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STATE INCOME TAX UPDATE

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I. NEXUS ISSUES

1. *International Home Foods v. Treasury*, Michigan Supreme Court Dkt. 130542 (January 5, 2007).

The Michigan Supreme Court reversed the Court of Appeals' decision that International Foods could rely on the Department of Treasury's Administrative Bulletins addressing nexus and that Treasury may not retroactively apply the *Gillette* decision to a tax year before the release of the decision. The Appellate Court had distinguished the *Rayovac* decision because the Michigan Supreme Court had not considered a prior Supreme Court decision addressing the retroactive change of an administrative position.

2. *Steager v. MBNA America Bank*, 640 S.E. 2nd 226 (2006). Petition for Certiorari Pending. Dkt. 06-1228.

The West Virginia Supreme Circuit affirmed the Circuit Court's decision holding a Delaware domiciled bank that provided credit card services to West Virginia customers was subject to corporate net income tax.

In so holding the court concluded the taxation of the bank did not violate the Commerce Clause tests as set out in *Complete Auto Transit*. The first and fourth prongs require substantial nexus and a relationship between the tax and the state provided services. The court rejected the *Quill* bright line physical presence test reaffirming the test only applies to sales and use taxes. In reaching that holding the court noted that *Quill* reaffirmed the *Bellas Hess* physical presence for sales tax primarily on the ground of *stare decisis*. Second, the Court appeared to limit the application of the physical presence test to sales and use taxes. Finally, the evolution of commerce and the use of electronic commerce have made it possible for an entity to have a substantial presence in a state absent a physical presence. The court concluded that a significant economic presence test was a better indicator of whether substantial presence existed under the Commerce Clause because it requires both a quantitative and qualitative analysis.

3. *Lanco Inc. v. Director, Division of Taxation*, 908 A 2d 176 (2006). Petition for Certiorari Pending.

The New Jersey Supreme Court affirmed and incorporated the Appellate Court's decision holding that New Jersey may subject a corporation to income tax even though the corporation has no physical presence in New Jersey. Lanco, Inc. is a Delaware corporation that licensed intellectual property to its affiliate Lane Bryant. The company had no employees or property in New Jersey. The intellectual property however was used in the

state. In affirming the lower court the Supreme Court rejected Lanco's argument that the imposition of tax on a company that lacked physical presence in the state violated the Commerce Clause of the U.S. Constitution. The court specifically addressed the application of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), holding that the U. S. Supreme Court "did not equate the substantial nexus standard requirement with a universal physical presence requirement". Thus, the court concluded that the physical presence standard should only be applied in a sales and use tax context. The court reasoned that the substantial physical presence standard set forth in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), was met and the imposition of the tax did not violate the Commerce Clause.

4. *Sonic Industries v. State of New Mexico*, New Mexico Supreme Court No. 26,447. August 3, 2006.

The New Mexico Supreme Court reversed the Appellate Court holding franchise fees paid by New Mexico franchisees to an out-of-state corporation were subject to the gross receipts tax. The franchise fees are not subject to tax because the Legislature intended that the granting of license be taxed where it occurred. The transactions at issue occurred outside of the state of New Mexico.

The court concluded that the agreements between Sonic and its franchisees were similar to the license agreements in *Kmart Corp. v. New Mexico Department of Taxation*, New Mexico Supreme Court No. 27,269 (December 29, 2005). Thus, the Sonic agreements like those in *Kmart* were not sold in New Mexico. The Sonic agreements were executed and sold in Oklahoma and the rights set forth in those agreements were employed in New Mexico. The mere use of the property in New Mexico did not subject the franchise fees to tax.

5. *Geoffrey Inc. v. The Oklahoma Tax Commission*, Oklahoma Court of Appeals, No. 99,938 December 23, 2005.

The Appellate Court affirmed the holding of the Tax Commission that the imposition of Oklahoma income tax attributable to royalty income earned by Geoffrey under a licensing agreement which was based on sales within Oklahoma did not offend the Due Process Clause nor burden interstate commerce in violation of the Commerce Clause of the U.S. Constitution.

Geoffrey a Delaware corporation appealed an Order of the Oklahoma Tax Commission imposing income tax on the royalties received from licensing its intangibles. Toys R Us as part of a corporate restructuring in the mid-80's assigned certain intellectual property to Geoffrey. Geoffrey entered into licensing agreements with Toys R Us for the use of the marks. The

royalties for the use of the marks were equal to either two percent or three percent of sales depending on the mark. The licensing of intangible property was the sole business activity of the company. The company did not maintain an office or have employees in Oklahoma.

The Appellate Court rejected Geoffrey's argument that the Commerce Clause requires substantial nexus through physical presence and that the Due Process requires minimum contacts. In so doing, the court rejected the argument that the *Quill* decision extended the bright-line physical presence test to all taxes. Applying the benefits test, the court concluded that the real source of income was not the agreement but rather the Oklahoma customers and by providing an orderly society in which to conduct business made it possible for to earn the income. The tax is rationally related to the benefits and protections provided by Oklahoma. Further, the Due Process minimum contacts requirement was met because Geoffrey purposefully directed its activities toward Oklahoma.

6. *Union Tank Car Company v. Department of Revenue*, Alabama Court of Civil Appeals, No. 2050652, April 13, 2007.

The Appellate Court has affirmed the Circuit Court holding an Illinois-based company engaged in manufacturing and leasing railcars is not "doing business in Alabama or deriving income from sources within Alabama" and, therefore, is not subject to Alabama corporate income tax. The statutory threshold for imposing the tax is not met, because all of the lease agreements are negotiated and executed in Illinois; the amount of the lease payments are fixed and are received in Illinois; and the manufacturer/lessor exercises no control over where the leased railcars are used.

7. *Asher, Inc. v. Director, Division of Taxation*, Dkt. No. 004061-2003, New Jersey Tax Court. January 5, 2006.

A Pennsylvania candy manufacturer that did not lease or own any real property in New Jersey was subject to the corporate business tax because the company's delivery drivers' activities included picking up damaged or returned goods and collecting delinquent accounts and those activities were not protected under P.L. 86-272. The drivers' activities were not ancillary to the solicitation of sales and could not be characterized as *de minimis*. Thus, the company lost the immunity of P.L. 86-272. Although the drivers' activities may have helped facilitate the sales because of the quality of service the activities did not help to facilitate the request for sales. The collection of both past and current accounts by the drivers was an activity that was independent of the sales activities and the solicitation of orders. Finally, the Tax Court relied on the fact there was a company policy regarding the pick-up of packages and collection of accounts.

Therefore, despite the total number of deliveries the existence of the policy made the activity sufficiently systematic to constitute a connection between the company and New Jersey.

8. *Texas Comptroller of Public Accounts, Decision Hearing No. 46,540* May 10, 2006.

The Comptroller has held that a corporation that solicited Texas customers through an Internet site was subject to the Franchise Tax because it used independent contractors to perform services for the customers. Specifically, the independent contractors performed building maintenance and repair services for the Texas customers. The Comptroller concluded the use of those independent contractors created a physical presence in the state because those individuals were significantly associated with the corporation's ability to establish and maintain a market.

9. *Cruise Intermodal Corp. v. Commonwealth*, Pennsylvania Commonwealth Court Dkt. No. 667 F.R. 2004, January 18, 2007.

The Commonwealth Court has held that a broker who hired independent truck drivers to make deliveries in Pennsylvania was doing business in the state for franchise tax purposes. Cruise Intermodal Corporation had no office, customers or payroll in Pennsylvania. The company hired independent truckers to make deliveries into the Commonwealth. The truckers made approximately 200 trips a year into the Commonwealth. The court held that since the franchise tax is a tax on the privilege of doing business in Pennsylvania rather than an income tax the safe-harbor provisions of P.L. 86-272 did not apply. Also, the company's reliance on Department rulings holding that deliveries by common carrier exempt a foreign corporation from taxation was misplaced. Cruise leased trucks from independent owners to make deliveries into the Commonwealth. As such, the company was engaged in the transportation of property in and through the Commonwealth. Through the lease agreements the company is employing property in the Commonwealth to accomplish a corporate purpose.

10. *Ruling of the Commissioner, P.D. 06-114*, Virginia Department of Taxation, October 11, 2006.

The Commissioner concluded a taxpayer's collection activities that consisted of calling and writing debtors to collect receivables alone was not sufficient to create nexus for Corporate Income Tax purposes. The net income tax is imposed on corporations with income from Virginia sources. In general a corporation will be subject to tax if it has sufficient business activity in Virginia to create a positive apportionment factor. In the matter in issue the taxpayer had no property or payroll within the

Commonwealth. Further the income producing activities for sales factor purposes occurred mostly outside the Commonwealth. Thus, the taxpayer was not likely to have a positive apportionment factor. Therefore, even if nexus had been created the taxpayer would not be subject to the Virginia corporate income tax.

11. *Secretary of the Department of Revenue and Taxation v. Dell International, Inc. et. al.*, Louisiana Appellate Court No. 2004 CA 1702, December 15, 2005. Remanded to Circuit Court.

The Louisiana Appellate Court has held that the use of independent contractors to provide repair services was sufficient contact with the state to require Dell to impose a use tax on the products it sold in the state. Dell had no property or direct employees in the state. Dell solicits orders from outside the state and the products are shipped from either Texas or Tennessee. The Dell products come with a “return-to-the factory” warranty. The company did provide on-site repair services and contracted with an unrelated third-party to provide those repair services. Dell collected and remitted tax on the service contracts but did not collect use tax on the sale of the products.

The court concluded that the use of independent contractors to provide computer repair services was substantial nexus as it allowed Dell to establish and maintain a market in Louisiana. The court found the third-party repair service provider to be an agent of Dell. The contract terms detailed the services to be provided and Dell retained control over a number of the services. The technician were trained and directed by Dell on how to perform the service call and repairs. The court concluded the extent and nature of the services provided the third-party service providers to Dell’s Louisiana customers as well as the impact of the service on the ability to establish and maintain a market was sufficient nexus to create the physical presence that is constitutionally required to impose a use tax collection requirement.

II. UNITARY ANALYSIS

1. *Yoshinaya West Inc. v. Franchise Tax Board*, California Court of Appeals No. B178751, June 26, 2006.

The Appellate Court concluded that a U.S. corporation was unitary with its Japanese parent. The U.S. corporation was engaged in a fast food take out business similar to that of its parent. In reaching the conclusion that the two companies were unitary in nature the court pointed to the fact the companies were in the same line of business, the management team of the U.S. company and two members of its Board of Directors were officers

and directors of the Japanese parent. Further, there was a systematic transfer of management between the two companies. Therefore, in the opinion of the court the U.S. affiliate received the benefit of an experienced management team. Thus, the presumption of unity as set forth in the California regulations had been met.

2. *Appeal of Apple Computers, Inc, California State Board of Equalization, 2006-SBE-02* The formal opinion was issued on November 29, 2006.

