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**UPDATE  
STATE TAX LITIGATION**

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## I. NEXUS ISSUES

1. *Capital One Bank v. Comm’r of Revenue*, Massachusetts Supreme Judicial Court No. SJC-10105, January 8, 2009. Petition for Certiorari filed Dkt. No. 08-1169

The Taxpayers were banks that were wholly-owned subsidiaries of a Delaware Corporation (“parent”). One of the taxpayers, Capital One Bank (“COB”), was a Virginia chartered credit card bank that offered credit card products. COB’s commercial domicile was in Virginia, where the credit approval activity took place. The other taxpayer, Capital One F.S.B. (“FSB”), was a federally chartered savings bank that offered consumer lending and deposit products to individuals and small businesses. The parent owned the “Capital One” trademark and provided it to the taxpayers without charging royalties. Taxpayers neither owned nor leased real property in Massachusetts, and no bank employee, agent or independent contractor was located in Massachusetts during the years at issue. Taxpayers targeted specific potential consumers in Massachusetts and conducted an increasing amount of business in the state. Taxpayers spent an estimated \$20 million-plus to acquire Massachusetts residents as customers during the periods at issue, resulting in millions of dollars in income to the taxpayers. Taxpayers were members of the Visa and Mastercard associations and thus received numerous benefits, including technology and equipment necessary to process credit transactions. Taxpayers were also able to tap into a nationwide infrastructure that provided value to their business and customers. In the event of non-payment by its customers, the taxpayers worked with collection agencies and attorney networks to collect delinquent accounts related to their Massachusetts customers, and legal proceedings were instituted on behalf of the taxpayers in Massachusetts courts.

Under Massachusetts law, every financial institution engaged in business in the state must pay a financial institution excise tax (“FIET”) measured by its net income. The commissioner imposed the FIET on the taxpayers’ net income based on their in-state activities. Taxpayers argued that its in-state activities did not constitute substantial nexus with the Commonwealth of Massachusetts to justify the imposition of the FIET.

The Tax Board (“Board”) held that the taxpayers’ deliberate and targeted exploitation of the Massachusetts economic market and its use of the commonwealth’s governmental infrastructure and resources constituted “substantial nexus” with Massachusetts. Further, the use of the parent’s trademark on its products within the Massachusetts economic market to generate substantial revenue also contributed to the finding of nexus.

The Massachusetts Supreme Judicial Court affirmed the Appellate Tax Board holding that imposition of the financial institution excise tax on two out-of-state banks was constitutional because they had a substantial nexus with the state through their credit card business activities.

On appeal, the banks argued that the *Quill Corp. v. North Dakota* (1992) physical presence requirement is applicable to an income-based excise tax, such as the FIET. The court declined to expand the U.S. Supreme Court's reasoning beyond its articulated boundaries and concluded that its holding was limited to sales and use taxes. The court determined that the proper test for whether the FIET violates the commerce clause is the substantial nexus test set forth in *Complete Auto Transit Inc. v. Brady* (1977). The court held that the bank's targeted solicitations and significant credit card business in the state constituted substantial nexus under *Complete Auto*.

The court explained that the banks provided valuable financial services to Massachusetts consumers that generated millions of dollars in income. The court also noted that the banks could not provide such services without using local banking and credit facilities, the state attorney general and court system to address customer complaints and recover delinquent accounts.

The Massachusetts Supreme Court in a companion case held that an out-of-state holding company was subject to the corporate excise tax because it had a substantial nexus with the state through its trademark licensing activities. *Geoffrey Inc. v. Commissioner of Revenue; No. SJC-10106*, January 8, 2009. Petition for Certiorari pending.

Geoffrey Inc., a Delaware corporation, is wholly owned by Toys R Us Inc. In 1985, Toys transferred trademarks, trade names, and service marks (collectively trademarks) to Geoffrey in exchange for stock. Geoffrey also licensed the trademarks to other Toys subsidiaries and affiliates for use in their retail operations. In 2002, the Commissioner of Revenue issued a notice of assessment against Geoffrey for failure to file corporate excise tax returns. Geoffrey filed an application of abatement, which was denied. Geoffrey then applied to the Appellate Tax Board, arguing that it did not have a physical presence in the state. The board found in favor of the commissioner and Geoffrey appealed to the Massachusetts Supreme Court.

The court held that whether physical presence was required under the commerce clause was resolved in its *Capital One Bank v. Commissioner of Revenue* decision. In that case, the court determined that the constitutionality of an

income-based excise tax on an out-of-state entity is not determined by the physical presence test articulated in *Quill Corp. v. North Dakota* but by the substantial nexus test set forth in *Complete Auto Transit Inc. v. Brady*. The court concluded that Geoffrey's trademark licensing activities in Massachusetts constituted a substantial nexus with the state. The court noted that Geoffrey entered into licensing agreements that permitted the entities to use the trademarks exclusively in the state and that Geoffrey encouraged Massachusetts consumers to shop at affiliated retailers. The Board's decision was affirmed.

2. *MBNA American Bank, NA & Affiliates v. Indiana Department of State Revenue*, Indiana Tax Court 49T10-0506-TA-53, October 20, 2008.

MBNA is headquartered in Delaware and issues Visa and MasterCard credit cards to consumers throughout the United States. During the years in issue the company had no property or payroll in Indiana. Rather, it obtained Indiana customers through telephone and mail solicitations. The Department issued a Notice of Assessment to MBNA in 2001, the company paid the assessment and sought a refund. The refund was denied in 2005.

The Tax Court in upholding the denial of the refund held that an economic presence in the state is sufficient to meet the substantial presence requirement of the Commerce Clause. In reaching that conclusion the Tax Court rejected the argument that the U.S. Supreme Court's decision in *Quill* controlled the outcome of the case. The Supreme Court did not extend the physical presence requirement beyond sales and use taxes.

3. *Cynthia Bridges, Secretary of Revenue State of Louisiana v. Geoffrey, Inc.*, Court of Appeals, First Circuit, No.2007-CA 1063, February 8, 2008. Petition for Review denied.

The Appellate Court held that Geoffrey's, an intangible holding company, receipt of income from licensing of trademarks and trade names in Louisiana constituted substantial nexus for purposes of the Commerce Clause. Therefore, although the company had no physical presence in Louisiana, it was subject to the corporate income and franchise tax on its receipt of royalty income.

Geoffrey's affiliate, Toys R Us, filed Louisiana corporate income and franchise tax returns and took a deduction for the royalty expenses paid to Geoffrey. The Department audited Geoffrey for the tax years of January 1995 through January 1998 and determined that the company was subject to corporate income and franchise tax. Geoffrey appealed the assessment.

The trial court concluded that the company's income was generated in Louisiana and therefore, the assessment did not violate either the Due Process or Commerce Clauses of the U.S. Constitution.

In affirming the trial court, the Appellate Court concluded that the Department had established that Geoffrey had derived income from Louisiana sources and the royalty income was for the use of the intellectual property within Louisiana. In reaching its conclusion, the court rejected the argument that physical presence was required prior to the imposition of the tax. The court acknowledged that the U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) left unanswered the question of whether the physical presence requirements applied to taxes other than sales tax. Further, the question has not been addressed by the Louisiana courts. Thus, the court relied on the decisions of a number of other state Appellate Courts in reaching the conclusion that the *Quill* physical presence requirement did not extend to taxes other than sales taxes. Finally, the Appellate Court declined to waive the penalties imposed by the assessment, concluding that there was not evidence of good faith on the part of the taxpayer.

6. *Cynthia Bridges v. Family Dollar Marketing Inc.*, East Baton Rouge Parish District Court No. 550522, July 24, 2008. Appeal pending.

The District Court has concluded that Family Dollar Stores of Michigan on its own behalf and as successor to Family Dollar Marketing had sufficient contacts with Louisiana to subject the entity to personal jurisdiction in the state. The court in reaching its decision relied on the decision of the Appellate Court in *Secretary, Department of Revenue v. Gap*, 886 So. 2d 459 (2004). As with Gap, FD-Services and FD Marketing continued to license the rights to the trademarks to each of the Family Dollar retail corporations including FD-Louisiana. FD-Louisiana used those marks in the state and in return for the use the company paid royalties. It is for these reasons that the court found sufficient contacts for personal jurisdiction.

7. *Arizona Department of Revenue Decision of Hearing Officer*, No. 20070083, March 27, 2008.

The Arizona Department of Revenue held that an out-of-state franchisor that received license and royalty fee from Arizona franchisees had sufficient nexus in Arizona to subject the company to the corporate income tax. In reaching that conclusion, the Hearing Officer rejected the taxpayer's argument that the company had to be physically present in the state to meet the Commerce Clause substantial presence requirement. The Hearing Officer found that under the franchise agreements, the franchisees were required to utilize the taxpayer's software and allow the taxpayer to

have access to the franchisees' software and computer equipment. Further, the taxpayer provided the franchisees with operating manuals and training and promotional materials to assist in the business. The taxpayer's employees acted as liaisons between the taxpayer and the franchisees. These employees visited Arizona. Thus, based on these facts, the taxpayer had substantial income tax nexus with Arizona. Further, the Due Process requirements were met because the taxpayer purposefully directed its efforts toward Arizona.

8. *KFC Corporation v. Department of Revenue*, Iowa Department of Inspections and Appeals, Administrative Hearings Division August 8, 2008.

The Administrative Hearings Division has held that KFC was liable for corporate income tax on royalty and license income derived from its franchisees' use of the corporations trademarks, trade names and service marks. The Corporate Income Tax is imposed on corporations doing business in the state as well as on corporations deriving income from sources within the state. KFC was determined to be deriving income from sources within the state by receiving the royalty and license income from restaurants in Iowa. The franchisees entered into agreements for purposes of using KFC's intellectual property. The nature of the agreements requires the KFC to rely on services and the jurisdiction of Iowa in order to benefit from the agreements regardless of the fact that KFC had no physical situs in the state.

The Administrative Hearings Division determine the taxation of KFC did not violate the Commerce Clause because the physical presence was not the standard for imposing an income tax. Nexus was deemed to have been established with every Iowa purchase by an Iowan at a franchise location because the franchisee was obligated to pay the royalties and license fees based on gross revenue. In addition, the tax could be fairly apportioned and was related to governmental functions.

9. *Ruling of the Commissioner, P.D. 08-168*, Virginia Department of Taxation, September 11, 2008.

The Virginia Department of Revenue has concluded that an out-of-state corporation that made sales into Virginia through mail order and the Internet using third-party delivery services had nexus for purposes of the corporate income tax. The nexus would be established if the third-party delivery services which included un-packaging and set-up go beyond mere solicitation of sales. In addition, an instate affiliate as a service to its customers will allow the return of merchandise purchased from the taxpayer. Thus, based on these activities the Commissioner found nexus.

## II. UNITARY ANALYSIS

1. *Appeal of Apple Computers, Inc*, California State Board of Equalization, 2006-SBE-02. The formal opinion was issued on November 29, 2006. Appeal pending San Francisco Superior Court No. C GC 084711 29.

