BUSINESSES AND STATE REVENUE DEPARTMENTS: WHERE THE BATTLES ARE IN 2011

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I. FORCED COMBINED REPORTING

A. Generally

1. Combined reporting is a method taxpayers use to apportion their incomes to a state for corporate income tax purposes by reference to the combined tax attributes of the unitary entities.[1] Like other aspects of state taxation, the specific laws applicable to combined reporting vary from state to state. However, several principles of combined reporting are universal, such as the requirement of a unitary business and the aggregation of income and apportionment factors. A basic summary of combined reporting is as follows.

a. Combined reports only include members of a unitary group.[2]

b. Combined reports eliminate intercompany transactions that take place between members of the unitary group.[3]

c. Combined reports aggregate the unitary group members' income and losses.[4]

d. Combined reports aggregate the unitary group's apportionment factors and require a single apportionment calculation after eliminations and aggregations.[5]

e. Combined reports accompany the tax returns of those entities of the unitary group that have nexus with the state.

f. Entities filing returns using combined reports are normally not jointly liable for the unitary group's total tax liability; instead, they are only responsible for their own tax

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[1] See Richard D. Pomp, State & Local Taxation, Volume II (6th ed. 2009) at 10-42–43
[2] Id. at 10-43 (explaining that combined reporting states consider a group to be "unitary" if it is conducting business as if each entity were "divisions or branches of the parent corporation," despite the "formal corporate structure" of the group).
[3] Id.
[4] See John C. Healy & Michael S. Schadewald, 2010 Multistate Corporate Tax Guide (2009) at I-470.
[5] See Pomp, supra note 1, at 10-48.

liability. The fact that combined reporting states do not purport to assert jurisdiction over those members of a unitary group without nexus is crucial to its constitutional validity.[6]

2. Combined reporting is often confused by states and taxpayers alike with the concept of filing a consolidated return.[7] Many states allow, and some states require, corporate taxpayers that are members of a consolidated group to file a consolidated return. Although similar in that they both involve a multi-corporate group with a common ownership threshold, the two concepts are otherwise quite different.

a. Unlike combination, consolidation normally involves the separate apportionment of each entity prior to the netting of income and losses.[8]

b. Only entities having nexus with the taxing state can be required to be included on the consolidated return, and the unitary business concept is not relevant.[9]

c. Moreover, each filing member is jointly and severally liable for the group's entire liability.[10]

B. Forced combination

1. An increasing number of states require—rather than merely allow—taxpayers who are engaged in unitary businesses to apportion their income on a combined basis. Enforcing such "forced combined reporting" has been regarded as "[t]he most popular reform of the day," and thus presents itself as a potentially major issue for corporate taxpayers.[11]

2. Forced combination has become a popular reform among states because they generally perceive combined reporting as providing increased revenue with respect to unitary businesses over the alternative separate entity apportionment regime.[12]

a. Recently, as combined reporting proposals have been introduced in state legislatures, many state officials have concluded that forced combination "expand[s] their tax bases and

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[6] Allied-Signal v. Dir., Div. of Taxation, 504 U.S. 768 (1992) (upholding constitutionality of combined reporting generally).

[7] For example, North Carolina's putative forced combination statute authorizes the secretary of revenue to require taxpayers engaged in a unitary business to file a "consolidated return." N.C. Gen. Stat. § 105-130.6.

[8] Combination is sometimes loosely referred to as "pre-apportionment consolidation." Perhaps the best example of pre-apportionment consolidation is Florida's consolidation approach, which requires a single apportionment of an affiliated group with a predicate showing of a unitary relationship, something that would certainly be unconstitutional but for its elective nature. See Fla. Stat. § 220.131.

[9] See Pomp, supra note 1, at 10-43.

[10] See, e.g., Ohio Rev. Code Ann. § 5751.014 ("All members of a consolidated elected taxpayer or combined taxpayer group during the tax period or periods for which additional tax, penalty, or interest is owed are jointly and severally liable for such amounts.").

