FEDERATION OF TAX ADMINISTRATORS
2002 CONFERENCE

Nashville, Tennessee
June 2-5, 2002

CASE LAW UPDATE

RECENT STATE INCOME TAX DEVELOPMENTS

Marilyn A. Wethekam, Esq.
Partner
Horwood Marcus & Berk Chartered
180 North LaSalle Street
Suite 3700
Chicago, IL 60601
Telephone: (312) 606-3240
Facsimile: (312) 606-3232
mwetheka@hmblaw.com

I. U.S. SUPREME COURT

A. Petition Denied

1. *Hoechst Celenese Corporation v. Franchise Tax Board*, California Supreme Court No. S085091, Petition for Certiorari denied November 26, 2001.

   The California Supreme Court held that the income received from a reversion of surplus pension plan assets was properly characterized as business income apportionable to California.

   Hoechst conducted business operations in California and claimed tax deductions for contributions on both its federal and California tax returns. The company had surplus assets in its pension trust and recaptured the surplus by dividing the pension plan into two plans. The surplus assets reverted to Hoechst. The gain recognized on this transaction was characterized as nonbusiness income.

   The Franchise Tax Board ("FTB"), on audit, recharacterized the income as business income apportionable to California. The FTB denied Hoechst's claim for refund and the Superior Court upheld the denial. The Court of Appeals reversed the Superior Court holding the income was nonbusiness income.

   The California Supreme Court applying the functional test reversed the Appellate Court holding that the reversion income was business income. The court explained that Hoechst created income producing property, the pension plan and trust, to retain employees and to attract new employees. Hoechst funded the plan, retained an interest in the surplus pension plan assets and exercised control over the plan through committees. The court stated that although the company did not own legal title to the pension plan assets, the control over the assets and use contributed to the production of business income by improving the quality of its workforce.

   With respect to the constitutional claim, the court concluded subjecting an apportionable share of the reverted pension plan assets to tax was not a violation of the federal Due Process or Commerce Clauses because the income served an operational function.

2. *In the Matter of the Appeal of the Kroger Co*, 12 P.3d. 889 (KS 2000), Petition for Certiorari denied April 30, 2001.

   Kroger Co. operated retail grocery stores in Kansas and other states. In an effort to defend against a hostile takeover, Kroger declared a special dividend to its shareholders. To finance the dividend the company borrowed $4.1 billion. As a result, Kroger was required to pay large amounts of interest. The interest was characterized as an ordinary and necessary business expense and Kroger apportioned part of the interest costs to Kansas. The Department determined that Kroger's interest cost was a nonbusiness expense.

   The Kansas Supreme Court held that for the interest expense to qualify as a business expense, the transaction and activity must have been in the regular course of the taxpayer's business operations. Kroger argued that the expense at issue was an operational business expense required to retain financial management of the

corporation's assets and not an investment. The Kansas Supreme Court rejected the argument and concluded that the Board of Appeals correctly determined that under the transactional test, the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense.

3. *Citicorp North America Inc. et al. v. Franchise Tax Board*, 100 Cal. Rptr. 2d 509, Petition for Certiorari denied June 29, 2001.

   The California Court of Appeals held that California destination sales by a South Dakota affiliate included in the unitary group should be included in the group's California sales.

   Citicorp North America is a Delaware company with its principal place of business in New York and is part of a worldwide financial organization. The Franchise Tax Board recalculated the sales factor to include the sales by Citibank South Dakota following the rule in *Finnigan*. Citicorp argued that the result in *Finnigan* twists the unitary method in a manner that allows the state to tax income of a non-taxpaying entity. The court rejected the argument concluding that the FTB was not taxing the entity but is apportioning income attributable to California. The court notes that the taxes are actually imposed on the corporation that is subject to the California tax. The court also rejected the constitutional argument holding there is nothing arbitrary or unconstitutional about assigning Citibank's South Dakota credit card sales and transactions actually occurring in California to California. Therefore, the FTB's computation of the sales factor was correct.

4. *Deluxe v. Franchise Tax Bd.*, No. A088142 (Cal. Ct. App. Apr. 26, 2001) Petition for Certiorari denied January 7, 2002, Dkt. No. 01-603.

   In an unpublished decision, the Court of Appeal in *Deluxe* held that the assignment of a unitary group's California-apportioned income (determined pursuant to *Finnigan*) to Delux did not constitute a violation of 86-272, even where the assigned income was attributable to the California activities of a unitary affiliate that was protected under 86-272. The method of assigning unitary income to California taxpayers upheld by the court involved a procedure set forth in FTB Notice 90-3, which assigns the unitary group's California apportioned income based solely upon the factors of the members taxable in California, even though income and factors of corporations protected by 86-272 contributed to such apportioned income.

5. *Bernard Egan & Co. and Subsidiaries*, U. S. Supreme Court, DKT. 01-357, Petition for Certiorari denied October 29, 2001.

   The taxpayer disputed disallowance of the exclusion of subpart F income received from its foreign subsidiary. It argued that discrimination resulted when Florida's taxing scheme excluded dividends received from domestic sources but taxed subpart F income received from foreign sources. The court found no discrimination present, since the taxpayer here filed consolidated returns that included the income of its domestic subsidiaries.

II. NEXUS ISSUES

A. P.L. 86-272

1. The Multistate Tax Commission has amended its P.L. 86-272 statement to delete delivery of a seller's products in company trucks from the list of unprotected activities. Deleting this activity has the effect of protecting this activity under PL 86-272 so long as delivery occurs from outside the taxing state. *Resolutions of the Multistate Tax Commission Amending MTC Statement of Information Concerning Practices of the MTC and Signatory states under PL 26-272,* July 27, 2001.

2. Amendment to California Regulation 23101.5

   The Board may determine that a corporation is not doing business in California if its only activities within California are the purchase of personal property or services solely for its own use outside California. That determination is valid only if:

   - the corporation does not have more than 100 employees in California whose duties are limited to solicitation; or

   - the corporation does not have more than 200 employees in California whose duties are limited to solicitation, and the property or services purchased are used for the construction or modification of a physical plant located outside of California; and

   - the combined number of employees satisfying the two conditions does not exceed 200.

   The rule amendment clarified that "solicitation" refers to activities in connection with the corporation's purchase of property or services in California. The amendment also noted that 'purchase of personal property' includes the storage of property purchased, manufactured, or assembled in California pending shipment to destinations outside California. An employee "temporarily present in this state" does not count toward the statutory limitations of 100 or 200 employees, according to the amendment. The rule amendment took effect September 17, 2001.

3. *Reader's Digest Association v. Franchise Tax Board*, Dkt. No. CO36307, California Court of Appeals, January 4, 2002.

   The California Appellate Court denied Reader's Digest's refund request holding that the company's wholly-owned subsidiary was not an independent contractor. Thus, Reader's Digest California activities were not protected by P.L. 86-272. Reader's Digest Sales & Services ("RDS&S") was a wholly-owned subsidiary of Reader's Digest. The company sold and solicited sales of advertising pages for Reader's Digest.

   Reader's Digest was headquartered in New York and had no property in California. During the years in issue, RDS&S solicited advertising sales for Reader's Digest and a number of its subsidiaries as well as four unrelated foreign companies. RDS&S had two California offices and employed approximately 10 individuals in the state. Reader's Digest provided administrative services for RDS&S. A

California unitary return including RDS&S was filed by Reader's Digest. In filing its refund claim, Reader's Digest argued that RDS&S was an independent contractor and thus Reader's Digest was protected by P.L. 86-272.

The Appellate Court in affirming the trial court held RDS&S was not an independent business that held itself out as an independent contractor but rather was an integral part of Reader's Digest's business. Therefore, Reader's Digest is not protected by P.L. 86-272.

2. Florida

A taxpayer was determined to have exceeded the protections of P.L. 86-272 where the taxpayer maintained inventory in the state and its in-state affiliate acted as its agent in conducting business. TAA 01C1-004 (March 7, 2001).

3. Iowa

The Department of Revenue and Finance amended Regulation 701-52.1(2) to provide that brokers or manufacturers' representatives are not engaged in activities protected by No. 86-272 and, thus, have income tax nexus. The amended regulation became effective April 25, 2001.

4. Iowa

In Policy Letter 00240104, the Iowa Department of Revenue and Finance ("DRF") addressed whether a taxpayer whose activities otherwise would be protected by P.L. 86-272 would establish income tax nexus under three scenarios. Under the first scenario, the DRF ruled that nexus would not be established if the taxpayer paid a management fee to its Iowa subsidiary for the compilation of financial statements and consolidation. Under the second scenario, the taxpayer occasionally utilizes legal services that are provided by the subsidiary in Iowa and pays the subsidiary fair market value for these services. According to the DRF, generally, this would not constitute nexus for Iowa corporate income tax. However, if the Iowa corporation is authorized to represent the Nebraska taxpayer in non de minimis activities which are not protected by P.L. 86-272 as part of the legal services contracted, then this may be sufficient to constitute nexus for Iowa corporate income tax purposes. Under the third scenario, the DRF ruled that arranging for a contract carrier to pick up and deliver raw material that the taxpayer purchases from Iowa suppliers does not create nexus.

5. Nebraska

In Revenue Ruling 24-01-01, the Nebraska Department of Revenue explained that a company that uses its own vehicles to ship goods into Nebraska does not lose its protection under P.L. 86-272 because such deliveries are not sufficient to create income tax nexus. The Department noted that Congress did not identify the manner of delivery necessary to qualify for immunity when it enacted P.L. 86-272. Therefore, the deliveries into Nebraska by a company using its own vehicles are a protected activity and are not, by themselves sufficient to create income tax nexus.

B. Substantial Presence

1. *Kmart Properties, Inc. v. Taxation and Revenue Department of the State of New Mexico*, New Mexico Appeals Court, No.21,140 (November 28, 2001) certiorari granted 2002 N.M. Lexis 26 (January 9, 2002).

The Court of Appeals ruled that the imposition of gross receipts tax and income tax against a Michigan corporation did not violate the U.S. Constitution. KPI, a wholly owned Michigan subsidiary of Kmart Corp., owns and manages trademarks previously developed by Kmart Corp. The marks include trade names such as "Blue Light Special," "At Home with Martha Stewart," as well as the trade name "Kmart." In 1991,Kmart Corp. transferred ownership of the marks to KPI, and the two corporations entered into a licensing agreement whereby KPI granted Kmart Corp. the exclusive right to use the marks in the United States. In exchange for Kmart Corp.'s right to use the marks, the licensing agreement required Kmart Corp. to make royalty payments to KPI based on 1.1 percent of Kmart Corp.'s gross sales throughout the United States. The licensing agreement was negotiated, drafted, and signed by the parties in Michigan.

Before the court of appeals, KPI challenged New Mexico's assessment of state income taxes and gross receipts taxes upon royalties paid by Kmart Corp. to KPI. KPI based its challenge upon five grounds: (1) the state's assertion of jurisdiction to tax KPI violates the Due Process Clause of the U.S. Constitution; (2) the state's assessment of the tax against KPI is prohibited by the Commerce Clause of the U.S. Constitution; (3) the state's tax on KPI's gross income is not authorized by state law; (4) the method for apportioning KPI's income violates state law; and (5) the hearing officer was not independent and impartial and his decision was not timely as required by state law.

KPI contended that it lacked any connection to New Mexico and argued that its corporate business was conducted solely within Michigan. KPI has no tangible property or formal KPI representative located in New Mexico or in any other state other than Michigan. Accordingly, KPI argued that it does not have the minimum contacts with New Mexico that would justify the imposition of any state tax consistent with the Due Process Clause. The court disagreed, explaining that the licensing agreement ties KPI to New Mexico and to other states outside of Michigan where Kmart Corp. has stores. By allowing its marks to be used in New Mexico to generate income, KPI "purposefully availed itself of the benefits of an economic market in the forum state." Thus, the court concluded, New Mexico satisfies the traditional due process standard.

Regarding KPI's Commerce Clause argument, the court explained that, as an initial matter, it must determine whether the physical- presence component of the Commerce Clause analysis in *Quill Corp. v. North Dakota* (1992) is limited to the sales and use taxes that were at issue in *Quill* or whether the component applies to income taxes as well. The court determined that the physical-presence component does not apply to income taxes. The court pointed out that, unlike an income tax, a sales and use tax can make the taxpayer an agent of the state by obligating it to collect the tax from the consumer at the point of sale; whereas, a state income tax is usually paid once a year to one taxing jurisdiction and at one rate. Thus, the court continued, collecting and paying a sales and use tax can impose additional burdens

on commerce that the U.S. Supreme Court identified in *Quill* and prior opinions. The court concluded that the Commerce Clause analysis of New Mexico income tax is controlled not by*Quill's* physical presence text but by the overreaching substantial nexus test announced in *Complete Auto Transit v. Brady* (1972). The court concluded that the use of KPI's marks within New Mexico's economic market for the purpose of generating substantial income for KPI establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax.

The court also concluded that the gross receipts tax does not unduly burden interstate commerce in this instance. The department argued that the use of Kmart Corp. stores and employees in New Mexico to represent KPI's goodwill gives KPI a "physical presence" in New Mexico under the analysis of *Tyler Pipe Industries Inc. v. Washington Department of Revenue* (1987) and *Scripto Inc. v. Carson* (1960). In each of those cases, the U.S. Supreme Court upheld the constitutionality, under the Commerce Clause, of state sales or use taxes imposed on out-of-state companies that did business in the taxing state solely through independent representatives. The court agreed with the department, explaining that the instant case presents far more than just merchandise bearing out-of-state trademarks for sale in New Mexico stores. An extensive apparatus of Kmart stores, signs, and employees are also physically present in New Mexico to work on behalf of KPI's goodwill and associated interests, the court continued. That apparatus, the court determined, represents KPI's property interests in New Mexico under the licensing agreement that requires Kmart Corp. to act on KPI's behalf.