The SBE upheld the Franchise Tax Board's ("FTB") assessment on dividends paid by a controlled foreign corporation ("CFC") that was partially included in the water's-edge combined report. The issue relates to how subpart F income is included in a water's-edge combined return. The decision of the SBE is contrary to the holding in *Fujitsu IT Holdings v. Franchise Tax Board*, 120 Cal. App. 4th 459 (2004), that Subpart F income should be prorated between the Section 25106 dividend elimination provisions and Section 24402 dividend deduction provisions. Section 25106 requires the elimination of dividends paid by one member of the group to another if the income has been included in the combined return. Pursuant to section 24402 for the years in issue 100 percent of the dividends received from a subsidiary are eliminated. The method adopted by the SBE deemed that dividends are paid in part from the excluded income in a ratio that included income bears to the total income. In adopting this approach the SBE rejected the *Fujitsu* preferential ordering method that would have eliminated a larger portion of the dividend income.

Finally, the SBE addressed the issue of ordering when the taxpayer had previously filed on a worldwide basis. The SBE concurred with the FTB's position that the dividends must be first allocated to the current year's earning and profits. As a result, the dividends were subject to only a partial inclusion under the water's-edge provisions.

3. *Kidde America and Subsidiaries v. Director of Revenue, Missouri Supreme Court Docket No. SC87192, June 30, 2006.*

The Missouri Supreme Court has struck down a regulation prohibiting a corporation from electing to file a consolidated return after the due date of the original return. Kidd America is the parent company of an affiliated group of corporations. Masterchem is one of its affiliates and for the 2000 tax year the company filed a separate Missouri corporate income tax return. Subsequent to that filing Kidde determined it would be beneficial to file on a consolidated basis and amended its 2000 return requesting a refund. The Department denied the refund on the basis that the election was not made prior to the due date of the original return. Kidde conceded that it did not make the election before the due date of the original return

but argued the regulation was invalid because it did not contain a good faith exception similar to that found in the federal regulations. The court agreed pointing out the statute §143.961.2 requires that the rules and regulations follow as nearly as practicable the federal regulations. While the Missouri regulation reasonably approximated the language of the federal regulation it failed to take into consideration that portion of the federal regulation that grants taxpayers relief from the deadline by showing they acted reasonably and in good faith. Therefore, the regulation as adopted did not follow the federal regulation as “nearly as practicable” and was invalid. The court found that Kidde acted in good faith as it had relied on its accounting firm to file the returns and the firm failed to make the election.

4. *Letter of Findings No. 02-200400427* Indiana Department of Revenue, January 1, 2006.

A cigarette manufacturer was required to include its subsidiary an intellectual property company in its combined Indiana adjusted gross income tax return. The subsidiary had to be included because it was unitary in nature with its parent. The sole business activity of the subsidiary was the ownership and administration of the parent’s trade names and trademarks. The company’s income was generated by royalty payments for the use of the intellectual property. The Department concluded this was integral to the manufacture’s business and thus was unitary in nature. The combined return was required to fairly reflect the transactions between the companies.

5. *Appeal of Talbots, Inc.*, New York Division of Tax Appeals, Administrative Law Judge Unit, DYA No. 820168 (March 22, 2007).

The Administrative Law Judge held that the Division of Taxation did not err in requiring a corporation to file a combined report that included its wholly owned subsidiary because the taxpayer failed to rebut the presumption of distortion. The subsidiary held intellectual property and licensed the property to Talbots. The company paid royalties on the use of the property. Talbots argued that the royalty rates were arm’s length rates and as such there was not distortion. The ALJ concluded that although the payments were made at an arm’s-length the company must still establish there is economic substance and a business purposes for the transaction. The company failed to rebut the presumption of distortion and that the intellectual property assignment lacked both business purpose and economic substance.

III. TREATMENT OF PARTNERSHIPS AND LLCs

1. *Lanzi v. Department of Revenue*, Alabama Court of Appeals, Dkt. No. 2040298, June 30, 2006. Petition for Leave denied.

The Appellate Court reversed the lower court holding that a nonresident's income from an investment in a limited partnership was subject to tax. The court concluded the mere ownership of a passive investment did not meet the minimum contacts standard of the Due Process Clause.

Pursuant to the Alabama case law and statutory provision, the state may tax a nonresident's income from intangible property only if the taxpayer has established a commercial domicile in the state or if the intangible acquired business situs in Alabama. The taxpayer had no contact with Alabama other than the partnership investment. Therefore, neither exception to the general rule prohibiting the taxation applied to this matter.

2. *Asworth Corporation, HT Forum Inc. and D Aviation Services v. Revenue Cabinet*, Kentucky Board of Tax Appeals, Order No. K-19449, January 27, 2006. Appeal Pending.

The Board of Tax Appeals has held that a corporation that has no property or employees in Kentucky is not subject to tax on its distributive share of partnership income from a partnership doing business in the state. In so holding, the Board rejected the Department's argument that physical presence was not required and the receipt of a partnership distribution from an entity doing business in Kentucky was sufficient to meet the substantial nexus test. It should be noted the statute in effect for the period in issue imposed a tax on foreign corporations owning or leasing property in the state or who had employees in the state. Therefore, based on the statutory language Ashworth was not subject to tax.

Note: The Tax Modernization Plan, H.B.272, Laws 2005 amended the Kentucky statutory nexus standard to specifically provide that taxpayer's are doing business and are subject to the corporate income tax base on holding a general partnership interest in a partnership doing business in the state.

3. *Manpower, Inc. v. Commissioner of Revenue*, Minnesota Supreme Court, No. A06-468, December 7, 2006.

The Minnesota Supreme Court has held that it was proper for a taxpayer filing Minnesota corporate income tax returns to exclude the distributive share of a wholly-owned foreign subsidiary's net income. In so doing the court rejected the Commissioner's claim that the subsidiary became a

domestic entity when it elected under the federal check-the-box regulations to be classified as a partnership for federal income tax purposes. In so concluding the court accepted the taxpayer's argument that the subsidiary's change from a corporation to a partnership changed only the entity's legal nature not its nationality.

Although the entity was deemed a partnership under federal tax law a partnership cannot be formed or created under any federal law. In the United States partnerships may only be created or organized under the laws of the states. Further, the federal regulation to be treated as a partnership refers only to the entity's classification and not its nationality. The entity's status under the laws of France did not change.

4. *Northwest Energetic Service LLC v. Franchise Tax Board*, Superior Court for San Francisco County No. CGC 05-437721. April 13, 2006. (Appeal Pending)

The Superior Court has held that the California limited liability company ("LLC") fee scheme is an unfairly apportioned tax in violation of both the Due Process and Commerce Clauses of the U.S. Constitution. In so holding the court concluded the fee imposed by *Rev. & Tax Code* §17492 was a tax that raised general revenue funds and not a regulatory fee. The fee is imposed on any LLC doing business in California or holding a certificate of registration within the state regardless of the LLC's business activity in the state. Because the fee is based on the total net income from all sources worldwide the court concluded it was not fairly apportioned. Thus, the fee failed the third prong of the *Complete Auto Transit* test. The court also concluded the tax failed both the internal and external consistency tests of the fair apportionment prong because if an LLC has no activity in the state the fees reached beyond that portion of the economic activity conducted in the state of California. Further, if every state enacted a similar fee there would be an additional burden on interstate commerce because intrastate companies would only pay one tax and interstate companies would pay tax on the same income in every state in which they were doing business.

- a. See: *Ventas Finance LLC v. Franchise Tax Board*, San Francisco Superior Court No. CGC-05-44001, November 17, 2006 holding the LLC fee was an unfairly apportioned tax. The Franchise Tax Board has appealed the decision.
- b. The Franchise Tax Board has advised LLCs to file protective claims for refund to preserve their rights to refund upon completion of the litigation. Procedures dated March 17, 2006.
- c. Assembly Bill 1614, enacted in the 2006 Session would have

retroactively corrected the LLC fee. The Governor returned the Bill without his signature.

5. *Sahi USA Inc. v. Commissioner*, Massachusetts Appellate Tax Board, No. C262668, October 27, 2006.

The Appellate Tax Board concluded that the distributive share of the capital gain and ordinary income realized by a Delaware corporate general and limited partner from the sale of a lower-tiered New York partnership's interest in a lower tiered Massachusetts based partnership was subject to Massachusetts corporate excise tax. The Board held that the taxpayer, as a result of the tiered partnership arrangement had sufficient nexus for purposes of imposing the tax. The conclusion was based on the fact that the New York partnership and the taxpayer failed to establish that either entity had any business activities outside of Massachusetts. Further, the gain and the income at issue were directly attributable to the ownership, operation and management of a Boston hotel, the receipts of which were properly attributable to Massachusetts.

6. *In the Matter of the Appeal of Eli Lilly and Co.*, California State Board of Equalization, February 1, 2007.

The State Board of Equalization ("SBE") has concluded that a corporate partner was required to include its proportionate share of the apportionment factors of a unitary LLC that was characterized as a partnership for federal and state tax purposes in its combined return for the year in which the LLC was liquidated. California requires a partner to include its share of the partnership's factors for any partnership year ending within or with the partner's taxable year. Pursuant to both Federal and California tax laws the taxable year of a partnership closes when the entire partnership interest is terminated. Therefore, because the partnership interest terminated within the taxpayer's tax year the partnership's factors were required to be included in the unitary report.

IV. BUSINESS PURPOSE AND ECONOMIC SUBSTANCE

1. *VFJ Ventures, Inc. v. Surtees*, Montgomery County Circuit Court, CV-03-3172, January 24, 2007.

The Alabama Circuit Court held that a manufacturer was not required to add back royalty expense it paid to an affiliated intangible management company.

Lee in 1983 transferred its operating assets to Lee Apparel but retained the ownership of the intellectual property. In 1993, VF was created to hold,

manage and license the trademark portfolio. The company was headquartered in North Carolina. VFJ, manufacturers and markets jeans wear throughout the United States. The company had two distribution centers in Alabama. VJF paid royalties to Lee and Wrangler for the use of trademarks owned by each of the corporations. The company deducted the royalty expenses in computing apportionable Alabama income.

During the course of the trial VFJ established that the centralization of the trademark management created efficiency and allowed third-party licensing efforts to be coordinated. The centralization was also part of a larger corporate effort to have shared services. The company maintained an office with employees including trademark attorneys, a controller and a staff account. The employees monitored the trademark registration worldwide and authorized the licensing of such trademarks. The royalty rates were the same for related and third-party licensees. The company filed a return and paid tax on the royalty income in North Carolina.

The Circuit Court rejected the Department's argument that VFJ was required to add the royalty expenses back to apportionable income consistent with §40-18-35 because such an adjustment would be unreasonable based on the facts presented. The court found the companies were not sham companies but rather carried on activities that were vital to the operations of the entire group. Further, the payments were made in cash and thus, there was economic substance. Therefore, the royalty expense represented an ordinary and necessary business expense and did not represent the type of transaction the statute was designed to prohibit.

2. *In the Matter of Petition of Hallmark Marketing Corporation*, New York Division of Tax Appeals Dkt. No. 819956. January 26, 2006. (Appeal pending.)

The Administrative Law Judge (ALJ) has held the Department of Taxation and Finance could not forcibly combine Hallmark's distribution company with the out-of-state manufacturing company. In so concluding, the ALJ held Hallmark sustained its burden of establishing the inter-company pricing met the requirements of Internal Revenue Code §482. Thus, the company successfully rebutted the Department's presumption of distortion.

