonbusiness earnings. The Department of Revenue, however, determined that the gain was business earnings that should have been included in the taxpayer's apportionable income subject to the state's excise tax. On appeal the taxpayer argued that the Department could not levy tax on the capital gain because the one-time stock redemption transaction carried out in another state by the parent lacked sufficient nexus with its production, sale and distribution of ice cream in Tennessee.

The Court of Appeals agreed with the taxpayer, finding that the taxpayer and parent were not unitary under either the three unities test or the operational function test. In regard to the three unities test, the court found that while there was evidence of overlap in the management of the entities, the record did not reflect sufficient control on the part of the parent over the taxpayer's Tennessee activities to support a finding of centralized management. In addition, the entities were not functionally integrated as there was not a substantial interrelationship or interdependence among the entities basic operations. Further, because the parent did not provide the taxpayer with any "central services" (i.e., staff functions, pension plans, legal services, etc.) that would undermine its operational independence, there was no economies of scale. The court then turned to the operational function test to determine whether the gain served an operational rather than an investment function in the taxpayer's business. The gain was not used to fund operations, rather it was distributed to the taxpayer's partners, who owned the parent's stock when it appreciated. Moreover, the purpose of the reorganization was not for the benefit of the "entire business". Rather, the purpose was to reorganize the parent into an S corporation so that it and its remaining shareholders could obtain favorable tax treatment and avoid the expense and inconvenience of registering its securities and publicly reporting its financial results. *Blue Bell Creameries v. Chumley*, No. M2009-00255-COA-R3-CV (Tenn. Ct. App. Sept. 29, 2009).

Tennessee—Gain from the sale of target's capital stock to purchaser pursuant to a valid IRC §338(h)(10) was properly included in target's excise tax base and categorized as apportionable business earnings. This case involves the Tennessee excise tax consequences of the 100% liquidation of the capital stock of target to purchaser, where purchaser and seller treated the stock sale as a sale of assets pursuant to IRC §338(h)(10). Following the sale, target reported the gain from the sale as income on the pro forma federal income tax return that was filed as part of seller's consolidated federal return. Target then filed a Tennessee excise

tax return and deducted the gain from the sale from its reported net earnings and claimed the amount as a refund. In denying the refund, the tax commissioner found that the gain on the sale of target's capital stock subjected purchaser (as the successor to target) to Tennessee's excise tax.

In affirming the commissioner's determination, the Court of Appeals rejected purchaser's argument that the gain should be included in seller's excise tax base. The court noted that because Tennessee imposes an excise tax on each separate corporation doing business in the state, it could not recognize the consequences of the parties' election under §338(h)(10), including the deemed sale of the subsidiary's assets and the gain reported on such sale. Accordingly, as a result of the purchaser's and seller's decision to make a §338(h)(10) election, the target must independently report the gain from the deemed sale. Further, the court found that the income should be classified as business earnings apportionable to Tennessee as the assets that were deemed to be sold by target were an integral part of target's regular business. Lastly, the court found that including the gain from the deemed liquidation in target's excise tax base does not violate the Due Process or Commerce Clauses of the U.S. Constitution under the unitary business principle. *Newell Window Furnishing, Inc. v. Johnson*, No. M2007-02176-COA-R3-CV (Tenn. Ct. App. Dec. 9, 2008).

C. Formulary Apportionment—Weighted Sales Factor Formulas

Although many states use the UDITPA three-factor apportionment formula consisting of equally-weighted payroll, property and sales factors, many states use a modified three-factor apportionment formula that assigns more weight to the sales factor than the other two factors. Some of these states assign a double weight to the sales factor, *i.e.* 50% sales, 25% property, 25% payroll.³² However, several states have adopted other variations in this formula.³³

Arizona—New law allows taxpayers to elect to use either an apportionment formula consisting of a property, payroll and double weighted sales factor or a more heavily weighted sales factor. The phasing-in of the more heavily weighted sales factor is as follows:

³² Corporate income tax states that utilize a double-weighted sales factor apportionment formula include, but are not limited to, the following: Arizona, Arkansas, California, Florida, Idaho, Kentucky, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, North Carolina, South Carolina, Tennessee, Utah, Vermont, Virginia, and West Virginia.

³³ States that have adopted more than 50% weighted sales factor apportionment formula include, but are not limited to, the following—Georgia (phasing in a single sales factor), Illinois (100% sales), Indiana (phasing in a single sales factor), Michigan SBT (90% sales, 5% property and payroll), Minnesota (phasing in a single sales factor), New York (phasing in a single sales factor), Oregon (100% sales), Pennsylvania (60% sales, 20% property and payroll), and Wisconsin (phasing in a single sales factor).

- for tax years beginning from and after Dec. 31, 2006 through Dec. 31, 2007 -- two times the property factor, two times the payroll factor and six times the sales factor with a denominator of 10;
- for tax years beginning from and after Dec. 31, 2007 through Dec. 31, 2008 -- one and one-half times the property factor, one and one-half times the payroll factor and seven times the sales factor with a denominator of 10;
- for tax years beginning from and after Dec. 31, 2008 -- the property factor, the payroll factor and eight times the sales factor with a denominator of 10.

Ariz. Laws 2005, H.B. 2139, enacted May 20, 2005.

New Mexico—New law (H.B. 75) extends the period in which a taxpayer whose principal business activity is manufacturing can elect to use a double weighted sales factor apportionment formula. The election, which was scheduled to sunset for tax years beginning prior to Jan. 1, 2011, can be made through tax years beginning prior to Jan. 1, 2020. N.M. Laws 2009, H.B. 75, enacted April 7, 2009.

Pennsylvania—New law (H.B. 1531) increases the weight of the sales factor as follows:

- For tax years beginning after Dec. 31, 2008, the weighting of the sales factor increases from 70% to 83%, and
- For tax years beginning after Dec. 31, 2009 it increases to 90%.

Pa. Laws 2009, H.B. 1531, enacted Oct. 9, 2009.

Single Sales Factor Formula—A recent trend has led several states to consider adoption of a single sales-factor apportionment formula. For example, Massachusetts adopted a single sales factor formula for mutual fund service corporations and manufacturers. Maine allows mutual fund service providers an election to use a single sales factor formula. Connecticut and Maryland have enacted a single sales factor formula for manufacturers. Georgia, Indiana, Minnesota, New York, and Wisconsin are phasing-in single sales factor formulas.

California—New section CR&TC 25128.5 provides that effective for tax years beginning on or after January 1, 2011, taxpayers may make an irrevocable annual election on an original, timely filed return to apportion their income using a single sales factor apportionment formula, instead of using the traditional, double-weighted sales factor apportionment formula provided under CR&TC 25128. This option is not available to apportioning taxpayers that derive more than 50% of their gross business receipts from one or more of the following industries:

- Agriculture;
- Extractive businesses (such as mining);
- Financial services, such as savings and loan, banking or other financial businesses.

Taxpayers engaged in such trades or businesses will continue to apportion income using a standard, equally weighted three-factor apportionment formula.

It is anticipated that the Franchise Tax Board will issue regulations on how the single sales factor election will be administered. Cal. Laws 2009, Ch. 17 (S.B.X3 15), enacted Feb. 20, 2009.

Colorado—New law (H.B. 1380) establishes a single sales factor apportionment formula. Currently, taxpayers may choose between using the Multistate Tax Compact "three factor" (property, payroll, and sales) apportionment formula or Colorado's statutory "two factor" (property and revenue) apportionment formula. Effective for tax years beginning on or after January 1, 2009, provisions of H.B. 1380 eliminate the taxpayer's annual option to select the Multistate Tax Compact formula, and require the taxpayer to use the Colorado statutory method, which on that date becomes a single sales factor apportionment formula. The new single sales factor is generally determined in the same manner as the sales factor is determined under the existing Colorado statutory two factor formula. Colo. Laws 2008, H.B. 1380, enacted May 20, 2008.

Note—The Department of Revenue has proposed special regulations that would apply the single sales factor apportionment formula adopted in 2008 to various industry groups, effective for tax years beginning on or after Jan. 1, 2009. Industry groups include: (1) Publishing - Special Regulation 3A; (2) Railroads - Special Regulation 4A; (3) Television and Radio Broadcasting - Special Regulation 5A; (4) Trucking - Special Regulation 6A; (5) Telecommunications and Ancillary Services - Special Regulation 8A; (6) Airlines - Special Regulation 1A; (7) Contractors - Special Regulation 2A; and (8) Financial Institutions - Special Regulation 7A. The Department will also consider regulation on the allocation and apportionment of corporate income for mutual funds service companies - Regulation 7.2. A hearing was held on these proposed regulations on Nov. 4, 2009.

Delaware—New law (S.B. 213) provides that the entire net income of an asset management corporation is apportioned to Delaware based on a single ratio of Delaware-sourced gross receipts from asset management services over all gross receipts from asset management services. Any receipts or items of income that are excluded in determining the taxpayer's

entire net income or are directly allocated as provided under Del. Code §1903(b)(1) to (5) are disregarded. An "asset management corporation" is defined as a corporation (i) 90% or more of the gross receipts of which are derived from the performance of asset management services, (ii) that is not exempt from the corporation income tax, and (iii) that makes an election for each taxable year to be treated as an asset management corporation by filing the appropriate election form. In general, gross receipts derived from providing asset management services are sourced based on the domicile of the consumer of the asset management services. The term "asset management services" means, with respect to intangible investments, rendering investment advice, including investment analysis; making determinations as to when sales and purchases are to be made; (c) selling or purchasing intangible investments; (d) rendering administrative services; (e) rendering distribution services; or (f) managing contracts for subadvisory services. This provision is effective for taxable years beginning after December 31, 2008. Del. Laws 2008, S.B. 213, signed by the Governor on June 3, 2008.

Georgia—New law phases-in a single gross receipts apportionment for all taxable years beginning on or after January 1, 2008 (currently the state uses a double weighted gross receipts fraction in a three factor apportionment formula). Specifically, the phase-in is as follows:

- for tax years beginning on or after January 1, 2006 and before January 1, 2007 -- 80% gross receipts, 10% property, and 10% payroll;
- for tax years beginning on or after January 1, 2007 and before January 1, 2008 -- 90% gross receipts, 5% property, and 5% payroll; and
- for tax years beginning on or after January 1, 2008, a single gross receipts factor will be used.

Ga. Laws 2005, H.B. 191, enacted April 6, 2005.

Indiana—On March 24, 2006 Governor Daniels signed a bill (H.B. 1001), provisions of which phase-in over a four period a single sales factor. The phase-in of the single sales factor is as follows:

Tax Year	Sales Factor	Property Factor	Payroll Factor	Denominator Of
2007	3	1	1	5
2008	4.67	1	1	6.67
2009	8	1	1	10
2010	18	1	1	20
2011 and	100%	0	0	

thereafter				
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Kansas—New law (S.B. 240) allows eligible manufactures to elect to use a single sales factor apportionment formula. To be eligible a manufacturer must make an investment of \$100,000,000 for construction in Kansas of a new business facility, employ at least 100 new employees at such facility by December 31, 2009, and pay higher than average wages within the wage region for such facility. The election may be made only once and must be made on or before the last day of the taxable year during which the investment is placed in service, but not later than December 31, 2009. The election is effective for 10 years provided that the taxpayer maintains the wage requirements. Kan. Laws 2007, S.B. 240, enacted.

NOTE: Recently enacted legislation gives the Secretary of Revenue the authority to extend by six months from Dec. 31, 2009 to June 30, 2010, the deadline by which manufacturers have to qualify to elect to use a single sales factor apportionment formula. The Secretary is permitted to grant the extension upon a showing of good cause and substantial taxpayer compliance with the qualified investment requirements (i.e., the manufacturer must invest \$100 million in construction and employ a minimum of 100 new employees with higher than average wages). Note that an election to use the single sales factor is binding for 10 years. These provisions are effective upon publication in the statute book. Kan. Laws 2009, H.B. 2270, signed by the Governor on March 27, 2009.

Minnesota—A single sales factor apportionment formula will be phased-in over an eight year period for general businesses and financial institutions, effective for tax years beginning after December 31, 2006.

