

# State Income Tax Litigation

## State Income Tax Litigation Our Top Topics

FTA

2008 Annual Conference

Monday – June 9, 2008

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## Economic Nexus – Beyond Nexus

### Economic Nexus

- **Have the states won the economic nexus battle?**
  - *Geoffrey (SC & OK), K-Mart (NM), A&F Trademark (NC), Lanco (NJ) and MBNA (WV)*
- **Where do the states go from here? Will the states win the battle (economic nexus) but lose the war?**
  - **Complicating Issues**
    - **Apportionment**
    - **Add-back statutes**
    - **Taxpayers migrating to other tax structures, and**
    - **Federal preemption – the BAT bill**

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## Economic Nexus – Complicating Issues

### Apportionment

- Will apportionment issues be the focus of the next round of litigation?
- Is New Mexico's *Wal-Mart* decision a model?
- Is a UDITPA Section 18 alternate apportionment methodology the best argument for states?
  - Will more states adopt an apportionment regulation applicable to IHCs?
    - What about east / west structures?
- Can taxpayers apply the UDITPA three-factor formula, with its income producing activity / cost of performance rules, and get to zero apportionment?

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## Economic Nexus – Complicating Issues

### Add-Back Statutes

- Majority of separate company states now have some form of intangible expense add-back.
- Should a state pursue add-back and economic nexus at the same time?
  - As alternatives against the same business?
  - Economic nexus when taxpayer satisfies add-back exception?
- Add-back statutes are under constitutional attack.
- Are there inconsistencies with the approaches of economic nexus and the add-back?

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## Economic Nexus – Complicating Issues

### Federal Preemption

- Is the success states are having in court moving “business” to seek Congressional intervention?
- BAT Bill – Is it still alive this year?
- Will we have a BAT Bill every year?
- Streamlined Sales Tax legislation and the BAT Bill

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## Economic Nexus – Complicating Issues

### Taxpayer Migration to Other Tax Structures

- East / West Structure
- Intermediate Transactions (Ex = Dual Royalty Company)
- Imbedded Royalties
- Others

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## The Add-Back Cases Begin

In what may be the first of many, 2007 – 2008 marked the first reported cases addressing challenges to state add-back statutes.

### ■ *VFJ Ventures (Alabama Court of Civil Appeals)*

#### ■ *February 2008*

- Appeal to Alabama Supreme Court is pending.
- Opinion expected the end of 2008 early 2009.

### ■ *Ruling of the Commissioner No. 07-15 (VA)*

#### ■ *October 2007*

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## Common Add-Back Statute Litigation Issues

### ■ Issues Common to Early Add-Back Cases

#### ■ “Subject to Tax” Exception

- Pre- Apportionment vs Post apportionment (AL and VA cases)
- Effective Tax Rate Calculation

#### ■ “Unreasonable” Exception

- Is business purpose and economic substance enough? (AL)

#### ■ Constitutional Challenges

- Discrimination through the subject to tax exception (AL)
- *Hunt Wesson* nexus argument – indirect tax on related member / IHC (AL)
- Fair Apportionment?? (AL)

- If Add-Back statutes fail the Constitutional test, will add-back states turn to combined reporting?

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## Unitary / Business Income Cases

### ■ *Mead (IL – US Supreme Court)*

- To be discussed later today.
- But what about footnote four and two unitary businesses in one taxpayer?
- Alabama's *Perelman* case

### ■ *Kimberly-Clark (AL Court of Civil Appeals)*

- Petition for cert pending with Alabama Supreme Court.
- Even without functional test, sale of a division still produces business income.

### ■ *Tate and Lyle (AL ALD)*

- Appealed to circuit court.
- Even with broad business income definition, sale of affiliate stock (same line of business) produced non-business income.

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## Business Income and 338(h)(10) Cases

### ■ Recent businesses / non-business cases involving a 338(h)(10) transaction conclude the gain is non-business allocable income.

- *ABB C-E Nuclear Power (Missouri Supreme Court)*
- *Chambers (UT) (Settled)*
- *NICOR (IL) (Appeal pending)*
- *McKesson (NJ) (Appeal pending)*

### ■ Secondary issues need to be addressed.

- Should the gain be sourced based on the stock sale?
- Should the gain be sourced based on the “deemed” asset sale and the location of the underlying assets?
  - If so where do you source the gain attributable to goodwill?

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## Other Income Tax Cases to Watch

### ■ *Wal-Mart Stores (NC)*

- Appeal pending
- Captive REIT
- Forced combination
- Bad facts and Bad Press (WSJ Article)
- Captive REIT Legislation

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## Other Income Tax Cases to Watch

### ■ Alternative Adjustments

#### /// Disallowance of deductions

- *AutoZone (KY)*
- *Bank Boston Corp. (MA)*
- *Indiana Ruling No.06-0511*
- *Virginia Ruling 06-33*

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## Other Income Tax Cases to Watch

### ■ Remedies

#### /// Discriminatory Taxes

- *Vulcan Lands* (AL)
- *River Gardens* (CA)
- *Macys* (CA)
- *Johnson Controls* (KY)