The court also rejected KPI's challenge of the imposition of gross receipts tax upon its royalties. KPI argued that New Mexico is without jurisdiction to impose the tax and NMSA 1978, section 7-9- 3(F)(2001) could not have intended such a result because the grant of license occurred in Michigan. The court pointed out that, in a prior case, it rejected a similarly formalistic, place-of-contracting argument. In that case, the court held that the act of licensing intangible trademarks from an out-of-state franchiser to a New Mexico franchise to be used in New Mexico constituted "selling property in New Mexico" with sufficient nexus to be subject to New Mexico gross receipts tax.

2. *Trucks Renting & Leasing Assoc., Inc. v. Commissioner or Revenue*, Massachusetts Supreme Judicial Court, SJC-08308 (April 17, 2001).

The Massachusetts Supreme Judicial Court has held that a truck leasing company that rented trucks to customers (under operating leases) for use in the state established nexus for Massachusetts corporate excise (income) tax purposes. The court ruled that Commerce Clause nexus was satisfied because the lessor's trucks were physically present in the state. The court also held that the lessor established minimum contacts sufficient to justify the imposition of tax under the Due Process Clause. The court noted that the lessor obtained Massachusetts fuel decals and fuels licenses, as well as, registration permits necessary for its lessees to operate its trucks in Massachusetts. However, the Court's analysis overlooked the fact that the lessor merely registered the trucks as "apportioned vehicles" in North Carolina and, for the most part, did not have any specific registration requirements in Massachusetts. The analysis takes a very narrow view of the Due Process Clause, finding that facilitating use of a product in a state is sufficient to meet the standard. Moreover, in the

context of the Commerce Clause, the court disregards the fact that the taxpayer did not have dominion or control over the property in the state.

3. *America Online, Inc. v. Johnson*, Chancery Court No. 97-3796-III (March 13, 2001). (Appeal Pending)

The Tennessee Chancery Court citing the decision in *Quill Corporation v. North Dakota*, 564 U.S. 298 (1992) and *J.C. Penney National Bank v. Ruth Johnson*, 19 S.W. 3d 831, held that an out-of-state corporation must have more than economic presence in a state to impose both a sales and franchise tax. AOL, a Delaware corporation, owns no real property in Tennessee, maintains no offices or employees in the states. The Commissioner assessed $9,645,339 in the state taxes. (The taxes included sales, use, franchise excise and business taxes.) The court applying the Commerce Clause test concluded that in the context of both sales tax, the franchise and excise tax, physical presence is required to pass Commerce Clause muster. The court in reaching that conclusion rejected the Commissioner's argument that physical presence was established by the fact: 1) AOL entered into contract with AOL members in Tennessee; 2) AOL provided services either originated or were received in Tennessee; 3) AOL owned software distributed in the state; 4) AOL had local access numbers in the state; and 5) AOL leased equipment in the state.

4. *Wisconsin Department of Revenue; Private Letter Ruling*, No. W118004, (February 14, 2001).

The Department held an out-of-state countertop manufacturer was subject to the corporate income tax because the company owned countertops in Wisconsin. The countertops were located in Wisconsin prior to their sale and installation as real property improvements by another company operating in Wisconsin.

5. *Illinois Department of Revenue*, IT 01-0046-GIL (May 15, 2001).

An out-of-state online reseller of long distance telephone and Internet services, which has broker relationships with other third party providers for the sale of other services that result in a one-time payment for acquiring customers, has the requisite nexus and may be subject to the state income tax if any part of its income is allocable to Illinois even though it has no physical presence in any state other than Massachusetts.

6. *Decision of the Texas Comptroller of Public Accounts*, No. 200106294L (June 15, 2001).

An out-of-state company providing telecommunications services through prepaid calling cards, which were sold to independent retailers, does not have nexus with Texas for franchise tax purposes. While the company had a Certificate of Authority, it had no offices, property, employees or sales people in Texas. The Texas Appellate Court decision in *Rylander v. Bandag Licensing Corp.* (Tex. Ct. App., May 11, 2000) invalidated a provision in the Texas Tax Code that held that a Certificate of Authority for transaction business in the state was sufficient nexus to subject a foreign corporation to the franchise tax.

7. *Florida Technical Assistance Advisement,* No. 2001(c)1-004, (Florida Department Revenue March 7, 2001).

The Florida Department of Revenue reaffirmed that a taxable nexus exists if an out-of-state taxpayer has both agents and inventory in Florida. There are three principal players: A, B, and C. A is the taxpayer, C is A's Parent, and B is C's Affiliate. The taxpayer, A, stipulated that B and C had nexus with Florida, and the only issue presented was whether a taxable nexus existed between A and Florida.

Although A did not have any employees, real property, or offices in Florida, it did have at least two connections with the state. First, it maintained some inventory in Florida until it could be combined with B's products and shipped internationally. Second, B's employees, based in Florida, acted as A's agents and representatives. These employees sold and demonstrated A's products; trained A's customers; processed A's customer complaints; and accepted, approved, processed, billed and collected A's orders.

Based on these facts, the Florida Department of Revenue simply concluded that "[c]ompany A has established nexus in Florida and is subject to corporate income tax in Florida." Interestingly, the decision did not rely on the entities' status as affiliates but, instead drew its conclusion from the facts surrounding A and B's working relationship.

8. *Kevin Associates, Inc.*, Louisiana District Court Dkt No. 460-981

In Kevin Associates, Inc, Louisiana District Court Dkt No. 460-981, which involves the use of a Delaware holding company to reduce the Louisiana franchise tax, the 19th Judicial District Court held in favor of the taxpayer. Noting that the plan involved the transfer of assets to Delaware and citing SYL v. Comptroller of the Treasury, 1999 WL 322666 (Md. Tax), Judge Calloway found that while the purposes of the conduct was to reduce Louisiana tax, there was nothing wrong with the conduct. The Louisiana Department of Revenue has filed a Petition for Appeal of this case.

C. Other Nexus Developments

1. MTC

In September 2001 the Multistate Tax Commission (MTC) issued a response to the Internet Tax Fairness Coalition's document titled "Business Activity Taxes: Myth vs. Fact." The response clearly indicates the MTC's position that businesses have nexus in states in which they have a significant customer base, whether or not they have a physical presence in the state(s).

2. Georgia

Effective for tax years beginning after 2001, the Georgia Department of Revenue amended Revenue Rule 560-7-7-.03 to provide that a corporation will be considered to be owning property or doing business in Georgia whenever the corporation is a partner, whether limited or general, in a partnership that owns property or does business in Georgia; and to provide that a corporation that is a limited partner in a

business partnership must include its pro rata share of partnership property, payroll, and gross receipts in its own apportionment formula. The validity of the regulation is questionable given that it runs clearly contrary to case law.

3. Iowa

In Policy Letter 00240076, the Iowa Department of Revenue and Finance responded that the mere holding of a Certificate of Authority does not create income tax nexus.

4. Massachusetts

In LR 01-12, the Massachusetts Department of Revenue ruled that the filing of a Massachusetts Business Trust document with the Massachusetts Secretary of State, without more, will not subject such Massachusetts Business Trust to taxation in Massachusetts.

5. Massachusetts

In a ruling dated May 29, 2001, the Massachusetts Department of Revenue ruled that the company's provision of accounting, custodial, investment management, shareholder and other administrative services as well as the receipt, generation and maintenance of relevant electronic and paper records and reports for investment companies ("Funds") organized outside the U.S. will not cause those Funds to be subject to Massachusetts taxation.

6. New York

In TSB-A-01(14)C, the New York Department of Taxation and Finance ruled of that Company A, an out-of-state seller and manufacturer of industrial blowers, is subject to New York corporation tax based upon its maintenance of a constant supply of its industrial blowers at the in-state facility of Company B. Company A maintains a supply of blowers at Company B's facility in order to timely respond to customers' orders for modified blowers. Upon receipt, an order for a modified blower, Company A relays the customer's order to Company B, which, in turn, adds additional parts to the blower in accordance with customer specifications, and then ships the blower directly to the customer. On average, Company A maintains an inventory of blowers at Company B's facility in New York valuing approximately $35,000. Pursuant to N.Y. Tax Law § 209.1, and Regulation §§ 1-3.2(c) and (d) of Article 9-A, the Department determined that Company A had nexus by virtue of "employing capital and owning personal property in New York on a regular basis." In addition, the Department found that Company B's activities of adding additional parts to Company A's industrial blowers, per the customer's specifications, before shipping the blowers to Company A's customers exceeded "the use of fulfillment services," exception from tax provided under N.Y. Tax Law § 209.2(f). Accordingly, Company A was deemed to be subject to Article 9-A franchise tax.

7. North Carolina

Effective January 1, 2001, royalty payments received for the use of trademarks in North Carolina are considered income derived from doing business in the state. (HB 1157, Laws 2001) In addition, the new law requires that certain deductions for

royalty payments resulting from the use of a trademark or similar intangible property made to related members be added back to net income or that the trademark entity elect to file and pay the tax.

8. Ohio

The Ohio Department of Taxation has issued information releases describing the nexus standards that are applied to determine whether an out of state taxpayer is subject to the franchise (income) tax, pass through entity tax, personal income tax, and use tax. The releases enumerate activities creating nexus, safe harbor activities, and certain filing requirements. PIT 2001 1 and PIT 2001 2 available online at www.state.oh.us/tax/practitioner_information.html.

9. Ohio

In LSDHC Corp. v. Tracy, No. 98-J-896, Nov. 9, 2001, the Ohio Board of Tax Appeals held that a corporation whose only contact with Ohio on January 1 is its registration to do business in the state is not subject to the net income basis of the franchise tax.

10. Oklahoma

Effective April 2, 2001, nexus for income tax and sales/use tax purposes is not created if the activities within Oklahoma are limited to: (1) ownership of tangible or intangible property located at the Oklahoma premises of a commercial printer for use by the printer to perform services for the owner; (2) periodic presence of employees at the commercial printer's premises directly related to the printer's services; and (3) printing (including printing-related activities and distribution of printed material) performed by the commercial printer in Oklahoma on behalf of the person or entity. (Ch. 15 (S.B. 24), Laws 2001)

11. Pennsylvania

Question 12 from the 2000 annual meeting between the Pennsylvania Department of Revenue and the PICPA Committee on State Taxation concluded that "[a] corporation that obtains a license to do business in Pennsylvania has nexus for Pennsylvania corporate tax purposes."

12. Virginia

In P.D. 01-70, the Virginia Department of Taxation (Department) ruled that the activities of the Taxpayer's sales staff create nexus. According to the Department, the following activities appear to go beyond the mere solicitation of sales: serving in a consultant's role for dealers for their product support operations; providing input for dealer business plan development; providing sales coverage analysis; providing dealer operations studies; assessing dealer management capabilities and addressing deficiencies including replacing dealers; assisting dealers in assessing sales personnel; providing technical training to the dealer's customers; and, resolving user, customer and dealer disputes and problems. The Department noted that the information provided gives no indication as to whether the activities of the Taxpayer would be considered *de minimis*; however, taken as a whole, it appears likely that

the unprotected activities would constitute a continuous pattern of activity, which are not *de minimis*, and are not considered trivial additions to the Taxpayer's business carried on in Virginia.

13. Washington

In General Motors Corp. v. City of Seattle, et al, Ct. App., Nos. 46152-4-I, 47562-2-I, 47561-4-I, May 7, 2001, the Washington Court of Appeals held that the City of Seattle properly imposed business/occupation taxes on General Motors (GM) and Chrysler. Although neither GM nor Chrysler maintains an office or bases any of their employees in the City and no direct solicitation of business occurs within the City, the court found that both companies conduct substantial marketing activities in Seattle.

14. Wisconsin

Under The Budget Act (Act 16), effective for tax years beginning after 2000, the definition of "doing business" has been expanded to include "owning, directly or indirectly, a general or limited partnership interest in a partnership that does business in Wisconsin, regardless of the percentage of ownership; and owning, directly or indirectly, an interest in a limited liability company that does business in this state, regardless of the percentage of ownership, if the LLC is treated as a partnership for federal income tax purposes." In addition, the new law provides that the limited partnership's or LLC's apportionment factors are attributed to its partners/members for purposes of computing their Wisconsin tax liability.

III. UNITARY ANALYSIS

1. *Hyundai Precision & Industries Co., Ltd., and Hyundai Steel Industries, Inc.*, California State Board of Equalization, Nos. 89002463190 and 69002463200 (April 19, 2001).

For California corporation income tax purposes, a foreign parent corporation was doing business in California and was conducting a unitary business with its foreign manufacturing and railway rolling stock production facilities and its California subsidiary. In addition, the State Board of Equalization held the Franchise Tax Board's computation of their taxable income and assessment of late filing penalties were appropriate.

The foreign parent corporation was doing business and subject to California corporation franchise (income) tax because its California activities, consisting of an office leased for its employees who provided services on its behalf and on behalf of its California subsidiary, were for the purpose of financial or pecuniary gain or profit. These activities exceeded the "mere negotiation of the terms of a lease," which was held to be sufficient activity to constitute doing business in *Appeal of Ebee Corp. et al.,* California State Board of Equalization, No. SBE-XIX-314, February 19, 1974.

The subsidiary corporation was conducting a unitary business with its foreign parent and was doing business in California. The foreign parent was a manufacturer of steel shipping containers and steel trailer chassis used to transport the steel containers. The foreign parent marketed its products in the United States through its California subsidiary.