Hallmark Cards is engaged in the design, manufacture and sale of social expression products. Hallmark Marketing, a subsidiary, was the exclusive domestic distribution arm of the products. The products were sold primarily to third-party retailers located throughout the U.S. Hallmark marketing purchased the products from Hallmark Cards. The purchase price was set in accordance with a contemporaneous transfer pricing study. The product's purchase price was arrived at by analyzing the

profits earned by comparable third-party companies. Hallmark Marketing's profitability was consistent with that of the unrelated third-party companies.

Hallmark Marketing filed its own New York return. On audit the Department attempted to combine the company with Hallmark Card. The ALJ in holding the companies should not be combined relied on the fact that the inter-company pricing was consistent with the reasonable and flexible approach suggested by Internal Revenue Code §482.

3. *Ruling No. 06-33, Virginia Department of Revenue, March 22, 2006.*

The Commissioner of Revenue has concluded that a corporation was not entitled to an expense deduction for interest paid to its wholly-owned subsidiary because the subsidiary lacked economic substance. The taxpayer filed a separate corporate income tax return deducting the interest paid on an outstanding loan from a wholly-owned subsidiary. The subsidiary was formed in the late 1980's to manage the loans of the taxpayer's affiliates that were located in a number of foreign jurisdictions. As the foreign loans were repaid the funds were loaned to domestic affiliates. The loans were structured as demand notes generally with a floating rate of interest. The loans were not collateralized. In analyzing the economic substance of the company the Commissioner looked to the governance of the company. The officers and directors of the company were similar to those of the taxpayer and there was no evidence that they were fairly compensated for their duties. Further, the company incurred minimal expenses for payroll and rent. The expenses were not commensurate with that of a company with \$100 million portfolio. The notes themselves did not meet the statutory safe harbor requirements for intercompany loan transaction because there was no collateral and no penalty for failure to pay. Finally, the Commissioner found neither the taxpayer or the subsidiary incurred any risk in the transactions. Therefore, because the subsidiary does not have a valid economic substance and the intercompany transactions were not conducted at arm's length the Commissioner consistent with the holding in *Commissioner v. General Electric*, 372 S.E. 2d. 599 (1988), has the authority to disallow the interest expense deduction.

VI. BUSINESS INCOME

1. *ABB C-E Nuclear Power, Inc. v. Director of Revenue, Missouri Supreme Court, Dkt. SC 87811, January 30, 2007.*

The Missouri Supreme Court affirmed the Administrative Hearing Commission's decision that the gain recognized on the deemed sale of assets was non-business income.

ABB C-E Nuclear ("ABB") was sold in April 2000 and the parties elected to treat the stock sale as a deemed asset sale under IRC section 338(h)(10). The sale proceeds were distributed to the parent in a complete liquidation of the company. The court concluded the transactional test was not met because the sale of ABB's assets in a complete liquidation was not the type of business transaction in which the company regularly engaged. With respect to the functional test the sale of ABB's assets was not a disposition that constituted an integral part of ABB's ordinary business. The sale and liquidation were a one time extraordinary event. The gain was properly characterized as non-business income.

2. *National Holding, Inc. v. Zehnder*, Dkt. 4-06-013-48 Illinois Appellate Court 4th District, January 18, 2007. Petition for Leave to Appeal pending.

The Appellate Court has affirmed the Circuit Court's holding that the gains recognized on the sale of assets of National Tea and Super Markets were properly characterized as non-business income. In so holding the court re-affirmed the existence of the exception to the functional test when a transaction results in a cessation of business and the proceeds are distributed to the shareholders.

National Holding was owned and controlled by Loblaw Corporation, Ltd. a Canadian company. National Holding in turn owned a 100 percent of national Tea which in turn owned a 100 percent of national Super Markets, Inc. National Super Markets and National tea operated retail grocery stores in Illinois. In June 1995, Super Markets and national Tea sold their assets to Schuuck Markets, Inc. and ceased operating the retail grocery store business. In September 1995, Supermarkets distributed its assets to National Tea and national Tea paid a dividend of the total proceeds to National Holdings. The proceeds were then contributed to a wholly owned subsidiary of Loblaw. The proceeds were not used in conducting business within the United States.

In reaching the conclusion that the gain was non-business income the court rejected the Department's argument that the functional test had been met because the assets had been used in the regular business operations. Rather, the court found that a complete reading of the *Texaco Cities Services Pipeline v. McGaw*, 182 Ill. 2d 262 (1998), indicated that a modified form of the functional test would be applied if the transaction involves a disposition of assets made pursuant to a corporate liquidation and a cessation of business. The transaction in issue involved a complete

cessation of the retail grocery business. Further the proceeds of the liquidation were not re-invested in the ongoing retail grocery business. Thus, the liquidation exception of the functional test was correctly applied. Therefore, the gains were properly characterized as non-business income.

3. *Science Application International Corporation v. Comptroller of the Treasury*, Maryland Tax Court No. 04-IN-00-0632, May 11, 2006.

The Tax Court has held that the gain recognized on the sale of a subsidiary's stock was not taxable by Maryland. Science Application held the stock as an investment and it did not serve as an operational function to the company's business activities. Further the taxation of the gain resulted in income being attributed to Maryland that was out of the appropriate proportion of the business transacted in the state.

Science Application is a Delaware corporation that was headquartered in San Diego. The company provided diversified and technical computer services to both the government and commercial customers on a global basis. In 1995 the company purchased the stock of Network Solutions, Inc. ("NSI"). NSI's primary business activity was providing Internet domain registration services on a worldwide basis. In 1997, Science Application sold 24 percent of its interest in an initial IPO. A second public offering of NSI shares was held on February 2, 1999 and Science Applications reduced its ownership interest to 45 percent. Initially, the \$715,850,753 capital gain from the second offering was reported to Maryland. The taxpayer sought a refund and the Comptroller denied the request.

The Tax Court in concluding the gain was not subject to tax cited the Appellate Court decision in *Hercules v. Comptroller*, 351 Md. 101 (1998) holding that to levy a tax there must be some nexus linking the income to the activities within the state. In reaching the conclusion the Tax Court notes NSI had no facilities, employees or operations in Maryland. Further, the company was operated as a distinct business and had minimal arm's length contacts with Science Application. The proper level of inquiry under the *Allied Signal*, standard is the actual connection between the subsidiary investment and the parent. It was evident from the facts that the acquisition of and the ultimate sale of NSI served a purely investment function and that there was no integration of the businesses. The evidence supports the fact that Science Applications acquired NSI for the purpose of selling the company for a profit in an IPO. As a result there is no link between the gain and the Maryland operations.

4. *Siegel-Robert, Inc. v. Ruth E. Johnson*, Tennessee Chancery Court No. 00-3763-III, August 17, 2006.

The Chancery Court has held that the interest income earned on investments in U.S. Treasury securities was non-business income and not subject to apportionment. The company invested in repurchase agreements and other overnight investments. The investment income was not returned to the business in the form of working capital. Therefore, the court concluded that the income served an investment function. In reaching that conclusion the court rejected the Commissioner's argument that the liquidity of the funds made them susceptible to being used as working capital. Finally, the court concluded that the income generating activities took place out side the state and were not connected to the business activity in the state. Therefore, citing *Allied-Signal*, the court concluded that the unitary business principle was not satisfied and the income could not be apportioned to Tennessee.

5. *The Mead Corporation v. Illinois Department of Revenue*, Illinois Appellate Court No. 00-CH-7854, November 3, 2006. Petition for Leave to Appeal denied January 24, 2007. Petition for Certiorari filed.

The Appellate Court affirmed the Cook County Circuit Court's decision that the gain recognized by Mead on the sale of the assets of Lexis/Nexus was properly characterized as apportionable business income.

Lexis/Nexus was a division of Mead in 1994 and the income and apportioned factors of the division were included in the Illinois combined return. The company sold the assets of Lexis/Nexus in 1994 recognizing a gain of \$1,056,001,948 on the transaction. Mead characterized the gain as non-business income. In addition, Mead included the gross receipts from the sale of various financial instruments in the denominator of the sales factor. On audit, the Department recharacterized the gain as apportionable business income and excluded the gross receipts from the sale of the financial instruments from the computation of the sales factor. The interest income earned on the financial instruments was included n the denominator of the sales factor.

In reaching its conclusion, the court rejected Mead's argument that taxing the gain violated the Constitution finding that Lexis/Nexus served an operational purpose for Mead. Specifically, Mead included Lexus/Nexus in its strategic planning. Although there was no functional integration between the two companies there was sufficient evidence to support the Circuit Court's finding that it was an operational asset. In reaching its conclusion the court distinguished the decision in *Hercules Inc. v. Department of Revenue*, 324 Ill. App. 3d 329 (2001).

The court also rejected Mead's argument that the gain was non-business income because it resulted from the liquidation of an entire line of business, thus, falling within the exception to the functional test. The basis

for the court's conclusion was the fact Mead did not distribute the sale proceeds to its shareholders but rather used the proceeds to buy back stock and reduce the company's debt. The fact that Mead invested the proceeds in its ongoing business takes the transaction outside the scope of the exception to the functional test.

Finally, the court affirmed the Circuit Court's holding that only the net proceeds from the sale of financial instruments should be included in the denominator of the sales factor. The court concluded that the apportionment statute explicitly provides for modification of the provision and the regulation requiring only the net gain is considered within that statutory provision and within the authority of the Department. The inclusion of the net proceeds resulted in a fair representation of Mead's business activities in Illinois.

6. *Chambers et. al v. Utah State Tax Commission*, District Court No. 050402915, January 25, 2007.

The District Court has concluded the gain recognized on the sale of River Gas corporation (RGC) to Conoco Phillips was not apportionable business income. RGC was an S corporation domiciled in Alabama. The shareholders sold all of the company's outstanding stock to Conoco Phillips on September 12, 2000. The parties made an election pursuant to IRC section 338(h)(10) to treat the Sale as an asset sale. As a result RGC filed a short period return and reported the gain on the deemed asset sale. The gain was characterized as non-business income allocable to Alabama. The plaintiff paid personal income tax on the gain.

Utah has adopted the UDIPTA definition of business income. The court in a case of first impression interpreted the application of both the transactional and functional tests. The court recognized that a total liquidation would not meet the transactional test because it would never be executed in the ordinary course of the business.. In applying the functional test the court concluded that it should not read the it so broadly as to include gains from the complete sale or liquidation of a business. The disposition of the property was not integral to RSG's regular trade or business operations as it resulted in a complete cessation of the business operations.

7. *Idaho State Tax Commission Decision Nos. 18721-18730*, June 9, 2006.

The State Tax Commission has held that a corporation was not required to apportion the gain recognized on the sale of stock initially purchased in a failed hostile takeover attempt because there was no indication the company was in the business of corporate raiding or trading in stock. Further, the acquisition and disposition of the stock did not occur in the

regular course of the taxpayer's business activity. Similarly, the gains recognized on the disposition of stock warrants were also characterized as a allocable non-business income because the warrants represented a passive investment in an unrelated company. Finally, the Commission did conclude the gain recognized on the sale of a consolidated subsidiary was apportionable business income because the entity was in the same general line of business as the taxpayer.