[11] Helen Lemmon et al., "Are You Prepared for the Feeding Frenzy? States are Starving for Revenue," J. of Multistate Taxation & Incentives 20, 22 (Feb. 2010).

[12] See Pomp, supra note 1, at 10-42. Under separate entity reporting, taxpayers use only their own income and apportionment factors to determine their tax liability, even if they would be considered a part of a unitary group in a combined reporting state. "Separate entity states treat related corporations as if they were unrelated strangers." Id.

increase[s] income tax revenues while keeping stable, or even reducing, income tax rates."[13] However, other reports have disputed that it will provide more revenue to states in every situation.[14]

b. Nonetheless, what is of more concern to taxpayers is the challenge forced combination presents to tax planning, in addition to the aggressive nature in which it is being carried out in some states.

3. Forced combination represents a challenge to state tax planning. Unlike in the consolidated return context, states that require taxpayers to report on a combined basis disregard corporate separateness in favor of the unitary business.[15] In other words, forced combination makes "the group's tax liability independent of business structure."[16]

a. Forced combination results in intercompany transactions being disregarded, even when taxpayers prove that such transactions take place at arms length and are not otherwise unfair, as was the case in the Wal-Mart Stores East, Inc. case discussed below. Under the federal consolidated return and many state consolidated return regimes, this is not the case.

b. Another planning mechanism addressed by forced combination is the intercompany use of an intangibles company, which is usually nullified under a combined reporting scheme.[17] Although separate company return states have mechanisms to reach the income of holding companies, such as disallowed deductions and economic nexus in cases of perceived abuse, a combined reporting state need not rely on these fact-based contentions. For example, on a combined report, the intercompany transactions are simply eliminated and the pre-apportioned third-party income of the out-of-state holding company, which is "often substantial," is added to the pre-apportioned income of the taxpayer.[18]

4. The statutory trend toward enacting forced combination statutes is undeniable. Since 2006, seven states have added combined reporting laws, bringing the total nationwide to 23, with more considering following suit in 2010.[19] However, the more disturbing trend for taxpayers is the fact that state revenue departments are aggressively seeking forced combination whenever they see it as beneficial, even without explicit statutory authority. Such aggressiveness is prompted by statutes granting vague but arguably broad discretion and a lack of clear rules circumscribing such discretion.

a. One recent, egregious example of a revenue department taking an aggressive stance against taxpayers and forcing combination is in the Wal-Mart Stores East, Inc. v.

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[13] Helen Lemmon et al., supra note 11, at 22 ("According to calculations that state executive and legislative branches have used to move combined reporting measures through the state legislatures, significant increases in revenues related to corporate income taxes are anticipated.").

[14] For example, the Tennessee comptroller of the treasury commissioned a study in 2009 in order to evaluate "how combined reporting affects state tax revenue." Michele Borens et al., "Combined Reporting: Amid all the Fuss There are No Clear Winners," State Tax Notes, Feb. 1, 2010, p. 347. All things considered, the report concluded that "combined reporting does not . . . produce more tax revenue." Id. See also Pomp, supra note 1, at 10-43 ("A combined report does not systematically lead to a higher or lower tax than would separate entity reporting.").

[15] See Healy & Schadewald, supra note 4, at I-470.

[16] Robert Cline, "Understanding the Revenue and Competitive Effects of Combined Reporting," State Tax Notes, June 23, 2008, p. 962.

[17] Pomp, supra note 1, at 10-48.

[18] Id.

[19] See Healy & Schadewald, supra note 4, at I-471 (noting that the states that have recently enacted combined reporting include Massachusetts, Michigan, Virginia, and Wisconsin).