The State Board of Equalization concluded, for tax years 1984-1986, the foreign parent corporation, along with its manufacturing and railway rolling stock facilities and its California subsidiary, were engaged in a single unitary business because there existed among them:

a) intercompany transfers of executive level personnel that were indicative of a centralized management scheme;

b) substantial interrelationship among the foreign parent, its manufacturing and railway rolling stock facilities, and its California subsidiary; and

c) contribution and dependency as evidenced by the California subsidiary's reliance on the foreign operations for its continued operations as the marketer of their products in the United States, and thus a strong presumption that the foreign parent and the California subsidiary were engaged in similar lines of business.

Finally, the assessment of late filing penalties against the foreign parent corporation and its California subsidiary were appropriate because the corporation failed to offer any reason for the more than five months delay in filing the 1984 and 1985 returns and the one-month late filing of the 1986 return.

2. *A.E. Staley Manufacturing Co. v. Illinois Department of Revenue,* No. 1-99-1822 (Illinois Appellate Court May 17, 2001). (Unpublished)

The Illinois Appellate Court issued an unpublished order upholding a circuit court ruling granting summary judgment to A.E. Staley Manufacturing.

An audit by the Department of Revenue revealed that during the 1993 and 1994 tax years, Staley Manufacturing paid Staley Holdings $105 million in interest. Afterwards the Department determined that TLI and Staley Holdings should have been included in Staley Manufacturing's unitary business group.

In 1988, Tate and Lyle PLC and two other corporations acquired all the stock of Staley Continental, Inc. Tate and Lyle PLC borrowed money to make the purchase. This money was then loaned to its subsidiary TLI. In turn, TLI loaned the money to another subsidiary formed for the purpose of acquiring Staley Continental. This subsidiary was then merged into Staley Continental and the name was changed to Staley Manufacturing.

TLI formed Staley Holdings in 1988 to hold its investment in Staley Manufacturing. TLI originally owned 85.4% of Staley Holdings. Staley Holdings then borrowed $400 million, $99 million of which was from TLI, and loaned Staley Manufacturing $800 million to pay back its debt to TLI, with the remaining $200 million utilized to reduce short-term third-party debt.

Staley Manufacturing was in the business of wet-corn milling and produced items such as corn syrup and specialty starches. During 1993-1994, one of the ten members of Staley Manufacturing's board of directors was also on the board of director for TLI or Staley Holdings. In addition, Staley Manufacturing handled its own research, development, engineering, advertising and marketing and had its own tax, accounting, auditing and legal departments.

35 ILCS 5/1505(a)(27) of the Illinois Income Tax act defines "unitary business group." This statute was interpreted in *A.B. Dick v. McGraw*, 297 Ill. App. 3d 230, 232-233 (1997) to impose "three requirements: (1) that there be common ownership, (2) that the companies be in the same general line of business, and (3) that there be functional integration through the exercise of strong centralized management." The Department of Revenue asserted that there was no question that the first two requirements were satisfied. As to the third requirement the Department focused on the debt Staley Manufacturing owed to Staley Holdings. The Department described the loan as having a "net effect of saddl[ing] Staley Manufacturing with the loan for its own acquisition." Because Staley Manufacturing was more than a passive investment for TLI and Staley Holdings, the Department argued that the three companies were functionally integrated.

Staley Manufacturing argued there was no "strong centralized management" between it, Staley Holdings, and TLI. For support, Staley Manufacturing pointed to 86 Ill. Admin. Code §100.9700(g). In addition, Staley Manufacturing relied on the factor that the courts in *A.B. Dick*, and *Borden, Inc. v. Department of Revenue*, 295 Ill. App. 3d 1001 (1998) used to determine whether "strong centralized management" were present between commonly owned companies. These factors include: (1) the significant overlap of officers and directors; (2) centralized financing; (3) centralized authority over tax compliance; (4) centralized authority over product lines; (5) centralized authority over personnel decisions; (6) centralized authority over marketing and advertising; (7) centralized authority over insurance; (8) centralized authority over wages; (9) centralized authority over employee benefits; and (10) centralized authority over accounting and audit issues.

The Department of Revenue also relied upon *A.B. Dick* highlighting that in *A.B. Dick* the court considered the existence of a $12 million interest-free loan the parent made to its wholly owned subsidiary in concluding that a unitary business relationship was present between the parent and subsidiary. However, in *A.B. Dick* the court considered other factors such as the oversight and control the parent exercised over its subsidiary and the fact that A.B. Dick had no separate legal, real estate or insurance departments. Thus, the Appellate Court in comparing the case to Staley Manufacturing concluded "the existence of the loan in *A.B. Dick* was not determinative of the existence of a unitary business relationship, nor is it here.

The Appellate Court also placed emphasis on the statement of an officer of Staley Holdings that the loans at issue were based upon market conditions. The court even stated "[a]ssuming *arguendo* that a parent's loan of a substantial sum of money to a subsidiary may be sufficient in itself to warrant a finding of a unitary business group, such is not the case here." The court went on to find that Staley Manufacturing was not functionally integrated with either TLI or Staley Holdings, based upon the findings that Staley Manufacturing operated independently and was responsible for its own business operations.

3. *Zebra Technologies Corporation v. Illinois Dept. of Rev.,* Illinois Circuit Court, No.98 L 50479 (July 23, 2001). (Appeal Pending)

On July 23, 2001, the Illinois Circuit Court of Cook County held that services performed in the United States by the employees of an affiliated entity must be considered in determining whether 80 percent or more of a corporation's business activities are conducted outside the United States. In addition, the court ruled that a subsidiary corporation that limits its activities to providing investment management services to its affiliated group is not a "financial organization."

During the periods at issue, Zebra Technologies Corporation owned 100 percent of the stock of: (1) a foreign sales corporation ("FSC") incorporated in the Virgin Islands; (2) an investment and securities trading corporation ("ZIH") incorporated in Delaware; (3) a domestic intangibles holding corporation ("Domestic"); and (4) an international intangibles holding corporation ("International"). Zebra excluded the FSC, Domestic and International from its unitary business group, based on its determination that they qualified as 80/20 corporations subject to exclusion. Under the 80/20 rule, a unitary business group may not include any member whose business activity outside the United States is 80 percent or more of such member's total business activity (*i.e.*, the 80/20 rule), the court explained. Zebra initially included ZIH in its unitary business group but treated ZIH's income as nonbusiness income allocable to Delaware, but on appeal, Zebra alternatively asserted that ZIH was a financial organization that must be excluded from the unitary business group.

With regard to the FSC, the court noted a complete lack of any measurable business activity outside the United States and that Zebra's employees in Illinois conducted all of the FSC's sales transactions. While FSC maintained its corporate headquarters in the Virgin Islands, its office served no valid business purpose other than tax avoidance, the court added.

As to Domestic and International, the court noted that while these subsidiaries had no U.S. property and payroll of their own, they also had no property or payroll outside the United States in 1994. Although there was no statutory provision that authorized the department to impute payroll figures for these services, the court concluded that Zebra "was capable" of allocating this expense to the holding companies. Accordingly, the entities did not qualify for exclusion under the 80/20 rule.

Next, the court determined that ZIH was not a "financial organization." An entity formed primarily to protect the investments of its affiliated entities by securing the best possible return of the investments is not a financial organization, the court said. The court also ruled that ZIH is a member of Zebra's unitary business group. The department noted that the officers and directors of ZIH were common with Zebra and that Zebra maintained substantial control over ZIH's investments after ZIH's incorporation.

4. Illinois Department of Revenue Offers to Settle Foreign Sales Corporation Disputes.

Illinois is a water's edge state; therefore, a corporation whose business activity outside the U.S. constitutes at least 80% of its total business activities may not be included as a member of a unitary business group ("80/20 rule"). A corporation's business activity percentage within the U.S. is generally measured by its property and payroll factors.

The Department has, over the years, reversed its position as to whether the 80/20 rule applies in determining whether a foreign sales corporation ("FSC") should be included as a member of a unitary business group. On May 25, 2001, the Department adopted a regulation stating that the 80/20 rule does apply to FSCs, and that a FSC (unlike other foreign corporations) shall use all of its apportionment factors in apportioning its business income and in determining whether 80% or more of its business activity is conducted outside the U.S. The regulation further provides that a foreign corporation other than a FSC is to use only its apportionment factors related to its domestic business income when apportioning its business income. Because of the confusion in this area, the Department has offered to settle any dispute involving the issue of whether foreign apportionment factors of a FSC should be included or excluded for any open taxable year ending after December 31, 1989, and beginning prior to January 1, 1998. The Department will concede 70% of the tax liability

related to that issue during each taxable year, and the Department will abate any penalties associated with that issue.

5. *Cincinnati Casualty Co. and Affiliate v. Bower,* No. 00 L 50254 Illinois Circuit Court of Cook County (January 17, 2001).

   The Cook County Circuit Court has held that an out-of-state parent corporation was not required to be included in the unitary business group of its four insurance subsidiaries. In addition to owning 100 percent of the stock of the insurance subsidiaries, the parent owned a non-insurance investment company and, either on its own or through that subsidiary, managed a portfolio of stocks and bonds in excess of $1 billion. For Illinois income tax purposes, non-insurance companies, other than insurance holding companies, cannot be included in a unitary combined report with insurance (because insurance companies are required to use a special single-factor apportionment formula). The term "holding company" is not defined under Illinois law. The court determined that the common meaning of the term, "holding company" is a company that is (1) created solely to buy, own, and control the shares of stock of one or more other corporations and (2) does not engage directly in its own productive business operation. Since the parent owned a large portfolio of stocks and bonds in corporations it did not control, the court determined that it was not a holding company for Illinois income tax purposes and could not be required to be included in a unitary business group with its insurance subsidiaries.

6. *Armstrong World Industries, Inc. v. Bower,* Illinois Circuit Court, Cook County, No. 00 L50705, September 26, 2001. (On Appeal)

   Upon administrative review, the Cook County Circuit Court upheld the Director's decision that Armstrong World Industries ("Armstrong")'s wholly-owned captive insurance company, I.W. Insurance, was a member of Armstrong's unitary business group, notwithstanding that Illinois law precludes insurance companies from being combined with non-insurance companies. Armstrong is a Pennsylvania corporation engaged in manufacturing and branding products for use in finishing the interiors of residential and commercial buildings. I.W. Insurance was formed by an Armstrong subsidiary because Armstrong was unable to find cost-effective coverage in the third-party insurance market for certain overseas risks.

   During the 1992 through 1994 tax years, third-party insurance companies insured Armstrong and its affiliates, and I.W. Insurance provided "gap" insurance to Armstrong and its affiliates for limits and conditions not covered by its third-party insurance policies.

   I.W. Insurance is a Vermont corporation, and it engages in writing insurance and reinsurance as a captive insurance company pursuant to Vermont's captive insurance company laws. I.W. Insurance holds a Certificate of Authority issued by Vermont's Department of Banking, Insurance and Securities, allowing it to transact the business of a captive insurance company. I.W. Insurance files Vermont Captive Insurance Premium Tax Returns and pays taxes on direct insurance premiums and reinsurance premiums. I.W. Insurance maintains significant reserves for losses for casualty events. However, I.W. Insurance is not an insurance company for federal income tax purposes because it insures only related entities.

   Illinois' Income Tax Act provides that a taxpayer operating as part of a unitary business must apportion its income to Illinois in combination with the income of all the members of its unitary business group. It also provides that all members of a unitary business group must be eligible to use the same apportionment formula. During the 1992 through 1994 tax years,

Illinois taxpayers, except for insurance companies, financial organizations, and transportation service businesses, were generally required to employ a three-factor apportionment formula of payroll, property, and sales (double weighted). The apportionment formula for insurance companies is a single-factor formula based upon premiums written for insurance upon property or risks.

Illinois' Insurance Code has a section concerning domestic (not foreign) captive insurance companies. That section provides that "domestic captive insurance companies shall be insurance companies subject to the rules now provided for such companies under the Illinois Income Tax Act." Yet, no income tax statute, regulation, court case, or letter ruling defines the term "insurance company" for Illinois income tax purposes.

Both Armstrong and the Department moved for summary judgment at the administrative level. Armstrong contended that I.W. Insurance, a foreign captive insurance company must qualify as an insurance company because Illinois would be impermissibly discriminating against foreign captive insurance companies absent such a characterization in favor of domestic insurance companies in violation of the Uniformity Clause of the Illinois Constitution. The Department argued that I.W. Insurance was not a "real" insurance company for Illinois income tax purposes because the Illinois Income Tax Act provides that terms generally have the same meaning as used in a comparable context in the Internal Revenue Code, and under federal income tax law, I.W. Insurance was not an insurance company because there was no genuine shifting of risk to non-affiliated entities. The Administrative Law Judge ruled in the Department's favor and found no constitutional violation, reasoning that I.W. Insurance is not a "valid" insurance company and that the Department treats all "invalid" insurance companies alike, regardless of where the company is incorporated.

On appeal, the circuit court, after reciting the parties' arguments, held – without any of its own legal analysis – that the Director's decision was "neither clearly erroneous nor was it contrary to law." The circuit court's opinion did not explain or analyze the Uniformity Clause as it applied to the facts presented. Furthermore, the circuit court did not address whether a taxpayer similarly situated to I.W. Insurance, but incorporated under Illinois law, would be an "insurance company" for Illinois income tax purposes. And, if Illinois does confer different income tax treatment to foreign and domestic captive insurance companies, it is remains unanswered what, if any, legislative or public policy reason constitutionally permits such discrimination against foreign captive insurance companies in favor of domestic captive insurance companies.

7. *Appeal of Panhandle Eastern Pipe Line Co., et al. v. Kansas City Department of Revenue*, 39 P.3d 21 (KS January 25, 2002).