The phase-in is as follows:

Tax Year	Sales Factor %	Property Factor %	Payroll Factor %
2007	78%	11%	11%
2008	81%	9.5%	9.5%
2009	84%	8%	8%
2010	87%	6.5%	6.5%
2011	90%	5%	5%
2012	93%	3.5%	3.5%
2013	96%	2%	2%
2014 and after	100%	0	0

New York City—New law (A. 8867) gradually phase-in a single receipts factor beginning in 2009 for purpose of New York City's business

allocation percentage, with a fully phased-in single receipts factor applying to taxable years beginning after 2017. This change applies to the general corporation business tax, the unincorporated business tax, and the banking corporation tax but limited to certain banking corporations that substantially provide management, administrative or distribution services to investment companies. In addition, provision of the bill sunset the double-weighted receipts factor election for manufacturing corporations under the general corporation and unincorporated business tax regimes, effective Jan. 1, 2011 N.Y. Laws 2009, ch. 201 (A. 8867), signed by the Governor on July 11, 2009.

South Carolina—New law amends S.C. Code §12-6-2250 by adopting a single sales factor apportionment formula for taxpayers whose principal business in South Carolina is (1) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within the state; or (2) selling, distributing, or dealing in tangible personal property within the state. If the calculation permitted under the new single sales factor formula results in a reduction in income allocated to this state, the reduction is allowed as follows:

- taxable year beginning in 2007, the reduction allowed is 20%;
- taxable year beginning in 2008, the reduction allowed is 40%;
- taxable year beginning in 2009, the reduction allowed is 60%;
- taxable year beginning in 2010, the reduction allowed is 80%.

The Governor vetoed the measure on June 13, 2006, but the legislature overrode the veto the following day. S.C. Laws 2006, H.B. 4874, enacted June 14, 2006.

In 2007, the legislature overrode the Governor's veto of a bill (S.B. 91) that clarifies South Carolina's transition to a single sales factor. Per S.B. 91, if there is no sales factor, then income is apportioned to the taxpayer's principal place of business. The bill also amends the definitions of "sales" and "gross receipts" for purposes of computing the sales factor. S.C. Laws 2007, Act 110, governor's veto overridden by Senate on June 20, 2007 and by the House on June 21, 2007.

South Carolina—In a recent revenue ruling, the Department of Revenue set forth its long standing position regarding the single sales factor phase-in apportionment formula for income and license fee purposes. During the phase-in period, which is 2007 to 2010, taxpayers eligible to use the single sales factor must calculate tax using: (1) the three factor -- property, payroll and sales -- apportionment formula, and (2) by using the single sales factor apportionment formula. If use of the single sales factor reduces the amount of income apportioned to South Carolina, then the

taxpayer is allowed to use a 20% to 80% reduction to determine the phase-in apportionment ratio. The phase-in reduction used to calculate the income tax will also be used to calculate the license fee. In the ruling, the Department further advised that the phase-in reduction applies to taxpayers with either South Carolina taxable income or loss. While the legislation only mentions "reduction of income", the Department after reviewing the legislative history, concluded that the single sales factor provisions are not limited to taxpayers that have South Carolina taxable income. The Department also indicated that the corporate license fee amount does not automatically have to be apportioned using the same apportionment ratio used for income tax purposes. The Department's position is that the phase-in provisions provide that a multistate taxpayer whose principal business in South Carolina is dealing with tangible personal property must use the method (either three factor or three factor modified by the phase-in) that provides the lower South Carolina license fee. The ruling includes various examples. S.C. Dept. of Rev., Revenue Ruling 09-15 (Nov. 17, 2009).

Virginia—New law (H.B. 2437) phases-in an elective single sales factor apportionment formula for manufacturing companies, effective for taxable years beginning on or after July 1, 2011. The phase-in of the single sales factor is as follows:

- (1) from July 1, 2011 until July 1, 2013, manufacturing companies may use a triple-weighted sales factor;
- (2) from July 1, 2013 until July 1, 2014, manufacturing companies may use a quadruple-weighted sales factor; and
- (3) from July 1, 2014, and thereafter, manufacturing companies may use a single sales factor.

An election to use a more heavily weighted sales factor apportionment formula is binding for three taxable years. Further, a taxpayer making the election must certify to the Department of Taxation that the average weekly wage of its full-time employees is greater than the lower of the state or local average weekly wages for the taxpayer's industry. If the average annual number of full-time employees for the company for the first three taxable years is less than the base year employment, the Department will assess the manufacturing company with additional taxes and a 10% penalty. Va. Laws 2009, H.B. 2437, enacted April 2009.

D. Sales Factor

Throwback Rule

Joyce and Finnigan Rules. A minority of states—Arizona, Indiana,

Kansas, Missouri, Tennessee and Utah—apply the rationale of the California State Board of Equalization in *Appeal of Finnigan*³⁴ and take the position that sales shipped from a state by a corporation not taxable in the destination state are not thrown back if any member of the corporation's unitary group is taxable in that state. Other states, such as Alabama, Alaska, California (until 2011), Colorado, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois³⁵, Kentucky, Maine, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Ohio, Oregon, South Carolina, Vermont and Virginia follow the *Joyce* rule³⁶ which considers only the in-state activities of the taxpayer in determining application of the throw-back rule.

The following is a decision on recent activity.

California—Effective for tax years beginning on or after January 1, 2011, the *Finnigan* rule is adopted. Accordingly, for purposes of determining the sales factor, all sales of the combined reporting group properly assigned to California are included in the sales factor numerator regardless of whether the member of the group making the sale is subject to the California corporate franchise or income tax. Non-California assigned sales will not be included in the California sales factor numerator if a member of the combined reporting group of the taxpayer is subject to tax in the state of the purchaser. Cal. Laws 2009, Ch. 17 (S.B.X3 15), enacted Feb. 20, 2009.

Throwback Rule

Maine—New law (L.D. 353) repeal the throwback rule and replace it with a throwout rule, effective for tax years beginning on or after Jan. 1, 2009. Maine Laws 2009, Ch. 213 (L.D. 353), enacted May 28, 2009.

Wisconsin—New law (A.B 75) increases from 50% to 100% the amount of sales that are thrown back to Wisconsin. Throwback is required when the property is shipped from an office, store, warehouse, factory or other place of storage in Wisconsin and delivered to the federal government or a purchaser outside the state and the taxpayer is not within the jurisdiction of the destination state, and provides a throwback transition safe harbor, authorizing the Department to deem timely paid the estimated tax payments attributable to the difference between a taxpayer's tax liability

³⁴ 88-SBE-022-A (Cal. SBE Aug. 28, 1988) ("taxpayer" in Cal. Rev. & Tax. Code §25135(b)(2) means all of the corporations within the unitary group; thus, when sales are shipped from California to another state by a member of a group conducting a unitary business, the throwback rule does not apply if any of the corporations within the unitary group are taxable in the other state.

³⁵ See *Hartmarx Corp. v. Bower*, 309 Ill. App. 3rd 959 (1st Dist. 1999); *Beatrice Companies v. Whitley*, 292 Ill. App. 3d 532 (1st Dist. 1997); and *Dover Corp. v. Department of Rev.*, 271 Ill. App. 3d 700 (1st Dist. 1995).

³⁶ *Appeal of Joyce, Inc.*, 66-SBE-069 (only the in-state activities that are conducted by or on behalf of the taxpayer shall be considered when determining in-state nexus for throwback purposes).

computed using the 50% throwback and 100% throwback for installments that become due during the period beginning January 1, 2009 and June 29, 2009, provided that the estimated payments are paid by the next installment. Wis. Laws 2009, Act 28 (A.B. 75), enacted June 29, 2009.

Throwout Rule

Maine—New law (L.D. 353) repeal the throwback rule and replace it with a throwout rule, effective for tax years beginning on or after Jan. 1, 2009. Under the throwout rule, the sales factor excludes from both the numerator and denominator, sales of tangible personal property delivered or shipped (regardless of F.O.B. point or other conditions of sale) to a purchaser within a state in which the taxpayer is not taxable. In contrast, under the repealed throwback rule, receipts were sourced to Maine if the receipts were attributable to a state in which the taxpayer was not taxable. Maine Laws 2009, Ch. 213 (L.D. 353), enacted May 28, 2009.

New Jersey—On May 29, 2008, the New Jersey Tax Court found that the state's throwout rule is facially constitutional under the Due Process, Commerce and Supremacy Clauses, because in some instances it can operate in a manner that satisfies the requirements for constitutionality. In reaching this conclusion, the Court rejected the taxpayers' contention that if every state had a similar rule, multiple taxation -- and therefore, lack of internal consistency -- would result when several states "threw out" receipts not taxable in foreign states under P. L. 86-272, and held that because the throwout rule is not a tax, "the use of a throwout procedure in multiple states would not produce multiple taxation." It is important to note that while the Court held the throwout rule is facially constitutional, its opinion does not consider or address whether the throwout rule is unconstitutional as applied to each taxpayer. Separate proceedings for each taxpayer will be scheduled to determine these issues. *Pfizer Inc. v. Director, Division of Taxation*, Dkt. No. 000055-2006 (N.J. Tax Ct. May 29, 2008); *General Engines Company, Inc. v. Director, Division of Taxation*, Dkt. No. 008807-2006 (N.J. Tax Ct. May 29, 2008); *Federated Brands Inc. v. Director, Division of Taxation*, Dkt. No. 008806-2006 (N.J. Tax Ct. May 29, 2008); and *Whirlpool Properties, Inc. v. Director, Division of Taxation*, Dkt. No. 000066-2007 (N.J. Tax Ct. May 29, 2008).

Note: New law (A. 2722) repeals the throwout rule and the regular place of business 100% allocation factor requirement. For tax years beginning on or after July 1, 2010, New Jersey taxpayers are no longer required to throw out of the sales factor denominator those sales made to a state or foreign country in which the taxpayer is not subject to an income tax. Additionally, with the repeal of the regular place of business rule, all taxpayers are now eligible to apportion their income, regardless of

whether they maintain an office with an employee outside of the state. It should be noted that repealing the throwout rule and regular place of business requirement are part of Governor Corzine's proposed economic assistance and recovery plan that was announced on Oct. 16th. In addition, a number of cases challenging the constitutionality of the state's throwout rule are currently being considered by the New Jersey judicial system. N.J. Laws 2008, A. 2722, signed by the Governor on Dec. 19, 2008.

Inclusion of Gross Receipts Derived from the Sale of Short-Term Investments

On July 27, 2001, the Multistate Tax Commission adopted a resolution, amending MTC Reg. IV.2.(a) to include a definition of "gross receipts." The MTC definition excludes certain proceeds, e.g., the repayment of principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instruments; pension reversions; amounts realized on the federally-unrecognized exchanges of inventory, from "gross receipts" even if the income is included in apportionable business income. The amendment providing a uniform definition of "gross receipts" is an attempt to settle the issue of whether net profits, not gross receipts, from the sale of intangibles are includable in the sales factor.

California has recently amended a regulation excluding the gain from the sale of certain intangible assets from the sales factor. Kentucky, however, has recently enacted legislation which includes those types of transactions in the sales factor.

California—In reversing a trial court ruling, the appellate court found that the full sales price of commodity hedging futures sales contracts are gross receipts included in the calculation of the UDITPA sales factor. The taxpayer primarily manufactures and markets consumer food products, but it also engages in futures trading as a hedger. These hedging futures sales help the taxpayer protect against the risk of fluctuations in the price of agricultural commodities it uses in its business. The taxpayer amended its returns to include the full sales price (i.e., the number of bushels of the commodity multiplied by the price per bushel in the contract) of all of its futures sales contracts in the denominator of the sales factor. Inclusion of the full sales price reduced the taxpayer's California apportionment percentages, which resulted in the current refund claim.

The Franchise Tax Board denied the refund claim, and excluded the futures sales contracts receipts from the sales factor denominator. The trial court upheld the denial, finding that under the plain language of UDITPA futures trading does not qualify as sales income.