8. *NICOR, Inc. v. Illinois Department of Revenue*, No. 05-L-01306, Circuit Court of Cook County, April 19, 2007. (Appeal Pending)

The Circuit Court in granting the Taxpayers Motion for Summary Judgment held that the gain recognized on a Section 338(h)(10) transaction must be characterized as non-business income as a matter of law. .NICOR Oil and Gas Corporation (“Company”) owned all of the stock of NICOR Exploration and Production Company which in turn had a number of subsidiaries. The Company and its subsidiaries were domiciled in Denver and had no property in Illinois. In 1992 sold all of the stock of in its subsidiary. The parties jointly entered into an agreement to treat the sale as a deemed asset sale pursuant to IRC Section 338(h)(10). NICOR reported the gain on the transaction as non-business income. The Department re-characterized the gain as apportionable business income. The court in rejecting the Departments re-characterization reaffirmed that there was a liquidation exception to the functional test. A n election under Section 338(h)(10) fails squarely within that exception as there is a cessation of business by the “target” and there is a distribution of the proceeds to the shareholders.

VII. APPORTIONMENT ISSUES

A. Receipts Factor

1. What are Gross Receipts?
 - a) Multistate Tax Commission Resolution

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.

- b) *The Limited Stores, Inc. v. Franchise Tax Bd* California Supreme Court No. S136922, November 15, 2006.

The California Supreme Court returned the case to the Appellate Court with instructions to the court to vacate the prior decisions and reconsider the case in light of the decisions *Microsoft* and *General Motors*.

- c) *General Motors Corp. v. Franchise Tax Bd., General Motors Corp. v. Franchise Tax Board*, California Supreme Court No. S127086, August 17, 2006. Petition for Reconsideration denied October 25, 2006.

The California Supreme Court reversed the Appellate Court holding the redemption of marketable securities at maturity generates gross receipts that are includable in the sales factor and remanded that portion of the case to determine if §25137 relief is applicable. The court affirmed the Appellate Court's decision that only the net receipts received from repurchase agreements should be included in the sales factor.

General Motors maintains a treasury department in New York. The treasury department invested excess cash in various marketable securities including treasury bonds, notes and bills as well as bank certificates of deposit. The investment income was derived from (1) direct sales, (2) redemptions; and (3) repurchase agreements. Approximately 90 percent of the proceeds were from repurchase agreements. General Motors filed its return for the 1986 through 1988 tax years characterizing the income as non-business income. The FTB re-characterized the income as apportionable business income and included the net proceeds from the transactions in the factor. After exhausting its administrative remedies General Motors filed a refund complaint in Superior Court. A secondary issue was the use of the research credit, *e.g.*, should the entire unitary group be allowed to use the credit.

The court first addressed the issue of marketable securities concluding that the entire redemption price is included in the sales factor as a gross receipt. This conclusion is consistent with the *Microsoft* decision. This issue was remanded to allow the FTB to make a §25137 argument consistent with the court's analysis in *Microsoft*.

The matter was remanded to the Appellate Court for further proceedings in light of *Microsoft*. The Appellate Court has remanded the case to the Superior Court with instructions to consider the FTB's argument that the inclusion of the receipts results in distortion. Court of Appeals January 29, 2007.

- d) *Toys "R" Us, Inc. v. Franchise Tax Bd.*, California Supreme Court No. S143422, November 15, 2006.

The California Supreme Court returned the case to the Appellate Court with instructions to the court to vacate the prior decisions and reconsider the case in light of the decisions *Microsoft* and *General Motors*.

- e) *Microsoft Corporation v. Franchise Tax Board*, California Supreme Court No. S133343 August 17, 2006. Petition for Reconsideration denied October 25, 2006.

The California Supreme Court has held that the proceeds derived from the sale of short-term securities are gross receipts for apportionment purposes but may not be included in the computation of the sales factor because to include the receipts in the denominator would distort the apportionment of Microsoft's business activity within and without California.

Microsoft invests its cash portfolio in marketable securities. The company filed an amended return for the 1991 tax year and included the gross proceeds from these security transactions in the computation of the sales factor. The FTB, on audit, excluded the portion of the receipts that represented the return of principal. Microsoft appealed the adjustment. The Superior Court agreed with Microsoft holding the entire amount received from the redemption of securities were gross receipts and that the FTB failed to carry its burden of showing that a §25137 modification to the formula was required. The Appellate Court reversed holding the inclusion of the gross receipts seriously distorted the apportionment formula. Citing §25137 the court concluded the return of capital portion of the transaction should be excluded from the computation of the apportionment formula.

The California Supreme Court first addressed Microsoft's argument that §25120 defines the term "sale" to mean all gross receipts. The court agreed that as the term is defined it implies the whole amount received not just that in excess of the purchase price. In reaching that conclusion the court looked to the legislative history behind UDITPA as well as economic reality of the transaction. Focusing on the actual rights and benefits acquired

the court concluded gross receipts include the entire redemption price.

Upon concluding that the entire redemption price constituted gross receipts the court then addressed the FTB's §25137 argument that the inclusion of the receipts did not fairly represent Microsoft's business activity in the California. The court recognized that §25137 ordinarily applies to non-recurring situations but there is nothing to limit it to such situations. Therefore, the court rejected Microsoft's argument that the section does not apply.

The court applied both a qualitative and quantitative analysis for purposes of a §25137. The Microsoft treasury function is qualitatively different from its principal business. Thus, the nature of the treasury function receipts differ from the gross receipts derived from other business activity. The difference was analogous to an apple and orange comparison that may require a correction.

Turning to the quantitative analysis, the court compared the income generated by the treasury transactions to the impact those receipts have on the factor. Specifically, the treasury function generated approximately two percent of Microsoft's business income but approximately 73 percent of the receipts. The inclusion in the factor would reduce by approximately half the income attributable to California. The court found this to be distortion and sufficient to invoke relief under §25137.

Finally, although the inclusion of net receipts in this instance is reasonable it may not be a reasonable resolution in all cases. Therefore, the court rejected the FTB's proposed that the inclusion of net receipts is the only adjustment that is acceptable. The court cautioned that if the treasury function provides a substantial portion of the business income the inclusion of the net receipts may not fairly represent the California business activity.

- f) *Notice 2006-3*, California Franchise Tax Board, September 28, 2006.

The Franchise Tax Board on August 6, 2004 issued Notice 2004-5 that provided a taxpayer who is subject to the standard apportionment rules may be subject to the accuracy-related penalty of *Rev. & Tax Code* §19164 if the taxpayer took a position based on *Rev. & Tax Code* §25137 without prior approval from the FTB. The FTB, in light of the *Microsoft* decision has indicated that a taxpayer that has included on the interest income and net gains

from the sales of securities will not be subject to the accuracy-related penalties. However, the determination as to whether the receipts should be excluded from the sales factor as a fair reflection of the taxpayer's business activity will remain a subject to audit and may be adjusted on a case by case basis.

- g) *Arizona Corporate Tax Ruling, CTR 07-1, April 3, 2007.*

The Department of Revenue has concluded that the inclusion of the return of principle from the investment of liquid assets that are held for use in the business in the computation of the sales factor inherently distorts the apportionment of income to Arizona. Therefore, only the net gain from the investment of short-term securities is included in the sales factor of the apportionment formula. This ruling is consistent with the decision in *Walgreen Arizona Drug. Co. v. Department*, 209 Ariz. 71 (Ariz. App. 2004)

2. *Paccar Inc. v. State of Alabama Department of Revenue*, Administrative Hearing Dkt. No. Corp-04-715, January 11, 2006.

An Administrative Law Judge ("ALJ") has held that sales of trucks to Alabama dealers must be included in the numerator of the sales factor because the trucks were ultimately delivered in Alabama. Paccar manufactures trucks and truck parts outside of Alabama. The company sold the trucks and parts to dealers located in Alabama. The parts were shipped directly to Alabama via common carriers and are not in issue in this matter. With respect to the trucks, Paccar contracted a third-party carrier to pick up the trucks at one of the company's manufacturing locations. Title and risk of loss passed to the dealer at that time. Paccar argued that the truck sales should not be included in the numerator of the sales factor because the trucks were delivered outside of Alabama. In rejecting that argument, the ALJ analyzed the purpose of the sales factor and the language of UDITPA. He concluded that the purpose of the sales factor is only satisfied if the sales are attributed to the state where the property is finally delivered because the delivery state is the state from which the income is derived. Therefore, the Alabama truck sales should be included in the numerator of the sales factor.

3. *In the Matter of Disney Enterprises, Inc. v. The Appeals Tribunal*, New York Supreme Court Appellate Division, (March 1, 2007).

The Appellate Court affirmed the Tax Tribunal's holding that the sales of Buena Vista Home Video, Inc. (Video) should be included in the numerator of the sales factor and the value of the intangible property should not be included in the computation of the property factor.

Disney Enterprises files a combined New York return that includes Video. Video had no New York presence on a stand-alone basis. The Department on audit included Video's sales in the numerator of the receipts factor and excluded the value of the intangible property from the property factor denominator. Disney argued the inclusion of the receipts violated P.L. 86-272. In rejecting the argument the court concluded that Video could not be viewed alone but rather had to be viewed as part of the unitary group. The inclusion of the receipts did not result in the taxation of Video but rather was required to adequately represent the group's New York activities. Further, P.L. 86-272 only prohibits the taxation of the business activities within the state by or on behalf of the person are limited only to the solicitation of orders for sales. One must look to the activities of the members of the unitary and in this matter their activities benefited Video and were beyond mere solicitation. The court rejected the concept that a single member's role should be extracted from the group and analyzed separately and then afforded the protection of P.L. 86-272.

The court also rejected Disney's argument that the value of the film negatives should be included in the property factor denominator. Pursuant to the plain meaning of the statute intangibles such as the copyrights are not to be included in the factor.

4. Throwback Rule

- a) *Home Interiors & Gifts, Inc. v. Comptroller of Public Accounts*, Tx. Appellate Court No. 03-04-00660-CV, July 28, 2005. Taxpayer's Petition for Rehearing granted and revised decision issued September 22, 2005. Petition for Review denied March 9, 2007.

The Texas Appellate Court reversed the District Court and held the earned surplus throwback rule was not internally consistent and therefore violated the second prong of *Complete Auto Transit* test.

Home Interiors is a Texas corporation that is engaged in the business of purchasing home decorating products and accessories and wholesaling the products to independent contractors. The company sells products in all states and the District of Columbia, but has no business facilities outside Texas. The Texas Franchise Tax is imposed for the privilege of doing business in Texas. The tax is assessed on the greater of a 4.5% tax on net taxable surplus (income based) or a .25% tax on net taxable capital (net worth base). A single sales factor is used to apportion a multistate corporation net earned surplus or net taxable capital. If the corporation is not subject to tax in the purchaser's state the sales are thrown-back to Texas and included in the numerator of the

factor.

Home Interiors argued the application of the throwback rule resulted in unfair apportionment and thus is an unconstitutional burden on interstate commerce. The Appellate Court agreed concluding the Texas tax scheme was internally inconsistent. Applying the hypothetical internal consistency test to the integrated Texas franchise tax on an interstate corporation that resides in Texas and is protected by P.S. 86-272 in other states, would be subject to both a tax on capital in one state and on earned surplus tax in Texas. However, a similarly situated intrastate corporation would only be subject to the greater of the two taxes. In reaching that conclusion the Appellate Court rejected the Comptroller's argument that the internal consistency test should be applied to each tax base.