The Kansas Supreme Court has upheld a Board of Tax Appeals decision that two gas companies qualify as unitary businesses entitled to file combined corporate tax reports. In 1986, Panhandle Eastern Pipe Line Co. and National Helium Corp. requested permission from the Department of Revenue to amend corporate returns and to file combined reports as a unitary business for tax years 1981 through 1984. The Department denied Panhandle's request to file a combined return including Helium, rejected the amended returns, and denied Panhandle's refund request. The Secretary of Revenue agreed with the Department and held that Panhandle and Helium could not be unitary because Panhandle did not own at least 50 percent of Helium's stock.

Panhandle appealed to the Board of Tax Appeals, which found that Panhandle and Helium were engaged in the same general line of business, were vertically integrated, and shared management; that Panhandle had over 50 percent control of Helium through direct and indirect means; and that Panhandle and Helium were unitary. The Board concluded that Panhandle and Helium were entitled to file combined income tax reports. The Department appealed to the Supreme Court.

The Court rejected the Department's arguments and found that the Board employed the proper standard of review when it considered the matter *de novo* and that the Board did not act unreasonably by choosing not to follow the Department's rule that Panhandle must own more than 50 percent of Helium. The Department asserted that the Board mistakenly concluded that Panhandle owned or controlled Helium. The Department also argued that the Board erred in holding that Panhandle had direct or indirect control of Helium and enjoyed a unitary relationship that made combined reporting appropriate.

The Court explained that Kansas law does not support a strict more-than-50-percent-ownership requirement and that the court has made it clear in past cases that the dependency/contribution test is the appropriate test for determining whether two or more business entities are unitary for taxation purposes.

The Court also rejected the Department's argument that Panhandle did not have direct or indirect control over Helium. The court found that the president of Helium reported directly to the president of Panhandle and that Panhandle exercised control over the day-to-day operations of Helium. Also, the court noted that the board determined that Helium and Panhandle were engaged in the same general line of trade or business and exhibited centralized management because of their shared board members, shared administrative and marketing services, and Panhandle's more-than-50 percent control of Helium through direct and indirect means. In addition, expert testimony supported the finding of the Board that Panhandle and Helium operated in a unitary fashion.

8. *National Cooperative Refinery Association*, Kansas Supreme Court, No. 87,295, April 19, 2002.

   Two companies, one of which owned 74% of the other, were not a unitary business required to use the combined reporting method of allocation and apportionment for Kansas corporate income tax purposes because their relationship did not satisfy the dependency-or-contribution test. Although the subsidiary refined crude oil and the parent purchased the refined product, (1) their transactions were at arm's length, (2) there were no other relationships between the two, and (3) there was no significant central management. The subsidiary refined crude oil and the parent sold farm supplies, some of which were derived from refined oil. Their only management relationship was the ability of the parent to appoint four board members for the subsidiary pursuant to federal court order. Neither entity owned or controlled the other.

9. Indiana

   Legislation enacted during 2001, modified the definition of "unitary business" for purposes of the Indiana Financial Institutions Tax by adding the following phrase to the definition "[H]owever, the term does not include an entity that does not transact business in Indiana". (HEA 1578, Laws 2001)

10. Maine

Maine Revenue Services adopted new Rule No. 810, "Maine Unitary Business Taxable Income, Combined Reports and Tax Returns," to establish standards for determining Maine income tax for unitary businesses and for filing combined reports and related tax returns.

IV. TREATMENT OF PARTNERHIPS

1. *Exxon Corp. v. Bower,* No 99 L 51234 (Cook County Cir. Ct. Aug.31, 2001) (Appeal pending)

The circuit court, on administrative review, upheld the Director's decision and ruled that Exxon improperly computed its taxable income for the 1988-94 tax years by failing to include within its base income and apportionment factors its pro-rata share of the base income and apportionment factor of a "unitary" partnership. The court rejected Exxon's argument that as a partner, it was required to specifically allocate to Illinois any income that the partnership allocates to Illinois. Instead, the circuit court held that apportionment here occurs at the partner level, not at partnership level as contended by Exxon. A similar decision was reached in the below cases.

2. *BP Oil Pipeline Co. v. Zehnder,* (Circuit Court of Cook County No. 98 L 50300, May 25, 2001), consolidated with*UNOCAL Pipeline Co. v. Illinois Dep't of Revenue,*(Circuit Court of Cook County No. 00 L 50255, May 25, 2001). (Appeal Pending)

The Circuit Court upheld the validity of a Department of Revenue regulation in ruling that a corporate partner must combine its distributive share of a partnership's income and apportionment factors with its own for purposes of apportioning the partner's income to Illinois.

The taxpayers, BP Oil Pipeline Co., and UNOCAL Pipeline Co., owned minority interests in several partnerships that operated pipelines in Alaska and California. The partnerships operated entirely outside Illinois so that none of the partnership's apportionment factors (payroll, sales and property) were located in Illinois. The taxpayers, therefore, claimed that the income from the partnerships should be sourced entirely outside Illinois.

The Illinois Department of Revenue disagreed, asserting that the taxpayers were unitary with the partnerships and that the income and apportionment factors of the partnership therefore flowed up to the taxpayers for apportionment to Illinois along with the taxpayers' other income. An Administrative Law Judge ruled in favor of the Department and the taxpayers appealed to the circuit court.

Section 305 of the Illinois Income Tax Act generally provides that a nonresident partner is taxed in Illinois on its distributive share of the partnership's business income that is apportioned to Illinois using the partnership's own apportionment factors.

Under Section 304(e), when two or more "persons" are engaged in an unitary business, a part of which is conducted in Illinois, the business income attributable to Illinois must be apportioned under the combined apportionment method. The Department issued regulations to implement Section 304, 86 Ill. Admin. Code §100.3380(c). This regulation requires a corporate partner of a unitary partnership to combine its distributive share of the partnership's income and factors with its own for purposes of apportioning the partner's

income to Illinois, irrespective of the size of the partnership interest owned and irrespective of whether the corporate partner has authority to control the partnership, i.e., the factors and income flow up to the partner.

The taxpayers made three arguments in support of their position. First, they argued that Section 305 controls the apportionment of income and factors from partnerships, and, to the extent that Regulation 100.3380(c) does not follow the statutory scheme of Section 305, the regulation is invalid. The court first observed that the filing of a combined return is required in the case of a unitary business under Section 304, and that although Section 304(e) does not refer specifically to partnerships, the term "person" is defined to include a partnership and the definition of the term "unitary business" refers to a group of persons related through common ownership whose business activities are integrated and dependent upon and contribute to each other. The court reconciled the apparent conflict between Sections 304 and 305 by interpreting Section 305 as applying when the partner is not engaged in a unitary business with the partnership, with Section 304 applying when the partner and partnership are engaged in a unitary business. The court found the regulation consistent with Section 304 and therefore valid.

The taxpayers next argued that the treatment of the partnerships as part of their respective unitary businesses was improper because the taxpayers, as minority partners, did not have a controlling interest in any of the partnerships. Citing to the reasoning of the Administrative Law Judge, the court stated that the Department "is not treating the partnerships as members of the [respective taxpayer's] unitary, …[but] is only including the [taxpayers' respective] shares of [their] partnership income in [their] business income." While a corporate parent must own at least 50% of a corporate subsidiary for that subsidiary to be considered part of the parent's unitary business, the court ruled that, because a partnership is a "flow-through" entity, a corporate partner need not control the partnership for there to be an unitary business, so long as the corporate partner and the partnership are in the same unitary business. Since the taxpayers and the partnerships were in the pipeline business, this was sufficient.

Finally, the taxpayers argued that the combined method of apportionment for unitary business groups could not be applied at all, because the legislation enabling the combined method in Illinois, Public Act 82-1029 is invalid due to an improper amendatory veto by then-Governor Thompson. The court summarily rejected this constitutional challenge as well.

3. California Rev. & Tax Code sections 17942 and 17943 concerning tax and fees on limited liability companies were amended to adopt a fixed-tiered fee structure for LLCs that replaced the previous system of annual adjustments set by the Franchise Tax Board ("FTB"). Perhaps more importantly though, the definition of "total income" in determining the applicable fees has been changed to eliminate the chance for double-taxation that previously existed. Formerly, the FTB defined total income to include income apportioned to one LLC from another LLC. Thus, there was an inherent possibility for double taxation of the same income. This problem has now been resolved by defining total income to remove allocations or attributions of income from one LLC to another if that income has already been subject to imposition of the LLC fee.

V. BUSINESS PURPOSE AND ECONOMIC SUBSTANCE

A. What is Economic Substance

1. *In re The Sherwin-Williams Co.,*DTA No. 816712, N.Y.S. Division of Tax Appeal, June 7, 2001. (Appeal granted)

   The New York State Division of Tax Appeals has ruled that The Sherwin-Williams Co. could not be forcibly combined with its two trademark protection company affiliates for corporate franchise tax purposes.

   The Division of Tax Appeals found that the trademark protection companies "were formed for valid business purposes and carried out substantial business in their own names." This holding was based on "the credible testimony" of several individuals familiar with the formation and operation of the corporations as well as the documents in the record. The opinion provides: "In sum, the assignment of the trademarks by Sherwin-Williams to SWIMC and DIMC [the trademark protection companies] and the license back of those trademarks to Sherwin-Williams were accomplished for valid business purposes, were characterized by economic substance, and were not motivated solely by tax avoidance."

   It was also held that all of the transactions between Sherwin-Williams and its trademark protection company affiliates were conducted on an arm's length basis. Specifically, it was found that the royalties paid by Sherwin-Williams to SWIMC and DIMC were arm's length; that the interest rate charged by SWIMC on its loan to Sherwin-Williams was arm's length; and that the rates charged by Sherwin-Williams for the trademark services that it performed for SWIMC and DIMC were at arm's length.

   Because all of the transactions between the companies were at arm's length, Sherwin-Williams was found to have rebutted the presumption of distortion arising from the existence of substantial intercorporate transactions. The division then held that it had not established the existence of distortion in connection with any of the transaction between the companies.

   Because distortion did not result from the transactions between Sherwin-Williams and its affiliates, the division could not force Sherwin-Williams to file a combined tax report with either of the trademark protection companies.

2. *Carpenter Technology Corp. v. Commissioner of Revenue Services*, 772 A.2d 593 (Conn. 2001).

   The Connecticut Supreme Court has held that a parent corporation could deduct interest expenses incurred on a loan to a wholly-owned subsidiary because the subsidiary had economic substance and business purpose, and the transactions between the companies were legitimate. The subsidiary, which was established with a $300 million capital contribution from the taxpayer, was created to own a number of foreign subsidiaries and thus shield the taxpayer from potential foreign liabilities. Each of the five installments of the $300 million contributed by the taxpayer to the subsidiary as capital was immediately loaned back to the taxpayer. The Commissioner had attempted to disallow the deductions on the basis of the sham

transaction doctrine. However, the lower court held that, since there was a valid business purpose for setting up the subsidiary, the parent could deduct the interest expense on the intercompany loans. In a *per curium* decision affirming the lower court's ruling, the Connecticut Supreme Court adopted the lower court's reasoning without further analysis.

3. *Matter of Carpenter Technology,* DTA No. 816680 New York State Tax Appeals Tribunal (April 21, 2001).

The New York State Tax Appeals Tribunal has upheld an administrative law judge ruling that a taxpayer could not deduct interest expense related to an intercompany loan because the expense was directly attributable to subsidiary capital (*i.e.*, nontaxable income). The taxpayer contributed $300 million to a newly formed subsidiary, taking back a $300 million loan. While the taxpayer did make interest and principal payments on the loan, the subsidiary distributed this income back to the taxpayer as a dividend. The Tribunal concluded that even though there may have been a valid business purpose for the capital contribution to the subsidiary (to create a buffer from liabilities of foreign affiliates) the fact that the funds were loaned back to the parent and the subsequent interest payments on the loan indicated that the transaction was undertaken to achieve a tax benefit. The Tribunal thus upheld the ALJ's determination that the transaction must be evaluated by reference to its "economic reality."

4. *Syms Corp. v. Commissioner of Revenue*, SJC-08513 (Mass. Apr. 10, 2002); *Sherwin-Williams Co. v. Commissioner of Revenue*, No. F233560 (Mass. App. Tax Bd. Jan. 14, 2000).

In each case the Board disallowed deductions for the royalty and interest payments made by the taxpayer to related trademark licensing companies, on the theory that the payments did not constitute ordinary and necessary business expenses under I.R.C. §162. The Board failed to accept the taxpayers' arguments that the trademark protection companies had economic substance and were formed for business purposes. The Board went so far as to conclude that the trademark protection companies should license their marks royalty free, which appears to be contrary to the arm's length standard long relied upon by the Internal Revenue Service. Appeals in both cases were argued before the Massachusetts Supreme Judicial Court on September 10, 2001, and on April 10, 2002 the Court issued a decision in *Syms* affirming the Board's determination. The Supreme Judicial Court accepted the Board's findings of fact that the transfer of the trademarks and the license back "had no practical economic effect on Syms other than the creation of tax benefits, and that tax avoidance was the clear motivating factor and its only business purpose."

VI. NET OPERATING LOSSES

A. Disallowance

1. *Ribb Corp. d/b/a Boles Ready Mix*, Alabama Department of Revenue, Administrative Law Division, No. CORP. 00-601 (January 26, 2001).

A net operating loss carryover was disallowed because the corporation had not filed Alabama tax returns before the year in which it reported Alabama income. Because

the corporation had not filed Alabama returns, there was no loss attributable to Alabama in prior years that the taxpayer could carryover to the subject year's return.

2. *A.H. Robins Comp., Inc. v. Director, Div. of Taxation*, ____ N.J. Tax ____ (N.J. Tax Ct. Feb. 21, 2002).