In reversing this ruling, a California Court of Appeal focusing on the rights and benefits acquired found that the full sales price of futures sales contracts should be counted as gross receipts. The court explained that if the futures contract is offset, the offsetting party is relieved of its binding obligation to purchase or sell the commodity at the price stated in the offset contract. Such relief constitutes consideration. Further, because hedging allows the taxpayer to stay in business and make a profit despite frequent and significant fluctuations in the prices of the raw commodities, such transactions are an integral part of the taxpayer's business activity. The case was remanded back to the trial court so that it could determine whether the FTB met its burden of proof that use of the standard apportionment formula did not fairly represent the company's business activities in California, a finding that would allow the FTB to use an alternative formula. *General Mills v. Franchise Tax Board*, No. A120492 (Cal. App. Ct. April, 15, 2009), *reh'g denied* (Cal. Sup. Ct. July 29, 2009).

Sourcing of Receipts from Sales of Other Than Tangible Personal Property

Multistate—During its annual meeting July 29 to August 2, 2007, the MTC, approved an amendment to MTC Regulation IV.17(2) (Cost of Performance) and made recommendations on various uniformity projects. The amendment to Regulation IV.17(2) revises the definition of “income producing activity” and “cost of performance” to include transactions and activities performed on behalf of a taxpayer, such as those conducted by an agent or an independent contractor (the prior definition excluded these activities). As amended, the term “income producing activity” applies to each separate item of income and means “the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.” Thus, under the amended definition, “income producing activity includes...[t]he rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.”

In addition, the definition of “cost of performance” is modified to include in the taxpayer's cost of performance, payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property giving rise to the particular item of income. The amendment also adds new section IV.17(4)(C), which provides that income producing activity performed on behalf of the taxpayer by an agent

or independent contractor is attributed to the state if such income producing activity occurs in the state. In addition, new section Reg. IV.17(4)(C)(b) creates a “throwout” rule.

California—Proposed amendments to regulation 25136 - sales other than sales of tangible personal property - would incorporate recent changes made to the Multistate Tax Commission model regulation - MTC Regulation IV.17(2). The amendments would revise the definition of "income producing activity" to include transactions and activities performed on behalf of a taxpayer, such as those conducted by an agent or an independent contractor (the prior definition excluded these activities). The term "income producing activity" would apply to each separate item of income and would be defined as "the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income."

In addition, the proposed amendment would modify the definition of "cost of performance" to include in the taxpayer's cost of performance, payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property giving rise to the particular item of income. The proposed amendment would add a new section, which would provide that income producing activity performed on behalf of the taxpayer by an agent or independent contractor would be attributed to the state if such income producing activity occurs in the state. Lastly, the proposed amendment would create a "throwout" rule. Specifically, the proposed amendment provides that if the location of the income-producing activity cannot be assigned or the customer's domicile cannot be determined or the activity is in a state in which the taxpayer is not taxable, such income-producing activity would be disregarded in determining the taxpayer's income-producing activity. A hearing on the proposed amendments is scheduled for Jan. 13, 2010. Cal. Franchise Tax Bd., Announcement (Oct. 23, 2009).

California—For tax years beginning on or after Jan. 1, 2011, California joins the growing number of states resorting to “market-based” sourcing for purposes of determining the sales factor. The cost of performance rules for sourcing “sales, other than sales of tangible personal property” are repealed and replaced with specific provisions for sourcing services, intangible property, real property, and tangible personal property.

Under these new provisions, sales from services are sourced to California to the extent that the purchaser of the service received the benefit of the service in California. Sales from the sale of intangible property are sourced to California to the extent the property is used in California. If the revenue is derived from the sale of a marketable security, the sale is deemed to be from property used in California if the customer is located in

California. Sales from the sale, lease, rental, or licensing of real property or tangible personal property are in this state if such property is located in California. Cal. Laws 2009, Ch. 17 (S.B.X3 15), enacted Feb. 20, 2009.

Illinois—Effective for tax years ending on or after December 31, 2008, S.B. 1544 amended provisions related to the sourcing of sales other than sales of tangible personal property. Current law focuses on the location of the income producing activity and, if in more than one state, on the location of the direct costs incurred to earn the income with the sales being assigned to a single state when 50% or more of the direct costs incurred are in a single state. Per S.B. 1544, sales other than sales of tangible personal property are sourced to Illinois if the purchaser is in Illinois or if the sale is attributable to the state's marketplace.³⁷ S.B. 1544 included four illustrative examples with respect to when a sale would be considered an Illinois sale. The examples involve the sales from the lease or rental of real property, sales from the lease or rental of tangible personal property, sales of intangible personal property, and sales of service.

S.B. 783 modifies these provisions by removing the reference to purchaser in the state or otherwise attributable to the state's marketplace by indicating that such sales are in Illinois *if any of the following criteria is met* – the criteria being a modified version of the illustrative examples set forth in S.B. 1544 with significant changes made to the sales of intangible personal property and sales of service provision.

The reference to sales of intangibles is deleted and replaced with specific rules for "in the case of interest, net gains (but not less than zero) and other items of income from intangible personal property" followed by specific rules in the case of a dealer in intangible personal property within the meaning of IRC §475 and by a general rule for all other cases of interest, net gains and other items of income from intangible personal property. The sourcing of sales of service is changed to add specific ordering rules to determine the location of where the benefit was received by the purchaser. The sourcing rule for services contained in S.B. 1544 effectively required the seller to obtain information from the purchaser to determine where the purchaser realized the benefit of the service. The throw-out rule would still apply to this category if the taxpayer is not taxable in the state where the purchaser realizes the benefit of the service.

Wisconsin—Provisions of the bill, effective for tax years beginning on and after January 1, 2009, repeal Wis. Stat. §71.25(9)(d), the sourcing provisions for sales, other than sales of tangible personal property³⁸, and

³⁷ Amendment 35 ILCS §5/304(a)(3)(C-5).

³⁸ Under the repealed provision (Wis. Stat. §71.25(9)(d)), sales, other than sales of tangible personal property, were

in its place add a provision for sourcing gross royalties and other gross receipts received for the use or license of intangible property and sales of intangible property (excluding securities). The sourcing for these receipts is generally based on the location of the payor. Wis. Laws 2009, Ch. 2 (S.B. 62), enacted Feb. 19, 2009.

Miscellaneous Sales Factor Developments

California—Effective for tax years beginning on or after January 1, 2011, the definition of “gross receipts” is added for purposes of computing the sales factor. “Gross receipts” means “the gross amounts realized...on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized...under the [IRC]...” Gross receipts do not include:

1. Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, CD, or similar marketable instrument;
2. The principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
3. Proceeds from issuance of the taxpayer’s own stock or from sale of treasury stock;
4. Damages and other amounts received as the result of litigation;
5. Property acquired by an agent on behalf of another;
6. Tax refunds and other tax benefit recoveries;
7. Pension reversions;
8. Contributions to capital, except for the sale of securities by securities dealers;
9. Income from discharge of indebtedness;
10. Amounts realized from exchanges of inventory that are not recognized under the IRC;
11. Amounts received from transactions involving intangible assets held in connection with a treasury function; or
12. Amounts received from hedging transactions involving intangible assets

Exclusion of an item from the definition of “gross receipts” is not determinative of its character as business or nonbusiness income. Cal. Laws 2009, Ch. 17 (S.B. X3 15), enacted Feb. 20, 2009.

Florida—Income from sales of customizing software is sourced to the state in which the software customization takes place. Under Florida law

in Wisconsin if the income-producing activity was in the state. If, however, the income-producing activity was performed both in and outside Wisconsin, the sales were divided between the states in proportion to the direct costs of performance incurred in each state in rendering the services.

(Rule 12C-1.0155(2)(h)), computer related sales are generally sourced to the location of the customer. Thus, income from sales of customizing software is included in the numerator of the sales factor when the customization activity takes place in Florida. Since the activities at issue occur outside Florida, income from such sales is excluded from the numerator of the sales factor. Fla. Dept. of Rev., TAA 09(C)1-003 (Sept. 30, 2009).

Illinois—New law (S.B. 1739), effective for taxable years ending on or after Dec. 31, 2008, provides that the sales factor for receipts from the sale of broadcasting services is determined based on the audience or subscribers located in Illinois. Specifically, advertising revenue from broadcasting is received in Illinois if the commercial domicile of the advertiser (i.e., the customer) is in Illinois. Where film or radio programming is broadcast by a station, a network or a cable system for a fee or other remuneration from the broadcast's recipient, the portion of the service received in Illinois is measured by the portion of the recipients of the broadcast located in Illinois. If the fee or other remuneration is from the person providing the programming, the portion of the broadcast service that is received by such station, network, or cable system in Illinois is measured by the portion of recipients of the broadcast located in Illinois. Where film or radio programming is provided by a taxpayer that is a network or station to a customer for broadcast in exchange for a fee or remuneration from that customer, the broadcasting service is received at the customer's office location. Lastly, if the programming is provided by a taxpayer that is not a network or station to another person for broadcasting in exchange for a fee or remuneration from that person, the broadcasting service is received at the customer's office location. Ill. Laws 2009, Pub. Act 96-763 (S.B. 1739), enacted Aug. 25, 2009.

Massachusetts— The Appeals Court affirmed the Appellate Tax Board determination that the taxpayer's "income-producing activity" is its operation of building travel packages. The taxpayer purchased air-fare, hotel accommodations, and ground transportation in bulk, and then bundled these items into individual travel packages. The taxpayer, however, did not market these travel packages in bulk or sell individual travel packages. Rather, such packages were sold by independent travel agents and broker/dealers. A taxpayer's "income-producing activity", which is used to determine apportionment for a business activity conducted both inside and outside of Massachusetts, focuses on the activity in which the taxpayer directly engages to generate sales income for itself. The court agreed with the Board's finding that the taxpayer's income-producing activity which gave rise to its sales income is its overall operation of bundling travel packages, and not the individual sales of these packages. *The Interface Group v. Commissioner of Revenue*, Doc. No. 08-P-1861 (Mass. App. Ct. Dec. 8, 2009)(unpublished).

Michigan—New law (S.B. 671) allows taxpayers that restructure as a financial institution on or after Jan. 1, 2008, and that prior to the restructuring had been using an apportionment formula for spun-off companies, to elect to continue to use the same apportionment method it used prior to the restructuring. Mich. Laws 2009, PA 0157'09 (S.B. 671), signed by the Governor on Dec. 10, 2009.

Minnesota—The Department of Revenue issued guidance on the situs of drop-shipped inventory for purposes of determining the property factor. According to the Department, inventory that is delivered by drop shipment is included in the numerator of the taxpayer's property factor based on the destination state. Thus, property in transit and inventory shipped to a Minnesota destination is inventory used in the state by the taxpayer in carrying on its business activities and, as such, is included in the numerator of the taxpayer's Minnesota property factor. Minn. Dept. of Rev., Revenue Notice 09-07 (Aug. 24, 2009).

New York—Royalty receipts from the licensing of intellectual property are allocated to New York based on where the activity that generates the licensee's fee occurs. The taxpayer owns and licenses artistic and literary intellectual property, most of which is copyrighted or trademarked. New York law provides that receipts from the license to use copyrighted property are allocable to New York to the extent the use of the copyright occurs in New York. A copyright is deemed to be used in New York to the extent the activities relating to the use of the copyright are carried on in New York. Further, receipts from the license to use non-copyrighted intellectual property are allocated to New York when the receipts are earned in New York. Citing *Matter of Disney*, the Department of Taxation and Finance said that "the location of the licensee's sales of goods would be a better way to allocate royalty income, because it would be more reflective of the geographic location of its economic activities." Finding the taxpayer's licensing activities to be similar to those in *Disney*, the department concluded that the taxpayer's receipts from licensing its copyrighted property should be allocated where the property is used, while receipts from the licensing of non-copyrighted property will be allocated where the receipts from that property are earned. N.Y. Dept. of Taxn. and Fin., TSB-A-09(14)C (Aug. 5, 2009).