Hinton decision.[20] There, the N.C. court of appeals upheld the North Carolina statute's discretionary, "we know it when we see it" approach to forcing combined reporting, as well as approved the revenue department's rather remarkable practice of cherrypicking which affiliates to require for inclusion in the combined report (as opposed to including all entities of the unitary business).

i. In the case, Wal-Mart Stores East (WMSE) operated every Wal-Mart retail store in North Carolina through an arrangement whereby it leased each store from an affiliate that qualified as a REIT. More specifically, Wal-Mart Real Estate Business Trust (WMREBT) held all of the group's freehold and leasehold estates and leased and subleased such interests to WMSE, which paid rent to WMREBT. As a REIT, WMREBT was able to reduce its net income to near zero by distributing such income as tax deductible dividends to its WMSE, its affiliate parent.

ii. WMSE filed its North Carolina corporate income tax returns on a separate basis, deducting the rent paid to WMREBT and allocating the dividends received from WMPC as non-business income to a state other than North Carolina. From its total state net income of $3,173,869,445, WMSE apportioned $79,237,782 to the state and paid $5,701,282 in taxes. WMREBT also filed North Carolina corporate income tax returns on a separate basis. It deducted its dividends paid to WMPC from its income. From a total income of $1,208,178,874, WMPC apportioned $10,845 and paid $786 in taxes.

iii. The North Carolina Department of Revenue relied on the state's limited forced combination statute to require WMSE and WMREBT to report on a combined basis, also assessing interest and penalties. The statute's pertinent clause stated that the secretary may force combined reporting if he or she "finds as a fact that a report by a corporation does not disclose the *true earnings* of the corporation on its business carried on in this State."[21] The department claimed that the secretary's discretion to force taxpayers to report income on a combined basis was confined only by this broad standard.

iv. The court of appeals agreed with the revenue department's interpretation of the statute. The taxpayers attempted to argue that the secretary's authority should apply only in situations where there were intercompany payments in excess of fair value.[22] This argument had an explicit basis in the statute. The court, however, rejected this argument. As a result, after this case it is difficult to ascertain whether there are any meaningful circumscriptions on the revenue department's authority to force combined reporting under North Carolina's statute.

v. Alternatively, the taxpayers argued that if the statute did not limit the secretary's discretion, then forced combination under it was unconstitutional. The court of appeals again disagreed. The court found that the "true earnings" standard was "sufficiently definite so that the Secretary may set policies within it without exercising a legislative function."[23] The court proceeded to reject the taxpayers remaining arguments, including that the statute allowed retroactive taxation, violated the uniform taxation clause and the commerce clause, and taxed income other than net income.

vi. To make matters worse for the taxpayers, the court of appeals upheld the revenue department's imposition of a 25% underreporting penalty. The court acknowledged that the 25% penalty had nothing to do with negligence, but rather, was tied solely to the degree of the

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[20] 676 S.E.2d 634 (N.C. Ct. App. 2009).
[21] N.C. Gen. Stat. § 105-130.6.
[22] Wal-Mart Stores East, Inc., 676 S.E.2d at 642.
[23] Id. at 649.

underreporting by taxpayers. Thus, even though the taxpayers had no clear standards by which to predict whether the revenue department might force them to report on a combined basis, they were still on the hook for steep penalties.[24] This sort of strict liability will surely have a chilling effect on other taxpayers in the state, prompting them to consider reporting on a combined basis even before the revenue department steps in and forces it.

vii. Finally, although it was not an issue on appeal, one of the more disturbing aspects of this case was the fact that the revenue department decided to pick and choose which entities of the taxpayers' unitary group it would require to be included in the combined report. Although this was not material to the outcome in Wal-Mart Stores East, Inc., the North Carolina DOR has been similarly cherrypicking other unitary businesses based on whether the selected entities will increase the amount of taxable income due the state from the taxpayers in question.

b. The N.C. Department of Revenue is also involved in the Delhaize America, Inc. v. Hinton case.[25] There, the taxpayer argued that the revenue department had a policy of withholding from taxpayers the criteria it used in exercising its discretionary authority when determining whether affiliated corporations will be forced to file a combined return.

