



## State Tax Litigation

Update

TAX

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## U.S. Supreme Court Developments

### Decisions

- *Polar Tankers v. Valdez*
  - Decided on Tonnage Clause rather than Commerce Clause
- *Hemi Group v. NYC*
  - RICO claim by city dismissed due to lack of direct causation



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## U.S. Supreme Court Developments

### Pending Decisions

- *Levin v. Commerce Energy*
  - Question – does comity or the TIA prevent a federal court from hearing a state tax discrimination case where the plaintiffs do not seek refunds.

### Petition for Certiorari Granted

- *Arizona Christian School Tuition Organization v. Winn*
  - Question - does a facially neutral tax credit violate the First Amendment if the beneficiary of the credit makes the qualifying donation to an organization that restricts benefited scholarships to religious schools.



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## U.S. Supreme Court Developments

### Important Pending Petitions

- *Triple-S Management Corporation* (Puerto Rico) – can executive retroactively withdraw exemption
- *CSX Transportation, Inc.* (Alabama) – does the 4-R Act preempt a generally applicable sales and use tax that exempts competitors or railroads



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## U.S. Supreme Court Developments

### Recent Petitions Denied

- *Time Warner Telecom of Oregon* – fee versus tax under TIA
- *Treesh v. DirecTV* (Kentucky) – are local taxes preempted
- *Henri-Duval Winery* (Alabama) – meaningful backward-looking relief
- *Missouri Gas Energy* (Oklahoma) – property tax on gas temporarily stored by pipeline company during transportation through state
- *Exelon Corp.* (Illinois) – prospective only application of state court interpretation of tax law
- *Monumental Life Insurance* (Kentucky) – preemption under ERISA
- *Johnson Controls, Inc.* (Kentucky) – can legislature retroactively prohibit granting of refunds
- *Textron, Inc.* – can IRS obtain tax accrual workpaper info on UTPs



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## Sales Tax

### *Amazon.com* litigation

- New York
- North Carolina



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## Sales & Use Tax

### Mixed Transaction Cases - Examples

- *Noble Energy Inc. v. Dep't of Revenue* (Colorado 4/15/10)
  - Oil and gas well fracturing
- *Western Blue Print Co.* (Missouri 4/20/10)
  - Conversion of paper documents service (although production of videos is not)
- *Midwest Bus Corporation* (Michigan 3/16/10)
  - Remanufacturing of busses, including parts, is a service
- *Combs v. Chevron USA, Inc.* (Texas 2/5/10)
  - Providing of scaffolding along with safety employees is rental not service



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## Personal Income Tax

### Domicile cases - Examples

- *In the Matter of the Petition of Peter and Patricia Handal* (New York ALJ Division, 11/25/2009).
  - Illustrates the substantial factual analysis that goes into not only determining domicile but statutory residency.
- *Place v. Alabama Dep't of Revenue* (Alabama Dep't of Revenue ALJ Division, 11/16/09).
  - Servicemembers' Civil Relief Act (the SCRA) (formerly the Soldiers' and Sailors' Relief Act) did not prevent the state from finding that a service member had abandoned prior residence.
  - Military Spouse Residency Relief Act – fertile ground for future litigation



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## Property Tax

### Charitable Use Exemption - Examples

- *Provena Covenant Medical Center v. Dep't of Revenue* (Illinois)
  - Non-profit tax exempt hospital denied charitable use exemption
- *CHF-Kutztown LLC v. Berks Count Board of Assessment Appeals* (Pennsylvania)
  - Nonprofit partnership with university to build student housing not entitled to exemption
- Other – Kansas, Washington, Ohio, New York, New Jersey.



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## First Amendment

### Free Speech

- *Combs v. Texas Entertainment Association, Inc.* (Texas S.C. cert. petition granted 2/12/10, oral argument 3/25/10).
  - State appeal of decision holding that a Texas tax on adult entertainment establishments was unconstitutional as a content-based tax.
- *Pooh-Bah Enterprises, Inc. v. County of Cook* (Illinois 3/19/09).
  - Exclusion of adult entertainment from amusement tax exemption does not violate First Amendment since exemption represented a subsidy by state.
- *Bushco v. Utah State Tax Commission* (Utah 11/20/09).
  - Tax on nude performances constitutional but escort tax unconstitutionally vague.