New York City—A real estate investment company was not required to include in its New York City allocable income gain from the sale of California property owned by a limited partnership in which it held a 30% interest, because inclusion of the income does not properly reflect of the company's business activities in the City. During the years at issue, the company invested in limited partnerships that owned property in New York City and California. Money did not flow between the California and New

York partnerships or properties, and income generated by each of the properties remained with the respective partnership owners. Following the sale of the California property, the company calculated its NYC general corporate tax return using a separate accounting method that excluded the gain from the property's sale from its City ENI and business allocation percentage. An audit agent disagreed with the company's use of a separate accounting method, and issued a notice of a proposed deficiency that was based on the use of an allocation percentage that included factors attributable to both California and New York. Under the Due Process and Commerce Clauses, the City can tax income from non-City sources if the partnerships and the company are engaged in a unitary business; however, non-City income can be excluded if its inclusion does not appropriately reflect the company's business activity in the City. In finding in favor of the company, an Administrative Law Judge held that even though the New York and California partnerships are in the same line of business they are not engaged in a unitary business. Even if there was a unitary business, the income would be excluded because including the gain from the sale of the California property is "distortive and would result in a tax which is out of all appropriate relation to the [company's] City business." For instance, if a formulary apportionment basis was used, it would result in an income basis that is 20 times greater than the income determined using a separate accounting method. *Matter of Imperial Rental Investments, Inc.*, No. TAT(H)06-20(GC) (N.Y. City Tax App. Trib., ALJ, April 1, 2009).

Virginia—Expenses a taxpayer that files a combined Virginia corporation income tax return incurs that are billed and reimbursed at cost by subsidiaries and other related entities can be included in the gross receipts used to calculate the sales factor if the "affiliates deal with each other at arm's length". Transactions where no gain or loss is realized are not arm's length for apportionment factor purposes and, as such, proceeds from such a transaction are not included in the sales factor. The taxpayer is also the general partner of two limited partnerships and holds a 15% limited partnership interest in a third partnership. The taxpayer would include its proportionate share of limited partnership property, payroll and sales in its own factors when computing its apportionment formula. In regard to the limited partnership interest, a corporate limited partner is not required to include a partnership's apportionment factors if: (1) the corporation holds a limited partnership interest; (2) all general partners are unrelated third parties; (3) the combined partnership interests held by the corporation and all related parties constitute 10% or less of the profit and capital interests in the limited partnership; and (4) the structure is not a device primarily designed to avoid Virginia taxes. Since the taxpayer holds a 15% interest in the limited partnership it is required to include its proportionate share of the partnership's payroll, property and sales in its

Virginia apportionment factors. Lastly, the department advised that it would not have to include the income of a subsidiary that is a controlled foreign corporation in its combined Virginia return. Va. Dept. of Taxn., Rulings of Tax Comm's PD 09-148 (Oct. 8, 2009).

E. Property Factor

No New Items

F. Payroll Factor

Kentucky—A corporation that operates towboats on the Mississippi River and maintains its headquarters in Kentucky properly excluded from the payroll factor compensation for nonresident towboat captains and other crew because the towboats never stopped in Kentucky and as such the captain and crew did not perform services in Kentucky. Under Kentucky law, an employee's compensation is included in his/her employer's payroll factor under the following five circumstances: (1) the employee performed all of his/her services in Kentucky; (2) the employee performed services both inside and outside Kentucky but the services performed outside the state were incidental; (3) the employee performed some services in Kentucky and the employee's base of operations was in Kentucky; (4) if the employee does not have a base of operations, the employee was directed or controlled from Kentucky; and (5) if the employee's base of operations or place from which he/she was directed was not in any state where the employee performed his/her services, the employee resided in Kentucky. In finding that the compensation of the nonresident captain and crew is excluded from the payroll factor, the Kentucky Court of Appeals determined that while the nonresident towboat captains and crew may have performed 1.5% of their service while traveling in Kentucky waters, the evidence failed to establish that the towboat employees actually performed some services in Kentucky. *Ky. Rev. Cabinet v. Marquette Transportation Co., Inc.*, No. 2006-CA-002639 (Ky. Ct. App. April 3, 2009).

G. Miscellaneous

Massachusetts—New rule (830 CMR 63.38.11) explains the allocation and apportionment of income derived from sales of telecommunications and ancillary services. The new rules apply regardless of whether the telecommunications service income is earned by a traditional telephone company, a VOIP company, a cable company, an electric company, or any other type of entity subject to the apportionment rules set forth in M.G.L. c. 63 §38. The definition of "telecommunications service" is defined as "the electric transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points." While the telecommunications services is

broadly defined to include a "range of services", the term does not include: (1) certain data processing and information services; (2) installation or maintenance of wiring or equipment on a customer's premises; (3) tangible personal property; (4) advertising, including but not limited to directory advertising; (5) billing and collection services provided to third parties; (6) Internet access service; (7) certain radio and television programming services; (8) ancillary services; and (9) digital products delivered electronically. In addition, the rule provides a detailed list of sales of telecommunications and ancillary services that are either included or excluded from the numerator and/or denominator of the sales factor. The new rule is effective for taxable years beginning on or after Jan. 1, 2009. Regulation 830 CMR 63.38.11, promulgated March 20, 2009.

Missouri—A marketer and processor of prepaid debit cards and prepaid debit card services will apportion its revenue from debit card sales, or "fulfillment fees", using either the single-sales factor method or the three-factor "property, payroll, sales" method. If the single-sales factor method is used, the sale of a debit card is a sale of tangible personal property and, therefore, all sales to Missouri customers are wholly within Missouri. If, however, the three-factor apportionment method is used, fulfillment fees from sales of debit cards in Missouri are included in the numerator of the sales factor. Transactional fee revenue from interchange fees, service fees, account maintenance fees, lost or stolen card fees, balance inquiry fees, account-to-account transfer fees, and check fees associated with the sale of debit cards, is also apportioned using either the single-sales factor or the three-factor apportionment methods.

For purposes of the apportionment computation, taxpayers using the "source of income" test, must identify the sales as "wholly in this state", "partly in this state", or "wholly without this state". For purposes of the three-factor method, the cost of performance rule applies. In this case the prominent income producing activities performed by the taxpayer are performed by its employees and regional account managers in other states. Thus, for any account that does not involve a customer in Missouri or regional account manager in Missouri, the greater proportion of income-producing activity is performed outside of Missouri, and the fees from that account are included in the denominator of the sales factor, but not the numerator. Mo. Dept. of Rev., LR 5453 (Feb. 13, 2009).

New York—A company that owns and operates a social networking website and provides online advertising services to advertisers is required to allocate its advertising income based upon the location of the website subscriber that views the advertisement, and should base the allocation of its Internet advertising revenue on the ratio of its New York subscribers to the number of subscribers everywhere. This allocation treatment is similar to advertisement revenue allocation rules for newspapers, periodicals,

radio and television advertising, and cable programming. The company was incorrect in suggesting that such revenues should not be allocated to New York because its employees do not perform any income-generating services in the state. NY DOTF, TSB-A-09(5)C (March 9, 2009).

V. FINANCIAL SERVICES/INSURANCE COMPANIES

Arizona—A unitary group of taxpayers was not allowed to include in the denominator of its Arizona sales factor the dollar value associated with the disposition of mortgages and servicing rights on the secondary mortgage market, and must determine where to source this income based on the cost of performance. In reaching this conclusion, the Court of Appeals, citing its decision in *Walgreens*, agreed with the revenue department and held that when the taxpayer sells its Arizona mortgage loan contracts to third parties on the secondary market within 15 to 45 days of origination, the resulting gain constitutes gross receipts to be included in the sales factor denominator. The court also agreed that the amount of the transaction representing the principal value of the mortgage is a return of principal and should be excluded from the sales factor, noting that excluding these proceeds prevents an artificial distortion of the apportionment factors.

The court also found that the income included in the sale factor should only include the net proceeds from the sales of mortgage loans and servicing rights if the greater costs of performance are incurred in Arizona. While the court acknowledged the Multistate Tax Commission's rule for financial institutions, which provides that loans secured by real property are generally assigned to the state in which the property is located, it declined to follow the regulation because the state has not expressly adopted the regulation. Thus, attribution of income from selling the mortgages and mortgage services rights "must be pursuant to the specific language of A.R.S. section 43-1147, which broadly applies to [s]ales, other than sales of tangible personal property." Per the statute, sales of property other than tangible personal property are attributable to the state if either the income-producing activity is performed in the state or a greater proportion of the income producing activity is performed in Arizona than in any other state based on costs of performance. In this case the activity of selling the mortgage loans and servicing rights occurred in Colorado. Accordingly, income attributable to these sales is not included in the Arizona sales factor numerator. *MDC Holdings, Inc. et al. v. Ariz. Dept. of Rev.*, No. 1-CA-TX-07-0011 (Ariz. Ct. App., Div. 1, Oct. 6, 2009).

California—New law (A.B. 11) provides that IRS Notice 2008-83 does not apply for California Corporation Tax purposes with respect to any ownership change occurring at any time. Per Notice 2008-83, the IRS for purposes of §382(h) will not treat any deduction properly allowed after an ownership change to a bank,

relating to losses on loans or bad debts, as a built-in loss or a deduction that is attributable to periods before the change date. Provisions of the American Recovery and Reinvestment Act of 2009 repeal Notice 2008-83 on a prospective basis for most ownership changes occurring after Jan. 16, 2009. However, it generally allows institutions to apply the notice to ownership changes occurring after Jan. 16th, if the ownership change was pursuant to a written binding contract entered into on or before that date, or a written agreement entered into on or before that date and described on or before that date in a public announcement or in a filing with the SEC. Provision of A.B. 11 took immediate effect. Cal. Laws 2009, A.B. 11, signed by the Governor on Oct. 11, 2009.

Illinois—The Department of Revenue adopted Regulation 100.3405 discussing how to apportion the business income of financial organizations. Effective for tax years ending on or after Dec. 31, 2008, a financial organization is required to apportion its business income to Illinois using market based sourcing. The rule provides the following specific guidance:

- (1) receipts from the lease of real or tangible personal property are in Illinois if the property is located in the state during the rental period, but if receipts are from mobile property then the income is sourced to Illinois to the extent that the property is used in the state;
- (2) interest income, commissions, fees, gains on disposition, and other receipts from loans that are secured primarily by real estate or tangible personal property are from Illinois sources if the security is located in Illinois;
- (3) interest income, commissions, fees, gains on disposition, and other receipts from consumer loans that are not secured by real or tangible property are from Illinois sources if the debtor is an Illinois resident;
- (4) interest income, commissions, fees, gains on dispositions and other receipts from commercial loans and installment obligations that are not secured by real or tangible property are from Illinois sources if the proceeds of the loan are to be applied in this state;
- (5) interest income, fees, gains on disposition, service charges, merchant discount income, and other receipts from credit card receivables are from Illinois sources if the card charges are regularly billed to a customer in Illinois;
- (6) receipts from the performance of services such as fiduciary, advisory or brokerage services, are in Illinois if the services are received in the state; and
- (7) receipts from the issuance of travelers checks and money orders are from Illinois sources if the checks and money orders are issued from an Illinois location.

The regulation provides detailed guidance for sourcing receipts from investment/trading assets and activities. The regulation became effective on Oct. 26, 2009.

Indiana—New law (H.B. 1001) updates the date of conformity to the IRC to the IRC in effect on Feb. 17, 2009, but decouples from various provisions, including the provision of the Emergency Economic Stabilization Act of 2008 (EESA) that allows the sale or transfer of certain preferred stock in Fannie Mae and Freddie Mac to be treated as an ordinary loss are not operative for state income tax purposes. Rather, taxpayers must make an adjustment equal to the amount of adjusted gross income that would have been computed had the loss not been treated as an ordinary loss. In addition, taxpayers are required to add back an amount equal to any exempt insurance income under IRC §953(e) that is active financing income under Subpart F. Ind. Laws 2009 (special session), Pub. Law 182 (H.B. 1001), enacted June 30, 2009.

Indiana—In *MBNA America Bank*,³⁹ the Indiana Tax Court held that the Commerce Clause does not require an out-of-state credit card bank to have physical presence in Indiana in order to be subject to the state's Financial Institutions Tax, rather the bank's economic presence is sufficient to establish substantial nexus with the state. In reaching this conclusion, the court found that the U.S. Supreme Court has not extended the physical presence standard set forth in *Bellas Hess*⁴⁰ and *Quill*⁴¹ beyond sales and use taxes.