i. The taxpayer alleged that this policy is unconstitutional in that it constitutes a "secret law" designed to increase taxes, interest, and penalties assessed against certain North Carolina taxpayers.

ii. Upon the parties' motions for summary judgment, the trial court reaffirmed the Wal-Mart Stores East, Inc.'s holding that the N.C. Department of Revenue had the "discretionary authority to force combination of entities on a finding that a report does not disclose true earnings in North Carolina."[26] The court stated that Wal-Mart Stores East, Inc. "foreclosed Delhaize's constitutional arguments that the Secretary violated the law by the arbitrary and capricious manner in which the Department forced a combination with [the affiliated holding company]; the Department's disparate treatment of similarly situated taxpayers when ordering the combination; and the violation of Federal Due Process rights with respect to the combination."[27]

iii. The court also held, however, that the commissioner abused his discretion in imposing the 25% penalty that was at issue in Wal-Mart Stores East, Inc. The court concluded that the penalty violated the N.C. constitution's power of taxation clause, as well as exceeded the commissioner's statutory authority as it existed at the time.

c. Another alarming development occurred in the Media General, Inc. v. South Carolina Dep't of Revenue case, decided by the Supreme Court of South Carolina in 2010.[28] Although the outcome of the case represents a victory for the taxpayers in question, it has single-handedly provided the South Carolina Department of Revenue with a means of forcing combined reporting.

i. In Media General, the taxpayers were Media General, Inc. and two of its subsidiaries, MG Communications and MG Broadcoasting, both Delaware corporations domiciled in Virginia. The taxpayers argued that the state's version of section 18 of UDITPA, which provides for alternative apportionment, should allow them to report to South Carolina on a combined

[24] Id. at 653.
[25] Dkt. No. 07-CVS-020801 (N.C. Sup. Ct., Wake Co. Jan. 12, 2011).
[26] Id. (quoting Wal-Mart Stores East, Inc., 676 S.E.2d at 649)).
[27] Id.
[28] 694 S.E.2d 525 (S.C. 2010).

basis. Section 18 of UDITPA as enacted in South Carolina provided that if the ordinary statutory allocation and apportionment provisions "do not fairly represent the extent of the taxpayer's business activity" in the state, "the taxpayer may petition for, or the department may require" alternative apportionment.[29] Under South Carolina law at the time, the ordinary statutory allocation and apportionment provisions only allowed separate entity returns, even for taxpayers engaged in a unitary business. For most taxpayers, this is an acceptable result. However, combined reporting would have netted the taxpayers in this case a tax *savings* of nearly three million dollars.

ii. The court agreed with the taxpayers, holding that South Carolina's adoption of section 18 of UDITPA allowed the taxpayers' to compute their tax on a combined reporting basis. According to the court, "the standard apportionment formulas allowed under South Carolina law result in a statutory distortion of [t]axpayers' incomes and that the combined entity apportionment method would fairly represent their business activities in South Carolina."[30]

iii. The court found that South Carolina's adoption of section 18 of UDITPA did not place any limitations on the type of alternative apportionment methods that could be used. Although the ultimate holding in this case was in favor of the taxpayers, the court further reasoned that "the Department is authorized to use the combined entity apportionment method," as well.[31] This decision thus arguably equipped the South Carolina Department of Revenue to force taxpayers to report on a combined basis if it could establish that the state's ordinary allocation and apportionment provisions "did not fairly represent" the extent of the taxpayer's business activity in the state.[32]

iv. Unlike in other states, where combined reporting is at least based on a statute (which may or may not have clear standards, as discovered in North Carolina), in South Carolina, there is nothing restricting the power of the revenue department to act other than the broad standard reflected in section 18 of UDITPA.

v. Therefore, the state revenue department may have lost the battle in Media General, since the taxpayers walked away with a lower tax obligation, but it clearly won the overall war—a tradeoff that many argue the department of revenue intended to achieve all along.

vi. The key for taxpayers is to prevent South Carolina from establishing that the state's ordinary allocation and apportionment provisions—i.e., the separate entity method—do not fairly represent the extent of the taxpayer's business activity in the state.