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. 4<sup>th</sup> 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 at 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 bear 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.

2. *Cendant Corporation and Subsidiaries v. Department of Revenue of Colorado*, *Colorado Court of Appeals*, No. 07CV676, February 5, 2009. Petition for Reconsideration pending.

The Colorado Court of Appeals reversed the District Court holding the Department of Revenue was correct in rejecting Cendent's amended corporate income tax returns because it was not timely filed. The Taxpayer had initially filed a combined return and then amended the return to file on a combined consolidated basis. The Taxpayer argued that at the time of the filing it did not know that a combined consolidated filing was allowed. The Appellate Court rejected that argument and determined that the Cendant should have had knowledge of its filing options when filing the initial return. The court noted that the statute and the regulations in effect at the time the initial return was filed clearly stated that a combined-consolidated filing was allowed. There was no Due Process violation

because the Taxpayer had constructive knowledge of the combined-consolidated filing options.

3. *AT&T Corp. V. Department of Revenue*, Jefferson Circuit Court No. 08-C1-01272, September 9, 2008. (Kentucky).

The Circuit Court has reversed the Board of Tax Appeals and held that AT&T was due a refund after electing to file a consolidated return. The Department's position that a consolidated return had to include all members of the affiliated group including companies that did not have nexus with the Commonwealth violated both the Commerce and Due Process Clauses of the U.S. Constitution.

In so holding, the court concluded the statute was ambiguous because to referenced and contradicted the statutory provisions that established the Commonwealth's authority to impose a corporate income tax based on some form of nexus. Further, the consolidated return regulation was inconsistent with the statute and thus, invalid.

The statute did not withstand the Commerce Clause challenge because it imposes a tax on a corporation without substantial nexus or physical presence. Therefore it established a discriminatory reference for instate interests. The statute violated the Due Process Clause because it singled out and compelled certain interests to bear a heavier tax burden than other similarly situated interests. In so holding, the court rejected the Department's argument that AT&T waived its constitutional rights when it voluntarily filed a consolidated return.

4. *Gannett Satellite Information Network, Inc., et. al. v. Revenue Department, Finance and Administrative Cabinet*, Commonwealth of Kentucky, Board of Tax Appeals No.K04-R-03, July 16, 2008.

The Board of Tax Appeals upheld the Department of Revenue's denial of refund sought by Gannett for the tax years 1988 through 1993. The taxes were paid on the basis of separate return filings by Courier Journal and the Louisville Times Co., a wholly-owned subsidiary of Gannett Co. Inc. The refund claims were based on amended returns filed on behalf of a unitary group which included the Courier Journal and a number of other affiliates.

The Board found that the statute allowed only separate and consolidated returns during the period at issue and that Gannett had no statutory authority for filing the combined return on behalf of the unitary group. This conclusion is in contrast to the Kentucky Supreme Court decision in *GTE v. Revenue Cabinet*, 889 S.W.2d 788 (1994), which recognized the right of a unitary group to file combined Kentucky corporate income tax returns for the same period. Further, the Board held that Gannett had not

identified the appropriate entities for the unitary group. The conclusion was based on the fact that 18 other states and the Multistate Tax Commission had not included the Courier Journal in the unitary filings. The Board did not identify the correct legal standard for determining the appropriate composition of the group.

5. *Gannett Co. Inc., et. Al. v. State Tax Assessor*, Maine Supreme Judicial Court, DKT No. Ken-07-629, November 18, 2008.

In 1995, Gannett Company Inc., purchased newspaper, broadcast, and cable television businesses from Multimedia Inc. During the tax years at issue, Gannett reported all of its affiliates, including the cable division as a unitary group on its corporate income tax returns. In 2000, Gannett sold the cable division and reported a portion of the sale gain as income. Gannett subsequently filed a corporate income tax refund claim with the State Tax Assessor, arguing that the cable division was not part of its unitary business. The tax assessor denied the claim and Gannett appealed to the superior court, which granted its refund claim. The tax assessor appealed to the Maine Supreme Judicial Court.

The Maine Supreme Judicial Court has held that a corporation's cable, broadcast news, and newspaper publications constituted a unitary business for corporate income tax purposes, and therefore income derived from the sale of its cable division must be apportioned. Maine defines a "unitary business" as a business activity that is characterized by unity of ownership, functional integration, centralized management and economies of scale. The court held that Gannett operated a unitary business because its affiliates, including the cable division, were functionally integrated. The court explained that Gannett provided centralized tax, legal, internal audit, financial, and risk management services to all of its affiliates. These services were provided at cost. Furthermore, the court noted that Gannett had centralized health and benefit plans and interlocking corporate officers and cash. The court rejected Gannett's argument that the apportionment formula resulted in gross distortion of its income. The court determined that Gannett's unitary business had extensive business in the state through its newspaper publications and television stations. Gannett's operating components, the court concluded, formed a functionally integrated corporation that benefited from an exchange of value among the various components. The superior court's decision was reversed and remanded.

6. *Golden West Financial Corporation et. al. v. Florida Department of Revenue*, Florida Appellate Court, First District No. 1 D07-0135, February 19, 2008.

The Appellate Court reversed the Circuit Court's holding granting the Department's Motion for Summary Judgment. In so doing, the court

invalidated the Department's rule that prohibited a federal consolidated group from deducting net operating losses sustained in a prior tax year. The court found that the Department's SYLR rule enlarged, modified and contravened the statute implemented by Rule 12C-1.013(14)(j).

Golden West originally filed separate returns for those affiliates with Florida nexus. In 2000, the company filed amended returns on a consolidated basis and requested a refund. The amended returns utilized the losses of certain affiliates to offset the income of the consolidated group. All of the net operating losses in question had been allowed for federal tax purposes. The Department denied the refunds, citing the Florida SYLR rule.

The Florida statute provides that a net operating loss allowable for federal tax purposes is allowed for Florida purposes and shall be deemed net operating loss carryovers. The carryovers are to be treated in the same manner as for federal purposes. The Florida SYLR rule restricts the statutory section, and as such, is an invalid exercise of the delegated legislative authority.

7. *Letter of Decision, Appeal of Electronic Data Systems Corp.* No. 361467, California State Board of Equalization, August 8, 2008.

The State Board of Equalization has held that EDS combined report was required to include its wholly-owned unitary insurance subsidiary that conducted a non-insurance business within California even though the company was not subject to the California Premiums tax but conducted an insurance business in Texas. The company was classified as an insurance company in Texas. Further, the sales factor properly included the premiums received by the subsidiary during the course of its Texas insurance activities. In reaching its conclusion the SBE rejected the Franchise Tax Board's reliance on Legal Ruling 385 which states in-state insurance affiliates must be excluded from the combined return. The Ruling further states it applies to an insurance affiliate that operates entirely outside the state. The FTB read the Ruling to apply regardless of whether the affiliate conducted any other kind of in-state business. While the holding of the Legal Ruling is entitled to deference it is not necessarily binding on the SBE.

### **III. TREATMENT OF PARTNERSHIPS AND LLCs**

1. *Asworth Corporation, HT Forum Inc. and D Aviation Services v. Revenue Cabinet*, Franklin County Circuit Court No. 06-C1-00-288. June 14, 2007. Appeal Pending.

The Circuit Court reversed the Board of Tax Appeals and held that a corporation with no physical presence in Kentucky other than a 99 percent ownership interest in a Delaware Limited partnership had nexus and was subject to the tax on its distributive share of the partnership income. In reversing the Board, the court noted that the Board failed to take into consideration the Kentucky statute that imposed an income tax on corporations that carry on a business as a partner in a partnership doing business in the state even though the corporation does not have any property or payroll in Kentucky. Thus, since the corporation had minimum contacts in Kentucky and the dispute involved multistate entities, it was correct to use the three factor apportionment formula to apportion the partnership income.

On December 4, 2007, the Circuit Court amended and restated its Order. The original order was incorrect in that it remanded the matter for a determination of the amount of the corporate refund, as the parties had stipulated to the amount. Therefore, Asworth was entitled to an immediate refund. The amended Order also stated that it was appropriate to review the constitutional issues.

**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.

2. *Northwest Energetic Service LLC v. Franchise Tax Board*, 159 Cal. App. 4<sup>th</sup> 841, January 31, 2008.

The California Appellate Court affirmed the Superior Court's decision that the imposition of the former limited liability company fee on an out-of-state LLC violated the Commerce Clause because it was an unapportioned tax. In addition, the court remanded the issue of attorney fees back to the Superior Court.

The Appellate Court found that the LLC fee was a tax and not a fee. As such, the fee violated the Commerce Clause because it was not fairly apportioned. The fee violated the internal consistency test because an LLC operating interstate would be subject to a fee based on its total worldwide income in every state in which it operated. However, an LLC operating in only one state would only be subject to the fee once. Thus, the court rejected any argument that the fee was strictly related to the local activities occurring in the state. The fee also failed the external consistency test because it taxed LLC income attributable to economic activity outside the state.

The court further concluded that even if the fee were classified as a fee rather than as a tax, it would still be unconstitutional under the holding of *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970). The court, applying the balancing test found in *Pike*, questioned whether the fee was applied equally to all LLCs due to the fact that an out-of-state LLC was required to pay for services it did not receive. Further, the fee imposed more than an incidental burden, as the burden on interstate commerce was excessive in relation to the local benefits received. In addition, the court found no public benefit for the fee. Finally, the court rejected the FTB's argument that the taxpayer was barred from raising the Commerce Clause argument because it had voluntarily chosen its structure as an LLC.

- a. See: *Ventas Finance LLC v. Franchise Tax Board*, First District Appellate Court Nos. A116277 and A17751, August 11, 2008. Petition to California Supreme Court denied. Nos 166870, 11/13/02. Petition for Certiorari denied. The California Appellate Court has affirmed the San Francisco Superior Court holding that the LLC fees as applied to Ventas violated the Commerce Clause because it was not fairly apportioned. Ventas did business in within and outside California. In addition, the court declined to judicially reform the fee by re-writing it to include an apportionment mechanism. The court however, lessened the amount of the refund to the amount Ventas would have paid had there been a fair apportionment method. The court remanded the matter back for a determination of the amount of the refund and attorneys fees. The Petition asks the U.S. Supreme Court to reverse the decision limiting the refund because the California Remedy Violates Due Process.
- b. The Franchise Tax Board has advised LLCs to file protective claims to preserve their rights for refunds upon completion of the litigation. Procedures dated March 17, 2006.
- c. AB198 was signed into Law October 10, 2007. Effective for tax years on or after January 1, 2007, the fee must be apportioned. The Bill also addresses refunds if the fee is declared unconstitutional.

#### **IV. BUSINESS PURPOSE/ECONOMIC SUBSTANCE AND ADDBACK STATUTES**

1. *Ex parte VFJ Ventures, Inc.* Alabama Supreme Court, No. 1070718, September 19, 2008. Petition for Certiorari denied.