A judge of the New Jersey Tax Court has held that the new incarnation of a company, formed in a bankruptcy proceeding to operate the identical business formerly operated by its predecessor, cannot carry forward the net operating losses of the predecessor. The Tax Court relied on *Richard's Auto City v. Director, Div. of Taxation*, 140 N.J. 523 (1995), which had upheld the Division's regulation denying the carryforward of losses after a corporate merger. However, in *Richard's Auto City* the New Jersey Supreme Court had found that the new business was similar but not identical to the predecessor business. In *A.H. Robins*, the Tax Court denied use of the losses to exactly the same business. An appeal is expected to be filed.

3. *The Colonial BancGroup v. Alabama Dept. of Rev.*, Dkt. No. Corp. 99-515.

In The Colonial BancGroup v. Alabama Department of Revenue, Dkt No. Corp. 99-515, an Alabama Administrative Law Judge (ALJ) ruled that a financial institution is not permitted to claim net operating losses generated by its nonfinancial subsidiaries that were merged into a subsidiary financial institution. Although it was not the basis upon which the ruling was decided, the ALJ noted that there is no evidence of a valid business purpose for the merger other than tax avoidance (e.g., to obtain the use of the NOLs); the ALJ further noted that there is no precedent that the Alabama Supreme Court would disallow the transaction solely for lack of a business purpose.

B. Mergers and NOLS

1. *Department of Revenue v. Caterpillar Inc.*, 625 N.W.2d 338 (Wis. App. Ct. 2001).

The Wisconsin Court of Appeals held that a surviving corporation of a pre-1987 merger is permitted to offset Wisconsin net operating loss carry-forwards against current net operating income in the same manner as allowed by the Internal Revenue Service under federal law. The Department argued that since statutory amendments, tying the computation of the state net operating loss deduction to the federal net operating loss deduction enacted in 1987, state that the amendments "first apply" to 1987 taxable year, NOLs generated in pre-1987 years are not available for carry forward. The court noted that the Legislature enacted the net business loss statute in an attempt to federalize Wisconsin's corporate franchise tax. In doing so, it clearly intended to allow taxpayers to utilize the provisions of I.R.C. Sec. 381 starting with the 1987 tax year. A reading that requires a merger to occur in 1987 would frustrate that intention; rather, the more logical reading is that a taxpayer may first deduct the losses in 1987.

VII. **BUSINESS INCOME**

A. Application of Allied-Signal Doctrine

1. The Minnesota and Maryland *Hercules* cases.

In a number of cases dealing with the same capital transaction, several states have applied the principles set forth in *Allied-Signal* in determining whether a corporation's investment in stock served an operational rather than investment function, and whether the states therefore had the power to tax an apportioned share of the gain from the stock's disposition. In most instances, the states' lower courts tended to give a very broad interpretation to the concept of "operational function." In Minnesota and Maryland, the two states where the issue involving Hercules' gain on a 1987 sale of stock reached the highest courts, both courts held the gain to be non-apportionable.

Hercules was a Delaware corporation engaged in many diverse businesses, including the manufacturing and marketing of polypropylene resin. In 1983, Hercules entered into a joint venture agreement with Montedison, S.p.A., an Italian manufacturer of polypropylene. Under the joint venture agreement, Hercules and Montedison each contributed all their polypropylene manufacturing assets to create a new corporation, Himont, Inc., and each owned 50% of the stock in Himont. In addition to the Himont stock, Hercules received a promissory note from Himont to equalize the relative value of the assets transferred by Hercules and Montedison, with interest set at an arm's length rate. Until Himont was able to supply or build its own offices, the company leased office space from Hercules and Montedison. In addition, when Himont was created, it contracted for certain administrative services from both Hercules and Montedison.

Himont issued additional stock which it sold in a public offering. After the public offering, Hercules and Montedison each owned approximately 38.7% of Himont's stock. In 1987, Hercules sold its entire interest in Himont to Montedison, recognizing a substantial capital gain. Montedison had threatened a hostile takeover of Hercules if it refused to sell the stock.

In *Hercules, Inc. v. Comptroller of the Treasury* 351 Md. 101 (1998), the Maryland Court of Appeals, the state's highest court, ruled that Maryland was prohibited from requiring Hercules to include gain from the sale of Himont stock in the apportionable tax base. First, the Maryland Court found that there was no unitary relationship between Hercules and Himont, in that there was only the potential for control, and because, on a day-to-day basis, Himont was "relatively autonomous" of Hercules, particularly in that they shared no employees. The Court rejected the notion that there was any significance to the manner in which Himont had been formed four years earlier, *i.e.,* Hercules created Himont rather than acquiring it on the open market. Relying on *ASARCO* and *Allied-Signal,* the Court made clear that the purpose for forming Himont was as irrelevant as the use of the proceeds from a sale; each has no bearing on how the asset in question is used.

Finally, the Court rejected the state's argument, based upon *Corn Products Refining Co. v. Commissioner of Internal Revenue,* 350 U.S. 46 (1955), that Hercules' purchases of resin served a business purpose as a hedge against potential scarcity of

resin or as a guaranteed source of supply of an essential product. Rather, the Court found that Hercules was not able to secure a more favorable discount than any other large volume purchaser could have achieved; that there had been no period where there was a shortage of resin; and that Hercules continued to purchase resin on the same pricing basis after it divested itself of its interest in Himont. The Court also found no evidence of a flow of value, since the administrative services were paid for at arm's length prices.

The Minnesota Supreme Court likewise concluded that Hercules' gain from the sale of stock in Himont was not subject to apportionment. *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.32d 111 (Minn. 1998). First, the Court analyzed the Minnesota statute, Section 290.17, subd. 3, which requires a corporation's income "derived from carrying on a trade or business" to be apportioned, and found that it had "minimal statutory guidance as to what it means for an intangible asset to be connected to a trade or business." The only statutory definition the Court found was in Section 290.17, subd. 6, which provides that "intangible property is employed in a trade or business if the owner of the property holds it as a means of furthering the trade or business." For guidance, the Court then looked to its interpretations of Minnesota's prior statute, which had been based on UDITPA, and to its decisions in *Great Lakes Pipe Line Co. v. Commissioner of Taxation*, 138 N.W.2d 612 (Minn. 1965) and *Montgomery Ward & Co. v. Commissioner of Taxation*, 151 N.W.2d 294 (Minn. 1967).

In both of those cases, the Court stated, "investment of excess assets in intangibles was an integral part of the corporations' day-to-day financial operations." The Court found the circumstances of Hercules' stock ownership of Himont to be very different. The stock interest had been held for more than four years, as an investment, and was sold only in response to a hostile takeover threat. The Court found "no indication that Hercules wanted or needed the proceeds from the Himont gain to provide operating funds." Therefore, under the Minnesota statute, the gain was insufficiently connected to Hercules' day-to-day business to be treated as business income under the statute.

The Court then went on to analyze the gain under the standards of the Due Process Clause, finding that apportionment of this gain would also be unconstitutional. It noted that, under *Allied-Signal*, the Due Process clause requires that, in order for income from an intangible asset to be apportionable, either the taxpayer and the payor corporation must have a unitary business relationship, or the intangible asset has to have served "'an operational rather than an investment function.'" It found "scant evidence" of any unitary relationship between Hercules and Himont, noting that intercompany services and resin purchases were conducted on an arm's length basis. The Court also noted that Hercules could never exercise control over Himont's management, since it never owned more than 50% of the stock. It also found that ownership of the Himont stock did not create an operational relationship, differentiating Hercules' treatment of its Himont stock from the two examples given by the U.S. Supreme Court in *Allied-Signal,* 504 U.S. at 787: the Himont stock was not used as a short-term investment comparable to a bank account or certificate of deposit; and it was not used as a hedge against a fluctuating supply of polypropylene resin, since the resin was widely available on the world market during the 1980s, and Hercules continued to buy resin from Himont after the sale at the same price. Therefore, the Court held both that the gain from the sale of Himont stock was

nonbusiness income, not apportionable to Minnesota, and that, in any case, apportionment of the gain would violate the Due Process Clause.

2. *Hercules, Inc. v. Department of* Revenue, 324 Ill. App. 3d 329 (Ill. App. Ct.) June 29, 2001. Petition for Leave to Appeal denied December 5, 2001.

The Appellate Court reversed the circuit court's decision, which had upheld an administrative decision, and ruled that Illinois could not tax, on an apportioned basis, Hercules' $1.3 billion capital gain from selling its stock interest in Himont, a publicly traded company. The court found that the Due Process and Commerce Clauses prohibited Illinois from classifying and taxing the gain as apportionable business income because neither the "unitary relationship test" nor the "operational function test" was satisfied.

The Appellate Court addressed Hercules' constitutional arguments first. The sole constitutional issue was whether the Department could apportion and tax Hercules' gain under the operational function test. The Department had conceded that the unitary relationship test was not met because Hercules did not own or control more than 50% of Himont's stock.

The Department contended that Hercules' investment in Himont served an operational function because Hercules contributed substantial assets, expertise, and services to Himont. The Department emphasized that Hercules not only created Himont, but it chose members of its board of directors and its president. Furthermore, the Department contended that Hercules' interest in Himont constituted an integral part of Hercules' overall business operations.

Notwithstanding the Department's arguments, the court found that Hercules had met its burden of demonstrating that its ownership interest in Himont served merely an investment function. The Appellate Court based its conclusion on the fact that Himont was operated as a stand-alone company; that Hercules never owned a majority of Himont's stock; and that nearly four years had passed after Hercules created Himont before selling its interest in Himont. The court also noted that Hercules did not exercise management control over Himont and that the two companies did not have common officers or employees. Furthermore, amounts charged for products and services between the two companies were at arm's length. And, upon selling it Himont interest, Hercules did not invest its proceeds in the polypropylene business.

The appellate court also noted that the highest courts of Maryland and Minnesota had both ruled that Hercules' capital gain was not apportionable business income. Because the Illinois appellate court found for Hercules on its constitutional argument, the court did not address Hercules' alternative, statutory nonbusiness income argument.

4. *Southland Corporation v. Comptroller*, No. 1661, June 13, 2001.

In an unreported opinion, the Maryland Court of Special Appeals reversed the Baltimore Circuit Court's opinion and disallowed the Comptroller's attempt to apportion income from the gain on the sale of stock (Southland Corporation v. Comptroller, No. 1661, June 13, 2001). The Comptroller sought to impose an

income tax on the gain from the sale of a 50% interest in Citgo stock by Southland. The Maryland Tax Court previously ruled that Southland and Citgo did not have a unitary relationship and the sale of stock was non-unitary income since the income came from a "discrete business enterprise" and the sale did not serve as an operational function. The Baltimore Circuit Court reversed finding that an operational relationship existed between Citgo and Southland. The Court of Special Appeals reversed the holding of the Baltimore Circuit Court and reinstated the Maryland Tax Court's findings.

B. The UDITPA Cases - Cessation of Business

1. *May Department Stores Co. v. Indiana Dept. of Revenue*, No. 49 T 10-9906-TA-144 (Indiana Tax Court May 7, 2001).

The Indiana Tax Court held an isolated sale of a division by a May Department store was not business income. The Tax Court concluded that May was not engaged in the business of selling divisions and as such the transactional test was not met. With respect to the functional test the Tax Court concluded that the statute required that the acquisition, management and disposition of the property had to be an integral part of the taxpayer's business. The disposition of the division was not integral to May's business. In fact, the court-ordered divestiture was for the benefit of a competitor not for the benefit of May Department Stores.

See also: *Chief Industries Inc. v. Indiana Department of Revenue*, 737 N.E.2d 1246 (Ind. Tax Ct. 2000) where the Tax Court found that the income from the sale of stock was not subject to the adjusted gross income tax because to tax such income the stocks must have situs in Indiana. It should be noted that the statute imposing the tax on income from intangible personal property was amended to replace the phrase "having situs in this state" with "attributable to Indiana."

2. *Lenox Incorporated v. Offerman*, 538 S.E.2d 203 (2000), affirmed No. 17A01 (North Carolina S.Ct., July 20, 2001).

The North Carolina Supreme Court has held the income received from the complete liquidation of one of the operating divisions should be characterized as nonbusiness income.

Lenox, Inc. is a New Jersey based corporation engaged in the business of manufacturing and selling various consumer products in a number of states including North Carolina. In 1970, Lenox formed "ArtCarve" as a separate and distinct operating division devoted exclusively to the manufacture and sale of fine jewelry. ArtCarved was a separate and distinct operating division. In 1988, Lenox sold ArtCarved, ceasing the manufacturing of fine jewelry. The sale proceeds from the sale were distributed to its sole shareholder.

The Court used the functional test to determine whether the gain recognized on the sale of ArtCarve qualified as business or nonbusiness income. In holding the gain was nonbusiness income the court focused on the fact its transaction caused a complete liquidation of ArtCarve and a partial liquidation of Lenox. Lenox did not return to the jewelry business and in fact the sale of the assets and property that generated the gain was an extraordinary event. When an asset is sold under

complete or partial liquidation the analysis must take into consideration more than just whether the asset was integral to a corporation business. When assets of a business are disposed of in either a complete or partial liquidation and the proceeds are distributed to shareholders rather than re-invested in the company, the gain recognized on the transaction is nonbusiness income under the functional test. The disposition of ArtCarve did not generate business income because the liquidation was not an integral part of Lenox's regular trade or business.

3. *Blessing/White, Inc. v. Zehnder*, 1st District Appellate Court No. 1-01-0733 (March 29, 2002) Petition for Leave to Appeal pending.