Note: *MBNA did not appeal this ruling.*

Indiana—Out-of-state loan origination and loan holding companies that do not have a physical presence in Indiana are subject to the financial institutions tax (FIT) on interest and fees earned from loaning money to Indiana customers, because such activity created an economic presence in the state sufficient to impose the tax. The FIT is imposed on resident and nonresident taxpayers conducting business within the state. For purposes of the FIT, a taxpayer is transacting business within Indiana if the taxpayer regularly engages in transactions with Indiana customers that involve intangible property, including loans, that result in receipts flowing to the taxpayer. In upholding the assessment, the Department of Revenue found that the taxpayer was transacting business in Indiana because the banks had established a lively and profitable economic presence within the state via interest, services fees, over-the-limit fees, and other income it received from loans to Indiana customers. In addition, the Department declined to waive negligence penalties, as it has consistently used the economic presence standard for nexus for FIT situations. Ind. Dept. of Rev., Letter of Findings 08-0718 (Jan. 21, 2009).

Maine—For purposes of insurance premiums tax, the taxable premium includes all consideration paid by the insured for title insurance, regardless of whether a

³⁹ *MBNA America Bank, N.A. & Affiliates v. Indiana Dept. of Rev.*, No. 49T10-0506-TA-53 (Ind. Tax Ct. Oct. 20, 2008).

⁴⁰ *National Bellas Hess v. Illinois Dept. of Rev.*, 386 U.S. 753 (1967).

⁴¹ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

portion of the consideration is attributable to the cost of a title search or examination completed by either the insurer or its agent. The tax on insurance premiums is based upon the "gross direct premiums" charged to the insurers' customers in Maine. In this case, the taxpayer insures only title risks and does not conduct title examinations. Instead, the taxpayer engages an agent within the area to complete those tasks. At issue is whether "gross direct premiums" includes the total amount an insured pays as consideration for a title insurance policy (including title examination fees) or whether it includes only the total amount the insurer receives after its agent has deducted amounts associated with its title examination services. In vacating a lower court ruling and finding in favor of the State Tax Assessor, the Maine Supreme Court held that while "gross direct premiums" is not defined by statute, the term "premium" is defined as "the consideration for insurance, by whatever name called." This includes all consideration paid, regardless of whether the premium is paid to the insurer, its agent, or both. Also, legislative history and prior guidance indicate that the tax is based on the amount paid to the company as consideration for insurance. The court concluded by stating that the term "gross direct premiums" means insurance premiums that are directly attributable to risks located or resident in Maine, and excludes premiums that are indirectly associated with such risks. *Stewart Title Guaranty Co. v. Maine State Tax Assessor*, No. Ken-07-042 (Maine Sup. Ct. Jan. 20, 2009).

Massachusetts—New law (H. 4129) provide that IRC §382 is applied without regard to the treatment of a change in ownership of a bank or other corporation provided in IRS Notice 2008-83 or in any federal statutory or administrative codification, supplement or implementation of such Notice. For purposes of Ch. 62 (taxation of incomes) and 63 (taxation of corporations), Notice 2008-83 and such codification, supplement or implementation has no force or effect in any taxpayer year. In addition, IRC §382(n) which repeals Notice 2008-83 on a prospective basis for most ownership changes occurring after Jan. 16, 2009, but generally allows institutions to apply the notice to ownership changes occurring after Jan. 16, if certain criteria is met, has no force or effect in any taxable year. Mass. Laws 2009, H. 4129, signed by the Governor on June 29, 2009.

Massachusetts—The Massachusetts Supreme Judicial Court affirmed the Appellate Tax Board's ruling in *Capital One* that two out-of-state credit card banks' activities in Massachusetts created substantial nexus with the Commonwealth for purposes of imposing the Financial Institution Excise Tax (FIET), despite the fact that the banks had no physical presence in the Commonwealth during the tax years at issue. In reaching this conclusion, the court found the physical-presence nexus standard established by the U.S. Supreme Court in *Quill* is limited to sales and use taxes. *Capital One Bank v. Commissioner of Revenue*, No. SJC-10105 (Mass. Sup. Jud. Ct. Jan. 8, 2009), *cert. denied*, Dkt. No. 08-1169 (U.S. Sup. Ct. June 22, 2009).

Minnesota—A single sales factor apportionment formula will be phased-in over

an eight year period for general businesses and financial institutions, effective for tax years beginning after December 31, 2006.

The phase-in is as follows:

Tax Year	Sales Factor %	Property Factor %	Payroll Factor %
2007	78%	11%	11%
2008	81%	9.5%	9.5%
2009	84%	8%	8%
2010	87%	6.5%	6.5%
2011	90%	5%	5%
2012	93%	3.5%	3.5%
2013	96%	2%	2%
2014 and after	100%	0	0

Montana—New law (H.B. 160) revises provisions regarding captive insurance companies. Specifically, a captive insurance company may now be organized as an LLC, and any captive insurance company incorporated in the state must be incorporated or organized by at least one incorporator or organizer that is a resident of the state. The provisions also provide for a waiver of risk-based capital (RBC) report filing requirements for a captive risk retention group that files a proper annual report or statement or for a captive risk retention group formed in the last two years. Also, the tax on direct premiums collected within the state is calculated at 0.4% on the first \$20 million and 0.3% on each subsequent dollar collected. The provisions are effective July 1, 2009. Mont. Laws 2009, Ch. 28 (H.B. 160), signed by the Governor on March 20, 2009.

New York—The New York Supreme Court, Appellate Division, has affirmed a lower court ruling that a financial corporation and its subsidiaries were not entitled to an investment tax credit (ITC) pursuant to NY Tax Law §1456(i) based on its acquisition and improvement of a building and the equipment contained therein, because it did not meet the "principal use" test. Under the principal use test, the property must be principally used in the ordinary course of the taxpayer's trade or business as a *broker or dealer* in connection with the purchase or sale of stocks, bonds or other securities. At issue in this case is whether the corporation's loan originations constitute a qualifying activity for purposes of "broker or dealer" status. Originating a mortgage loan, which results in the creation of a mortgage note, is not purchasing a security from a customer, nor is originating and holding such created security considered a sale of a security. Because the corporation banking function of loan origination does not include the sale of the resulting securities, this function may not be considered broker or dealer activities for purposes of the ITC. After eliminating these activities, the corporation failed to satisfy the principal use test because less than 50% of the usable business floor space for the building was utilized in the regular course of

the corporation's activities as a broker or dealer. Accordingly, the corporation did not qualify for the credit. *In the Matter of the Petition of Astoria Financial Corp. v. Tax Appeals Tribunal of New York*, No. 504393 (N.Y. Sup. Ct. App. Div. - 3rd Jud. Dist., June 11, 2009).

New York—New law (A.157B/S.57B) increases from 30% to 40% the first mandatory estimated franchise tax payment for general business corporations, banking corporations, and insurance companies to the extent the tax liability for the previous tax year was \$100,000 or more; requires an "overcapitalized captive insurance company" to file a combined report with its direct parent, provided the parent is doing business in New York or is otherwise included in a combined return; and amends the definition of insurance company under N.Y. Tax Laws §1500(a) and the definition of non-life insurance company under §1502-a, to include a HMOs. These provisions took effect Jan. 1, 2009. N.Y. Laws 2009, Ch. 57 (A.157B/S.57B), signed by the Governor on April 7, 2009.

New York—New law (A. 9807C /S.6807C) establishes an economic nexus standard for certain banking corporations that issue credit cards (i.e., credit card includes bank, credit, travel and entertainment cards). Under the new provision, a banking corporation is doing business in New York if:

- it has issued credit cards to 1,000 or more customers who have a mailing address within New York as of the last day of its taxable year;
- it has merchant contracts with merchants and the total number of locations covered by the contracts is 1,000 or more New York locations to whom the banking corporation remitted payments for credit card transactions during the taxpayer year;
- it has receipts of \$1 million or more in the taxable year from customers who have been issued credit cards by the banking corporation and have a mailing address within the state;
- it has receipts of \$1 million or more arising from merchant customer contracts with merchants located in New York; or
- the sum of customers described in (1) plus the number of locations described in (2) equals 1,000 or more, OR the amount of its receipts describe in (3) and (4) equals \$1 million or more.

For purposes of this provision, receipts from processing credit card transactions for merchants include merchant discounts fees received by the banking corporation. The bill also codifies the customer sourcing rules for credit card receipts contained in the current regulations.

In addition, Part EE-1 generally precludes banking corporations doing business in New York solely because it meets one of the prongs under the credit card bank nexus provisions described above from being included in a combined report with another banking corporation or bank holding company which is exercising its corporate franchise or doing business in the state. This preclusion will not apply if

the credit card bank or the commissioner shows that inclusion of the credit card bank in the combined return is necessary to properly reflect the tax liability of the credit card bank, the banking corporation or bank holding company. Further, any banking corporation that meets the aforementioned nexus provisions and was included in a combined return for its last taxable year beginning before January 1, 2008 may continue to be included in the combined return. Once said banking corporation is included in a combined return for any taxable year beginning on or after January 1, 2008, it will be required to continue to be included in the return until it obtains the commissioner's consent to no longer be included.

Credit card banks will be included in a combined return with one of the following corporations if one of these corporations provide services for or support to the credit card bank's operation:

- (1) any banking corporation not subject to the bank franchise tax, 65% or more of whose voting stock is owned or controlled, directly or indirectly, by the credit card bank; or
- (2) any banking corporation or bank holding company not subject to the bank franchise tax which owns or controls, directly or indirectly, 65% or more of the voting stock of the credit card bank; or
- (3) any banking corporation not subject to the bank franchise tax, 65% or more of the voting stock of which is owned or controlled, directly or indirectly, by the same corporation(s) that own or control 65% or more of the voting stock of the credit card bank;

Combined reporting will not be required if the credit card bank or commissioner show that inclusion of any of these corporations in the combined return fails to properly reflect the tax liability of the credit card bank. For purposes of this provision, services include billing, credit investigation and reporting, marketing, research, advertising, mailing, customer service, information technology, lending and financing services, and communication services. Services do not include accounting, legal or personnel. N.Y. Laws 2008, Ch. 57 (A. 9807C/S.6807C), signed by the Governor on April 23, 2008. See also N.Y. Dept. of Taxn. & Fin., TSB-M-08(7)C (June 9, 2008).

New York City—New law (A. 8867) adopts numerous measures to conform the New York City tax law to recent changes made by New York State. Establish, effective for tax years beginning on and after January 1, 2011, economic nexus provisions for certain credit card banks by requiring them to file a New York City banking corporation tax return if they have:

1. 1,000 or more customers with mailing address in New York City;
2. 1,000 or more merchant customer contracts with merchants located in New York City;
3. \$1 million or more of receipts from credit card customers with mailing address in New York City;

4. \$1 million or more of receipts relating to merchant contracts from merchants located in New York City; or
5. The sum of customers described in (1) plus the number of locations described in (2) equals 1,000 or more, OR the amount of its receipts describe in (3) and (4) equals \$1 million or more.

N.Y. Laws 2009, ch. 201 (A. 8867), signed by the Governor on July 11, 2009

New York City—New law (A. 8867) adopts numerous measures to conform the New York City tax law to recent changes made by New York State. Key provisions of the bill:

- Mandate combined reporting for general corporation tax purposes when there are substantial inter-corporate transactions among related domestic corporations, regardless of the transfer price for such transactions. The legislation would also conform to New York State legislation that requires captive REITs and captive RICs to file on a combined basis with the closest controlling corporation that is subject to New York City tax. RICs and REITs included in the combined report will determine entire net income without regard to a dividends paid deduction to affiliated stockholders for tax years beginning on or after January 1, 2009.
- Conform to the New York State legislation that requires captive REITs and RICs to file on a combined basis for banking corporation tax purposes subject to certain exceptions. The legislation would allow a 25% dividends paid deduction for captive REITs and RICs for tax years beginning on and after January 1, 2009 but before January 1, 2011. A dividends paid deduction would not be allowed for tax years beginning on or after January 1, 2011.
- Gradually phase-in a single receipts factor beginning in 2009 for purpose of New York City's business allocation percentage, with a fully phased-in single receipts factor applying to taxable years beginning after 2017. This change would apply to the general corporation business tax, the unincorporated business tax, and the banking corporation tax but limited to certain banking corporations that substantially provide management, administrative or distribution services to investment companies.
- Replace the \$300 fixed dollar minimum tax with a scaled rate based on New York City receipts. Effective for tax years beginning after 2008, the amount of tax would range from \$25 for New York City receipts of less than \$100,000 and \$5,000 for receipts over \$25 million. Effective for tax years beginning on or after January 1, 2009.
- Effective for tax years beginning on or after January 1, 2011 replace the current alternative minimum tax for foreign banks based on allocated capital stock, with the tax on allocated gross assets imposed on domestic banks (0.01%), In addition, effective for tax years beginning on or after January 1, 2011, specific conforming provisions are added allowing reduced tax rates on taxable assets for taxpayers with a net worth ratio of

less than 5% and 4% and whose total assets are comprised of 33% or more of mortgages.