The Alabama Supreme Court affirmed the Appellate Court decision and adopted the court's decision in its entirety.

The Alabama Appellate Court reversed the Circuit Court and held that a manufacturer was not required to add back royalty expense it paid to an affiliated intangible management company because such expenses were reasonable expenses.

In 1983, Lee transferred its operating assets to Lee Apparel but retained 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. VFJ 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.

In reversing the Circuit Court's decision, the Appellate Court noted that the statute does not define the term "unreasonable". Absent a definition, the court gave deference to the Department's consistent interpretation that an addback would be unreasonable if the resulting tax was out of proportion to the taxpayer's activities within the state. In so concluding, the court rejected the argument that a showing of business purpose or economic substance would support the reasonableness exception. Further, the record did not demonstrate that the application of the addback statute was unreasonable.

The court also addressed the "subject-to-tax" exception because the royalty income had been reported to and taxed in North Carolina. The taxpayer argued that because the tax had been paid to another state, the exemption applied. The court rejected this argument and adopted the position of the Department- that only the portion of the royalty payment that was apportioned to North Carolina and actually taxed was not required to be added back.

Finally, the Appellate Court held that the addback statute did not violate either the Commerce Clause or the Due Process Clause of the U.S. Constitution because it did not impose a tax on an out-of-state entity, the tax was not disproportionate to the taxpayer's business activities and the

statute did not provide a benefit to an in state corporation to the detriment of an out-of-state corporation.

The issues presented in the Petition were: (1) Whether the Alabama add-back statute discriminated against interstate commerce by denying a deduction for ordinary business expenses because the expenses are paid to corporation outside of Alabama; (2) Whether the statute violated the due Process Clause by denying a deduction for ordinary business expenses paid to a corporation outside of Alabama.

2. *Ruling of the Commissioner, P.D. 09-14*, Virginia Department of Taxation, February 4, 2009.

The Commissioner has determined that trademark and licensing fees collected from the taxpayer's franchisees and paid to the taxpayer's intangible holding company were required to be added back to the taxpayer's taxable income. The holding company did not derive at least one-third of its gross revenues from the licensing of intangible property to unrelated parties. Rather, all of the licensing revenue was received from the taxpayer. Therefore, the unrelated exception to the add-back requirement did not apply.

3. *Pacificare Systems, Inc. Pacific Care Life Assurance Co. Pacific Life and Health Insurance Co. v. Department of Revenue*, Oregon Tax Court No. 4762, July 1, 2008.

Pacificare Health Systems (PHS) is the common parent of a group of corporations that include Pacificare Life Assurance Company (PLA), and Pacificare Life and Health assurance Company (PLHIC). PHS and its non-insurance affiliates filed a consolidated Oregon return. In 1998, PHS entered into an agreement with an insurance subsidiary to contribute all of its service marks, trademarks, logos, slogans and other intellectual property to the company. In exchange for the use of the property PHS provided all of the administrative services to the insurance subsidiary. The other affiliates who used the intellectual property paid cash royalties that represented 1.75% of the adjusted gross revenue of the licensee. On audit the Department disallowed the royalty expense deduction.

PHS argued that the royalties represented arm's-length rates and as such the deductions were valid expenses. The Department admitted the royalties met the arm's-length standard but the analysis should focus on the initial transfer of the intellectual property. In effect PHS remained the owner of the property. The Tax Court concluded that if the income from the property is reported by a controlled group member who is not the

owner the Department has the authority to adjust the return to properly reflect ownership for tax purposes. In reviewing the terms of the transfer and the legal relationship among the members the court concluded the transfer to the subsidiary should not be respected. The basis for the court's conclusion was the fact the transfer could be rescinded at any time. PHS had control with respect to the revocation of the transfer. The Tax Court held the transfer should not be respected because there has been no substantial change in the economic position of PHS, the transferor. The Tax Court concluded that before an analysis of the economic terms of the license arrangement between the insurance subsidiary and the affiliates is relevant it must be determined whether PHS or the insurance affiliate is the owner of the intellectual property. Because PHS retained substantial control and the economic benefits that accompany that control, PHS had to be treated as the owner of the property.

4. *Family Dollar Store of Ohio v. Tax Commissioner*, Ohio Board of Tax Appeals, 2005V-469 (January 4, 2008).

The Ohio statute requires corporations to include payments made to a related company for intangible expenses when reporting Ohio net income amounts. A corporation is allowed to make an adjustment to the addback to the extent that the related member's income is apportioned and taxed in another state. The exception does not apply if a combined or consolidated report is or could be filed. Family Dollar Stores (FDS) is an Ohio corporation that operated discount retail stores in Ohio. FDS is a wholly-owned subsidiary of Family Dollar Stores, Inc. a North Carolina corporation. An affiliate Family Dollar Marketing, Inc. (FD Marketing) owns all of the groups' intellectual property. FDS paid a royalty for the use of the property. Initially, FDS added the royalty expenses back to income. The company filed amended returns seeking a refund because FD marketing was subject to tax in the states of Massachusetts, North Carolina and South Carolina.

The Commissioner the claim for fees paid to North Carolina but denied the claim for the other states on the grounds that FD Marketing could have filed a combined or consolidated return in those states. In upholding the Tax Commissioner's denial the Board of Tax Appeals rejected FDS's argument that although they had the opportunity to file a consolidated or combined return the language of the statute should be ignored because neither South Carolina no Massachusetts actually eliminated the effects of the related member transactions. The Board found the language to be plain and unambiguous. Therefore, it was not subject to various interpretations.

5. *Ruling of the Commissioner No. 07-15, October 2, 2007.* Virginia Department of Revenue.

The Virginia Tax Commissioner affirmed a corporate income tax assessment holding that a manufacturing company's licensing fees paid to a parent corporation were required to be added back to the tax base. The taxpayer argued that the fees fell within the exception because the fees were subject to tax in another jurisdiction. The parent reported the fees in two states in which the apportionment factors were 1.37% and 1.083%. The auditor reduced the amount to 2.453% and increased the net add-back amount to 97.457% of the royalties. The Commissioner concluded that the "subject to tax" test must be satisfied for each item of the parent's income that corresponds to each portion of the royalty payments for which the exception is claimed. The exception is not automatically allowed for all royalty payments if one of the conditions is met.

6. *Wal-Mart Stores East, Inc. v. Hinton*, North Carolina Superior Court, No. 06-CVS-3928, December 31, 2007. Appeal pending.

The Superior Court held that the Department of Revenue was authorized to require Wal-Mart to file a consolidated return with its wholly-owned REIT. The use of the consolidated return was required in order to determine the businesses true net income subject to North Carolina tax.

Wal-Mart had structured its business operations to establish an operating company, the taxpayer at issue in this matter. The company contained a REIT to hold real estate and a property company. The structure allowed the taxpayer to claim a rent deduction for the rent paid to the REIT and a dividends received deduction for the dividends received from the property company. The property company's income consisted of the rental income distributed by the REIT. Wal-Mart argued that by forcing the companies to file a consolidated return, the Department was denying the company statutory deductions. Further, Wal-Mart argued that the Department did not have the authority to require the filing of a consolidated return.

The court found that the transactions lacked economic substance. In reaching its conclusion, the court relied on the fact that the property mortgages were never transferred to the REIT, the rental amounts were based on a percentage of sales and the property transfers were never recorded. Further, the court found that there were several statutory provisions that granted the Commissioner the authority to adjust income reported on returns to accurately reflect business activity in North Carolina. Under one of the provisions, the Commissioner can require the filing of a consolidated return. There was no requirement that the Commissioner establish that the compensation resulting from the

intercompany transactions were excessive. Further, because the Department used existing authority to require the filing of the consolidated return the action did not amount to a constitutionally prohibited retroactive application of a tax.

Finally, the court refused to waive the 25 percent penalty, as it found that there was nothing in the statute that required a showing of negligence to impose such a penalty.

7. *Letter of Finding, No. 06-0511*, Indiana Department of Revenue January 30, 2008.

The Taxpayer, an Indiana company engaged in the business of preparing and printing financial business documents, deducted royalty fees paid to a related entity located in California. The royalty fees, which were based on the taxpayer's monthly income, were paid for the right to use various trademarks and logos. The taxpayer never owned the intellectual property. On audit, the Department disallowed the deduction, citing the statutory provision that allowed the Department to adjust income to fairly reflect income derived from sources within Indiana.

In reversing the audit's position, the Department relied on evidence that established that the California entity was an operating company that actively promoted and preserved the intellectual property. The California entity employed the royalty payments as working capital and the royalty fees were neither loaned back nor distributed as dividends. As such, the royalty payments did not constitute an abusive tax avoidance scheme such that the claimed royalty expenses did not fairly reflect the Taxpayer's Indiana source income.

8. *Oklahoma Attorney General Opinion, 07-25* August 28, 2007.

The Attorney General has ruled that the Tax Commissioner has the authority to analyze a taxpayer's structure to determine whether its taxable income is accurately and properly reported. In addition, the Tax Commissioner has the authority to make adjustments between two or more taxpayers owned or controlled directly or indirectly by the same interests when it reasonably determine such an allocation is necessary to prevent evasion of taxes or to clearly reflect income.

9. *Massachusetts DOR Directive, No. 07-9*, October 10, 2007.

The Massachusetts statute generally requires in the context of a transaction between affiliates involving intangible property the add-back of an otherwise deductible expenses that relate to that property. The Department has determined that the addback statute applies to the

deduction for the amortization of intangible under IRC Section 197 unless the deduction falls within one of the exceptions. The Department's position is that the statute broadly applies to various expenses and costs related to intangible property. Because the amortization amount that may be permitted as a deduction under IRC section 197 would represent a recovery of costs related to the acquisition or ownership of intangible property its meets the definition of an intangible expense subject to the addback statute.

10. *The Classics Chicago Inc. v. Comptroller*, Maryland Tax Court No. 06-IN-00-0226 (April 11, 2008) and *The Talbots, Inc. v. Comptroller*, Maryland Tax Court No. 06-IN-00-0027 (April 11, 2008).

The Maryland Tax Court held that the sham doctrine is not the standard to be applied when determining nexus of affiliated entities. Rather, the test to be applied is whether the out-of-state affiliates had real economic substance as separate business entities.

Talbots is a Delaware corporation with its commercial domicile in Massachusetts. The company retails specialty women's clothing through both catalogs and retail stores. In 1988, the company sold all of its intellectual property to a Dutch subsidiary of its parent, Jusco. The purchase was financed by a loan from the parent. The Dutch affiliate entered into license agreements for the use of the property. The royalty payments were deducted for federal tax purposes. In 1993, in conjunction with an initial public offering, Talbots incorporated Classics. Classics purchased the intellectual property from the Dutch affiliate. Upon completion of the purchase, Talbots entered into license agreements with Classics. Talbots paid a royalty to Classics based on net sales. Classics registered the marks with the Maryland Secretary of State. Talbots filed Maryland Income Tax returns; Classics did not file returns.