The Illinois Appellate Court has affirmed the Circuit Court of Cook County decision holding the gain recognized on the sale of substantially all the business assets was non-business income. Blessing/White was a business resource consulting firm with its principal place of business in New Jersey. The company operated a sales office in Chicago. On May 31, 1989, the company sold substantially all of its assets and distributed the proceeds to its shareholders. The gain was characterized as non-business income.

In holding the gain to the non-business income, the Appellate Court concluded the disposition amounted to a liquidation of the business property which was a one-time corporate event and marked the cessation of the company's business. Further, the liquidation proceeds were not used in any ongoing business operations. The liquidation of the assets was not integral to the company's regular business operations. Therefore, the court citing *Lenox* held the gain did not qualify as business income under the functional test. The parties had agreed the transactional test was not met.

4. *Kemppel v. Zaino*, 91 Ohio St. 3d 430 (2001).

The Ohio Supreme Court ruled that gain from the sale of the assets of an S corporation pursuant to a complete liquidation is nonbusiness income and may not be included in the measure of Ohio income of a nonresident shareholder. The court explained that the character of income attributed to S corporation shareholders is determined as though they had received it directly from the same source as the corporation. Therefore, if income is business income to the S corporation, it is business income to the shareholders, and if the income is nonbusiness income to the S corporation, it is nonbusiness income to the shareholders. Ohio Rev. Code. Ann. Secs. 5747.01(B) defines business income as income arising from transactions, activities, and sources in the regular course of a trade or business and includes income from tangible and intangible property if the acquisition, rental, management, and disposition of the property constitute integral parts of the regular course of a trade or business operation. Nonbusiness income means all income other than business income. In this instance, the court concluded that it was not necessary to determine whether a transactional test or functional applied because the income received by the S corporation was not business income under either test. The income in question resulted from a liquidation of assets followed by dissolution of the corporation. This was a one-time event that terminated the business; it was not a sale in the regular course of a trade or business. Therefore, the court held that the income from the gain on the sale of the intangible personal property was not business income to the shareholders.

5. *Jim Beam Brands Co.*, California State Board of Equalization No. 89002468010, March 29, 2001. (Appeal Pending)

The gain recognized on the sale of a subsidiary's stock was business income apportionable to California because the subsidiary was an integral part of the taxpayer's unitary business operations during the period that the taxpayer owned the subsidiary. The subsidiary was a member of the taxpayer's unitary group during the period in question.

Under the functional test, income from property is considered business income if the acquisition, management, and disposition of the property were integral parts of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or an extraordinary transaction. Under this test, there is no independent requirement that the disposition of the property be an integral part of the taxpayer's trade or business operations. Also, the Board concluded there was no justification for carving out a partial liquidation exception to the functional test.

In so holding, the California State Board of Equalization declined to follow the decision of the North Carolina Court of Appeals in *Lenox, Inc.,* 538 S.E.2d 203 (2000), affirmed, No. 17A01 (N.C. S.Ct. July 20, 2001), in which the court held that a partial liquidation of a taxpayer's business, including the sale of an operating division or subsidiary, generated nonbusiness income, even if the liquidated assets had been part of the taxpayer's unitary business. The SBE noted that the *Lenox* case was in direct conflict with the result the SBE has reached in cases with similar facts and with the underlying rationales of those cases.

6. *Appeal of Esprit De Corp*, SBE Apr. 20, 2001, *petition for redetermination denied*, Sept. 26, 2001. In a summary decision in *Appeal of Esprit De Corp.* ("Esprit"), the SBE held that acquisition interest expense incurred during a leveraged buyout ("LBO") constituted nonbusiness expense that was allocated entirely to the commercial domicile of the taxpayer.

On June 18, 1990, an acquisition holding company ("Acquisition") was formed to acquire the stock of Esprit. Acquisition incurred indebtedness of $160 million to finance the LBO. Immediately after the acquisition in July 1990, Acquisition merged into Esprit. On its 1991 and 1992 California Franchise Tax Returns, Esprit treated the interest on the acquisition note as a nonbusiness expense item allocated entirely to its commercial domicile in California. On audit, the Franchise Tax Board reclassified the acquisition interest as a business expense apportioned among all the states where Esprit did business.

7. *North Carolina Secretary of Revenue Decision,* No. 2000-5 (December 29, 2000).

The North Carolina Secretary of Revenue has concluded that an out-of-state telecommunication corporation doing business in North Carolina was not entitled to a refund of corporate income tax paid on the gain recognized on the sale of two operating divisions. The corporation was not allowed to use an alternative apportionment formula. Therefore, the income received as a result of the sale of the two divisions was business income.

First, the taxpayer was not entitled to use an apportionment method other than the statutory required single factor formula. The use of an alternative method must be approved by the Augmented Tax Review Board. This Board had previously denied the taxpayer's request to use an alternative formula.

The income received by the taxpayer from the sale of two divisions was characterized in business income because the divisions were integral parts of the taxpayer's regular trade or business. Applying the functional test, the Secretary found the income generated by the divisions and the gain recognized on the sale was business income. The two divisions were used by the taxpayer to produce business income. The taxpayer regularly and consistently reported as business income the income from the two divisions. There is no requirement that business income may include income from property that constitutes an integral part of the taxpayer's business operations in the state.

C. Intangible Assets

1. *Danov Corp. v. Alabama Department of Revenue*, Docket No. Corp. 97-283 (December 22, 2000).

The Administrative Law Judge has held that the Department could not tax dividend income of a Florida domiciliary corporation whose only contact with Alabama was a 21 percent ownership interest in a limited partnership which invested in Alabama oil and gas properties. The stock portfolio was managed from Florida and the dividends were reinvested in other stocks. The Administrative Law Judge concluded that Danov’s activities outside of Alabama were not unitary with the company’s business activity in Alabama and thus could not be taxed.

2. *Illinois Administrative Hearing Decision*, No. IT-01-18, October 5, 2001.

A taxpayer’s capital gain from the sale of a minority interest in another corporation was not business income subject to Illinois corporate income tax apportionment because an analysis using the transactional test showed no evidence that the taxpayer was in the regular business of buying, holding, or selling the stock of other corporations, and the disposition of the stock was simply a consequence of its divestiture of activities unrelated to the taxpayer’s core business. The taxpayer completely divested its specialty minerals business to the corporation to focus on its core health care business and ceased to exercise any control or play a role in the corporation’s specialty mineral business. In addition, the gain was not income under the functional test because the taxpayer’s acquisition, management, and disposition of this stock was not integrally related to its business operations at the time this stock was sold, even though the proceeds from the sale were used in the taxpayer’s ongoing business operations.

Further, under *Allied-Signal*, the income was nonbusiness income because the taxpayer and the corporation were not engaged in a unitary business and, therefore, taxation of the income by Illinois violated the Due Process and Commerce Clauses of the U.S. Constitution. Further, apportionment of the income to Illinois would violate the Due Process and Commerce Clauses of the U.S. Constitution because the operational test found in *Allied Signal* was not met since the taxpayer’s minority interest in the corporation was held for an investment, rather than operational,

purposes. The taxpayer held only minority interest in the corporation it liquidated; the corporation had its own Board of Directors and management that independently ran the corporation, made operational decisions, and set policies; and the taxpayer and the corporation were not functionally integrated after the sale.

3. *Computer Sciences Corp. v. State of Alabama Department of Revenue,* Docket No. Corp. 01-113 (Sep. 12, 2001).

The chief Administrative Law Judge ("ALJ") held that interest income received by a nondomiciliary corporation doing business in Alabama was apportionable business income. Computer Sciences (the parent) is domiciled in California, and provided computer services to customers in Alabama during the subject years. The parent received interest income from open-ended loans it had made from its excess operating capital to 13 subsidiaries. The parent in turn used the interest payments in its regular business operations. Computer Sciences reported the interest as nonbusiness income on its Alabama returns and allocated it 100% to California. The Alabama Department of Revenue re-characterized the income as business income and apportioned a part of it to Alabama. Computer Sciences appealed.

The ALJ first ruled that Alabama was not constitutionally prohibited from taxing the income under either the Commerce Clause or the Due Process Clause, citing *Allied-Signal* and related cases. The income could be taxed because the subsidiaries were unitary with the parent (for example, they had filed together on the parent's combined California franchise tax returns), and the income served an operational function in the parent's business. The ALJ next addressed whether the interest was business income under the Multistate Tax Compact's definition of the term, as adopted by Alabama. The ALJ found that the interest income derived from the short-term investment of operating profits clearly constituted apportionable business income.

4. T*omen America, Inc. v. Zehnder*, No. 1-98-3841 (Ill. App. Ct. March 29, 2001). (Unpublished)

The Illinois Appellate Court upheld the Department's administrative decision and ruled that Tomen America was taxable, on an apportioned basis, on its dividend and capital gain income. Even though Tomen America made only five stock purchases and six stock sales during the 1986-1990 tax years, the appellate court held that Tomen America's dividend and capital gain income was properly taxed as apportionable business income.

The Appellate Court reasoned that Tomen America's dividends and capital gain income was business income under the transactional test because trading stock was a "systematic and recurrent" business practice for the company. Indeed, Tomen America made either a purchase or a sale of stock every year. The court also held that the income was business income under the functional test because stock transactions were an essential part of the company's business. The gains from Tomen America's stock sales accounted for 94% to 100% of the company's federal taxable income.

The Appellate Court found no merit in Tomen America's Due Process and Commerce Clause arguments because the company failed to establish that a unitary

relationship did not exist between it and the companies in which it invested. The court also held that Tomen America's stock sales served an operational function, rather than an investment function, because, even though the average holding period of the stocks was 4.4 years, the company used the sale proceeds for operational uses, including paying down debt.

5. *Penzoil Co. v. Oregon Department of Revenue*, 332 Ore 542 (2001). Petition for certiorari denied.

   The Oregon Supreme Court, held that proceeds received in settlement of a tort judgment constituted apportionable business income.

   Pennzoil had reached an agreement to purchase about 43% of the stock of Getty Oil, during the course of the Penzoil negotiations Texaco had acquired all of Getty Oil's stock. Pennzoil then sued Texaco in a Texas court for tortuous interference with a contract and the jury awarded Pennzoil more than $11.1 billion in damages. Pennzoil's claimed damages were based on the loss of its bargain in an amount equal to the cost of finding and developing one billion barrels of oil reserves. Pennzoil and Texaco then entered into a settlement agreement pursuant to which Pennzoil agreed to accept $3 billion in satisfaction of the outstanding judgment.

   Pennzoil's only activity in Oregon during the year at issue was the operation of a facility designed to blend, package and distribute motor oil and related automotive products. None of Pennzoil's employees in Oregon played a role in the Texas litigation or the negotiations that followed. Pennzoil reported the settlement proceeds as "nonbusiness income" on its Oregon tax return, allocating none of the settlement proceeds to Oregon and claiming therefore that the settlement proceeds were not subject to the Oregon corporate excise tax. The Oregon Department of Revenue (the "Oregon DOR") disagreed with Pennzoil's return position and assessed an additional corporate excise tax on the settlement proceeds.

   The Oregon statute defines "business income" to include "income arising from transactions and activity in the regular course of the taxpayer's trade or business." After determining that Pennzoil had received the settlement proceeds in lieu of its agreement to obtain the Getty Oil stock and that Pennzoil's purpose in entering into the agreement was to acquire access to Getty Oil's oil reserves, the court concluded that Pennzoil entered into the agreement in the regular course of its business. Therefore, the court held that the settlement proceeds constituted "business income."

   Because the acquisition of oil reserves was related to Pennzoil's business activities, the court held that the settlement proceeds served an operational function and could constitutionally be apportioned to Oregon. The court also held that apportioning the settlement proceeds to Oregon did not grossly distort the extent of the Pennzoil's activities in Oregon since Pennzoil conducted part of its unitary business in Oregon.

D. <u>Legislative Response to Recent Decisions</u>

1. Pennsylvania House Bill 334 was signed into law on June 22, 2001. This bill retroactively repealed Pennsylvania's Nonbusiness Income provisions to tax years beginning after December 31, 1998. The statutory definition of "Nonbusiness Income" was amended to read"…all income other than business income THE

TERM DOES NOT INCLUDE INCOME WHICH IS APPORTIONABLE UNDER THE CONSITITUTION OF THE UNITED STATES."

The statutory definition of "Business Income" was amended as follows:

"'Business Income' means income arising from transactions in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if EITHER the acquisition, THE management (,and) OR THE disposition of the property (constitute integral parts) CONSTITUTES AN INTEGRAL PART of the taxpayer's regular trade or business operations. THE TERM INCLUDES ALL INCOME WHICH IS APPORTIONABLE UNDER THE CONSTITUTION OF THE UNITED STATES."

These changes legislatively overrule the Pennsylvania Supreme Court's decision in *Laurel Pipeline v. Commonwealth*, in which gain from the sale of a separate, idle, pipeline was treated as nonbusiness income and allocated based on the proportion of the pipeline located in Pennsylvania.

2. HB7, signed into law by Alabama Governor Siegelman as Act 1113 adopts the Multistate Tax Commissions definition of business income and effectively overruled the *Uniroyal Tire Company* decision. The amendment is effective for tax years beginning on or after December 31, 2001.

   Specifically "business income" is defined as "income arising from transactions or activity in the course of the taxpayer's trade or business; or income from tangible or intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer's trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of real property or of tangible or intangible personal property, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Alabama or operationally related to sources within Alabama."

3. Legislation enacted during the year amended the definition of business income to include income described in either the transactional or functional test (HB 1695, Laws 2001). The new law applies retroactively to January 1, 2001.