C. Summary

1. It is important to understand the distinction between combined reporting and consolidated returns. Although the two involve multi-corporate groups, combined reporting is a method of apportionment rather than a method of filing. Further, combined reporting implicates the income and apportionment factors of entities that lack nexus with the taxing state; consolidated returns do not.

2. Forced combined reporting represents an attack by states and revenue departments on tax planning. Combined reporting can render even substantive intercompany transactions ineffective.

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[29] S.C. Code Laws § 12-6-2320(A).
[30] Media General, 694 S.E.2d at 529.
[31] Id. at 532.
[32] Id. at 529; see also S.C. Code Laws § 12-6-2320(A).

3. As the Media General decision discussed above indicates, forced combined reporting itself is not necessarily the problem. In fact, in some situations, it could lead to a more favorable outcome for taxpayers that are engaged in unitary business.

4. Rather, the concern is over the broad discretion wielded by state revenue departments, which coupled with a lack of clear rules and regulations, leads to aggressive positions taken against taxpayers.

5. Further, state revenue departments are only interested in forcing combined reporting when it will increase the amount of taxes owed by the taxpayer.

II. AMAZON LAW/WEB NEXUS/NO-NEXUS INFORMATION REPORTING

A. Introduction

1. As discussed supra, the U.S. Supreme Court upheld a physical presence standard for sales/use taxes in Quill. Since then, many states have attempted to circumvent this standard by attributing acts of in-state agents to nonresidents. In several cases decided before Quill, the Supreme Court held that acts performed in a state by an agent that allow a nonresident to create or maintain a market in a state may be attributed to the nonresident. Scripto, Inc. v. Carson; Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue.[33]

2. In recent years, states have used "agency nexus" to assert sales/use tax filing obligations on internet companies that have "brick and mortar" affiliates in the state. In such case, the states argued that actions taken by the in-state affiliates allowed the internet seller to create and maintain a market in the state.[34]

B. Web nexus/Amazon tax

1. A more recent and aggressive twist on this theme is so-called "web nexus." This approach had its origin in a statute enacted by the State of New York in 2008, often colloquially referred to as the "Amazon tax."[35] Under the statute, a *rebuttable* presumption is created that a nonresident internet seller has nexus with New York for sales/use tax purposes if (i) the nonresident has agreements with in-state companies whereby potential customers are referred to the nonresident, and (ii) the nonresident's gross receipts from customers under such an agreement exceed $10,000 during the previous four quarters. The presumption may be rebutted by a showing by the nonresident that the agreements did not result in any actual solicitation of sales on the nonresident's behalf by the in-state affiliate.

2. The Amazon tax was challenged in New York's courts. Amazon.com and Overstock.com brought a declaratory judgment and injunctive relief action against the state Department of Taxation & Finance after New York, contending that the law was unconstitutional.

a. The Supreme Court, Appellate Division held that the law on its face comports with the dormant Commerce Clause physical presence nexus test articulated in National Bellas Hess and Quill Corp. v. North Dakota. Specifically, according to the court, the law: "[I]mposes a tax collection obligation on an out-of-state vendor only where the vendor enters into a business-referral agreement with a New York State resident, and only when that resident receives a commission based on a

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[33] 362 U.S. 207 (1960); 438 U.S. 232 (1987).
[34] See Borders Online, LLC v. State Bd. of Equalization, 29 Cal. Rptr.3d 176 (2006).
[35] N.Y. Tax Law § 1101(b)(8)(vi).

sale in New York. The statute does not target the out-of-state vendor's sales through agents who are not New York residents. Thus, the nexus requirement is satisfied."[36]

b. The court also held that the law on its face complies with due process

c. The court remanded, however, the as-applied Commerce Clause and Due Process Clause issues. The court stated that it was "unable to conclude as a matter of law that plaintiffs' instate representatives are engaged in sufficiently meaningful activity so as to implicate the State's taxing powers," and also that it was "unable to determine on this record whether the in-state representatives are engaged in activities which are 'significantly associated' with the out-of-state retailer's ability to do business in the state," citing Tyler Pipe.