The Tax Court concluded that although Talbots may have had a legitimate business purpose other than tax avoidance to fund the purchase of the intellectual property, the key to the analysis was the substance of the resulting subsidiary. In reviewing Classics structure, the court focused on the fact that the company had minimal operating expenses during the 11 year period in question. There were little or no expenses for compensation to officers, salary, or wages. Classics minimal expenses were in contrast to the significant amount of royalty income reported. The Tax Court found that this was essentially the fact pattern in *SYL Inc.*, and as such, the company lacked real economic substance as a separate business entity. The activities of Classics had to be viewed through the activities of its parent and it had substantial activities with its parent. Therefore, Classics had constitutional nexus with Maryland and the assessments were affirmed. The Tax Court did, however, reduce the penalties.

11. *In the Matter of the Petition of Talbots, Inc.* State of New York Tax Appeals Tribunal, No. 820168, September 8, 2008.

The Tax Appeals Tribunal has held that Talbots Inc. was required to file a combined return with its wholly-owned subsidiary, The Classics Chicago, Inc. because the subsidiary lacked economic substance. Further, Talbots failed to meet its burden of establishing the appropriateness of the royalty charge.

Talbots is a Delaware corporation and was owned by Jusco a subsidiary of a Japanese corporation. All of the intellectual property was owned by Jusco, BV. Jusco BV purchased the property in 1988 and licensed the property back pursuant to an agreement which imposed an arm's-length royalty. In 1993 Chicago Classics was formed and the intellectual property held by Jusco BV was sold to Chicago Classics. Chicago Classics used a loan from its parent Talbots to purchase the property. The purpose of holding the property in a separate company was to maximize the value of Talbots stock. Classics charged an arm-length royalty rate for the use of the property.

The Administrative Law Judge (ALJ) explained that even though the payments may have been arm's-length the taxpayer must establish that there is a business purpose and economic substance to the intercompany arrangement. The ALJ found neither existed in this matter. In reviewing the decision the Tribunal concluded the business purpose inquiry concerns the motives of the taxpayer while the economic substance analysis requires an objective determination of whether a reasonable possibility of profits existed apart from the tax benefits. In applying these standards the tribunal noted that Classics never performed any quality work, research, or product management. The company had no employees. In fact, Talbot's role with respect to the intellectual property was the same before and after the transfer. Thus, the Tribunal concluded the movement of the property was merely for tax avoidance as there was no business purpose outside of the tax savings. Therefore, the transaction also lacked economic substance.

12. *Nordstrom, Inc. NIHC, Inc; N2HC, Inc. v. Comptroller of the Treasury*, Maryland Tax Court, Nos. 07-IN-000317, 07-IN-000318 and 07-IN-000319, October 24, 2008.

Nordstrom in 1996 incorporated NIHC and NTN in Colorado and then contributed a license agreement that allowed NIHC to license Nordstrom's intellectual property. In March 1997, N2HC was formed and Nordstrom transferred its stock in NTN and NIHC to the newly formed company in exchange for cash. N2HC entered into a license Agreement with

Nordstrom in exchange for royalty payments. N2HC maintained an office in Portland Oregon that was staffed with a full time intangible property specialist. Nordstrom, NIHC and N2HC all filed Maryland income tax returns listing the income shown on the federal consolidated return. NIHC and N2HC had zero apportionment factors in Maryland.

The Tax Court addressed whether there is sufficient nexus between Maryland and the two subsidiaries to impose an income tax. Nordstrom argued the companies were not subject to tax because the two companies were actively engaged in a business citing to *Comptroller v. SYL, Inc.*, 375 MD 78 (2003). Further Nordstrom argued NIHC was not subject to tax on the transfer of the right to license the property. Rather, consistent with the federal consolidated return regulations 1.1502-13, the IRC §311(b) gain was deferred and to be recognized over a 15 year period. Finally, Nordstrom challenged the denial of the deduction for royalty expenses paid pursuant to the license agreement.

The Tax Court in rejecting the argument that N2HC was engaged in active trade or business pointed out that the sham transaction doctrine is not the test for determining nexus. Rather, the test requires the existence of economic substance and business purpose. In applying those tests to N2HC the Tax Court found that N2HC's expenses were minimal when compared to its income. Further, NHC's income was only the gain on the transfer of the license agreement. Finally, the subsequent loan by N2HC to Nordstrom was not an arm's-length transaction. Thus, when taken together the Tax Court concluded that NIHC and N2HC lacked real economic substance as separate business entities. Therefore, the activities of the two affiliates must be considered the activities of Nordstrom and as such there are substantial activities in Maryland. Nordstrom has constitutional nexus with Maryland and therefore the assessments issued to the two affiliates are upheld.

13. *TD Banknorth, N.A. v. Department of Taxes*, Vermont Supreme Court , No. 2007-127, September 19, 2008.

The Vermont Supreme Court affirmed the Superior Court holding that the bank holding companies were essentially empty shells and were not engaged in a substantial independent business activity beyond the achievement of tax avoidance. TD Banknorth established three holding companies and capitalized the companies by transferring asset-backed securities, collateralized mortgage obligations, corporate bonds and restricted stocks. The bank continued to service the loans and the holding companies paid the industry rates for such services. The bank franchise tax is capped at the bank's federal taxable income. After the loans were transferred the income stream was assigned to the holding companies and the bank's federal taxable income was a loss. The Department argued the

holding companies had no economic substance or legitimate business purpose other than to evade the bank franchise tax. The court adopted the economic substance doctrine and concluded the holding companies had no non-tax business purpose and lacked economic substance. In reaching that conclusion, the court pointed to the fact the holding companies carried no economic risk and did not engage in any meaningful business with third parties.

V. **BUSINESS INCOME**

1. *The Mead Corporation v. Illinois Department of Revenue*. 553 U.S. \_\_\_ (2008).

The United States Supreme Court unanimously vacated and remanded the decision of the Illinois Appellate Court in *Meadwestvaco Corp. v. Illinois Department of Revenue*. The Illinois Appellate Court had permitted the Department of Revenue to tax an apportioned share of the Mead Corporation's gain on the sale of its Lexis/Nexis division. In its ruling, the Supreme Court reaffirmed that the unitary business principle is the linchpin of apportionment ability, but cast serious doubt on the continuing relevance of the operational function test in the context of certain corporate dispositions.

The issue presented to the Supreme Court was whether Illinois could constitutionally tax the gain realized by Mead on the sale of Lexis/Nexis. Mead acquired Lexis/Nexis in 1968 when it purchased Data Corporation, a company which included a full-text information retrieval system that eventually became known as Lexis/Nexis. Although Lexis/Nexis was subject to Mead's oversight, Mead did not manage the day-to-day affairs of the Lexis/Nexis business. Mead's involvement was limited to approving Lexis/Nexis' annual business plan and any significant corporate transactions that Lexis/Nexis wanted to undertake. Neither business was required to purchase goods or services from the other and, in fact, neither was a significant customer of the other. In 1994, Mead sold its Lexis/Nexis division to an unrelated party and realized a capital gain of approximately \$1 billion. Mead reported this gain as non-business income on its Illinois corporate income tax return. After an audit, the Department recharacterized Mead's gain as business income and issued an assessment of approximately \$4 million in tax and interest, which Mead paid under protest.

The Circuit Court concluded that Mead and Lexis/Nexis were not unitary, but found that Lexis/Nexis served an operational purpose in Mead's business. Therefore, the gain resulting from the sale of Lexis/Nexis was, under the U.S. Supreme Court's ruling in *Allied-Signal*, apportionable income. On appeal, the Illinois Appellate Court affirmed the Circuit Court's conclusion that the gain was apportionable because Lexis/Nexis

served an operational function in Mead's business. However, the Appellate Court never addressed the Circuit Court's finding on the unitary issue. The Illinois Supreme Court declined to take the case.

In its decision, the U.S. Supreme Court initially noted a "fundamental error" in the reasoning of the Illinois state courts, stating that the Illinois courts should never have considered whether Lexis/Nexis served an operational purpose in Mead's business after concluding that Mead and Lexis/Nexis were not unitary.

The Supreme Court traced the history of the unitary business principle in state income tax cases noting that this "venerable" principle had its origins in the states' attempt to tax railroads whose business crossed multiple state lines. The Supreme Court found that the unitary business principle shifted the constitutional inquiry from the "niceties" of geographic accounting to a determination of the proper taxpaying unit. The unitary business principle was eventually expanded beyond the taxation of railroads and ultimately was used to determine the proper taxation of the net income, dividends and capital gains of multistate businesses.

The Court then specifically addressed its 1992 decision in *Allied-Signal*. In *Allied-Signal*, the Supreme Court seemed to suggest two alternative tests for apportionable income: the unitary business test and the operational function test. Under the operational function test, an asset could produce apportionable income even if the payor and payee were not unitary as long as the asset served an operational purpose in the taxpayer's business. The *Meadwestvaco* decision calls into question the continuing vitality of the operational function test. Indeed, the Court's unanimous decision states that the reference to "operational function" in *Allied-Signal* was "not intended to modify the unitary business principle by adding a new ground for apportionment." The Court also stated that the Illinois Appellate Court "erred" when it interpreted *Allied-Signal* to support a "new ground" for constitutional apportionment in the absence of a unitary business.

The Court, in *Meadwestvaco* reaffirmed that apportionability turns on the unitary business principle. Thus, the *Meadwestvaco* decision, an asset -- whether it is short-term deposits at a bank, a futures contract, or another business -- will produce apportionable income as long as that asset is part of or used in a taxpayer's unitary business. While the Court did not discard the operational function test, it explained that the test simply recognizes that an asset can be part of a taxpayer's unitary business even if a unitary relationship does not exist between the payor and the payee. However, the Court, unlike the Illinois courts below, did not apply the operational function test to Mead's gain on the sale of Lexis/Nexis. The Court specifically stated that when the asset in question is another business, the only test to be applied is the traditional unitary criteria of

functional integration, centralized management and economies of scale. The Supreme Court remanded the case to give the Appellate Court the opportunity to review the unitary issues.

2. *Chambers et. al v. Utah State Tax Commission*, District Court No. 050402915, January 25, 2007. Utah Supreme Ct. NO. 20070467-SC January 25, 2008.

The District Court concluded that 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 Conaco 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, RSG 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 it so broadly as to include gains from the complete sale or liquidation of a business. Further, 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.

The Utah Supreme Court dismissed the matter because the parties entered into a Settlement Agreement.

3. *NICOR, Inc. v. Illinois Department of Revenue*, Illinois Appellate Court, 1-07-1359 and 1-07-1591 (December 5, 2008).

In an unpublished order, the Illinois Appellate Court (First District) ruled that the "business liquidation exception" to the former definition of business income under Illinois law applied to a taxpayer's sale of stock of a unitary subsidiary, which was treated as an asset sale pursuant to an IRC Section 338(h)(10) election. Thus, the gain from the sale was non-business income.