- Allow net operating loss (NOL) deduction for banking corporations that would largely mirror the federal deduction under IRC §172 plus/minus City modifications. The deduction would not include NOLs sustained during a taxable year beginning prior to January 1, 2009 or during any taxable year in which the taxpayer was not subject to this tax. The NOL would also be limited by the excess of deduction taken for bad debts or reserves for losses on loans of banks as allowed for New York City purposes over the amounts allowed, respectively, under IRC section 166 or 585. Further, the NOL would be determined as if the taxpayer had elected under IRC §172 to relinquish the entire NOL carryback period.
- Amend the definition of banking corporation to include investment company subsidiaries⁴² that are principally engaged in a business that holds and manages investment assets, including bonds, notes, debentures and other obligations for the payment of money, stocks, partnership interests or other equity interests, and other investment securities.
- Adopt loophole closers enacted in 2007 by New York State that prohibit banks from creating or acquiring 9-A subsidiaries to hold investment assets which would be taxed at a lower rate. This provision applies to grandfathered 9-A corporations that elected to be taxable under the corporate franchise tax back in 1985 or under the Gramm-Leach-Bliley transitional provisions. Conditions that cause such corporations to lose their grandfathered status include:
 - The corporation ceases to be a taxpayer under the general corporation tax;
 - the corporation has no New York City wages or receipts factor or is otherwise inactive;
 - the corporation becomes subject to the "fixed dollar minimum" tax;
 - 65% or more of the voting stock of the corporation becomes owned or controlled, directly or indirectly, by a corporation that acquired the stock in transaction that qualifies as a purchase within the meaning of Section 338(h), unless the corporation whose stock was acquired and the acquiring corporation were, immediately prior to the purchase, members of the same affiliated group;
 - the corporation acquires assets that have an average value or total tax basis that is more than 40% of the average value or tax basis of the corporation's existing assets.

⁴² Specifically, the provision applies to any corporation 65% or more of whose voting stock is owned or controlled, directly or indirectly, by a corporation(s) subject to Article three-a of the banking law or registered under the federal bank holding company act or registered as a savings and loan holding company.

- Adopt effective for tax years beginning on after January 1, 2009 the NY State customer sourcing rules for registered securities or commodities brokers or dealers. Receipts that are specified in this section subject to customer-based sourcing include brokerage commissions, margin interest, advisory services from securities underwriting, interest on intercompany loans and advances, and account maintenance fees. The law also provides specific rules for the sourcing of receipts from principal transactions and primary spread income. These rules would apply for both unincorporated business and general corporation tax purposes.
- Establish a financial institution data match system.

N.Y. Laws 2009, ch. 201 (A. 8867), signed by the Governor on July 11, 2009.

Oregon—New law (S.B. 182) replaces the definition of "financial organization" with "financial institution". Per the new definition, a "financial institution" is a person, corporation or other business entity that is any of the following:

- (1) a bank holding company;
- (2) a savings and loan holding company;
- (3) a national bank organized and existing as a national bank association;
- (4) a savings association;
- (5) a bank or thrift institution;
- (6) any entity organized under the provisions of 12 U.S.C. 611 to 631;
- (7) an agency or branch of a foreign bank;
- (8) a state credit union with loan assets that exceed \$50,000,000 as of the first day of the taxable year of the state credit union;
- (9) a production credit association;
- (10) a corporation, more than 50% of the voting stock of which is owned, directly or indirectly, by a person, corporation or other business entity described in 1-9, provided that the corporation is not an insurer taxable under ORS 317.655;
- (11) an entity that is not otherwise described in this provision, is not an insurer taxable under ORS 317.655, and derives more than 50% of its gross income from activities that a person, corporation or entity described in 3-9 or 12 is authorized to conduct, without taking into consideration income from nonrecurring extraordinary sources; and
- (12) a person that derives at least 50% of its annual average gross income, for financial accounting purposes for the current and prior two tax years, from finance leases, excluding gross income from incidental or occasional transactions.

This change applies to tax years beginning on or after Jan. 1, 2009. In addition, for purposes of entities described in 1-10, this provision applies to any tax year for which a return is subject to audit or adjustment on or after Jan. 1, 2009, any tax year for which a return is subject to an appeal on or after Jan. 1, 2009, and any

tax year for which a claim for refund may be made on or after Jan. 1, 2009. Or. Laws 2009, (S.B. 182), signed by the Governor on June 18, 2009.

Pennsylvania—Pursuant to a merger between an in-state bank and an out-of-state bank, the Bank and Trust Company Shares Tax is calculated by combining the six-year average value of the in-state institution with the post-merger value of the out-of-state bank. The Shares Tax is based on the book value of the bank's net assets, and when two or more institutions combine or merge, it shall be treated as if the constituent institutions had been a single institution in existence prior to as well as after the combination. The book values and deductions of all of the institutions are combined. The Commonwealth Court of Pennsylvania determined that this combination provision does not violate the Uniformity Clause of the Pennsylvania Constitution or the Equal Protection Clause of the U.S. Constitution because inclusion of the out-of-state entity's post-merger share value is necessary as the tax is imposed on the combined post-merger institution. *Lebanon Valley Farmers Bank v. Pennsylvania*, No. 698 F.R. 2005 (Pa. Commw. Ct. Feb. 12, 2009).

Wisconsin—Effective for tax years beginning on and after January 1, 2009, the definition of financial organization to include any subsidiary of a financial organization if a significant purpose for the subsidiary is to hold investments or if the subsidiary primarily functions to hold investments. Wis. Laws 2009, Ch. 2 (S.B. 62), enacted Feb. 19, 2009.

VI. PASS-THROUGH ENTITIES AND MEMBERS

A. Nexus

Multistate—On December 18, 2003, the MTC adopted proposed statutory language on reporting options for nonresident members of pass-through entities with withholding required. The provision permits pass-through entities to file composite returns and pay tax for electing nonresident members on their distributive share of the pass-through entity's instate income. Eligible nonresident members have the option of filing an individual return or joining the composite return. In addition, pass-through entities are required to withhold income tax at the highest tax rate assessed by the state on the share of income of the entity distributed to each nonresident member and to pay the withheld amount in the manner prescribed by the tax agency. Pass-through entities are liable to the state for the payment of the tax required to be withheld under this section and shall not be liable to such member for the amount withheld and paid over in compliance with this section. A pass-through entity is not required to withhold tax for a nonresident member if:

- (1) the member has a pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State of less than \$1,000 per annual accounting period;
- (2) the state tax agency has determined by regulation, ruling or instruction that the member's income is not subject to withholding; or
- (3) the member elects to have the tax due paid as part of a composite return filed by the pass-through entity; or
- (4) the entity is a publicly traded partnership as defined by IRC §7704(b) that is treated as a partnership for the purposes of the IRC and that has agreed to file an annual information return reporting the name, address, taxpayer identification number and other information requested by the tax department of each unit-holder with an income in the state in excess of \$500.

Alabama—New law (H.B. 69) repeals current pass-through entity composite return rules and replaces them with new provisions that require pass-through entities to file composite returns on behalf of its nonresident members and report (and pay tax at the highest applicable marginal rate on the nonresident members' distributive share of income) at the time its return is due. The pass-through entity is liable for payment of the tax, but is not liable to any member for any amount withheld from distributions and remitted in compliance with this section. At time of payment, the pass-through entity must return a form showing the total amounts paid or credited to its nonresident members, the amounts of tax remitted in accordance with this section, and any other information the Department of Revenue may require. A pass-through entity is not required to remit tax on behalf of nonresident members if any of the following apply: (1) the Department determines by regulation or ruling that the nonresident member's income should not be subject to composite return reporting; or (2) the pass-through entity is a qualified investment partnership (or a publicly traded partnership that is treated as a partnership for federal income tax purposes) that provides the Department upon reasonable notice a list of the names of each of its nonresident owners. The provision is effective for all tax years beginning after Dec. 31, 2008. Ala. Laws 2009 (H.B. 69), approved March 24, 2009.

Georgia—Amended Reg. §560-7-8-.34 updates withholding requirements for distributions to nonresident members of pass-through entities. The amended regulation broadly defines "distribution credited" as a "recognition or assignment of interest in proceeds or property" of a pass-through entity, including a "net distributive share of income which is passed through to members and which may be subject to Georgia income tax." A "nonresident" is defined as an individual or fiduciary member who resides outside Georgia and all other members whose headquarters or

principal place of business is located outside Georgia. As for distributions to nonresidents, certain items are subject to Georgia income tax, including the nonresident's share of Georgia separately stated (provided no deduction for items of loss exists) and non-separately stated income. An entity is required to withhold tax on the payment of guaranteed payments and distributions being credited, but not paid, to nonresident members. In lieu of withholding, the entity is allowed to make an election to file a composite return for one or all nonresident members. Nonresident members whose aggregate annual distributions are less than \$1,000 can now be included in the return. The amendment gives further guidance on computing the tax due, and the options available to make the computation under the composite return. Also, nonresident withholding is not required for distributions paid or credited to a member which also is a pass-through entity, provided the entity makes certain elections and agreements. Finally, a withholding statement must be distributed to any nonresident member and filed with the Department on or before the earlier of the date the return is filed or the due date for filing the return of the pass-through entity. These amendments are retroactively effective for taxable years beginning on or after Jan. 1, 2008. Ga. Dept. of Rev., Adopted Amended Reg. §560-7-8-.34. (issued Jan. 8, 2009).

Utah—New law (S.B. 23) requires certain pass-through entities to withhold and remit income tax on behalf of an individual, C corporation, or other pass-through entity owner, on or before the due date of the pass-through entity's return, not including extensions. Provisions of the bill define "pass-through entity" to include an S corporation, general partnership, limited liability company, limited liability partnership, limited partnership, or similar business entity. A pass-through entity is not required to withhold income tax on behalf of a resident *individual* owner. Thus, by implication, withholding is required on behalf of a resident owner that is a C corporation or pass-through entity. An exemption is also provided for a pass-through entity that is exempt from corporate income tax or that is (1) a publicly traded partnership as defined by IRC §7704(b), (2) classified as a partnership for federal income tax purposes, and (3) that files an annual information return identifying and reporting certain information on partners with Utah-source income exceeding \$500 in a taxable year. Provisions of S.B. 23 also provide rules for determining the character of the income, gain, loss, deduction, or credit, and reporting and filing requirements for pass-through entities for corporate and personal income tax purposes. This provision is effective for taxable years beginning on or after Jan. 1, 2009. Utah Laws 2009, S.B. 23, signed by the Governor on March 25, 2009.

Wisconsin—New law (A.B. 75) requires a pass-through entity to pay withholding tax on the income allocated to nonresident partners, members, shareholders, or beneficiaries in four quarterly installments (due

in the 3rd, 6th, 9th, and 12th month of the taxable year. Wis. Laws 2009, Act 28 (A.B. 75), signed by the Governor on June 29, 2009.