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## Administration

### *BIS LLP v. Div. of Taxation* (N.J. Tax Ct. 7/30/09)

- Court held that a regulation addressing which entities qualify as "investment companies" should be applied prospectively only
  - Rejected Division's argument that regulations merely clarify and interpret existing law



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## P.L. 86-272 and Throwback

### *Accuzip Inc. v. Division of Taxation (N.J. Tax Ct. 8/13/09)*

- Two out-of-state taxpayers sold copyrighted software on CD-ROM or diskettes to New Jersey customers
  - Division asserted that taxpayers were licensing intangibles, not selling tangible personal property
- Court held that selling software in hard copy not licensing intangibles in state (i.e., *Lanco* nexus situation did not exist)
  - As the taxpayers were selling tangible personal property, P.L. 86-272 applied
- Court also rejected Division's argument that the *MBNA* significant economic presence test should be applied in New Jersey



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## P.L. 86-272 and Throwback

### *Matter of Personal Selling Power, Inc. (3/16/09)*

- Out-of-state seller of magazine advertising was selling a service and was not protected from taxation under Public Law 86-272
  - The taxpayer argued that P.L. 86-272 applied because the magazines were tangible personal property
- The Board noted the sale transactions related to the right to have a customer's words and images appear in the taxpayer's magazine, not the purchase by the advertisers of the magazines themselves



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## P.L. 86-272

### *Arizona Dep't of Revenue v. Central Newspapers, Inc* (Ariz. App. 11/3/09)

- Court held that P.L. 86-272 did not bar the Department from including an out-of-state partnership's sales in the numerator and denominator of the sales factor in the taxpayer's Arizona consolidated returns
  - Several members of the consolidated group owned minority interests in the partnership
- In the court's view, it was appropriate to treat the group as one taxpayer that was the "person" for purposes of determining whether P.L. 86-272 protection applied
  - Consistent with *Finnigan* methodology



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## Nexus – Intangibles

### *KFC Corp. (Iowa Dist. 6/5/09)*

- Iowa district court upheld an assessment against out-of-state taxpayer that licensed intellectual property to certain in-state franchisees
  - Under Iowa law, corporate income tax is imposed on corporations deriving income from intangible property that becomes integral part of some business activity occurring regularly in state
- Assessment did not violate Commerce Clause
  - *Quill* "clearly" limited to sales and use taxes
  - Taxpayer had substantial nexus with Iowa
    - Derived royalty income from business in Iowa
    - Franchise agreements directly connected to Iowa
    - Royalty payments based on gross revenues of Iowa franchisees



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## Nexus – Intangibles

### *Praxair v. Div. of Taxation*, (N.J. 12/15/09)

- N.J. Supreme Court held taxpayer liable for corporation business tax (CBT) in tax years before the “doing business” regulation was amended to include an example of a taxpayer licensing intangibles in New Jersey
  - Taxpayer argued that it should not be held liable prior to the 1996 amendment to the “doing business” regulation
- Supreme Court held that the state’s expansive “doing business” statute was enough to put the taxpayer on notice that it would be subject to the CBT



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## Nexus – Intangibles

### *W.V. Admin. Decision Nos. 06-544 N and 06-545 FN* (1/6/10)

- ALJ held that an out- of-state taxpayer that earned royalty income from licensing trademarks and tradenames to corporations selling products in West Virginia was subject to the state’s corporate net income and business franchise taxes
  - Taxpayer argued imposition of tax violated Due Process and Commerce Clauses
- Court held that, while exact issue not yet addressed by West Virginia courts , *MBNA* court had adopted a substantial economic presence test for determining whether nexus exists
- Continuous presence of marks in state created substantial nexus



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## Pass Through Entities

### *Kmart Michigan Property Services, LLC v. Department of Treasury* (Mich. App. Ct. 5/12/09)

- A single-member limited liability company (SMLLC) treated as a disregarded entity for federal tax purposes was required to file a Single Business Tax (SBT) return as a “person”
  - Could not file as a division of its owner
- Neither the SBT nor federal regulations require an entity be consistently classified for state and federal taxation
- Note that the Department intends to apply this decision retroactively for all open tax years
- Subsequent legislations applied the decision to Kmart, blocked retroactive application of the decision and ‘clarified’ going forward



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## Business Purpose / Sham Transaction Doctrine

### *HMN Financial Inc. and Affiliates v. Commissioner of Revenue* (Minn. Tax Ct. 5/27/09)

- Department of Revenue challenged taxpayer’s use of captive REIT to avoid Minnesota tax
- Tax Court held that the transactions at issue had no real business purpose or economic substance and were properly disregarded
- Minnesota Supreme Court has overturned the Tax Court – 05/20/2010
  - HMN complied with all relevant statutory provisions. Fact that it resulted in substantial tax benefits essentially irrelevant
  - Specific discretionary authority granted Commissioner do not allow him to disregard transaction because he dislikes result.
  - No common law authority to disregard transaction when law is complied with.