Prior to 1993, Nicor's business consisted of the distribution, storage, exploration, production and containerized shipping of natural gas. Nicor owned all the stock of Nicor Oil and Gas Corporation (NOGC). NOGC owned all the stock of Nicor Exploration and Production Company (NEPC). NEPC, in turn, owned all the stock of five other subsidiaries

engaged in natural gas exploration and production. NOGC, NEPC and the five subsidiaries did not maintain their commercial domicile in Illinois. Nicor filed consolidated federal and combined Illinois corporate income tax returns, which included NOGC, NEPC, and NEPC's five subsidiaries.

In 1993, NOGC sold all of its stock in NEPC to Scana Petroleum Resources, Inc (Scana). The parties agreed to treat the sale as a deemed asset sale under IRC section 338(h)(10). As a result, NEPC was treated as two unrelated entities: the "old" target and the "new" target. Pursuant to IRC section 338(h)(10), the old target was deemed to have sold its assets to the new target, distributed the sale proceeds to its shareholder (NOGC), and liquidated. The "new target" was owned by Scana and no longer affiliated with Nicor.

On its 1993 Illinois combined income tax return, Nicor reported the gain on the sale of NEPC and the five subsidiaries as non-business income. After conducting an audit, the Department recharacterized the gain as business income and assessed additional taxes and interest. Nicor paid the additional taxes and interest under protest and subsequently filed suit.

The issue for the Appellate Court was whether the gain reported by Nicor qualified as business or non-business income under *American States Insurance Co. v. Hamer*, 352 Ill. App. 3d 521, 816 N.E.2d 659 (1<sup>st</sup> Dist. 2004). In *American States*, the Appellate Court applied the "business liquidation exception", to a deemed sale of assets under IRC 338(h)(10) and concluded that the gain from the sale was non-business income. In *Nicor*, the Department of Revenue argued that *American States* did not apply because the target (NEPC) was a member of the Nicor unitary business group while the target in *American States* was not a member of the seller's unitary business group (though it was a member of the seller's federal consolidated group).

The Appellate Court rejected the Department's position and found the *American States* holding directly on point. Accordingly, under a plain reading of the IRC, the former definition of "business income" under the Illinois Income Tax Act, and perhaps most importantly, *American States*, the Appellate Court held that the sale of NEPC must be treated as a complete liquidation and cessation of NEPC's business, resulting in non-business income for Nicor as a matter of law, notwithstanding the fact that NEPC was a member of the Nicor unitary group.

4. *McKesson Water Products Company v. Director of the Division of Taxation*, New Jersey Tax Court No. 000156-2004 (August 13, 2007). (Appeal Pending).

The New Jersey Tax Court held that McKesson Water was entitled to a corporate business tax refund because the gain recognized on a §338(h)(10) transaction was non-operational income.

In January 2000, McKesson Corporation, the parent of McKesson Water, entered into an agreement to sell McKesson Water. McKesson and the purchaser, Danone International, made an election pursuant to IRC §338(h)(10) to treat the sale as an asset sale for federal tax purposes. McKesson Water argued that the gain recognized on the transaction constituted non-operational income, and that consistent with N.J.S.A. 54:10-A6.1(a), the gain should be allocated to the company's principal place of business. The Tax Court, in holding the gain to be non-operational, analyzed both the out-of-state decisions that addressed IRC §338(h)(10) transactions as well as those decisions that interpreted UDITPA with respect to non-business income. The Tax Court found that, with the exception of California, other jurisdictions that have interpreted UDITPA have concluded that income received from a complete liquidation does not constitute business income if the proceeds have been distributed to the shareholders.

The Tax Court stated that operational income only results if the acquisition, management and disposition of the property constitutes integral parts of the trade or business. The result of the transaction under a deemed asset sale was a cessation of business with a complete liquidation. Therefore, there was a deemed termination of the operation and the gain was not operational income nor investment income that served an operational purpose because no operations of McKesson Water continued after the deemed sale of assets and liquidation.

**Note:** New Jersey has promulgated a regulation that addresses the sourcing of receipts from the sale of assets pursuant to IRC §338(h)(10) election. The receipts are allocated and sourced to New Jersey by multiplying the gain by a three year average of Target's apportionment factors for the three tax return periods immediately prior to the sale. N.J.A.C. 18:7-8.12, effective July 16, 2007.10.

5. *Newell Window Furnishing, Inc. v. Ruth E. Johnson, Commissioner of Revenue*, Tennessee Appellate Court No. M2007-02176-COA-R3-CV, December 9, 2008.

In January 1997 Kirsch Inc. became a wholly-owned subsidiary of Cooper and in May of that year Cooper sold 100 percent of Kirsch's capital stock to Newell Window Furnishing Inc. The parties agreed that the sale was to be treated as a deemed sale of assets under IRC section 338(h) (10). Kirsch filed Tennessee excise tax returns for the year ending May 1997

and deducted the amount representing gain from the sale from its reported net earnings and claimed the amount as a refund. The department of revenue denied the refund and assessed additional franchise and excise taxes against Kirsch. Newell, as Kirsch's successor in interest, filed suit in which the trial court granted summary judgment for the Department. Newell appealed to the Court of Appeals at Nashville.

The Tennessee Court of Appeals held that the Department of Revenue properly assessed excise taxes against a subsidiary whose capital stock was sold and treated as the deemed sale of assets pursuant to an IRC section 338(h)(10) election. The first issue before the court was whether the sale of Kirsch's capital stock was properly included in Kirsch's excise tax base following the section 338(h)(10) election. The court rejected Newell's argument that its federal election should not determine Kirsch's Tennessee excise tax liability. Using a New Jersey Tax Court decision in *General Building Products Corp. v. New Jersey*, 14 N.J. Tax 232 (1994) for guidance, the court held that Kirsch was bound for state tax purposes by its federal election. Next, the court rejected Newell's arguments that gain from the one-time sale assets could not be considered business income apportionable to Tennessee. The court concluded that the proper test was not whether the disposition of property was part of Kirsch's regular business but whether the property disposed of was an integral part of the business. The court concluded that was uncontested. Finally, the court rejected Newell's arguments based on the due process and commerce clauses. The court held that there was no violation because the tax was levied on Kirsch, which was doing business in Tennessee. The trial court's decision was affirmed.

6. *North Carolina Secretary of Revenue Decision No. 2007-28*, September 14, 2007.

The Secretary of Revenue concluded that an out-of-state holding company's income derived from a North Carolina LLC that was characterized as a partnership was apportionable business income. The company was required to use the payroll, sales and property of the LLC to compute its North Carolina corporate income tax liability. The Secretary rejected the taxpayer's argument that the income was non-business because it did not materially participate in the day-to-day operations of the LLC, and that its sole connection to the LLC was as a passive investment. The court found that the holding company had no other business activity apart from its investments, and that the holding company's and the LLC's business were directly and integrally related. The regulations in effect for the tax period at issue, required that the LLC's income be apportioned utilizing a proportionate share of the LLC's payroll, property and sales.

7. *Ruling of Commissioner. 08-188*, Virginia Department of Taxation, October 17, 2008.

The taxpayer, an out-of-state multi-national corporation with numerous subsidiaries, was not allowed a subtraction for non-business income resulting from the gains of a sale of subsidiary stock to an unrelated third party on its Virginia corporate combined income tax return. The taxpayer and the third party, elected to treat the transaction as an asset sale under IRC §338(h)(10). The taxpayer characterized the gain from the sale of stock as non-business income. However, the Virginia Department of Taxation has held that if the seller, target, purchaser, or any combination of such entities are Virginia taxpayers, the IRC §338(h)(10) election actually made on a federal return will be recognized exactly as it is for federal purposes. To the extent that any gain or loss is deemed to be recognized for federal purposes by any party, it will be similarly recognized by the applicable entity for Virginia purposes. Because Virginia follows the federal treatment of the IRC §338(h)(10) election, the taxpayer's subsidiary is deemed to have sold its assets, and must recognize the gain. The taxpayer's request for an alternative method of allocation and apportionment in regards to the gain was also rejected because the taxpayer's subsidiary sold its own assets and the gain was recognized in the subsidiary's separately computed Virginia taxable income. As such, the subsidiary had a unitary relationship with its operating assets (both tangible and intangible) and the gain was properly included in the subsidiary's apportionable income. Additionally, Virginia's treatment of the gain from the sale of the subsidiary was found to be fairly apportioned. Finally, the taxpayer's return was adjusted to include Virginia net operating loss deductions which were not carried forward to the taxable years at issue by the auditor.

8. *Tate & Lyle Ingredients America Inc. v. Alabama Department of Revenue*, Administrative Law Division No. Corp. 07-162, January 15, 2008. Petition for Rehearing denied June 23, 2008. Appeal pending.

The Administrative Law Judge held that Tate & Lyle was not subject to tax on the gain the company realized from selling its minority stock interest in a European company engaged in the same general line of business and owned by the same holding company. In reaching his conclusion, Judge Thompson determined that there was no flow of value between the companies. In addition, there was no functional integration, centralized management and/or economies of scale.

The two companies manufactured and marketed cereal sweeteners. Each sold their products to customers on different continents. The companies had separate manufacturing facilities and had separate administrative functions. Each company had its own independent management team and

had no common officers or directors. Although the companies had a common parent, the court found that there was no unitary relationship and that the companies were unrelated businesses.

The ALJ recognized that although the companies were not unitary in nature, the gain could be characterized as apportionable income if the asset served an operational function. Tate & Lyle had held the stock for 14 years and there was no evidence that the stock was purchased for anything but an investment. The evidence did not indicate that ownership of the stock served an operational function, or that it was used in the company's Alabama business operations. The European company was not used as a source of supply, and there were no sales or exchanges of raw materials between the companies. Thus, because the companies were not unitary in nature and the stock ownership did not serve an operational function, Alabama was constitutionally barred from taxing the gain.

Judge Thompson also analyzed the transaction under UDITPA, applying both the transactional and functional tests. In so doing, he concluded that the sale was an infrequent transaction and the transactional test was not met. Further, the company did purchase, manage and dispose of the stock as an integral part of its business. Therefore, the gain was properly characterized as non-business income.

9. *Kimberly-Clark Corp. & Kimberly Clark Worldwide, Inc. v. State Department of Revenue*, Alabama Civil Appellate Court No. 2061117, March 21, 2008.

The Appellate Court reversed the Circuit Court and held that the sale of a pulp/paper mill and related timberlands by the taxpayers was properly classified as apportionable business income under the transactional test.

In 1962, Kimberly Clark acquired an Alabama pulp/paper mill and related timberlands. The property was transferred to Kimberly Clark Worldwide in 1996. In March of 1997, the properties were sold to an unrelated party. Kimberly Clark characterized the gains recognized on the transaction as apportionable business income and excluded the gross receipts from the computation of the apportionment factor. On audit the Department characterized the gains as non-business income.