B. Classification of Entity

Massachusetts—New law (H. 4904), which was signed by the governor on July 3, 2008, adopts the federal tax classification rules for unincorporated entities starting with tax years beginning on or after January 1, 2009 (i.e., adoption of federal check-the-box provisions). Prior law adopted the federal entity classification rules for LLCs, but not for other unincorporated entities. Under H. 4904, partnerships, business trusts, and LLCs will generally be classified for Massachusetts purposes in the same manner as the entity is classified for federal income tax purposes. Business trusts that are taxed as corporations for federal income tax purposes will be fully subject to the corporate excise, including the corporate income tax and a .26% net worth / property tax. Under prior law, business trust income was taxed at a 5.3% rate and there was no net worth or property tax imposed at the state level. Dividends from former business trusts now taxed as corporations will be eligible for the corporate excise dividends received deduction to the same extent as dividends paid by corporations. Transition rules with respect to pre-existing business trusts require resident shareholders to pay tax on distributions of previously untaxed business trust income earned before the business trust became subject to taxation as a corporation.

In addition, under H. 4904, partnerships will no longer be permitted to be taxed as corporations for federal purposes while retaining partnership treatment in Massachusetts (so called “99-13 partnerships” under prior law). Rather, partnerships will now be taxed according to their federal income tax classification.

Consistent with the change to conform to the federal entity classification rules, the H. 4904 revises the entity level income tax with respect to S corporations with QSUBs. Under prior law, QSUBs and disregarded LLCs owned by S corporations were treated as taxable entities separate from the S corporation. Under H. 4904, QSUBs and LLCs owned by S corporations will be disregarded under the corporate excise. Effective for tax years beginning on or after January 1, 2009, the income, property and apportionment factors of a QSUB or disregarded LLC owned by an S corporation will be included in the income and non-income measures of its parent S corporation.

Department of Revenue Guidance

The Department of Revenue has issued a working draft of Technical Information Release 08-15, which addresses new federal check-the-box rules adopted as part of H.R. 4904. Unincorporated businesses with two

or more members are allowed to elect to be taxed as either corporations or partnerships. Unincorporated associations with a single member may elect to be taxed as corporations or they may elect to be disregarded as an entity separate from their owner. An entity's federal check-the-box election or default federal classification will also apply for Massachusetts personal income tax and corporate excise tax purposes; no separate Massachusetts election is required or permitted. S corporations for federal tax purposes, which were formerly permitted to be treated as a partnership, corporate trust or financial institution for Massachusetts tax purposes, are now treated as S corporations for federal tax purposes. Also, an S corporation must take into account its QSUB's income less deductions and credits in determining its net income. Previously, QSUB's were separately subject to an entity level tax. Also, partnership status in Massachusetts now conforms to the entity's federal status. As to corporate trusts, the new legislation eliminates the separate taxation rules. It is important to note that several provisions remain concerning the taxation of and required accounting for tax-free earnings and profits of corporate trusts, and other distributions. As to LLC's, the specific statutory provisions subjecting only LLCs to the federal check-the-box rules have been removed, since these provisions are no longer necessary in light of the general applicability of the federal classification rules. The guidance also explains the tax consequences of a reclassification of an entity and provides rules for changes to the estimated payment obligations of an affected entity and its shareholders or members. Mass. Dept. of Rev., Working Draft - Technical Information Release 08-15 (Dec. 5, 2008).

New rule (830 CMR 63.30.3) provides guidance on recently enacted entity classification rules that changed the manner in which unincorporated businesses are classified and treated for Massachusetts corporate excise and personal income tax purposes. The Commonwealth now adopts the federal check-the-box rules, which permit unincorporated businesses to elect how they will be classified. The final rule notes the effect of the changes upon entity classification and the potential tax consequences of reclassification of entity choice. The transition rule, in effect for events occurring on or after July 3, 2008, is also detailed in the regulation. The rule is effective for taxable years beginning on or after Jan. 1, 2009. Mass. Dept. of Rev., 830 CMR 63.30.3, promulgated March 20, 2009.

Massachusetts—The revenue commissioner used her discretionary authority to allow a company classified as a domestic manufacturing corporation to continue to qualify as such even though for its 2009 tax year the application of the new check-the-box rules will result in it no longer meeting certain thresholds. Under Massachusetts law, corporations engaged in substantial manufacturing activities and that receive manufacturing corporation status are eligible for certain tax benefits. In order for a corporation to qualify for manufacturing corporation

status, a minimum percentage of a taxpayer's gross receipts, tangible property (35%) and payroll must be derived from manufacturing activities. Prior to the application of the new check-the-box rules, a wholly owned pass-through entity's manufacturing attributes flowed up to the company, causing it to meet the tangible property 35% threshold. Under the new rules, however, the pass-through entity is treated as a separate entity and as such, its attributes do not flow-up to the corporation, causing it to not meet the threshold. Even though the corporation no longer meets the tangible property threshold, it may be treated as a manufacturing corporation if, in the discretion of the Commissioner, its manufacturing activities are otherwise substantial. In this case, the Commissioner exercised her discretionary authority and allowed the company to continue to retain its manufacturing classification because it has previously been classified as such and would otherwise qualify if the pass-through entity's activity were included. Mass. Dept. of Rev., LR 09-3 (May 1, 2009).

C. Miscellaneous

Alabama—Amended rule 810-3-176-.01 grants an automatic six month extension to S corporations to file a composite return. Under Alabama law, composite returns and payments are due on the 15th day following the third month following the close of an Alabama S corporation's taxable year. While the entity is now granted an automatic six month extension to file the composite return, the extension does not permit an extension of time for actual payment of tax. The regulation also states that if an S corporation fails to file the return by the extended due date, it may not be granted an automatic extension the following year. Such an entity, however, may be required request such extension in writing. If required, the request must state the reasons for failing to timely file the return the previous year and that the entity has no outstanding debts owed to the Department of Revenue. Ala. Dept. of Rev., Ala. Admin. Code §810-3-176-.01, effective March 12, 2009.

Illinois—New law (H.B. 2239) repeals recently enacted changes for determining partnership base income subject to the replacement tax and restores the deduction allowed for personal services income of a partnership and certain compensation paid to partners. The repealed provisions (see Pub. Act 96-0045) amended the addition modification found in 35 ILCS 5/203(d)(2)(C) to provide that effective for taxable years ending on or after Dec. 31, 2009 no addition was required for certain guaranteed payments to individual partners for personal services by that partner. The repealed law also amended the subtraction modification under 35 ILCS 5/203(d)(2)(H) to limit the deduction for personal service income to taxable years ending before Dec. 31, 2009. Under the new law, taxpayers once again are allowed a deduction for personal service

income. Ill. Laws 2009, Pub. Act. 96-0835 (H.B. 2239), signed by the Governor on Dec. 16, 2009.

Indiana—New law (H.B. 1001) effectively reverses the Indiana Tax Court's decision in *Riverboat Development, Inc.* in which the court held that an S corporation was not required to withhold Indiana tax for its shareholders on income the corporation received via its membership interest in an LLC that operated a riverboat casino in Indiana because it did not have a commercial domicile in Indiana. Effective retroactive to January 1, 2009, the bill adds new section IC §6-3-1-35, defining "pass-through entity" to mean a corporation exempt from adjusted gross income under IC §6-3-2-2.8(2), a partnership, a trust, an LLC, or a LLP. In addition, IC §6-3-2-2 is amended to provide that income received from a pass-through entity shall be characterized in the same manner it is characterized for federal income tax purposes. Such income is considered Indiana source income if the person, corporation, or pass-through entity that received the income had directly engaged in the income producing activity. Income that is derived from one pass-through entity and is considered to pass through to another pass through entity does not change these characteristics or attribution provisions.

Provisions of the bill also provide that effective July 1, 2009, refunds related to the *Riverboat* decision are to be claimed as a tax credit. Specifically, if a nonresident owner of a pass through entity has a refund claim due to the *Riverboat* case for taxes incorrectly paid in 2005 – 2008, the Department of Revenue does not have to issue a refund but, rather, the taxpayer entitled to the refund must claim the refund as a tax credit from 2009 through 2018. If there is still a credit remaining at the end of 2018, the taxpayer will forgo any future credits/refunds. Additionally, the nonresident owner of the pass-through entity must provide information that shows that they reported the income to their home state equal to the income attributable to the amount of credit or refund requested for years 2005 - 2008.

New Hampshire—Effective Jan. 1, 2009, all distributions from LLCs, partnerships and associations (collectively "entity") are subject to New Hampshire's Interest and Dividends Tax ("tax") to the same extent distributions from corporations are subject to the tax. According to guidance issued by the Department of Revenue Administration, a distribution that is a return of capital is not subject to taxation. In determining whether a distribution is a return of capital, the entity first must determine its accumulated profits, which are determined for an entity and an S corporation in the same way a C corporation calculates earnings and profits. Liquidating distributions are not subject to taxation. Lastly, an entity that has non-transferable shares and that, under prior law, was required to file and pay the tax will no longer be required to file returns or

pay tax. Rather, members, partners, owners will have to pay tax on distributions from these entities. The Department said that it will issue regulations on these new provisions. N.H. Dept. of Rev. Admin., Technical Information Release No. 2009-008 (July 16, 2009).

New York—Per New York state law, the shareholder of an S corporation is required to add back to federal adjusted gross income the full amount of bonus depreciation (IRC §168(k)) that was passed through to the shareholder pursuant to NY Tax Law §612(b)(8). While the shareholder is required to add back the bonus depreciation, the shareholder is allowed to subtract the amount of the depreciation deduction that was available under IRC §167 before enactment of IRC §168(k). N.Y. Dept. of Taxn. and Fin., TSB-A-09(12)I (Sept. 23, 2009).

New York—Proposed Regulations - Rev. 901.01 through 903.11, sets forth the manner in which trusts, partnerships and LLCs compute accumulated profits. It also discusses: (1) sequence of distributions; (2) guaranteed payments for use of capital; (3) distribution as compensation for services provided; and (4) support for claim on non-taxable distributions. Also included in the proposed regulations are examples on debt financed by the entity and total undistributed revenues. The department is holding a public hearing on the proposed regulations on Dec. 16, 2009. N.H. Dept. of Rev. Admin., Proposed Regulations - Rev. 901.01 through 903.11, not consecutive.

New York—New law (A.157B/S.57B) impose an annual filing fee (currently imposed on LLC and limited liability partnerships) on all partnerships; and treat as New York-source income a nonresident's gain or loss from the sale or exchange of an interest in a partnership, S corporation, or LLC that owns real property located in New York when such property has a fair market value representing 50% or more of the total assets held by such pass through entity on the date of the sale (applicable to sales or exchanges occurring 30 or more days after April 7, 2009). Unless otherwise provided, these provisions took effect Jan. 1, 2009. N.Y. Laws 2009, Ch. 57 (A.157B/S.57B), enacted April 7, 2009.

New York—An out-of-state non-life insurance company generating no premium revenue from New York state, but invested \$1.36 million in a New York based limited partnership that invests in passive investments, will not be subject to tax under Art. 9-A (corporate franchise tax) if the limited partnership is classified solely as a portfolio investment partnership. If, however, it is determined that the limited partnership is not a portfolio investment partnership, the insurance company's ownership interest in the partnership will be examined to determine whether it is engaged directly or indirectly in the participation in, or the domination or control of, the partnership's business activities. Because the insurance

company's ownership interest in the partnership at the time of initial investment is greater than \$1 million, the company is deemed to be participating in, or dominating and controlling, the partnership. If the limited partnership is deemed to be a portfolio investment partnership, the insurance company is subject to the insurance franchise tax and will be required to file annual returns. N.Y. Dept. of Taxn. and Fin., TSB-A-09(2)C (March 2, 2009).

North Carolina—The Department of Revenue issued guidance for LLCs electing S Corporation status for federal purposes. In 2006, the law was changed to include an LLC that elected to be treated as a C corporation in the definition of "corporation". In 2008 the definition of "corporation" was further amended to replace the reference to "C corporation" to "corporation", which also includes S corporation. The amendment is effective for tax years beginning on or after Jan. 1, 2009. Because the general business franchise tax is imposed for the tax year in which the tax becomes due, this amendment impacts the franchise tax reported on the 2008 C Corporation franchise tax return since it is due on or before April 15, 2009. N.C. Dept. of Rev., "LLCs Electing to be Taxed as S Corporations Subject to Franchise Tax" (March 18, 2009).