The Appellate Court on rehearing did not alter its conclusion but did suggest the Texas Legislature could resolve the issue.

- b) *In the Matter of the Appeal of Galvantech, Inc.*, California State Board of Equalization, No. 288289, February 1, 2006.

Galvantech was a privately held corporation that was involved in the design, manufacturing, and sale of semiconductors. The company was headquartered in California but manufactured its products in Taiwan. The company amended its California returns to remove foreign sales from the numerator of the sales factor. Galvantech argued that the sales were drop shipped by its subcontractors in Taiwan to customers located in the United States as well as to numerous foreign jurisdictions. The SBE in rejecting the company's refund claim held Galvantech failed to establish that it shipped the products to customers from locations outside the United States and that the company was subject to a net income tax in the destination country. Therefore, the sales were properly thrown back and included in the numerator of the sales factor.

- (c) *Knauf Fiberglass GmbH v. Alabama Department of Revenue*, Dkt. No. 05-970, November 30, 2006.

The Alabama Administrative Law Judge ("ALJ") held the sales made by Knauf to Michigan, Mississippi, Tennessee and Washington were not required to be thrown back for purposes of computing the sales factor.

For purposes of the Alabama income tax a person will be taxable in another state if he is subject to a net income tax, franchise tax

measured by income, a franchise tax for the privilege of doing business in the state or a capital stock tax.. First the Department argued that the Michigan sales should be throwback because the SBT is not measured by income. In rejecting that argument the ALJ concluded the SBT was a franchise tax for the privilege of doing business and as such the Michigan sales should not be thrown back to Alabama.

The taxpayer had non-resident employees in Mississippi. The company however, did not pay Mississippi Income Tax because it had been notified its activities were protected under P.L. 86-272. The company also had two resident salesmen in Tennessee but did not file returns because its activities were protected under P.L. 86-272. In analyzing whether a company must actually file a return and pay tax to a state the ALJ concluded if a corporation is protected under P.L. 86-272 it is deemed not to be subject to tax for purposes of the throwback rule. However, neither the Mississippi nor Tennessee franchise tax is imposed on net income. Therefore, P.L. 86-272 does not apply. Thus, because the company had significant business activities in both states it would have been subject to the franchise tax. Thus the sales to these states should not have been thrown back.

Similarly, because the Washington business and Occupation Tax is levied for the privilege of engaging in business the sales should not be thrown back to Alabama. Finally, the ALJ concluded that although the corporation had three employees in New Jersey the activities were protected by P.L.86-272. Because the minimum tax paid to New Jersey had no relationship to the business activities in the sales should be thrown back for purposes of computing the receipts factor.

5. Cost of Performance

a) *General Motors Corp. v. Commonwealth of Virginia*, Virginia Supreme Court No. 032533, September 17, 2004

The Virginia Supreme Court has held that the Department's rule defining "cost of performance" for purposes of apportioning the income of a financial corporation is inconsistent with the statute. The issue is whether for purposes of computing the cost of performance only the costs of activities directly performed by the taxpayer may be included. The Virginia Supreme Court rejected the narrow interpretation and concluded that the statute did not limit the cost of performance to direct costs and could include the costs for activities performed by third parties.

- b) *Virginia Department of Taxation – Tax Bulletin 05-3 April 18, 2005.*

The Department will not change its interpretation of the nexus standards until it has fully implemented policy changes attributable to the Virginia Supreme Court decision in *General Motors Corporation v. Commonwealth*.

- c) *Ruling of Commissioner, P.D. 06-130, Virginia Department of Taxation (October 25, 2006).*

The Commissioner has concluded that a taxpayer properly included a subsidiary's gain from the sale of stock in the sales factor numerator for corporate income tax purposes. Although, the subsidiary was headquartered outside Virginia all of the day to day activities of the subsidiary were performed in Virginia. All of the company's property and most of the payroll was located in the Commonwealth. Thus, the taxpayer argued and the Commissioner agreed that the income producing activity that generated the capital gain from the sale of stock occurred in Virginia.

- d) *Indiana Department of Revenue Letter of Finding No. 03-0154, January 1, 2005.*

The Indiana Department of Revenue has determined that an out-of-state business that collected financial market data in California and provided that data to customers throughout the United States including Indiana was subject to the Indiana adjusted gross income tax on the income received from Indiana subscriptions. In so concluding, the Department concluded the subscription fees received from Indiana customers should be sourced to Indiana even though the data collection and other activities related to the performance of the services occurred in California. The income producing activity namely the generation of the subscription fees only occurred when the data was received in Indiana.

- e) *Revenue Ruling No. 2006-011T, Indiana Department of Revenue, April 1, 2006.*

The Department has concluded for purposes of calculating the sales factor that an insurance company was required to source business receipts generated by commission revenues and management fees to the states in which the employee services were performed. The management fees and commissions were the principal sources of business income for the company and were required to be sourced both within and outside the state. The

sourcing was based on a ratio of the time spent performing the related services in Indiana to the total time spend performing the services everywhere.

- f) *Boston Professional Hockey Association, Inc. v. Commissioner of Revenue*, Massachusetts Supreme Judicial Court No. SJC-09287, January 13, 2005.

The Court determined that the revenue from the Boston Bruins' gate receipts and the licensing of the local broadcasting rights were properly apportioned to Massachusetts for corporate income tax purposes. The fees received for the broadcasting rights to away games were properly included in the numerator of the sales factor because the three licensees were commercially domiciled in Massachusetts and the licenses were deemed to used by the licensees in Massachusetts.

The statute and regulations provide that sales other than the sale of tangible personal property are sourced to the Commonwealth if the income producing activity is performed in the Commonwealth. If the income producing activity is performed both within and outside the Commonwealth the receipts will be assigned to Massachusetts if a greater proportion of the activity is performed in the Commonwealth. The taxpayer argued that the home and away games constituted separate income producing activities. Therefore the costs must be individually analyzed to determine whether any of the receipts should be sourced to the Commonwealth. The Court rejected this argument finding that the income producing activity was the operation of the NHL franchise rather than playing individual games. The costs of fielding and managing the Bruins through the tax year in issue were incurred in a greater proportion in Massachusetts.

With respect to the license fees from the broadcast rights of away games the taxpayer argued that the licenses were used in States outside Massachusetts and as such the direct costs were largely incurred outside the Commonwealth. Thus, a game-by-game analysis was required. The Court rejected the argument concluding that the three licensees were commercially domiciled in Massachusetts and, in accordance with the regulations in effect at the time, the licenses were deemed to have been used in the Commonwealth. However, the fees received from the licensing of the Bruins trademarks and logos should not be assigned to Massachusetts as the licensees are not domiciled in the Commonwealth.

The taxpayer's share of the partnership's revenues derived from licensing agreements with out-of-state affiliated cable television operators was not properly included in the numerator of the receipts factor. This revenue should be attributed to the commercial domicile of the affiliates. The partnership's share of the advertising revenue from advertising placed in sport's programs was apportionable to Massachusetts because 70% of the subscribers were located in the Commonwealth.

Finally, the Court concluded the capitalized value of the fees paid for the use of satellite transponders was not includable in the property factor. The agreement was a service contract rather than a lease.

- f) *California Franchise Tax Board – Legal Ruling 2005-1*, March 21, 2005.

The Franchise Tax Board has ruled for purposes of Regulation 25136 the term "personal service" includes any service performed where capital is not a material income-producing factor. In addition, personal services are not limited to a professional service or to a specialized service performed by one individual.

- g) *State of Michigan, Internal Policy Directive 2006-8*, September 28, 2006.

The Michigan Department of Treasury has issued an Internal Policy Directive (IPD) with respect to the application of the cost of performance methodology for Single Business Tax Purposes. The IPD provides that sales other than the sale of tangible personal property will be attributed to Michigan if the greater proportion of the business activity is performed in the State. Costs of performance will be used to determine if the greater proportion is in Michigan. The SBT does not define the term "cost of performance". It is the Department's position that the term means direct costs are those costs that are directly related to the activity being performed. The direct costs are determined consistent with the taxpayer's method of accounting and will include the costs of services performed on behalf of the taxpayer, *ex*, costs associated with an independent contractor if used to provide the contracted service. The Department has adopted a transactional approach to the analysis. Thus, if the business activity of the taxpayer is the performance of a service the costs must be considered for separately for each sale.

- h) *In the Matter of the Protest of Wal-Mart Stores Inc.*, New Mexico Department of Taxation and Revenue, No. 06-07, May 1, 2006.

The New Mexico Department of Taxation has held that the royalties received by WMR, Inc. (“WMR”) from Wal-Mart for use of trademarks in New Mexico were properly sourced to the state using a single sales factor. The Administrative Hearing Officer citing the decision in *Kmart Corporation* concluded that WMR was not subject to the gross receipts tax on the royalty income.

WMR was a wholly owned subsidiary of Wal-Mart. The company was incorporated in Kansas in 1991 and domiciled in Delaware. The company was formed to hold the trademarks of Wal-Mart. WMR pursuant to a license agreement charged each of the Wal-Mart entities royalties for the use of the intellectual property. WMR merged in Wal-Mart in February 1997. The Department audited WMR for the tax years 1991 through 1997 and issued both a corporate income tax and gross receipts tax assessment for the period. The company protested both assessments.

Wal-Mart stipulated that WMR had sufficient nexus with New Mexico to subject it to the state’s taxing jurisdiction. In addition, the company agreed the royalty income was business income subject to apportionment. Wal-Mart challenged the Department’s use of an alternative single factor formula to apportion WMR’s income, arguing the Department did not meet its burden of establishing the need for a standard three-factor formula. The Department in computing the apportionment formula eliminated the payroll and property factors because the factors were *de minimus* and did not contribute the company’s ability to generate royalty income. The sales factor was then modified to reflect only the ratio of the royalty receipts in New Mexico, *e.g.* those receipts earned as a result of the use of the trademarks in New Mexico, to the total receipts from the use of the trademarks.

In upholding the use of the alternative formula the ALJ rejected Wal-Mart’s argument that WMR had no business activity in New Mexico. The ALJ found that the licensing of trademarks in New Mexico was an income producing activity in the state and that activity took place where the Wal-Mart sales occurred. Therefore, because the company had an income producing activity in the state it had business activity within the state. The ALJ concluded the application of an alternative formula did not depend on the number of taxpayers in a certain type of business but rather the nature of the taxpayer’s business. The standard three-factor formula was designed for manufacturing and mercantile companies. The

business activities of WMR did not fit into that model. Thus, the business model is unusual in that context. This coupled with the fact that the payroll and property of the company contributed little or nothing to the generation of the royalty income supported the conclusion that the standard formula did not fairly represent the WMR business activities. Finally, the ALJ concluded the alternative formula used by the Department was reasonable because the formula was both internally and externally consistent. The formula did not create a lack of uniformity. Finally, the Department's application of an alternative formula did not represent a change in policy.

- i) *Texas Comptroller of Public Accounts, Letter No. 2006066226*, June 26, 2006.

The Comptroller determined that a credit card company's receipts related to cardholder membership fees should be sourced based on the location of the payor. The membership fees constituted the sale of intangible rights. Further, it was concluded that the discount fees received by the credit card company from the merchants was a processing fee for the services provided. These processing fees should be sourced to the location where the services were performed.