The Appellate Court, applying the transactional test, concluded that the gains from the sale were properly characterized as business income because the selling and acquisition of paper mills and timberlands by a corporation that is engaged in the manufacturing and sale of paper products generates earnings arising from transactions and activities in the regular course of business. The court remanded the matter to the Circuit

Court to determine if the Department's special rule is applicable to the exclusion of the gross receipts from the apportionment factors.

10. *Louis Dreyfus Petroleum Products Corp. v. Wisconsin Department of Revenue*, Circuit Court Dane County No. 08CV494, October 7, 2008.

The Circuit Court has held that the Tax Appeals Commission erred when it characterized the sale of the partnership interest as the sale of intangible personal property as that term is defined in the statute. Although the property was mis-characterized the Commission correctly applied the unitary business rule to conclude that the capital gain was apportionable to Wisconsin. The Commission reasonably concluded that the corporation and the partnership were functionally integrated and had centralized management. Further, there were economies of scale.

## VI. APPORTIONMENT ISSUES

### 1. Receipts Factor

- a) *General Mills, Inc. & Subsidiaries v. Franchise Tax Board*, San Francisco, 1st District Appellate Court No. A120492. April 15, 2009.

The California Court of Appeal, reversed the Superior Court and has held that the full sales price of a corporation's commodity futures sales contracts are gross receipts that may be included in its apportionment sales factor. General Mills and its subsidiary corporations manufacture and market finished consumer food products. General Mills also sells raw grain and grain products to unrelated third parties. The company engages in futures trading as a hedger to protect itself against fluctuations in the price of agricultural commodities used in its business. In a majority of its futures transactions, General Mills offsets the original futures contract and obtains most of the commodities it needs for manufacturing on the cash market. During the tax years at issue, General Mills' hedging activities contributed to its business income.

For federal tax purposes, General Mills included its futures and forward sales as adjustments to costs of goods rather than sales. General Mills did not include any amounts from its futures trading in its sales factor apportionment formula for state tax purposes. Between 2000 and 2003, General Mills filed amended state tax returns and reported the full sales price of its futures sales contracts

as gross receipts, which reduced its apportionment percentages. The Franchise Tax Board denied the refund claims and General Mills appealed to the trial court, which found in favor of the FTB.

Court of Appeal reversed the Superior Court and held that General Mills may include its commodity futures sales made to hedge against price fluctuations in its sales factor because contract sales constitute gross receipts. The court explained that the state Supreme Court has considered the meaning of "gross receipts" in two recent cases and concluded that the term refers to the entire amount of money or other consideration received. The court determined that a futures sales contract is a legally binding obligation to sell a commodity and a trader, such as General Mills, receives consideration at offset. The consideration, the court concluded, is the full sales price of the sales contract. The court noted that when General Mills offsets a futures purchase contract with an equivalent futures sales contract, it receives consideration in the form of being relieved of the obligation to deliver the commodity.

In so holding, the Appellate Court court rejected the FTB's argument that the receipts from futures trades should be considered adjustments to General Mills' cost of goods and held that General Mills' financial accounting treatment of its trades is not binding for tax purposes. Moreover, the court concluded that the apportionment sales factor includes receipts that are not counted as sales on a taxpayer's financial statements or federal tax returns. Turning to whether the standard apportionment formula fairly represented General Mills' business activity, the court noted that the trial court did not address this issue. The court remanded that issue to the trial court and vacated the board's denial of General Mills' refund claims.

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

On August 6, 2004, the Franchise Tax Board issued Notice 2004-5, providing that 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, indicated that a taxpayer that has included interest income and net gains from the sales of securities will not be subject to the accuracy-related penalties. However, the determination of 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.

- c) *In the Matter of Disney Enterprises, Inc. v. The Appeals Tribunal*, New York No. 37 Court of Appeals (March 25, 2008).

The Court of Appeals affirmed the Appellate Division's holding that Disney must include the sale of a unitary group non-taxpayer member in both the numerator and denominator of the apportionment formula. In so holding, the court concluded that the inclusion of the sales did not amount to a tax on the non-taxpayer member, the sales were not mere solicitation within the protection of P.L. 86-272 and that the Commerce Clause had not been violated.

The court rejected Disney's argument that the inclusion of Buena Vista's income in the numerator of the sales factor was in fact imposing a tax on Buena Vista. It has been previously recognized that there is a distinction between the inclusion of non-taxable income in a formula used to apportion income for purposes of imposing a tax and the tax itself. Further, with respect to the combined group's activities, the court held that the inclusion of the sales was necessary to arrive at the appropriate apportionment percentage.

Finally, in rejecting Disney's Commerce Clause claim, the court concluded that the tax on the Disney combined group was not grossly disproportionate to its New York activities and was fairly apportioned and not discriminatory.

## 2. Throwout and Throwback Rules

- a) *Arizona Department of Revenue v. Central Newspapers Inc.*, Arizona Tax Court No. 2006-050001, September 25, 2007.

P.L. 86-272 did not prohibit Arizona from imposing state income tax on an Arizona domiciled corporation's imputed income from a Washington state partnership. P.L. 86-272 did not prohibit the state from sourcing the partnership's sales to Arizona and imputing a distribution of the profits in order to compute the taxpayer's taxable income. To the extent that the partnership's sales were relevant to the computation of the taxpayer's Arizona gross income, they were properly included in the numerator of the taxpayer's apportionment factor.

- b) *Pfizer Inc. v. Director, Division of Taxation*, Tax Court of New Jersey Dkt. No. 000055-2006. May 29, 2008. The Supreme Court granted the Petition. New Jersey Supreme Court Docket No. 63, 147.

The New Jersey Tax Court held that the throwout rule which is applied to the sales factor denominator to apportion income for New Jersey purposes is constitutional on its face.

Pursuant to the throwout rule, if a corporate taxpayer's total receipts include receipts that would be assigned to a jurisdiction in which a taxpayer is not subject to income tax, the receipts are excluded from the denominator of the sales factor. The taxpayers argued that the rule violated both the Due Process and Commerce Clause of the U.S. Constitution. The Tax Court rejected this argument, stating that the throwout rule can operate in a way that satisfies the requirements for constitutionality. For example, the factor will operate in a manner which satisfies the constitutional standards if (1) The income being excluded from the denominator of the sales factor is generated in whole or in part by the activities in New Jersey; (2) The income generated in the non-taxing state is insignificant in relation to the total income of the corporation; or (3) The property and payroll fractions substantially temper the impact of the sales factor so that the corporation's income is fairly apportioned and fairly related to the services provided by the state. Although the sales factor is double weighted, a distortion in the sales factor would not automatically create an unconstitutional distortion.

The Tax Court pointed out that several Supreme Court decisions have held that the constitutional concerns with apportionment relate to the ultimate apportionment of income and not to each component of the formula that produce apportionment. The Director of the Division of Taxation has both the discretion and obligation to make adjustments to the apportionment formula when the apportionment of income to New Jersey is not fair.

The throwout rule does not violate the Supremacy Clause because it does not impose a tax that would be prohibited by P.L. 86-272. Rather, it is part of the calculation used to determine what portion of a corporation's income will be taxed by New Jersey. The throwout rule satisfies the requirements of the Due Process, Commerce and Supremacy Clauses of the U.S. Constitution. Therefore, it is facially constitutional. While it is possible that the

rule may operate unconstitutionally in some applications, this does not negate its facial constitutionality.

3. Cost of Performance

- a) *Ameritech Publishing Inc. v. Wisconsin Department*, Wisconsin Dane County Circuit Court, Dkt. 08-CV-1394 (January 8, 2009). Appeal pending.

The Dane County Circuit Court upheld the Tax Commission's use of the "ultimate benefits test" as the appropriate method to apportion Ameritech Publishing's income to Wisconsin. In so doing the court rejected the taxpayer's argument that the cost of performance method should have been used.

Ameritech Publishing has business operations in a number of states including Wisconsin. The company solicited and sold advertising in telephone directories. The company derived its revenue from both local and national advertising. It solicited the local advertising from offices in Wisconsin. National advertising was solicited from offices located in Chicago and Troy Michigan. The graphics arts were handled in Michigan and the directories were printed and bound by a third party outside of Wisconsin. Pursuant to an arrangement with Wisconsin Bell almost all of the directories were distributed in Wisconsin for the years at issue. The Tax Commission found that the directory advertising sales fell within the scope of a sale of a service. The Department did not challenge that finding. The Commission then concluded that the directory advertising services were the income producing activities and those activities were performed entirely within Wisconsin because it was the distribution of the directories that constituted the income producing activities of the taxpayer. Ameritech Publishing challenged this conclusion.

The court found that the Commission's decision was consistent with the statutory purpose and that there was not a more reasonable interpretation. The court citing the contractual language rejected the argument that the income producing activities consisted of soliciting, creating, developing and producing the advertisement for the directories. The terms of the contract are the best evidence of the company's revenue producing activity. Under the terms of the contracts the advertising are entitled to have the yellow and white page advertisements before the targeted Wisconsin audience. There is no right under those terms for any of the other services. The contractual services are performed wholly within Wisconsin. The taxpayer did not articulate a more reasonable interpretation.

Therefore, the Tax Commission's decision is consistent with the purpose of the apportionment statute. Finally, the court concluded that the taxpayer did not sustain its burden for establishing an equal protection claim.

- b) *Bell South Advertising & Publishing Corporation v. Chumley, Commissioner of Revenue*, Chancery Court Davidson County No. 04-2232-IV, July 31, 2008. Appeal pending.

The Chancery Court reversed the Commissioner's use of the statutory variance for apportionment purposes and concluded the statutory cost of performance method was the correct approach for apportionment purposes. The Taxpayer pursuant to an agreement with Bell South publishes all of Bell South's telephone directories. Its business activities include the sale of directory advertising, compilation and delivery of the directories. The Taxpayer's production office was located in Alabama and the administrative support functions were located in Atlanta Georgia. The Taxpayer computed its sales factor using the statutory cost of performance method. The Commissioner argued that the use of such method did not accurately reflect the extent of the companies business activities in Tennessee. Thus, she invoked the statutory provisions that allow for a variance of the factors.

The statute contemplates that receipts are only sourced to Tennessee if a greater proportion of the activity which produced the revenue occurred in the state. In this matter the business activity that produced the revenue is derived from the customers who place advertising in the directories. The Commissioner argued that a significant amount of revenue is received from the sale of advertising in the state and under the statutory method those amounts are not apportioned to Tennessee. The court concluded that that rationale in and of itself does not justify the adoption of a variance. Further, the Commissioner did not identify that a greater proportion of the Taxpayer's earning producing activities were performed in the state. Therefore, the proper formula for determining the receipts factor is the cost of performance method as set forth in the statute.

## B. Modification of Apportionment Formula

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

The Tax Court held that 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 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 that 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.

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

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 that the formula resulted in distortion. The FTB had recalculated the formula by grouping the aircraft by make and model. The regulation required that 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.

## **VII. INTERSTATE COMMERCE/DISCRIMINATION**

1. *George W. Davis and Catherine V. Davis v. Department of Revenue*, U.S. Supreme Court No. 06-666, May 19, 2008.