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## Business Purpose / Sham Transaction Doctrine

### *TJX Companies, Inc. (Mass. App. 4/3/09)*

- Transactions involving the transfer and licensing back of intangibles- where the former owner of the intangibles retained benefits and burden of ownership- lacked valid business purpose
- Were properly disregarded under the sham transaction doctrine
  - However, transactions involving marks previously owned by unrelated parties were respected



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## Allocation and Apportionment

### Allocable or Apportionable?

- *McKesson v. Division of Taxation* (N.J. Super. App. Div. 7/16/09)
  - Gain from 338(h)(10) deemed asset sale is nonoperational (nonbusiness) income
  - New Jersey law only incorporates the “functional test”
    - Requires that acquisition, management, and disposition must all be integral to the taxpayer’s business operations
  - Sale was an extraordinary event, proceeds were distributed to parent, no operational function continued after sale and parent did not reinvest proceeds in similar business



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## Allocation and Apportionment

### Allocable or Apportionable?

- *Kimberly Clark v. Alabama Dep't of Revenue* (Ala. 2/26/10)
  - Reversed appeals court and held that gain from sale of paper mill and timberland was nonbusiness income
  - Appellate court had focused too much on frequency of other sale transactions, rather than nature of the transactions themselves
    - This sale was “extraordinary” in nature and not in the regular course of the taxpayer’s business operations
  - Note that nonbusiness income classification resulting in the gain being allocated to Alabama



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## Allocation and Apportionment

### Allocable or Apportionable?

- *Oracle Corp. v. Ore. Dep't of Revenue* (Or. Tax Ct. 2/11/10)
  - Court declined to rule that the taxpayer was required to report business income consistently in UDITPA states
    - Court noted that the goal of uniformity was a matter of policy, not law
  - Number of practical considerations supported court’s declining to rule as urged by the Department
    - Would require courts to become experts in all states’ tax laws
    - Not clear which states’ laws would govern any interpretation
    - Likely Department would not accept classification based solely on taxpayer arguing consistency



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## Allocation and Apportionment—Sales Factor

### Gross Receipts vs. Net Gains

- *General Mills v. Franchise Tax Board* (Cal. App. 4/15/09)
  - Court held that gross receipts from commodity futures sales should be included in the taxpayer's California sales factor
    - Rejected FTB's contention that receipts should be excluded entirely or only net gains should be included
  - Remanded to determine whether including the full amount of the contracts created distortion so that the FTB could apply an alternative apportionment formula
- Definition of gross receipts effective for tax years beginning on or after 1/1/2011 excludes receipts from hedging transactions



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## Tax Base

### *Abbott Laboratories v. Franchise Tax Bd.* (Cal. App. 8/6/09)

- A statute allowing a dividends-received deduction was properly struck down because it was unconstitutional in its entirety and could not be judicially reformed
  - Taxpayer argued that only the portion of the statute providing that only dividends received from a corporation subject to California tax were deductible was struck
    - Thus, another subsection imposing limitations on the amount of such dividends that could be deducted was still operable
- Court rejected taxpayer's contention



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## Credits

### *Exelon Corp. v. Dep't of Revenue* (Ill. 7/15/09)

- Court held that a public utility was a retailer of tangible personal property- electricity- and was thus eligible for an investment tax credit
  - Relying on expert testimony and current scientific understanding, the court held that electricity was tangible personal property
- In reissued opinion, court held decision was to be applied prospectively only
  - Taxpayer did not qualify for tax credits for years at issue
  - U.S. Supreme Court denied cert



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## Legislative Activity

## Summary of 2010 Legislation

### Income/Franchise Tax Issues

Issue	Proposed	Enacted
Decrease Tax Rate	16 states	
Combined Reporting	10 states	
Increase Sales Factor Weight	7 states	Utah, Washington
Related Party Expense Disallowance	6 states	
Limit/Suspend NOLs	3 states	Colorado



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## Summary of 2010 Legislation