4. In Directive CD-01-1, the North Carolina Department of Revenue addressed the decision of the North Carolina Supreme Court in Lenox, Inc. v. Tolson, 353 N.C. 659, 548 S.E.2d 513 (2001), and its effect on the determination of whether income is business or nonbusiness. According to this Directive, gain or loss from a company's disposition of real or tangible property is classified as nonbusiness income and is allocated to the situs of the property only if both of the following conditions apply: (1) the disposition is the liquidation of a separate and distinct line of business of the company and results in the cessation of that line of business; and (2) the company distributes all of the proceeds of the liquidation to its shareholders and does not reinvest any of the proceeds in the company.

VIII. APPORTIONMENT ISSUES

A. Receipts Factor

1. *Stryker Corporation v. Director, Division of Taxation*, New Jersey S. Ct. No. A-27 (June 14, 2001).

   A Michigan-based corporation's receipts from sales of hip and knee replacements manufactured at its New Jersey facility, sold to its wholly owned New Jersey subsidiary at the same facility, and drop-shipped directly to the subsidiary's out-of-state customer's qualified as New Jersey receipts to be included in the numerator of the receipts fraction of the New Jersey corporation business (income) tax allocation formula because the receipts were earned in New Jersey.

   The Appellate Court found that the manufacturer's receipts must be included in the numerator of its receipts fraction under a catch-all statutory provision that included in the numerator "all other business receipts earned within the state." The manufacturer argued that application of the catch-all provision as improper because the legislature had enacted two provisions that specifically referenced types of tangible personal property receipts to be included in the receipts fraction numerator and both of those provisions looked solely to the destination of the physical shipment to determine whether the receipts should or should not be included in the numerator. However, the New Jersey Supreme Court held that the two specific provisions should not be interpreted as a limitation on the New Jersey Division of Taxation's right to include the manufacturer's receipts in the allocation formula. The catch-all provision must be interpreted to allow the Division to plug loopholes in the corporation business (income) tax law, such as here where the product was manufactured and sold in New Jersey to a New Jersey corporation, but did not fall under one of the enumerated inclusory statutory provisions. In addition, a drop-shipment transaction should not allow one manufacturer to enjoy an unfair tax advantage over another manufacturer that did not drop ship its products and was consequently required to include receipts from sales shipped to its customers in the numerator of its receipts fraction.

   Finally, the manufacturer's argument that the lower courts' application of the New Jersey corporation business (income) tax law was not internally consistently as required by the Commerce Clause of the United States Constitution was without merit because the doctrine of internal consistency requires only that a tax be structured so that it would not result in multiple taxation if applied by every state and that test was met in this case.

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

3. *Union Pacific Corp., et al. V. State Tax Commission*, Idaho Supreme Court No. 25876

In Union Pacific Corp., et al. v. State Tax Commission, No. 25876, the Idaho Supreme Court found that the proceeds from the sales of receivables should not be included in the sale factor under the provision allowing the Commission to deviate from the general apportionment provisions if those provisions do not fairly represent the extent of the taxpayer's business in Idaho. The court found that the inclusion in the sales factor of freight sales and the proceeds from selling the receivables from such sales did not fairly represent how Union Pacific earns its income. On this issue, the court remanded the case for consideration of an alternate method.

4. The Massachusetts Department of Revenue has issued Technical Information Release (TIR) 01-11 in response to the Combustion Engineering decision (A.T.B. Docket No. F228740, 2000). According to this TIR, the Commissioner will treat the sales factor receipts from an IRC Sec. 338(h)(10) transaction as belonging to the parent that sells the stock and because "sales" do not include receipts related to the disposition of securities, such receipts will not be included in the parent's sales factor. Further, the Commissioner will recognize the Board's decision in Combustion Engineering as applicable for all open tax years.

The Massachusetts Department of Revenue also amended 830 CMR 63.38.1(9)(b)7 to reverse the Department's position concerning a specific rule pertaining to a corporation's sale of a subsidiary corporation in the instance in which the parent elects to treat the sale as a sale of assets and not stock for sales factor purposes. The amendment also makes an analogous change reversing the Department's position concerning the treatment of certain distributions of appreciated assets by a subsidiary corporation to its parent.

5. Under Oregon rule 150-314.665(6), effective December 31, 2000, a taxpayer's primary business activity determines whether it must include gross receipts or net gains from the disposition of intangible assets in its sales factor. Under this rule, taxpayers must determine their primary business activity on a unitary basis upon filing a consolidated Oregon excise tax return. If the taxpayer's primary business activities indicate dealing in intangible assets as well as the production or sale of tangible personal property, greater weight will be given to criteria reflecting what the corporation actually did during the tax year.

B. Property Factor

1. *Matter of American Jet Engine Co., Inc., and Amjet Aerospace,, Inc.,* New York Division of Tax Appeals, DTA Nos. 816998, 816999 (January 18, 2001).

An ALJ has ruled that rent paid by two related corporations for shared warehouse space was properly included in their property factor denominators for New York franchise tax purposes. The taxpayers were brother-sister S corporations that shared storage space in a New Jersey warehouse. For New York tax purposes, rent paid for storage space may be included in the property factor of the business allocation percentage (*i.e.* apportionment factor) if designated for and under the control of the taxpayer. 20 NYCRR 4-3.2[c][3]. The ALJ concluded that the storage space was outlined by physical boundaries (walls, racks, etc.) and was specifically designed for

the taxpayers' inventory. The fact that the space was shared by related entities and expanded on occasion did not bar a finding that the space was specifically designated for the taxpayers. The ALJ concluded that the corporations' owner who dictated the storage terms and could obtain additional space on demand exercised "control" over the facility even though the warehouse owner was responsible for the day-to-day maintenance of the building.

2. In CTR 01-2, the Arizona Department of Revenue explained when computer software is included in the numerator and denominator of the property factor. Computer software that has been treated as tangible personal property and capitalized for federal tax purposes will be treated similarly for Arizona tax purposes. A.R.S. section 43-1140 provides that the numerator of the property factor includes real and tangible personal property used in Arizona; thus, computer software is includable in the numerators of the states in which the software is actually used, not in the state where the original program disk or tape is located.

C. Payroll Factor

1. *C&D Chemical Products Inc. v. Department of Revenue*, No. 00-288 (February 9, 2001).

An Alabama administrative law judge has ruled that a taxpayer could include in the payroll factor of its apportionment formula the portion of the management fee it paid to a related party that represented payments for employees furnished by that business. Under Alabama law, the payroll factor is broadly defined to include all compensation. The statute does not define the term compensation. The Alabama regulations, however, provide that the payroll factor includes only compensation paid to employees. The ALJ found that the restriction that compensation be paid to employees, contained in the regulation, conflicted with the statute defining the payroll factor. The ALJ even acknowledged that the company furnishing the employees probably included their compensation in its payroll factor, but noted that apportionment formulas are imperfect. Alabama's payroll factor statute is modeled after UDITPA, and the regulation rejected in this ruling is modeled after the MTC regulations, both of which have been adopted in many states.

D. Use of Standard Apportionment Formula

1. *Millward Brown, Inc. v. Connecticut,* Connecticut Superior Court, No. CV 98 04924725 (August 8, 2001).

A multistate market research company could use the three-factor apportionment formula for computing Connecticut corporation business (income) tax. The research company used computers, telephones, telephone interviewers, and other equipment to gather and analyze market research data because it derived its income from the use of tangible personal property.

During the tax years at issue, multistate businesses that derived their income from the manufacture, sale or use of tangible personal property were required to use a three-factor formula to apportion their income to Connecticut, while businesses that derived their income from business other than the manufacture, sale or use of tangible personal property were required to apportion their income to Connecticut

with a single, gross receipts, factor formula. As part of its information gathering and analysis activity, the market research company (1) designed a sampling plan, (2) collected respondent data, (3) tabulated the results, and (4) formulated its analysis. After analyzing the collected data, the company presented its analysis and conclusion to its clientele. The operation of the data collection process involved the use of tangible personal property as an essential part of the taxpayer's business, and was not incidental to the data collection process as part of the business of providing a service to clients. Therefore, the taxpayer could apportion its income using the three-factor apportionment formula, rather than the single-factor formula.

2. *U.S. Bancorp and Subsidiaries v. Department of Revenue*, Oregon Tax Court, Doc. 2001-24246, Sep. 19, 2001.

The Oregon Tax Court ruled that the Department of Revenue did not have the authority to modify the corporate excise tax income apportionment method required by it rules.

U.S. Bancorp and Subsidiaries is a unitary organization that does business in Oregon and other states. Bancorp reported its unitary income and correctly apportioned it in accordance with state corporate excise tax law. A department auditor while auditing years 1984 - 1992 concluded that if adjusting the property factor by including intangible personal property resulted in a more fair and accurate apportionment of Bancorp's income, the auditor was required to make the adjustment.

OAS 314.280(1) grants the department power to promulgate rules and regulations to permit or require the reporting of income by either of two methods. The court stated that the statute does not support the proposition that the department has the authority to modify either a method or its factors on an ad hoc basis. Although OAR 150-314.280 –(M), effective as of 1995, indicates that the department may require an alternative method of apportionment in any case in which it determines that the usual method is not accurate, it was not expressly made retroactive.

3. *Hoechst Celanese Corp. v. Director of Revenue*, No. 01A-03-001-SCD (Del. Sup. Ct. Jan. 9, 2002).

The Delaware Superior Court held that the December could not allocate to Delaware all the gain on the sale of property located in Delaware. A significant part of the gain arose from the recapture of excess depreciation deductions, which had been apportioned partially to Delaware and partially to other states in which the taxpayer conducted business, and these states also taxed the recaptured gain. Since the company had only benefited from partial deductions in Delaware, the court refused to allow the entire recapture gain to be allocated, permitted taxation only of the economic gain. An appeal has been filed.

4. Operative January 1, 2001, the California Franchise Tax Board (FTB) amended regulation 25137(c), the alternative apportionment. Among the amendments was the expansion of the substantial-amount special sales factor rule to include certain intangible assets and also provide guidance on determining what is "substantial." The amended regulation provides that where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the

regular course of the taxpayer's trade or business, such gross receipts must be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial. The amended regulation further provides that a sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole. For purposes of this subsection, a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.

5. Legislation enacted during 2001 in Maryland altered the apportionment formula for manufacturer. Under the new law, which applies to tax years beginning after 2001, a multistate manufacturer's income is apportioned to Maryland based solely on its percentage of in-state sales. For purposes of this provision, a manufacturer is defined as a corporation that, except for petroleum refiners, would fall under Section 11 or Sectors 31 through 33 of the North American Industrial Classification System of the United States Office of Budget and Management. Specified manufacturing corporations utilizing the new apportionment method are also required to submit specified reports as part of their income tax returns and requires the Comptroller to prepare and submit a report each year to the Governor and the General Assembly detailing the information from these reports.

IX. DISCRMINATION

1. *Ceridian Corp. v. Franchise Tax Board*, 85 Cal. App. 4th 875 (2001).

The Appellate Court has held that the statutory provision disallowing a deduction for dividends received from non-California domiciled insurance companies facially discriminated against interstate commerce. The statute allowed a California domiciled corporation to deduct dividends received from insurance companies to the extent that the dividends were paid from income from California sources.

Ceridian, a Minnesota based corporation received dividends from its wholly-owned insurance subsidiaries. The FTB on audit included these dividends in the unitary group's taxable income. Ceridian paid the assessment and filed suit claiming that taxing the insurance subsidiary dividends violated the Commerce Clause because the state was giving California corporations an advantage.

On appeal, the Board conceded that the provision limiting the deduction was discriminatory and violated the Commerce Clause. However, the second provision of the statutory section limiting the deduction to only dividends paid by California insurance companies was not discriminatory because it was designed to avoid the double taxation of insurance premiums. The Appellate Court rejected the Board's theory that a provision aimed at avoiding a double tax can never be discriminating.

In rejecting the Board's argument the court set forth the proper approach for analyzing a tax provision under the Commerce Clause, and concluded that the provision did discriminate against interstate commerce by disallowing a deduction based on the amount of gross receipts, property and employees that the dividend-declaring company has in another state.

Domestic corporations were favored over their out-of-state competition and this tax scheme burdened interstate commerce in violation of the Commerce Clause.

With respect to the remedy, the court concluded the only permissible remedy was a refund, because the years were closed for assessment of the favored domestic corporations.

The FTB's Response to *Ceridian:* Post-1995 Remedies**.** The FTB Staff has recommended that *Ceridian* be implemented by denying for tax years 1996 and forward, the deduction for dividends received from insurance companies. Various taxpayer organizations have opposed that proposal and the FTB has not yet resolved the dispute.

The Legislature's Response to *Ceridian***:** The California Legislature currently is considering legislation (A.B. 483, 2001-02 Leg., Reg. Sess. (Cal. 2001)) that would clarify post-*Ceridian* law as permitting a deduction for all dividends received from a corporation subject to California's gross premiums tax so long as the payee owns at least 80% of each class of stock.

Related Case**:** *Allianz of America Inc. v. Connell,* Cal. Super. Ct. No.01CS01530, 11/8/01. Frustrated that the FTB has not acted to change the rules, plaintiff filed suit on October 26 asking the court to compel FTB to resolve the issues the appellate court raised. The date to consider the companies' petition for writ of mandate is December 21.

2. California Legislative Counsel Opinion on *Ceridian* (Letter from B. (Bill) S. Heir, Deputy Legislative Counsel, to John L. Burton, California State Senator and President Pro Tem (December 7, 2001).

   In a more recent opinion, the Legislative Counsel also concluded that in light of *Ceridian*, section 24410 "is inoperative and unenforceable, and that there is no provision of section 24410 from which the rest of that section may be 'severed,' so as to leave remaining a deduction to any corporate taxpayer for the full amount of dividend income received from an insurance subject to California gross premiums tax."