The Supreme Court held that Kentucky's differential scheme for taxing interest on municipal bonds does not offend the Commerce Clause.

Kentucky imposes an income tax on its residents' income. The tax is assessed on "net income," which excludes "interest on any State or local bond." This exclusion is provided for Kentucky residents who purchase Kentucky bonds. At issue was the constitutionality of Kentucky's practice of exempting interest on bonds issued by it or its political subdivisions from its state income tax, but not exempting those bonds issued by other States and their subdivisions. George and Katherine Davis of Jefferson

County, Kentucky challenged the state law because it required them to pay tax on interest from out-of-state bonds. After paying Kentucky income tax on out-of-state municipal bonds, the taxpayers sued the Kentucky Department of Revenue claiming that the differential tax impermissibly discriminated against interstate commerce. The trial court ruled for Kentucky based on the “market participation” exception to the dormant Commerce Clause. The Court of Appeals of Kentucky reversed the trial court’s finding and held that the scheme ran afoul of the Commerce Clause.

The Supreme Court, in a 7-2 decision written by Justice Souter, reversed the Court of Appeals and held that Kentucky’s actions did not offend the commerce clause. The court reasoned that although modern dormant Commerce Clause law is driven by concerns about “economic protectionism,” there is an exception that protects states that go beyond mere regulation and actually “participate in the market” to “exercise the right to favor their own citizens.” Essentially, there is a “basic distinction...between States as market participants and States as market regulators.” Given such a distinction, the notion that certain government action is not susceptible to standard dormant Commerce Clause scrutiny because it is motivated by legitimate objectives distinct from simple economic protectionism applies with even greater force to laws favoring a state’s municipal bonds. This is due to the fact that issuing debt securities to pay for public projects is a quintessentially public function with a venerable history. The Court stated that “the fact that the differential tax scheme is critical to the operation of an identifiable segment of the current municipal financial market demonstrates that the States’ unanimous desire to preserve the scheme is a far cry from the private protectionism that has driven the dormant Commerce Clause development.”

2. *Vulcan Lands, Inc. v. Surtees*, Alabama Supreme Court, No. 1070386 and 1070399. September 26, 2008.

The Supreme Court in its decision addressed the two defenses raised by the Department of Revenue against the payment of refunds of the unconstitutional Franchise Tax. First, the Department has argued that although the U.S. Supreme Court had struck down the statutory scheme foreign taxpayers were not entitled to refunds unless they could establish that a specific domestic competitor had benefited from the unconstitutional tax scheme. Second, the Department argued it was not required to pay refunds because it had relied on the decision in *White v. Reynolds Metals*, 558 So. 2d 373 (Ala. 1989) which upheld the tax against a Commerce Clause challenge. In rejecting both defenses the court held that the first argument was not consistent with the U.S. Supreme Court precedent. With respect to the second defense that the due to the reliance on *Reynolds Metals* the state would suffer undue hardship the Court held

that undisputed evidence showed that by the time the Department had collected any tax from Vulcan it had abandoned any reliance on the *Reynolds Metal* decision citing the briefs filed by the state in *South Central Bell*. Although the Court rejected both defenses it did not define the appropriate remedy and remanded the matter back to the trial court to allow the court to fully address the remedy.

3. *AT&T Corp. v. Surtees*, Alabama Court of Appeals, No. 2040908. June 23, 2006. Remanded to Jefferson County.

With respect to the Business Privilege Tax (BPT) and the Corporate Share Tax (CST), the Alabama Court of Appeals held that limiting deductions for investments to only those investments in entities doing business in Alabama was facially discriminatory and violated 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 investments 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 that to determine if the statute was discriminatory on its face, the text of the statute must treat in-state economic interests differently from out-of-state economic interests in such a way as to benefit the in-state economic interests and burden the out-of-state interests. Applying this analysis, the court concluded that the differential treatment encouraged investment in entities doing business in Alabama to the detriment of those entities not doing business in Alabama. On its face, the statute places a greater burden on those corporations that do not invest in entities doing business in Alabama. Accordingly, the statutes were facially discriminatory and the burden of justification fell on the Department. In its original opinion, the court rejected the Department's argument that the discriminatory tax scheme was to prevent double taxation. The court stated that such an explanation fell short of an acceptable justification and did not overcome 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.

**Note:** The Jefferson County Circuit Court on remand granted the requested refund of the Alabama business privilege tax and corporate shares tax. *AT&T Corporation v. Surtees*, Case No. CV 04-3356 (September 3, 2008).

5. *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). Appeal Pending Court of Appeals 1<sup>st</sup> District.

The State Board of Equalization held that the *Rev. & Tax Code* §24402 dividends received deduction that was declared unconstitutional was disallowed for the 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.

**Note:** *Abbott Laboratories v. Franchise Tax Board Appeal*, California Appellate Court No. B 204210, March 20, 2009, affirmed the Superior Court holding the Court will not rewrite §24402.

6. *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, the court reversed the circuit court and held that the statute was unconstitutional.

The Johnson Controls' administrative claims for income tax overpayment were nullified by the 2000 session of the Kentucky General Assembly's enactment of H.B. 541. Appellants then filed a declaratory judgment action in circuit court seeking to have the subsection of the Kentucky Revised Statutes that codified H.B. 541 declared unconstitutional (K.R.S. 141.200). The Circuit Court did not find any violations of the constitution.

- a) *Johnson Controls, Inc., et al. v. Commonwealth of Kentucky*, U.S. District Court Eastern District of Kentucky, No. 3:07-CV-64-KKC, February 28, 2008.

The U.S. District Court held that the challenge to the Kentucky statute barring refunds under the *GTE* decision was not barred by the Tax Injunction Act. Further, while Eleventh Amendment protection did not extend to the individual defendants in this matter, the Eleventh Amendment does bar an action against the Finance Cabinet. The Plaintiff sought to have H.B. 316, enacted in 2007, declared unconstitutional under both the Due Process and Commerce Clauses. H.B. 316 specifically prohibited the Commonwealth from paying refunds for the tax years ending prior to December 31, 1995 resulting from the filing of combined amended returns based on the unitary concept.

## **VIII. MISCELLANEOUS DECISIONS**

1. *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 to deny 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 does 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 in a manner 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 that its purpose was to insure that the affiliates and subsidiaries did not create an additional liability when transferring revenue between related parties. To apply this 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. *Fleet Funding Inc. v. Commissioner of Revenue*, Massachusetts Appellate Tax Board No. C271862, February 21, 2008.

The Appellate Tax Board concluded that inter-corporate transactions between two Massachusetts REITS and two Rhode Island passive investment companies lacked both business purpose and economic substance. Therefore, the dividends paid deductions were properly denied. The Board found that the transactions were designed to reduce the parent bank's tax liability on interest earned from various real estate loans. The loans were transferred to the REITs and the income was returned in the form of dividends. As a result, the income was returned basically tax free from the Rhode Island investment companies.

In reaching its conclusion, the Board rejected the Bank's argument that the structure had both business purpose and economic substance because the Bank had intended to use the structure as a means to raise capital. The Board found that the REITS were established without a federally mandated exchange provision. Thus, by excluding the provision, it could be inferred that the Bank did not intend to use the structure to raise capital by selling the shares of the REIT. In addition, there was no business purpose offered for the establishment of the Rhode Island investment companies or for transferring the interest income from the loan portfolios to the investment companies in the form of REIT dividends.

Finally, the Board stated that the company was not entitled to apportion its income because it failed to establish that it was taxable in any state other than Massachusetts.

3. *Kentucky v. Autozone Development Corp.*, Kentucky Court of Appeals, No. 2006-CA-002175-MR, October 12, 2007. (Opinion not to be published)

The Appellate Court upheld the Board of tax Appeals decision that allowed a Nevada Real Estate Investment Trust (REIT) doing business in Kentucky to claim a deduction for dividends paid in computing corporate income tax liability. The statutory definition of "net income" for Kentucky purposes is equivalent to the definition for federal tax purposes. The dividends paid deduction under IRC section 857 is utilized to arrive at taxable income. The Kentucky deduction is used to arrive at a corporation's net income and effectively operates to reduce a corporation's net income for state tax purposes. Thus, the federal dividends paid deduction is functionally equivalent to an allowable deduction from gross income under Kentucky law. The court rejected the

Department's argument that deductions are strictly limited to those taken from gross income.

4. *Advanced on-site Concrete Inc. v. Department of Revenue*, Illinois Appellate Court (1<sup>st</sup> Dist) Docket No. 1-06-3426 (May 22, 2008) Unpublished Order

In May 2008, the Illinois Appellate Court (First District) issued an unpublished order upholding the constitutionality of the Illinois Tax Delinquency Amnesty Act ("Amnesty Act"). Enacted in 2003, the Amnesty Act provided a window from October 1, 2003 through November 15, 2003, for taxpayers to pay taxes allegedly owed to the State for any taxable period ending June 30, 1983 through July 1, 2002. Any outstanding taxes for the applicable periods that were paid during the amnesty period were not subject to interest or penalties that otherwise would have been due. 35 ILCS 745/10. However, if a taxpayer had a tax liability eligible for amnesty but failed to pay the tax during the amnesty period, the taxpayer would be subject to interest and penalties at twice the statutory rate. Amnesty was only available if the taxpayer paid all the taxes due for a taxable period and if the taxpayer satisfied all amnesty conditions. *Id.* To take part in the amnesty program, a taxpayer agreed to: (1) relinquish all rights to contest the tax paid; (2) not claim a refund of the tax paid to the Department or protest the denial of a claim for such refund; and (3) promptly correct any underpayment of tax. 8 Ill. Admin. Code Sec. 521.105.

After Illinois' tax amnesty expired, the Department audited Advanced On-Site Concrete, Inc. and assessed it additional sales/use taxes for periods including July 2000 through June 2002 (periods eligible for amnesty), and also assessed amnesty penalties and interest. The Plaintiff challenged the tax assessment, as well as the amnesty penalties and interest, and filed a declaratory action in Circuit Court after paying the amounts under protest. The Plaintiff alleged that the Amnesty Act violated, among other things not relevant here, the Uniformity Clause of the Illinois Constitution and the Illinois Statute on Statutes.

In upholding the Amnesty Act over a Uniformity Clause challenge, the Appellate Court found that the tax classification drawn by the Amnesty Act was reasonable and passed constitutional muster. To survive scrutiny under the Uniformity Clause, a tax classification must: (1) be based on a real and substantial difference between the persons taxed and those not taxed; and (2) bear some reasonable relationship to the object of the legislation or to public policy. In this case, there were two types of taxpayers: (1) taxpayers with outstanding tax liabilities for periods after June 30, 1983 and before July 1, 2002, who paid their liabilities during the amnesty window and therefore were given amnesty from interest and

penalties that otherwise would have accrued on the outstanding tax liability; and (2) those taxpayers with outstanding tax liabilities for periods June 30, 1983 and before July 1, 2002, who did not pay their liability during the amnesty window and therefore are subject to doubled interest and penalties on the outstanding tax liabilities.