- j) *The Interface Group v. Commissioner of Revenue*, Docket No. C266670-76, Massachusetts Appellate Tax Board, July 18, 2006.

The Interface Group is a Massachusetts business trust with its business domicile in the Commonwealth. The company is a public charter tour operator doing business under the names of GWV Travel and GWV International. GWV Travel created and marketed vacation packages. During the years in issue the packages were for either foreign destinations or to U.S. Territories located overseas. The travel packages included air, hotel accommodations and ground transfers. The hotel portion of the packages were negotiated and executed at the hotel site. The air transportation contracts were negotiated and executed by GWV employees outside the Commonwealth. Although the negotiations for the travel package components took place outside Massachusetts, the majority of the company's employees were located in the Commonwealth. GWV purchased the hotel accommodations, the airfare and ground transportation and then assembled the packages. The costs were recorded on the company's books as their costs. The company marketed its vacation packages to travel agents and trade shows. The packages were then sold to the general public by independent travel agents

who received a commission.

GWV did not pay any excise on the income received from the tours. The Commissioner audited the books and records of the company for the tax years 1991 through 2000 and assessed tax, interest and penalties citing the fact that the income producing activities occurred in Massachusetts. Therefore, 100 percent of the receipts from the sales of the tour packages should be allocated to Massachusetts. In computing the costs of performance the Commissioner excluded the costs for the purchase of the hotel rooms, airfare and ground transportation because these vendors were independent of GWV. GWV argued that the costs should be included in the computation and that the total of these costs exceeded the costs incurred in the Commonwealth if analyzed on a per-vacation package basis. Further, the company had employees and property in states outside Massachusetts. However, the company did not file tax returns in those states.

The Board concluded that the receipts from the sale of the tour packages had to be included in the numerator of the receipts factor. In so doing, the Board found that the company was not paying the hotels, air carriers or ground transportation companies to act as independent contractors of the company. Rather, these were the costs of performance that GWV incurred when assembling the travel packages. Thus, the Board rejected the Commissioner's argument. The Board has previously held that costs of performance include all costs relative to the creation of the final product. In this instance the booking of the various service providers were necessary steps in creating the ultimate vacation package. However, the company had extensive costs of performance incurred in the Commonwealth where 90 percent of its payroll was located. In determining whether the gross receipts are to be assigned to Massachusetts the costs incurred in Massachusetts must be compared to those incurred in the other individual states. The proper comparison is not the Massachusetts costs to the aggregate of the costs in the other states. The company had conceded that the costs incurred in Massachusetts were greater than the costs incurred in any one state. Therefore, the Board held that the company failed to meet its burden of proving that a greater proportion of the income producing activity was performed outside of the Commonwealth. In addition, the Board rejected the company's argument that each tour package constituted a separate income producing activity for purposes of computing the sales factor.

- k) *Legal Ruling 2006-02*, California Franchise Tax Board May 3, 2006.

Rev. & Tax Coded §25136 sets forth the methodology for assigning receipts from transactions other than the sale of tangible personal property. The receipts are to be assigned to the state where the income producing activity is performed or if the activity is performed in more than one state the location where the greater proportion of the income producing activity occurs based on the cost of performance. The Franchise Tax Board has addressed how payments made by one member of a unitary group to another member to perform activities related to the sale are to be considered when assigning sales. The FTB has concluded that the related payments are considered when determining where the income producing activity took place.

7. *Decision of Comptroller Hearing No. 36,564*, Texas Comptroller, February 22, 2006.

The Comptroller has held that interpartnership receipts received by a taxpayer from an operating partner were required to be included in the gross receipts for purposes of calculating the sales factor. The applicable statute requires that partnership gross receipts are included in the in the apportionment formula both in the Texas receipts and everywhere. In so doing the Comptroller rejected the argument that the receipts were not required to be included because the statute defines gross receipts as all revenues reportable by a corporation on its federal return and the taxpayer was required to report only net partnership income for federal tax purposes.

8. *Ammex, Inc. v. Department of Treasury*, Michigan Court of Appeals, No. 258901, January 18, 2007.

The Appellate Court has concluded that a taxpayer's duty-free sales were Michigan sales and subject to the Single Business Tax ("SBT") and that the taxpayer could not apportion any of its sales.

Ammex operated two duty-free stores in Detroit. The court rejected the legal fiction that the goods transported to the taxpayer's facilities were deemed outside the reach of federal tax and duties. Rather, the court noted the taxpayer was located in Michigan and enjoyed the privileges of Michigan resources. The SBT is imposed on every person with a business activity in Michigan. The taxpayer operated a business in Michigan and thus was subject to the SBT. Further, the taxpayer did not meet the statutory requirements to apportion its sales. The sales were not export sales because it was the taxpayer's customers that exported the

purchased goods. Therefore, the sales were Michigan sales. The taxpayer was also prohibited from apportioning the receipts from accounting and financial services performed in Canada because the greater proportion of the business activity based on the costs of performance were performed in Michigan.

B. Payroll Factor

1. *Marquette Transportation Company, Inc. v. Finance and Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, File No. K03-R-27 (Order No. K-19358, June 23, 2005.)

The Board of Tax Appeals held Marquette Transportation Company was entitled to a refund for the overpayment of estimated Kentucky corporation income tax because the company's payroll factor for previous tax years should not have been adjusted to include compensation paid to employees whose only service performed within the state was their presence on a towboat as it moved along the Mississippi River adjacent to 63 miles of Kentucky shoreline.

Evidence was clearly established that the towboat employees had a Kentucky "base of operations" within the meaning of the state's payroll factor statute. Although boarding locations were in foreign states and employees carried out their services on the river in an autonomous and independent manner, their services were directed and controlled from the company's Kentucky headquarters through e-mail, sales and safety departments, and barge building decisions.

However, there was no reasonable basis for concluding that the towboat employees were performing services in Kentucky as required under the payroll factor statute. The boats never stopped in the state for any reason. In addition, Kentucky's border along the river was somewhere in the middle of the flow. Therefore, if the company's boats stayed on the other side of the river, the employees would not have been in Kentucky waters. If the boats straddled the border, employees on one side of the boat would have been in Kentucky, while employees on the other side of the boat would not have been in Kentucky. If all the employees were eating dinner or sleeping as the boat passed Kentucky, no services would have been performed within the state.

2. *Plantation Pipe Line Co. v. Alabama Department of Revenue*, Alabama Department of Revenue, Administrative Law Division, No. Corp. 05-948. May 23, 2006.

The Administrative Law Judge held that a multistate corporation correctly included in the payroll factor amounts paid to its parent for services

performed by employees who the corporation had transferred to the parent. In 2001, Plantation Pipe Line transferred its employees to one of its parent corporations and paid the parent for the services performed by the employees. The Department took the position the company did not have a payroll factor and eliminated the factor for purposes of computing the apportionment formula. The employees in issues were the same employees that performed the duties as direct employees of Plantation Pipe Line. The ALJ concluded that the employees contributed to the corporation's production of Alabama business income in 2001 to the same extent that they had in prior years. Therefore, the corporation's income producing activities were most accurately attributed to Alabama when the compensation paid by the corporation for the transferred employees were included in the Alabama payroll factor.

C. Modification of Apportionment Formula

1. *Irving Pulp & Paper, Ltd. v. State Tax Assessor*, Maine Supreme Court Dkt. No. Ken-04-580. August 9, 2005.

The Maine Supreme Court affirmed the Superior Court holding the denominator of the apportionment formula must be computed on a water's edge basis.

Irving is a Canadian corporation with timber reserves in Maine. The company had no other presence in the United States. Irving sold its timber reserve. The company argued that the apportionment factors should be computed using its worldwide property, payroll and sales. The court rejected the argument concluding the apportionment statute contemplated starting with figures derived from a corporation's federal taxable income. The use of the worldwide factors would result in a mismatch of factors and the income to be apportioned.

2. *California Franchise Tax Board Legal Ruling No. 2006-03*, May 5, 2006.

The Franchise Tax Board has issued a ruling that addresses the apportionment of gains resulting from a deemed asset sale made pursuant to IRC §§ 338(g) and 338(h)(10). With respect to the gains recognized as a result of making an election under §338(h)(10) if the selling corporation and the target corporation are unitary in nature then the gains would be apportioned using the combined report that includes the selling corporation and the unitary affiliates.

If an election is made under §338(g), the seller is not party to the election therefore, the seller will treat the transaction as a stock sale. The gain or loss on the sale will be apportionable business income if the subsidiary

was unitary in nature. The apportionment method used by the buyer will depend on the following:

1. If Old Target is a separate entity the gain on the deemed asset sale will be apportioned using the apportionment percentage of Old target.
 2. If Old target is the common parent of a federal consolidated group and the group remains intact then the gain is apportioned using the apportionment percentage of the group.
 3. If Old target is a member of a federal consolidated group but not the common parent, the Old Target is considered to be disaffiliated from the federal consolidated group immediately before the sale. For California purposes, the gain on the deemed asset sale is treated as having arisen after the stock was sold. Therefore, the gain cannot be considered in the selling corporation's combined report. The gain should be reported on New Target's one-day return. Because the one-day return does not include the day-to-day operations there will be no payroll factor. The gain will be apportioned using a sales and property factor. For purposes of computing the sales factor, the sale will not be considered occasional. Therefore, the gross proceeds will be included in the factor.
4. *FedEx Ground Package System, Inc. v. Commonwealth of Pennsylvania*, Commonwealth Court April 17, 2006.

The Commonwealth Court has held the numerator of the apportionment must be computed using average receipts per mile in Pennsylvania. In so doing, the court rejected the Department's long-standing policy that the numerator should be computed using average receipts per mile everywhere. The court concluded the numerator of the transportation factor must reflect only in-state activity.

5. *U.S. Bancorp v. Department of Revenue*, Oregon Tax Court No. 4531, March 13, 2007.

The Tax Court held the Oregon Department of Revenue did not have authority to require a financial institution to include its intangible property in the computation of the apportionment formula used to apportion the company's income for the 1988 through 1992 tax years. The Taxpayer had filed its returns consistent with the regulation in effect for the years in issue. The regulation did not require the inclusion of the intangible property in the formula. The Department had argued that consistent with a 1995 regulation the apportionment formula had to be adjusted to accurately reflect the company's net income from its Oregon business activities. The Oregon Supreme Court held the rule could be applied

retroactively and remanded the matter back to the Tax Court for further determination. The Tax Court concluded that because the Supreme Court's decision only addressed the retroactive application of the 1995 rule it had the authority to determine if an alternative apportionment formula was properly applied to the Taxpayer. The Tax Court concluded that the original returns accurately reflected the Taxpayer's net income from Oregon operations.

6. *Appeal of Alaska Airlines, Inc.*, California State Board of Equalization, No. 342596 (March 1, 2007).

The State Board of Equalization held that the Franchise Tax Board could not require Alaska Airlines to vary from the special apportionment formula applied to the airline industry because the FTB failed to show the formula resulted in distortion. The FTB had recalculated the formula by grouping the aircraft by make and model. The regulation required the aircraft be grouped by "certified aircraft" for purposes of the property factor and by type, *ex.* Turboprop and two engine, for purposes of the payroll and sales factor. Pursuant to the statute the FTB may only deviate from the special formula regulation if it proves that the use of the formula does not fairly represent the extent of the taxpayer's business in California.