3. *Kraft General Foods, Inc. v. Comptroller of the Treasury*, Maryland Tax Court Dkt. No. 98-IN-00-0353 (June 8, 2001).

   The Maryland Tax Court has held that Maryland's corporate income tax discriminates against foreign commerce by allowing domestic but not foreign dividends to be included in the calculation of a taxpayer's net operating loss (NOL). The starting point for computing Maryland corporate income tax is Line 30 federal taxable income, which includes the domestic dividends received deduction (DRD). Among the modifications made to a federal taxable income is a subtraction for dividends received from foreign subsidiaries, enacted to alleviate discrimination against foreign commerce caused by Maryland's adoption of federal taxable income. See: *Kraft General Foods v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992). However, Maryland has a longstanding state policy that prohibits subtraction modifications from increasing an NOL in excess of a taxpayer's federal NOL. The Tax Court concluded that Maryland's taxing scheme unconstitutionally favors taxpayers that receive dividends from domestic subsidiaries because those dividends are included in the NOL calculation while foreign dividends are not. The Comptroller did not appeal the decision.

3. California FTB's Response to *Hunt-Wesson*

The California Franchise Tax Board has issued notice 2000-9, released on December 9, 2000, that no interest expense deduction will be disallowed as an offset against nonbusiness interest and dividend income allocable outside of California. The notice was issued in response to the U.S. Supreme Court's decision in *Hunt-Wesson v. Franchise Tax Board*, 538 U.S. 458 (2000), which found unconstitutional the provisions of California Revenue and Tax Code Sec. 24344(b) are invalid in their entirety and should not be enforced by the Franchise Tax Board. The legislative counsel found that under *Hunt-Wesson*, the second prong of Sec. 24344(b) is inoperative and unenforceable with respect to a nondomiciliary corporation. However, the legislative counsel continued, the three components of Sec. 24344(b) are inseparable, forming an interlocking system for the allocation of interest expense from whatever source. Severing the second prong from the remaining parts would destroy their intended application, the legislative counsel concluded. In addition, the legislative counsel found, even if the second prong could be severed, the remaining components "would still allocate interest expense without any rhyme or reason as to the type of income generated by that expense, and therefore involve just as arbitrary an allocation method as the court found unconstitutional in *Hunt-Wesson*." This flaw applies equally in the case of a California-domiciled taxpayer, the legislative counsel concluded.

The legislative counsel also found that California Code Regulations title 18, Sec. 25120(d) would apply in the absence of Sec. 24344(b) and provides a tracing method that allocates interest expense to the income that generates the expense in conformity with *Hunt-Wesson.*

4. *Farmer Brothers Co. v. Franchise Tax Board*, Superior Ct. of Los Angeles County BC237663 (November 21, 2001)

The Superior Court found that California's Revenue & Tax Code Section 24402 facially places an unconstitutional burden on interstate commerce.

Plaintiff California coffee manufacturer is a shareholder of various companies engaged in interstate commerce. Under Section 24402 it was allowed to deduct up to 70% any dividends received from companies that had a larger share of its sales, property and payroll in California than in any other state. No deduction is allowed for dividends from companies with a larger share of its apportionment factors outside of California. Farmer Brothers Co. challenged the constitutionality of Section 24402 on the basis that it imposes an impermissible burden on interstate commerce.

Defendant FTB maintains that the statutory goal is merely compensatory. The purpose of the statute is to prevent the imposition of a second tax upon the California stream of income leading to the dividend. "California's only responsibility is to prevent…double taxation…" The FTB argued that both the statute's intent and effect are non-discriminatory.

The court disagreed. It stated that "shareholders are the owners of a business. Dividends are declared earnings remitted to owners on a per-share basis. A tax on dividends properly is a tax upon an owner's income, not a tax on the 'stream of income leading to the dividend.' Therefore, what is really being 'compensated' is the state's initial inability to impose a franchise tax on foreign corporations. By the devise of giving harsher tax treatment to dividends from out-of-state businesses, California has managed to accomplish by indirection what it cannot do by direction, namely it effectively has levied an in-lieu tax based upon corporate income streams occurring beyond its borders. By subjecting shareholders of

foreign corporations to different treatment, the State says, in effect, 'since we can't impose a franchise tax on your business at the front end, we'll tax you personally in an equivalent sum at the back end.'"

5. *Jefferson Smurfit Corp. Michigan Court of Appeals*, No. 224267, November 13, 2001.

The Court of Appeals found that the site-based capital acquisition deduction (CAD) against the Michigan Single Business Tax ("SBT") did not violate the Commerce Clause of the U.S. Constitution because it had no discriminatory effect on interstate commerce.

In 1995, the CAD against SBT was amended to limit the deduction to assets located in Michigan by providing that taxpayers could utilize a site-specific CAD for the 1997 and 1998 tax years. Prior to this amendment, the CAD was available for assets without regard to their location. The taxpayer, a multistate business incorporated outside Michigan, challenged the site-specific aspect of the CAD in effect during the 1997 and 1998 tax years. The Michigan Court of Claims held that the site-based CAD burdened interstate commerce and thus violated the Commerce Clause in that both on its face and in its effect the provision operated in a discriminatory manner.

In reversing the Court of Claims, the Court of Appeals considered the third prong of the test established in *Complete Auto Transit, Inc.*, 430 U.S. 274 (1977), which specifies that, to be constitutionally valid under the Commerce Clause, a tax may not discriminate against interstate commerce. Under this prong, a state tax scheme is unconstitutional if it (1) is facially discriminatory against interstate commerce, (2) has a discriminatory effect, or (3) was enacted for a discriminatory purpose. The Court of Appeals determined that the site-specific CAD was facially neutral because it was available to all companies doing business in Michigan.

The Court of Appeals also decided that the site-specific CAD was not enacted for a discriminatory purpose. The CAD was available to all Michigan taxpayers who located new property in the state, whether intrastate or multistate businesses, and was available at the same apportioned rate that applied to the taxpayer's overall tax base. Finally, the CAD provision was not designed to punish multistate taxpayers who chose to not increase their Michigan presence nor was it responsible for any harmful effects suffered by multistate taxpayers who decided to increase activity outside Michigan. Accordingly, the site-specific CAD did not have a discriminatory effect on interstate commerce.

6. *PPG Industries, Inc., v. Commonwealth*, Pennsylvania Supreme Court, No. 87 MAP 1996, November 30, 2001.

The Pennsylvania Supreme Court ruled that the Pennsylvania capital stock and franchise tax was not a compensatory tax and, therefore, the manufacturing exemption for in-state manufacturing, processing, research, or development activities, in effect for tax years prior to 1999, was unconstitutionally discriminatory under the Commerce Clause of the U.S. Constitution. However, the unconstitutional exemption language was severable from the rest of the tax statute because the legislature originally enacted the statue without the exemption, and had previously repealed and reenacted the exemption.

The Court addressed what retrospective remedy was due to rectify the prior unconstitutional discrimination. The Court directed the state to either 1) refund to taxpayers who were discriminated against by the unlawful exemption the difference between the tax paid and the

tax that would have been assessed had they received the exemption; 2) assess and collect back taxes from those who benefited from the unlawful exemption, calibrating the retroactive assessment to create in hindsight a nondiscriminatory scheme; or 3) apply a combination of a partial refund and a partial retroactive assessment, so long as the resultant tax assessed during the contested period reflected a scheme that did not discriminate against interstate commerce.

7. Pennsylvania Department of Revenue PPG Remedy.

Beginning on July 1, the department will assess taxpayers with appeals pending for pre-1999 tax years that present manufacturing claims of additional tax in the amount of the manufacturing exemption previously allowed. Taxpayers who do not have appeals pending will not be so assessed, and taxpayers who before July 1 amend their appeals to delete any manufacturing claim will not be so assessed. The department will so assess taxpayers that take appeals on or after July 1 that include manufacturing claims. The department will settle tax reports for unsettled years before 1999 without the benefit of the manufacturing exemption, but will offer such taxpayers a compromise to permit the taxpayers to qualify for the manufacturing exemption that the Commonwealth would have allowed had it been constitutional if the taxpayer will waive any other manufacturing claim on appeal.

8. *AIA Services Corp., et al v. State Tax Commission*, Sup. Ct., No. 26029.

In AIA Services Corp., et al. v. State Tax Commission, Sup. Ct., No. 26029, the Idaho Supreme Court held that the taxpayer was not entitled to dividends received deductions for dividends received from its wholly-owned, unitary insurance subsidiary. The court first decided that because Universe Life and AIA Services, while unitary, do not have the same tax liability (i.e., Universe Life is required to pay premium taxes instead of income taxes), AIA Services was not required and cannot file a combined report with Universe Life. Then the court agreed with the district court that AIA Services clearly did not meet the requirements of former I.C. section 63- 3022(f) (dividends received deduction) because Universe Life did not pay more than 50% of its premium taxes to the state of Idaho. Thus, AIA Services was not entitled to a deduction for any amount of the dividends it received from Universe Life. The court declined to consider AIA Services' constitutional argument because it was first raised in AIA Services brief on its motion for reconsideration.

X. CREDITS AND INCENTIVES

A. California Manufacturing Investment Credit (MIC) - FTB Notice 2001-6, California Franchise Tax Board, Oct. 23,2001

If the California State Board of Equalization (SBE) examines a taxpayer's fixed assets in connection with a California sales and use tax audit for the same year in which the taxpayer claims a manufacturers' investment credit (MIC) against California corporation franchise (income) tax or personal income tax, and the taxpayer can establish that the assets upon which the MIC is claimed are included within the scope of the SBE audit, the Franchise Tax Board (FTB) will accept the audit determinations as proof that the taxpayer has satisfied the MIC requirement that sales or use tax be paid, directly or indirectly, on qualified assets.

B. *Ameritech Corp. v. Illinois Department of Revenue*, Cir. Ct of Cook County, Docket No. 00L50954, July 10, 2001

The Court affirmed the conclusions of the Director of the Department of Revenue who had adopted the recommended conclusion of the Administrative Law Judge.

The case involved the training expense credit (TEC) under the IITA.35 ILCS 5/201(j). The TEC allows taxpayer a credit equal to 1.6% of the amounts spent on training for Illinois employees. The first issue was whether the trainee wages paid to management employees, while they were receiving training qualify as training expenses. The Director determined that they did. The second issue was whether there was adequate documentation. Ameritech had provided documentation for one of its subsidiaries and extrapolated the percentages to two other subsidiaries. The Court refused to accept the presumption that one company's training expenses of management employees devoted to training could be extrapolated to two subsidiaries.

XI. <u>CONSOLIDATION</u>

1. Alabama

The Alabama Legislature enacted HB4 which substantially revises the consolidated return election available to members of an Alabama affiliate. Pursuant to the amendment, each member of the affiliated group must be subject to tax under the Alabama law and be members of a federal consolidated return. An election to file a consolidated is an irrevocable 10 year election.

2. Florida

A consolidated group was denied permission to file separate returns based on changes in the organizational structure of the group, including mergers, acquisitions, liquidations, dissolutions, and sales of subsidiaries, divisions and assets. TAA 01C1-005 (May 21, 2001).

3. Georgia

The Department of Revenue has proposed new Rule 560-7-3-.13 to permit multistate corporations to request permission to file a post-apportionment nexus consolidated filing for tax years beginning after January 1, 2002. Once permission is received the corporations would be required to continue filing consolidated returns except for limited circumstances. The proposed rule allows the Commissioner to eliminate one or more eligible corporations from the consolidated return if necessary to clearly and equitably reflect income attributable to Georgia. The proposed rule also provides that if any member of the group of corporations filing a Georgia consolidated return has interest expense or other deduction incurred in connection with the ownership of one or more corporations that are not included in the consolidated return, the Commissioner may as a condition of granting permission to file a consolidated Georgia return, require that such interest or deductions by excluded in calculating the Georgia income.

4. Indiana

Despite its unitary status, an Indiana subsidiary must file separate returns for years beginning after 1996. The Indiana Department of Revenue found that the group's business operations were not so integrated that separate returns would lead to a distortion of income. Ind. Dept of Rev., Letter of Findings, No. 98-0480, released 9/01.

5. Kentucky

In a September 2001 Kentucky Tax Alert, the Revenue Cabinet provided guidance on the election to file Kentucky consolidated corporation income tax returns. KRS 141.200(3) allows an affiliated group of corporations to elect to file a consolidated Kentucky corporation income tax return. KRS 141.200(1)(a) defines affiliated group to mean an affiliated group as defined in Section 1504(a) of the Internal Revenue Code and related regulations. The election to file a consolidated return is binding on both the affiliated group and the Revenue Cabinet for a period of eight years. Kentucky Administrative Regulation 103 KAR 16:200 provides the procedures to be followed in making the election. The common parent corporation on behalf of all members of the affiliated group must make the election. The election must be made on Form 722, Election to File Consolidated Kentucky Corporation Income Tax Return. The election form must be submitted to the Revenue Cabinet with a timely filed Form 720, Corporation Income and License Tax Return, for the first taxable year for which the election is made.

6. Missouri

Eddie Bauer, Inc., Missouri Supreme Court, No. SC83870, February 26, 2002.

Eddie Bauer, Inc., the parent corporation of an affiliated group of corporations was entitled to a refund of Missouri corporate income tax because the group's election to file amended consolidated returns for the tax years at issue was an appropriate remedy for the collection of an unlawful tax. Federal due process requires states to offer taxpayers procedural safeguards against unlawful extractions. The Missouri statute offers both pre-deprivation and post-deprivation remedies for purposes of contesting the validity of a tax. Eddie Bauer could not seek the pre-deprivation remedy because the company would have been subject to the risk of penalty. A pre-deprivation remedy which requires the taxpayer to pay tax under duress will not withstand constitutional muster.