The court found that these classifications did not run afoul of the uniformity clause because there was a real and substantial difference between the two classes of taxpayers. Furthermore, the court reasoned that the tax classifications set forth in the Amnesty Act were reasonably related to the undisputed objects of the legislation: raising revenue, remedying a budget shortfall, and providing finality to tax disputes. The court held that the Amnesty Act did not arbitrarily discriminate against a narrow class, but rather set forth rational classifications that bear a reasonable relationship to a valid State objective.

The court also rejected the Plaintiff's argument that the Amnesty Act violated Section 4 of the Statute on Statutes (5 ILCS 70/4) by retroactively doubling interest and penalties on tax liabilities. (1994), and found that Section 4 of the Statute on Statutes is implicated only if the General Assembly has not indicated whether the statute should be applied retroactively. In this case, the court found that the Amnesty Act imposed double interest and penalties on taxpayers who failed to take advantage of the Amnesty window, and that the window was prospective at the time of the statute's enactment. Accordingly, the court held that it was the plaintiff's "contemporaneous failure" to avail itself of amnesty that subjected it to double interest and penalties under the Amnesty Act.

5. *Ford Motor Company v. City of Seattle, et. al.*, Washington Supreme Court Dkt. No. 7767-7, April 12, 2007. Petition for Certiorari denied, February 19, 2008.

The Washington Supreme Court held that the cities of Seattle and Tacoma could impose their municipal business and occupation tax on the business of wholesaling. Ford Motor Company had an office in Bellevue, Washington. The company had no manufacturing plant in the state and did not sell vehicles directly to customers in Seattle or Tacoma. Ford's business activities in the two cities consisted of the sale of automobile parts, vehicles and accessories to independent dealers. The company also engaged in advertising, marketing, and selling warranties on the vehicles. Ford argued that because title to the vehicle did not pass in Seattle or Tacoma, it was not subject to the tax as a wholesaler on the sales made to the dealers. Further, Ford argued that the activities conducted within the two cities assisted the dealers in selling their products. Ford did agree that it was engaged in the wholesaling business in both Seattle and Tacoma,

but asserted that because the actual sales took place outside of the cities, that the cities did not have the right to impose a tax on the company.

The court rejected Ford's argument, holding that the tax was imposed for the privilege of doing certain activities in the cities. Therefore, it was irrelevant that the actual sale took place outside of the two cities, *i.e.* title passed outside the jurisdictions. Thus, the measure of the tax was properly determined by looking at the total volume of sales.

6. *Alabama Department of Revenue v. Jim Beam Brands Company, Inc.* Alabama Court of Civil Appeals Dkt. No. CV-04-1535, December 19, 2008.

Jim Beam Brands Co. Inc. filed amended Alabama corporate income tax returns for the 1993 and 1994 tax years and claimed additional interest expense deductions attributable to its Alabama business activities. The Department of Revenue disallowed the interest expense deductions, asserting that Jim Beam had incorrectly apportioned its interest expense deductions to Alabama using the gross income ratio formula under the version of Ala. Code §40-18-35(a)(2) then in effect. The Department argued that Jim Beam should have apportioned its interest expense deductions using the standard three-factor formula set forth in the Department's regulation, Ala. Admin. Code. §810-3-31-.02.

Jim Beam appealed the assessment to the DOR's Administrative Law Division which held in favor of the Department, reversing its earlier opinion in *Alco Standard Corp. v. State Department of Revenue*, June 25, 1997. This Administrative ruling had applied the same versions of §40-35-18(a) and Regulation 810-3-31-.02, holding that the gross income ratio formula was the proper method. Jim Beam appealed to the Montgomery Circuit Court, which reversed the Administrative Law Division's final order and held that Jim Beam had indeed properly calculated its interest expense deduction. The Alabama Court of Civil Appeals unanimously held that the Department of Revenue's regulation for apportioning interest expense deductions to Alabama, employing the standard three-factor formula, conflicted with the statutorily prescribed "gross income ratio" formula.

At issue was the proper interpretation of §40-18-35(a)(2), which provided a clear statutory method for prorating a foreign corporation's interest expense to Alabama. The statutorily prescribed gross income ratio formula required interest expense to be apportioned to Alabama based on the ratio of the taxpayer's gross income from sources within Alabama to gross income from all sources. The Department's regulation required multistate corporations to apportion their interest expense based on the average of their property, payroll, and gross receipts factors. In holding that the

taxpayer's gross income ratio formula was the proper method to calculate an interest expense deduction, the Court of Civil Appeals rejected each of the Department's arguments. Specifically the court rejected (1) that the Legislature had declared that any deduction allowed for interest expense was to be calculated according to the method specified by the Department; (2) that the three-factor formula is the only one that fairly reflects the net income of the corporation attributable to its operations in Alabama; and (3) that the DOR's long-standing interpretation of a statute should be given great weight.

The court applied the traditional rules of statutory interpretation and held that the three-factor formula urged by the Department conflicted with the statutory gross income ratio formula and, thus, the statute prevailed over the agency regulation, despite its long-standing application by the Department. The court said that to interpret the language of § 40-18-35(a) as urged by the Department would mean that the Legislature had authorized the Department to negate the application of the gross income ratio formula specified in the statute, and, "as a general rule, the Department is not authorized to subvert a statute." The court gave priority to the specificity with which §40-18-35(a)(2) addressed interest expense deductions. The court, relying on the earlier opinion in *Alco Standard*, stated that "any conflict or inconsistency in section 40-18-35(a) and section 40-35-18(a)(2) is resolved by application of the principle that a specific statutory provision must prevail over a more general statutory provision relating to a broad subject."

Finally, the court rejected the Department's remaining arguments: that the regulation was the only method that "fairly reflected" Jim Beam's income in Alabama and that the Department's interpretation should be given "great weight." In dismissing the "fairly reflects" argument, the court stated that such an argument "appears to challenge the appropriateness of the method adopted by the legislature . . . [but] all questions of propriety, wisdom, necessity, utility and expediency in the enactment of laws are exclusively for the legislature, and are matters with which courts have no concern." While the court recognized that, generally, Department's interpretations should be given great weight, because the interpretation here conflicted with a statute, the Department's regulation could not prevail.

7. *Commissioner of Revenue v. Comcast Corp. et.al*, Massachusetts Supreme Judicial Court, No. SJC -10209, March 3, 2009.

The Massachusetts Supreme Judicial Court has held that memorandums prepared by outside accountants by request of an in-house corporate counsel detailing the corporate excise tax implications of an affiliate stock sale were not protected under the attorney-client privilege. The memorandums were however, protected by the work product doctrine.

The Department began an audit of U.S. West Inc., (Comcast is the successor company.) and its affiliates regarding the gain from an affiliate's stock sale. The disposition was a result of an antitrust decree entered into with the United States. Prior to the disposition of the stock, in-house tax counsel retained outside accountants from Arthur Anderson LLP for advice on the Massachusetts Corporate Excise Tax implications of the stock sale. The accountants prepared memos analyzing the implications and risks associated with the sale.

During the audit, the Commissioner issued information document requests. Comcast produced some records and withheld others, including the Anderson memorandums, as protected by the attorney-client privilege and work product doctrine. The Commissioner filed a complaint in Superior Court to compel production of all documents listed on the privilege log. The court found in favor of Comcast, and the Commissioner appealed to the Supreme Judicial Court.

The court held that the Anderson memorandums were not protected by attorney-client privilege because although in-house counsel intended to keep the communications confidential, the privilege does not apply to advice pertaining to the Massachusetts tax law. The court explained that Comcast acknowledged that the accountants were retained to provide advice on how to structure the affiliate stock sale. The court concluded that it is well settled that the attorney-client privilege does not apply when an accountant provides additional legal advice about tax code compliance even if it assists the attorney in advising the client. The court noted that in-house counsel could have sought advice from a Massachusetts attorney and that in that case, the privilege would apply.

With respect to the work product issue, the court held that the Anderson memorandums were protected by this privilege because they were prepared in anticipated litigation. The court explained that the Anderson memorandums contained a detailed analysis of Massachusetts corporate excise tax law and outlined the feasibility of potentially restructuring the affiliates and the prospect of litigation. The court determined that the Anderson memorandums constitute work product representing the mental impressions, conclusions, opinions, or legal theories of the accountants.

8. *Exelon Corp. v. Department of Revenue, et. al.*; Illinois Supreme Court No. 105582, Feb. 20, 2009, Petition for Reconsideration filed March 13, 2009.

The Illinois Supreme Court reversed the Appellate Court and concluded that electricity is tangible personal property for purposes of the Corporate Income and Replacement Tax. The issue presented to the court was whether Exelon was engaged in “retailing” for purposes of claiming an investment tax credit. The term “retailing” is defined as “the sale of tangible personal property or

services rendered in conjunction with the sale of tangible consumer goods or commodities. 35 ILCS 5/201(e). Exelon had filed amended returns for the 1995 and 1996 tax years claiming the investment tax credit. The Department denied the refunds and Exelon protested the denial. The parties filed cross Motions for Summary Judgment. Exelon's Motion contained an un-rebutted affidavit and expert report concluding that as a matter of scientific fact electricity is physical and material. The Administrative Law Judge relying on *Farrand Coal Co. v. Alphin*, 10 Ill 2d 507 (1957) concluded that the General Assembly did not intend to include electricity within the meaning of tangible personal property when it enacted the Investment Tax Credit. In addition, the ALJ rejected Exelon's Uniformity Clause arguments with respect to the fact that natural gas was characterized as tangible property and thus qualified for the Investment Tax Credit. The Cook County Circuit Court relying on the language of *Farrand Coal*, affirmed the Administrative Hearing decision. The Appellate Court, affirmed the Circuit Court, holding as a matter of law Exelon did not engage in the sale of tangible personal property.

The Illinois Supreme Court concluded that any reference in *Farrand Coal* to the character of electricity was *dicta* and was not to be relied upon. The issue addressed in *Farrand Coal*, was whether coal sold to a Springfield electric company for use in the generation of electric was exempt as a sale for resale. The company argued that it was the energy that was stored in the coal that was being purchased and then resold as electric energy. The Illinois Supreme Court rejected that argument concluding that the coal was being sold as tangible personal property for the utility's use and not for resale as that term is defined in the Retailer's Occupation Tax. The current court concluded that the discussion of electricity in *Farrand Coal* was overly broad and not necessary to the case's holding. Therefore, it was *dicta* not to be relied upon.

The court in reaching its conclusion noted it cannot ignore the laws of physics and the un-rebutted affidavit of the Dr. Fajans, a professor of physics at the University of California Berkley. The court also noted that a number of other state courts have expressly held that electricity constitutes tangible personal property. The parties had agreed that if electricity was tangible personal property then Exelon would be engaged in retailing as defined by Section 201(e) and the statutory requirement for the credit would be satisfied.