VIII. INTERSTATE COMMERCE/DISCRIMINATION

1. *Fluor Enterprises Inc. v. Department of Treasury*, Michigan Supreme Court No. 129149. May 2, 2007.

This case required the Michigan Supreme Court to construe the provision of the Single Business Tax Act (SBTA) found at MCL 208.53 that explicates how to allocate sales of intangible personal property so as to determine whether they can be taxed by Michigan. Specifically, the court decided that receipts for plaintiff's services, performed entirely outside Michigan for construction projects located in Michigan, are deemed taxable sales under the statute and, if they are, whether that interpretation of the statute results in the statute's being unconstitutional as a violation of the Commerce Clause, US Const, art I, § 8, cl 3.

The Court of Appeals held that the services were taxable but that this section of the statute violates the Commerce Clause of the constitution and thus is unenforceable. *Fluor Enterprises, Inc v Dep't of Treasury*, 265 Mich App 711 ; 697 NW2d 539 (2005). The Michigan Supreme Court reversed in part and affirmed in part Michigan Court of Appeals decision; agreeing that such receipts are taxable under the statute, but holding that this provision is not unconstitutional and thus is enforceable.

Fluor is an engineering construction and technical services company. The company performed services at its out-of-state facilities for real estate improvement projects constructed in Michigan. In filing the SBT returns, Fluor excluded the receipts for services performed outside of Michigan because the receipts were not in the state for purposes of calculating the sales factor. The Commissioner upheld the assessment including the receipts in the apportionment factor. The Court of Claims reversed the holding.

For purposes of the SBT, sales will be considered in Michigan if derived from services performed for planning, design or construction activities within the state. Fluor argued the receipts were from activities outside Michigan. The Department's argument focused on the fact the services were performed for projects in Michigan. The Appellate Court agreed the receipts were derived from services performed for planning, design or construction activities in Michigan. Section 53(c). However, the Appellate Court held Section 53(c) violated the Commerce Clause because it violated the internal consistency component of fair apportionment formula more than one state would tax business activities performed in one state for construction activities in another.

2. *George W. Davis and Catherine V. Davis v. Department of Revenue*, No. 2004-CA-001940, Kentucky Court of Appeals, January 1, 2006. Petition for Certiorari Granted.

The Kentucky Court of Appeals has held the bond taxation system facially unconstitutional because it provides a more favorable taxation treatment to in-state bonds than it does to bonds issued outside Kentucky. The statute requires individuals to add back to taxable income derived from obligations issues by other states and political subdivisions. In holding the tax scheme unconstitutional the court rejected the Department's argument that a similar tax scheme has withstood a challenge in Ohio, concluding that a constitutionally infirm statute does not become permissible simply because it was not previously found to be unconstitutional. The court also rejected the Department's market participant argument. The court agreed that Kentucky was a market participant when it issued the bonds but that was not the matter in issue. Rather it was the decision to tax only extraterritorial bonds that was in issue. The market participant theory is not applicable to the issue at hand because the assessment and computation taxation is a government activity and as such the Department is acting as a market regulator not a market participant.

3. *AT&T Corporation v. Mississippi Tax Commission*, Chancery Court of Hinds County Docket No. G-2000-31S/Z. May 26, 2006. (Appeal Pending)

The District Court held the statutory scheme that allows a only dividends received deduction for dividends received from corporations that do business in Mississippi unconstitutional. The court concluded that the tax scheme disallowed a valuable tax exemption based solely on an interstate element that clearly favored domestic corporations. Citing the holding in *Oregon Waste Systems v. Department of Environmental Quality*, 511 U.S. 93 (1994), the court found the statute was discriminatory on its face. Further, the Mississippi Tax Commission failed to establish that the tax exemption was a compensatory tax designed to make interstate commerce bear a burden that was borne by intrastate commerce.

AT&T initially filed a corporate income tax return on a combined basis. In 1994 the company began to file its returns on a consolidated basis even though it had affiliates doing business outside Mississippi. On audit the Department changed the filing method to that of a combined return and assessed additional tax, interest and penalty. The Tax Commission upheld the assessment. The court in overruling the Commission's decision concluded that AT&T provided sufficient proof that the consolidated return method would provide a substantial benefit to the company that was not available under the combined method. The benefit was denied solely on the criteria of whether the taxpayer was engaged in interstate commerce. Such a criteria is clearly discriminatory. Therefore, the statutory scheme is unconstitutional. The appropriate remedy is to place AT&T on an even footing with those taxpayers who received the benefit. Therefore, AT&T is entitled to file on a consolidated basis and is due a refund of the tax it paid under protest.

4. *AT&T Corp. v. Surtees*, Alabama Court of Appeals, No. 2040908. June 23, 2006. Petition for Reconsideration granted and decision modified.

The Alabama Court of Appeals has held with respect to Business Privilege Tax (BPT) and Corporate Share Tax (CST) deductions for investments that were limited to only those investments in entities doing business in Alabama was facially discriminatory and a violation of the Commerce Clause. Further, upon establishing that the deduction was discriminatory the burden of proof shifted to the Department to justify the taxation scheme.

AT&T paid BPT for the 2000 through 2002 tax years and CST for the 2000 and 2001 tax years. The Alabama Code allowed corporations paying both taxes to deduct the investment in corporations doing business in Alabama. Thus, AT&T could only deduct its investments if the investment was in the equity of a company doing business in Alabama. The court in reversing the ruling of the Jefferson County Circuit Court concluded to determine if the statute was discriminatory on its face the

text of the statute must treat in-state economic interest differently from out-of-state economic interests in such a way to benefit the in-state economic interests and burden the out-of-state interests. Applying this analysis the court concluded that the differential treatment encourages the investment in entities that do business in Alabama to the detriment of those entities that do not do business in Alabama. On its face the statutes place a greater burden on those corporations that do not invest in entities doing business in Alabama. Therefore, the statutes were facially discriminatory and the burden of justification fell on the Department. In the original opinion, the court rejected the Department's argument that the discriminatory tax scheme was to prevent double taxation stating such an explanation fell short of fitting within an acceptable justification and overcoming the strict scrutiny standard required by the United States Supreme Court. The modified opinion remanded the matter back to the trial court for consideration as to whether the burden of showing a justification for the discriminatory tax scheme had been met.

5. *Vulcan Lands, Inc. v. Surtees*, Circuit Court of Montgomery County, No. CV2001-1106-PR, March 12, 2007. Appeal Pending.

The Circuit Court denied a refund of the former Franchise Tax because the company failed to prove that it had any in-state domestic competition that had benefited from the unconstitutional tax scheme. The court concluded that to seek a refund of an unconstitutional tax under the Commerce Clause the taxpayer must prove economic injury. Therefore, because the taxpayer failed to prove it had any in-state domestic competition it was not discriminated against in favor of a domestic corporation. Thus, the company was not entitled to a refund of the franchise tax.

6. *In the Matter of the Appeal of River Garden Retirement Home*, State Board of Equalization, No. 297405, September 10, 2006. (Not to be cited as precedent).

The State Board of Equalization held that the *Rev. & Tax Code* §24402 dividends received deduction that was declared unconstitutional is disallowed for period after December 1, 1999. River Garden, a California corporation, deducted dividends received from Fidelity and IDS in the 1999 and 2000 tax years. Both of the dividend payor corporations were taxed by the State of California. The company argued that the failure to allow the deduction would cause double or triple tax and was against the principles of equitable taxation. In rejecting the taxpayer's claim that the FTB's position is not within the spirit of the law and should be unconstitutional by statute the Board found that River Garden did not offer any legal analysis with respect to the proper application of the statute following the *Farmer Bros.* decision. The Board in deciding the case on its merits concluded that *Rev. & Tax Code* § 19393 should be applied. In

accordance with that section if a deduction is ruled unconstitutionally discriminatory the appropriate result is to assess taxes to those who benefited from the deduction rather than allowing refunds to those discriminated against. Because the statute of limitations was not open to all taxpayers for taxable years ending prior to December 1, 1999, the retroactive denial of the deduction as set forth in the statute was not possible,

7. *Johnson Controls, Inc. v. Rudolph* Dkt. No. 2004-CA-001566-MR, Court of Appeals (May 5, 2006)

The Court of Appeals held that the retroactivity period created by H.B. 541 exceeded the constitutional limits and violated Appellants' due process rights. Therefore, they reverse the circuit court and held the statute unconstitutional.

While the Johnson Controls' administrative claims for income tax overpayment languished in the Kentucky Revenue Cabinet, the 2000 session of the Kentucky General Assembly enacted H.B. 541, which nullified these claims. Appellants then filed declaratory judgment actions in circuit court seeking to have the subsection of Kentucky Revised Statutes Chapter (KRS) 141.200 that codified H.B. 541 declared unconstitutional. The Circuit Court did not find any constitutional infractions.

IX. MISCELLANEOUS DECISIONS

1. *Mississippi Tax Commission v. Murphy Oil USA, Inc.*, Mississippi S.Ct. No. 2003-CA-003250SCT, June 15, 2006.

The Mississippi Supreme Court held the destination theory for sales factor apportionment purposes did not apply to the Franchise Tax. Murphy Oil applied the destination theory to assign sales of its petroleum products to Mississippi for Franchise Tax purposes. The court rejected the argument because the tax is measured by the volume of business in Mississippi and not by the product's ultimate destination. The ultimate destination is not relevant for Franchise Tax purposes. Murphy Oil also argued that the statute violated the first and fourth prongs of the *Complete Auto* test. The court rejected this argument because the petroleum products were stored and metered in Mississippi. Therefore, there was substantial nexus with the state. In addition, because the Murphy Oil received police and fire protection as well as the use of the state court system, the services were fairly related to the franchise tax. Therefore, the Franchise Tax was not unconstitutional.

2. *Bank Boston Corporation v. Commissioner*, Massachusetts Appellate Court No. 05-P-1545, February 2, 2007.

The Appellate Court affirmed the Appellate Tax Board's decision denying a dividend received deduction for distributions from a Real Estate Investment Trust. (REIT).

The Massachusetts corporate excise tax like the federal tax scheme recognizes that corporate revenues should only be taxed once regardless of any subsequent transfers from subsidiary to parent. Essentially, a corporate taxpayer may deduct dividends received from its subsidiaries. The statute in effect for the years at issue is not specifically address the taxation of REIT distributions. At the federal level REIT distributions do not qualify for the dividends received deduction.

The Commissioner argued that the statute must be administered consistent with both the definition of dividend that appears in the Internal Revenue Code and the federal taxation of REITs. Thus, the exclusion of the REIT distribution from the dividends received deduction should be deemed to be part of the Massachusetts statute. The Appellate Court first analyzed the purpose of the dividends received deduction and concluded the purpose was to insure that the affiliates and subsidiaries should not create an additional liability when transferring revenue between related parties. To apply the underlying purpose to a REIT distribution distorts the concept that corporations are intended to be taxed only once on the revenue from within a corporate family. The exclusion of the REIT dividend defeats the uniformity between the Massachusetts statute and the Internal Revenue Code.

2. *Redman Homes Inc. v. Surtees*, Alabama Court of Appeals, Dkt. No. 2031079. November 18, 2005.