### Sales/Use Tax Issues

Issue	Proposed	Enacted
Soft Drink/ Candy Tax	17 states	Colorado, Washington
Affiliate Nexus	11 states	Colorado
Bag Tax/Fee	9 states	Colorado
Decrease/Eliminate Vendor Compensation	6 states	Virginia
Increase tax rate	6 states	Kansas
Expand to services	5 states	



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## Summary of 2010 Legislation

### Miscellaneous Issues

Issue	Proposed	Enacted
Tax Amnesty	9 states	Maine (limited), Nevada, New Mexico, Florida
Information Reporting	8 states	
Penalties	6 states	Nebraska, Virginia



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## State Revenue Actions – 2009/2010

### Amnesties

- More than 12 amnesties
- Increasing use of post-amnesty penalties
- Approved in Maine, New Mexico, Nevada and Florida in 2010

### Other one-time measures

- Accelerations – California, Pennsylvania, Virginia
- Sale-leaseback or leasing of state assets

### Sin and Excises

- Nearly 25 cigarette tax increases and 5 alcohol tax increases
- Expanded gambling
- Soda, candy and bags



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## Revenue Actions – Corporate Tax

### Statutory economic nexus standards

- California (2011), Wisconsin, Connecticut, New York (Credit Card Banks)
- Washington State (2010), Colorado regulation

### Continued adoption of combined reporting

- Wisconsin, D.C. (2011)
- Proposals in six states, including Pennsylvania and Rhode Island
  - Information reporting proposal in Rhode Island
- Captive REIT combination in Tennessee

### Continued tightening of expense disallowance statutes

- Significant activity with captive REITs



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## Revenue Actions – Corporate Tax II

### Continued movement to single sales factor

- CA (2011), WI (accelerated), NYC (phased), VA (phased), CO (accelerated), PA (greater weighting), Utah (selected industries), Washington State

### Market sourcing of services and intangibles

- California (2011), Wisconsin (2009), Washington State (2010)

### Net operating losses

- Cap or suspend NOLs – Colorado (passed), Hawaii, Kentucky, N.H.
- Uncap NOLs – Pennsylvania (proposed)

### Continued decoupling



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## Revenue Actions – Sales and Use Tax

### Colorado – Affiliate nexus and information reporting

- Nexus presumption for component member of an affiliated group where at least one member is a retailer in Colorado
- Non-collecting retailers must collect or have three information reporting obligations
  - Notify at the time of sale and on invoice that tax may be due
  - Notify purchaser annually by Jan. 31 of the purchases and amounts they made and that tax may be owed
  - Notify Colorado DoR annually by March 31 of purchases (what and amounts) by Colorado residents
  - Separate penalties (per occurrence) for each obligation



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## Revenue Actions – Sales and Use Tax

### Click-through Nexus Provisions

- Proposed, but not adopted, in California, Connecticut, Illinois, Maryland, Mississippi, New Mexico, Virginia, and Vermont
- California Assembly Bill 2078 would have adopted a sales and use tax nexus presumption for corporate affiliates and would impose certain information reporting requirements on non-collecting retailers
  - Watered-down version of the bill simply requires retailers to notify customers of their use tax obligation



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## Click-Through Nexus

### North Carolina's Internet Transactions Resolution Program

- An opportunity for noncollecting retailers operating an affiliate program in North Carolina to resolve their outstanding sales and use tax liabilities
- Retailers wishing to do so must submit an election to participate in the program by June 30, 2010
  - Resolution agreement between the retailer and the Department must be signed by August 31, 2010
- Participating retailers will be required to collect tax for a minimum of four years commencing on September 1, 2010.



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## Other Legislation – Sales and Use Tax

### Streamlined Conformity – Georgia

### Digital goods – Wyoming, Washington State

### Vendor compensation

- Reduced in Virginia, proposals in Illinois, New York, Oklahoma and Pennsylvania

### Rate increase – Kansas

### Soda and candy – Colorado and Washington



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## Summary Evaluation

**Most proposals probably best characterized as modest with moderate impact**

**Significant gaps with limited options implies potential for more broadly-based increases and fundamental reform**

### Potential corporate reforms

- Growing interest in taxes similar to Michigan modified gross receipts and the proposed California business net receipts tax
- Reduced volatility, broader taxpayer pool, broader base
- Issues of cascading and differential impact on start-ups, stressed companies and low-margin entities
- Little discussion at this point

**End game may well be broad-based rate increases**



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