Ohio—For tax year 2010, the Department of Taxation is waiving the requirement that S corporations file form FT 1120S - Notice of S Corporation Status. In general, corporations making a federal election to be treated as an S corporation must file with the Ohio tax commissioner a notice of such election between January 1 and March 31 of each tax year in which the election is in effect. Since this requirement is being waived for tax year 2010, investor information previously reported on FT 1120S, should now be reported on either form IT 4708 - Composite Income Tax Return for Certain Investors in Pass-Through Entity, or form IT 1140 - Pass-Through Entity and Trust Withholding Tax Return. Ohio Dept. of Taxn., CFT 2009-02 (Oct. 2009).

Oregon—New law (S.B. 180-A) requires regulated investment companies (RICs) and real estate investment trusts (REITs) that are not included in a federal consolidated return under IRC §1504(b)(6) to be included in the Oregon consolidated return filed by the affiliated group. This provision applies to tax years beginning on and after Jan. 1, 2010. Or. Laws 2009, S.B. 180-A, signed by the Governor on June 18, 2009.

Texas—The Comptroller of Public Accounts issued guidance regarding the tiered partnership election. According to the Comptroller, when filing the franchise tax return "the Tiered Partnership Election circle should not be blackened merely because an entity owns an interest in another entity that is treated as a partnership or S corporation for federal income tax purposes." This election is not mandatory. Rather, it is a filing option for

entities that have tiered partnership arrangements (i.e., an ownership structure in which any of the interest in one taxable entity treated as a partnership or S corporation for federal tax purposes -- a lower tier entity -- are owned by one or more other taxable entities -- an upper tier entity). The tiered partnership provisions allow a lower tiered partnership to pass its total revenue to an upper tier entity (the upper tier reports the passed revenue with its own revenue), but it does not allow the lower tier to pass its deductions for cost of goods sold or compensation to the upper tier. The guidance lists requirements for filing under the tiered partnership. Tex. Comp. of Pub. Accts., "Filing (or not) Using the Tiered Partnership Election" (May 2009).

Virginia—H.B. 2378 clarifies that the minimum tax is imposed on telecommunications companies and electric suppliers that are organized as pass-through entities (i.e., limited liability companies, partnerships, S corporations, or other entities treated as pass-throughs). The minimum tax on telecommunications companies is imposed at a rate of 0.5% of gross receipts, while the minimum tax on electric suppliers is equal to 1.45% of the electric supplier's gross receipts for the calendar year that ends during the taxable year minus the state's portion of the electric utility consumption tax billed to consumers. These provisions are retroactively effective Jan. 1, 2004. In addition, the bill provides that any taxes imposed on a pass-through entity itself (i.e., sales and use taxes, withholding taxes with respect to employees or nonresident owners, and minimum taxes in lieu of income taxes) must be paid by the pass-through entity. According to the bill, this change is "declarative of existing law" and as such is effective Sept. 1, 2004. Va. Laws 2009, Ch. 37 (H.B. 2378), enacted Feb. 23, 2009. See also Dept. of Taxn., Tax Bulletin 09-2 (March 11, 2009).

Wisconsin—The sole owners of two related small business S corporations were not permitted to take losses due to basis limitations. A small business S corporation may elect to have its profits and losses allocated pro-rata to its shareholders. A shareholder may deduct his or her share of the S corporation losses only to the extent of his or her adjusted basis in the stock of the S corporation. Basis may be acquired by either contributing capital or by directly lending funds to the company. Pursuant to IRC §1366(d)(1)(B), there are limited situations in which a shareholder can acquire basis with regard to indebtedness. First, the shareholder must make an actual economic outlay which leaves the taxpayer "poorer in a material sense". Second, the S corporation's indebtedness must run directly to the shareholder, and an indebtedness to another pass-through entity that advanced the funds and is closely related to the taxpayer does not satisfy this requirement. In this matter, the taxpayers' transfer of losses from one related S corporation to another related S corporation was not an economic outlay because the taxpayers failed to demonstrate they were "poorer in a material sense". The

taxpayers merely moved funds from one S corporation to another. Further, no "incorporated pocketbook" exception (i.e., an S corporation acts as an agent of the shareholder by making payments on the shareholders behalf) exists, and thus an S corporation's indebtedness to another closely-held pass through entity that advanced funds does not meet the requirements of IRC §1366. *Wayne Roden & Suzanne Balistreri*, Dkt. No. 05-I-157 (Wis. Tax App. Comm. Jan. 26, 2009).

VII. STATES' DISCRETIONARY AUTHORITY TO ADJUST INCOME

A. Intercompany Adjustments Under §482 or Similar Provisions

Illinois—Recently enacted legislation (H.B. 5069) limits the Director of Revenue's authority to reallocate items of income. Currently under IITA §404, the Director has the authority to adjust items of income and deduction, and any factor taken into account in allocating income to Illinois, to such extent as may reasonably be required to determine the base income properly allocable to Illinois. Effective August 29, 2008, the Director is prohibited from making an adjustment to base income that has the same effect as retroactively applying tax law changes made by certain tax legislation enacted in 2004 (Pub. Act 93-0840 - S.B. 2207), 2007 (Pub. Act 95-0233 - S.B. 1544) and 2008 (Pub. Act 95-070 – S.B. 783). These bills made significant changes to the corporate income tax law, including provisions related to apportionment, interest and intangible expense addback, captive REITs, business income, recapture of business expenses, investment partnerships, etc.

B. Adjustments Under UDITPA §18 or Similar Provisions

South Carolina—A group of taxpayers were allowed to use combined reporting as an alternative apportionment method in order to fairly represent the extent of their business activity in South Carolina, because use of the state's standard three factor (payroll, property, sales) apportionment methodology on a separate entity basis creates distortion. Under South Carolina law (S.C. Stat. §12-6-2320) if any of the statutory apportionment provision does not fairly represent a taxpayer's business activities in the state, the taxpayer may petition or the Department of Revenue may require the use of an alternative apportionment method, including the "employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." At issue in this case is whether "any other method" allows the use of combined reporting. In finding in favor of the taxpayer, the court held that use of combined entity apportionment methodology fits the definition of "any other"

apportionment method authorized by S.C. Stat. §12-6-2320 and that the Department has the statutory authority to allow the use of such method. Because application of the standard apportionment method on a separate entity basis results in an assessment that is 435% of the income tax and license fees compared to that resulting from use of combined reporting, an alternative method must be applied. In this case use of the combined entity apportionment methodology is an acceptable apportionment method as it accurately reflects the taxpayer's business activities in South Carolina. *Media General Communications v. South Carolina Department of Revenue*, No. 07-ALJ-17-0089-CC (S.C. Admin. Law Ct. May 4, 2009).

Tennessee—A taxpayer that publishes telephone directories for distribution in Tennessee was required to depart from the standard statutory apportionment formula to determine its Tennessee franchise and excise tax liability. Tennessee allocates and apportions income based on the formula adopted under UDITPA and, in pertinent part, uses the cost of performance method for sourcing sales, other than sales of tangible personal property. The state also adopts UDITPA's §18 relief provisions, which allow the taxpayer to petition for or revenue department to require the use of an alternative apportionment formula when use of the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in the state.

For the years at issue, the taxpayer calculated its Tennessee tax liability by apportioning its income, which was predominately derived from providing advertising services for directories it published, using the cost of performance method as all activities involved in producing the directories are either performed by the taxpayer in other states or are performed by independent contractors on behalf of the taxpayer in and out of Tennessee. The commissioner assessed tax, arguing that the statutory, cost of performance method used by the taxpayer does not fairly represent its activities in Tennessee, as evidenced by the fact that the taxpayer paid \$296,140 in Tennessee excise and franchise tax but derived advertising income from the distribution of almost 24 million directories in the state of \$897 million during the five year period at issue.

In upholding the commissioner's use of an alternative apportionment method -- the method used to source sales of tangible personal property -- an appellate court found this an unusual fact situation in that the costs of production occurred outside the state, but the revenue derived from the end product only occurred when the product was distributed in Tennessee, which only then obligated the purchasers to pay the revenue proceeds to the producer for the sale of the advertising. *Bellsouth Advertising & Publishing Corp. v. Tennessee Commissioner of Revenue*, No. 04-2232-IV (Tenn. Ct. App. Aug. 26, 2009).

C. Business Purpose Requirement/Sham Transaction Doctrine

Alabama—In reversing a Circuit Court ruling, the Alabama Court of Civil Appeals held that a manufacturer was required to add back deductions for royalties it paid to related intangible management companies (IMCs) for use of the IMC's trademarks, because it did not qualify for either the unreasonableness or "subject-to-tax" addback exceptions. In reaching this conclusion, the Alabama Court of Civil Appeals found that the lower court erred in interpreting the unreasonable exemption to be determined by an analysis of business purpose and economic substance. Rather, the unreasonable exception applies when the resulting tax would be out of proportion to the taxpayer's presence in the state. The Court also rejected the taxpayer's argument that since the IMCs paid North Carolina income tax on a portion of its royalty income, the entire amount of federal taxable income the IMCs listed on their North Carolina returns was "subject-to-tax". This exemption applies on a post-apportionment and not a pre-apportionment basis. Lastly, the Court found that the state's addback statute did not violate the Due Process or Commerce Clauses of the U.S. Constitution. *Surtees v. VFJ Ventures, Inc. f/k/a VF Jeanswear, Inc.*, No. 2060478 (Ala. Civ. App. Feb. 08, 2008), *aff'd*, *VFJ Ventures, Inc. f/k/a VF Jeanswear, Inc. v. Surtees*, No. 1070718 (Ala. Sup. Ct. Sept. 19, 2008), *cert. denied*, Dk. No. 08-916 (U.S. Sup. Ct. April 27, 2009).

Massachusetts—The tax commissioner properly disallowed deductions the Talbots claimed for royalties paid to a wholly owned intangible holding company (IHC) for use of its trademarks, trade names and services marks ("marks"), because the transfer and license-back transaction involving the marks lacked economic substance and a valid non-tax business purpose and as such were sham transactions. The Massachusetts Appellate Tax Board also found that the tax commissioner properly adjusted Talbots income by reattributing to Talbots all of the royalty and interest income earned by the IHC, eliminating interest and dividend income received by Talbots from the IHC, and allowing Talbots a deduction for amortization and other expenses related to the marks. *The Talbots, Inc. v. Commissioner of Revenue*, Nos. C266698, C271840, C276882 (Mass. App. Tax Bd. Sept. 29, 2009).

Massachusetts—The Appellate Tax Board reaffirmed and incorporated by reference its findings of fact in *The TJX Companies, Inc. v. Commissioner of Revenue* following remand of the case from the Massachusetts Appeals Court. In that case, the court held that a company that transferred its trademarks and service marks (marks) to related Nevada intangible holding companies (IHCs) that in turn licensed the marks back to the company was liable for additional corporation excise tax because the transfer and license-back arrangements constituted a sham transaction. At issue on remand was whether the Commissioner's

retribution of gain from the sale of certain intangible assets and other income to the related parties was proper. In finding that the retribution was proper, the Board reiterated that the fundamental objective of the company's plan to transfer the marks to the IHCs was "part of TJX's overall tax-avoidance strategy." Additionally, the Board noted that the company did not relinquish control of the marks upon transfer to the subsidiary and were, therefore, properly treated as the entity that sold the marks. *The TJX Companies, Inc. v. Commissioner of Revenue*, No. C262229-31 (Mass. App. Tax Bd. July 30, 2009).

Wisconsin—The new "transactions without economic substance"⁴³ provision allows the Wisconsin Department of Revenue to determine the amount of a taxpayer's taxable income or tax without regard to the transaction(s) not having economic substance that caused the reduction in taxable income or tax. In order for a transaction to have economic substance, the taxpayer must show all of the following: (1) the transaction changes the taxpayer's economic position in a meaningful way, apart from federal, state and foreign tax effects; and (2) there is a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing the substantial nontax purpose (i.e., the transaction has substantial potential for profit, disregarding any tax effects). Transactions between members of a controlled group will be presumed to lack economic substance. Taxpayers can rebut the presumption by establishing by clear and convincing evidence that a transaction or series of transactions between the taxpayer and one or more members of the controlled group has economic substance. This provision is effective for tax years beginning on and after January 1, 2009.

⁴³ Wis. Stat. §71.10(1m).
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