The Court of Appeals held the filing of a class action will not toll the statute of limitations for purposes of filing foreign Franchise tax claims because the Taxpayer Bill of Rights was the exclusive remedy for seeking a refund. A number of taxpayers had filed a class action in 1996 alleging the franchise tax statute was unconstitutional and sought refunds for all members of the class. This was a direct refund action against the state. The members of the class argued that the class action tolled the statute of limitations. In May 2002, the Alabama Supreme Court decertified the *Gladwin* class action and required all taxpayers to separately pursue refunds of franchise tax under the Taxpayer Bill of Rights Act. Thus, the taxpayers could not rely on the tolling requirement of the class action statute.

3. *In the Matter of Foster Poultry Farms*, California State Board of Equalization, May 17, 2006.

The State Board of Equalization held a poultry farm's electrical substation and primary electrical distribution facility were qualified property for purposes of the Manufacturer's Investment Tax Credit ("MIC"). In so doing the SBE rejected the Franchise Tax Board's arguments that the property was used in a separate activity of electrical transmission and distribution and not the qualified activity of poultry processing, the property was not used primarily in a manufacturing process because the transmission and distribution of the electricity occurred before the start of the poultry process, the property was not tangible personal property but was other tangible property and the taxpayer was using the property with respect to an intangible and was not altering tangible personal property. The SBE found there was no reason to distinguish the property in issue from substantially similar property that was found to be tangible personal property from purposes of the federal investment tax credit. The company was not in the business of transmitting and distributing electricity but rather the electricity was used in poultry processing. Therefore, the property qualified for the MIC.

4. *Ford Credit International Inc. v. Department of Treasury*, Michigan Court of Appeals No. 258389, April 4, 2006.

The Michigan Court of Appeals has held for purposes of the Single Business Tax a financial corporation was not required to excluded deemed dividends, *e.g.* Subpart F Income and §78 gross-up in the calculation of gross receipts. Ford Credit International ("International") is an international finance company that controls several foreign finance companies. International argued that the term "gross receipts" does not include deemed dividends. The Appellate Court analyzed the statutory language and concluded during the period in issue the phrase "gross receipts" was not a vague phrase or an all encompassing one, rather it was specifically defined as the sum of sales and rental or lease receipts. The term did not include dividends of any type. Further, the receipts in issues have not been received by International and may never be received by the company. The court reasoned that the legislature intended only the money a business actually received to be included in the computation. Finally, because the SBT has adopted the federal definitions and the definitions require an actual distribution the deemed dividends were not dividends for SBT purposes and are not to be included in gross receipts.

5. In *National City Corporation v. Department of Revenue*, 1-04-2907. Ill. App. Ct., May 22, 2006.

The Illinois Appellate Court, First District, has held that the "ripeness" doctrine does not preclude a taxpayer from filing a protest monies action after it received a notice of proposed deficiency for income taxes from the Illinois Department of Revenue ("Department"), but before it received a notice of deficiency that would trigger its right to administrative protest and review.

National City Corporation ("National City") filed income tax returns for the years 1998 through 2000, classifying some gains from the sale of stock and other investments as nonbusiness income. After audit, the Department sent the taxpayer a notice of proposed deficiency dated November 12, 2003, that reclassified the gains as business income and asserted a tax liability of more than \$2 million.

A letter accompanying the notice advised that, under the statute creating Illinois' 2003 amnesty providing National City must either pay the "assessment" by November 17, 2003, or face interest and penalties equal to 200 percent of normal interest and penalties if the assessment were ultimately upheld. The letter also noted that National City could avoid the risk of enhanced interest and penalties of the amnesty program by paying the tax and interest under protest and filing a Protest Monies Act lawsuit by November 18. National City paid the tax and interest at issue under protest and filed a complaint based on the Protest Monies Act in the Circuit Court of Cook County. The Department citing the administrative regulations argued that National City's complaint was not ripe for judicial review because the Department had not yet issued a final notice of deficiency.

The court noted that National City was in the administrative process at the time it filed its action. Although National City could not commence the administrative protest and review procedure before receiving a notice of deficiency. However, that is not the issue since the taxpayer did not proceed under the administrative review law, but under the Protest Monies Act.

As to whether the Protest Monies Act should be interpreted as permitting adjudication of the dispute on these facts, the court first noted that the act does not expressly require the person paying under protest to wait to file a lawsuit until the Department issues a final determination of tax liability.

The court rejected the Department's attempt to avoid the authority of *Chicago & Illinois Midland Ry. Co. v. Department of Revenue*, 359 N.E.2d 22 (1976), on the grounds that the Illinois Supreme Court there did

not address the ripeness issue. According to the court, "the procedural posture at the time the taxpayer filed its cause of action in *Chicago & Illinois Midland Ry. Co.* was identical to the posture of this case when National City filed its complaint. Because the Supreme Court believed an informal notice provided by employees of the Department to the taxpayer regarding the deficiency determined on audit was sufficient to confer jurisdiction in *Chicago & Illinois Midland Ry. Co.*, the court held that it must presume it is sufficient in this case.

As further support for its conclusion that the case was ripe for judicial review, the court pointed to the wording of the Department's letter, which called the asserted tax liability an "assessment" and told the taxpayer that it must act within a week to make a choice to pay or file suit. "It appears, for all practical purposes," said the appellate court, "that the Department had concluded its audit investigation.

6. *Advanced on-site Concrete Inc. v. Department of Revenue*, Circuit Court of Cook County No. 06 CH 377, October 30, 2006. (Appeal Pending)

The Circuit Court has upheld the constitutionality of the Illinois Amnesty Act. The Department audited Advanced for sales tax purposes and assessed tax and interest including the amnesty required double interest.

Advanced argued the Amnesty Act as it is applied violates the Uniformity Clause of the Illinois Constitution. To sustain its burden of proof Advanced had to show the Amnesty Act had classified Advance in a real and substantial manner differently when compared to other taxpayers and that the Amnesty Act was not reasonably related to a legislative purpose. The company argued that the Amnesty Act created two defined clauses, those who choose not to participate in the program who then became subject to the 200 percent interest and penalty and those taxpayers that did participate in the program. Both sets of taxpayers could have committed the same statutory infraction but only one class would be subject to the increased penalty and interest. The Circuit Court agreed that the first prong of the two-part test had been met.

Although the first prong had been met the court concluded that Advanced had not sustained its burden in establishing that the Amnesty Act was not reasonably or rationally related to a legislative purpose. In reaching this conclusion the court relied on the Department's assertion that the Amnesty Act was rationally related to: settling tax disputes; raising revenues and balancing the budget.

The court also rejected the taxpayer's assertion that the Amnesty Act violates the requirements of the Due Process Clause because a taxpayer is required to relinquish its rights to contest the liability and may not pay

under protest. With respect to the procedural Due Process argument, the court found Advanced had both actual and constructive notice of the Amnesty Act and had been provided numerous opportunities to be heard during the audit and in the Administrative Hearing Process. The court also concluded the Amnesty Act did not violate the concepts of substantive Due Process because the Act was rationally related to a legislative purpose and balancing those goals did not create a hardship that results in a deprivation of property for Advanced.

Finally, the court concluded the Amnesty Act did not violate the statute on statutes because it did not retroactively increase the rates for penalty and interest.

X. ECONOMIC DEVELOPMENT - CREDITS

1. *Northwest Airlines, Inc. v. Wisconsin Department of Revenue*, Wisconsin Supreme Court, Docket No. 2004AP319, July 7, 2006.

The Wisconsin Supreme Court reversed the Dane County Circuit Court and held the tax exemption for air carriers that operate a hub facility in the state to be constitutional. In so holding the court concluded that because Congress had acted with respect to the taxation of air carriers it was precluded from using a dormant Commerce Clause analysis. Further, the court concluded that the exemption did not violate either the Equal Protection Clause of the U.S. Constitution or the Uniformity Clause of the Wisconsin Constitution.

Northwest Airlines, does not operate a hub facility in Wisconsin, challenged the hub exemption on the grounds that it offered Midwest Airlines and Air Wisconsin a competitive advantage. The court in rejecting the challenge applied a reverse preemption analysis to determine whether Congress had consented to a differential treatment of air carriers. The court citing the provisions of 49 U.S.C. §40116 concluded Congress gave its express consent to differential taxation among air carriers. Specifically, 49 U.S.C. §40116 creates two types of taxes, *i.e.* taxes that are authorized and those that are prohibited. Taxes that do not fall within either category are authorized. The hub exemption is not a specifically prohibited tax. Further, the Code allows states to create property tax exemption for transportation property without exposing the exemption to a dormant Commerce Clause challenge.

With respect to the Equal Protection Clause challenge the court concluded there was a rationale basis for the classification. The creation of the hub exemption advanced a legitimate governmental purpose in that it helped retain air carriers and that service would bolster the economic

development of the state. Finally, the court concluded based on its Equal Protection Clause analysis that the exemption did not violate the Uniformity Clause of the Wisconsin Constitution.

2. *DaimlerChrysler Corp. et. al. v. Cuno et. al.* 547 U.S. _____. May 16, 2006.

The U. S. Supreme Court held the plaintiff did not have standing under Article III to challenge the Ohio Franchise Tax investment tax credit. Daimler Chrysler sought to expand its Toledo Ohio Jeep plant. The City of Toledo offered property tax exemptions to the company. In addition the company received additional credits against their income/franchise tax liability. The plaintiffs who pay both state and local taxes filed suit in the Ohio courts alleging the tax breaks violated the Commerce Clause. The rationale for the challenge was the fact the tax breaks depleted the local and state treasuries. DaimlerChrysler moved the matter to Federal District Court.

The District Court concluded the plaintiffs had standing and held the neither tax benefit violated the Commerce Clause. The Sixth Circuit affirmed the District Court's holding with respect to the municipal property tax exemption but held the Franchise Tax credit violated the Commerce Clause. The Supreme Court upon granting certiorari directed both parties to address the issue of standing.

The Court first pointed out the plaintiffs asserted the federal jurisdiction thus they must meet the federal standards of standing. In rejecting the argument that the franchise tax credits deplete the state treasury to which they contribute the Court cited its decision in *Massachusetts v. Mellon*, 262 U.S. 447 (1923) holding federal taxpayers lack standing under Article III simply because they are taxpayers. A federal taxpayer's interest in the money of the Treasury is shared with millions of others and is so remote an uncertain that here is no basis for an appeal. The Court concluded this rationale applies equally to state taxpayers that argue a fiscal decision will deplete the treasury and place a disproportionate burden on the taxpayers.

The Court also rejected the plaintiffs' argument that they have standing because the Commerce Clause challenge is similar to an Establishment Clause challenge that was resented in *Flast v. Cohen*, 392 U.S. 83 (1968). The plaintiffs' rights under the Commerce Clause are fundamentally unlike the rights under the Establishment Clause even though the Commerce Clause implicates a government fiscal decision.

Note: The North Carolina Wake County Superior Court citing to the *Daimler Chrysler* decision dismissed the state

and federal constitutional challenges to the incentives received by Dell. The matter is on appeal.

The Circuit Court of Ramsey County dismissed the suit challenging the credits granted under the Jobs Opportunity Building Zone Program and the Biotechnology and Health Science Industry Zone. *Olsen v. Minnesota*, No. C8-05-2727, October 9, 2006.