3. Since then, several other states have adopted "web nexus," including Illinois,[37] Rhode Island,[38] North Carolina,[39] and Arkansas.[40] Several other states have introduced web nexus legislation that did not pass the session.

C. Colorado affiliate nexus presumption and information reporting

1. Colorado upped the bar even more by enacting a law creating a rebuttable presumption that a nonresident has sales/use tax nexus with the state merely by reason of being part of a federal affiliated group that includes a retailer with a taxable presence in Colorado.[41]

2. The presumption may be rebutted by a showing that the affiliate did not actually engage in any solicitation of sales on behalf of the nonresident. If a nonresident chooses not to collect sales tax, the nonresident is required to notify all Colorado purchasers that their purchases may be subject to use tax and to provide an annual report showing the amount of such tax that may be due, broken out by each purchase. The Colorado Department of Revenue may also require the nonresident to file an annual statement with the Department listing the taxable sales made by each purchaser in the state.[42]

3. In response, Amazon.com informed all of its affiliates in Colorado that it was terminating its service agreements. Further, Colorado has been sued by the Direct Marketing Association in federal court. The DMA alleges that the law imposes discriminatory rules on out-of-state retailers, invades the privacy rights of residents, and exposes confidential consumer data. It also claims that the law harms retailers by taking away valuable proprietary consumer information without due process or fair compensation and imposes a significant administrative burden on businesses. On January 26, the district court granted DMA's preliminary injunction against the state.[43]

4. Since then, additional states have enacted information reporting laws, including Oklahoma[44] and South Dakota.[45]

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[36] Amazon.com LLC v. New York State Dep't of Taxation & Finance, 2010 N.Y. App. Div. LEXIS 7943 (1st Dept. Nov. 4, 2010)
[37] H.B. 3659 (2011).
[38] R.I. Gen. Laws § 44-15-15.
[39] N.C. Gen. Stat. § 105-164.8.
[40] S.B. 738 (2011).
[41] Col. Rev. Stat. § 39-26-102(3)(b)(II).
[42] Id. § 39-21-112(3.5).
[43] Direct Marketing Ass'n v. Colo. Dep't of Revenue, Dkt. No. 10-cv-01546-REB-CBS (D. Colo Jan. 26, 2011).
[44] H.B. 2359 (2010).
[45] S.B. 146, 147 (2011).

III. INTEREST/ROYALTIES ADD-BACK STATUTE[46]

A. Background

1. Since the vast majority of separate-company states have now enacted interest and intangibles (e.g., royalties) expense disallowance legislation, commonly called "add-back" statutes, the scope of the add-backs and the statutory exceptions to those provisions have become more varied. Although those statutes have some common themes, the specific expenses required to be added back (i.e., disallowed) and the exceptions contained in any state's statute are a unique combination of those themes.

2. State add-back statutes generally cover intangible expenses and interest payments to related parties. Some states have separate provisions that cover interest expenses which are unrelated to intangibles. Further, a couple of states include management fees, factoring transactions and/or intercompany rental transactions in the scope of their add-back statute.

3. The presence of statutory exceptions to the various state interest and intangible expense add-back provisions is a tacit recognition that those add-back provisions are blunt instruments of state tax policy. Under those add-back provisions, all interest or intangible expenses paid to a related member (as specially defined) are added back, regardless of whether the transactions that generated those expenses are legitimate, arm's-length, related-member transactions. The statutory exceptions are the states' attempts to cure the intrinsic overreach of the add-back provisions.

4. The exceptions to the add-back provisions identify specific transactions with related members that are considered legitimate and then exclude the expenses generated as a result of those transactions from the amounts required to be added back to the taxpayer's taxable income. States generally use the same characteristics to identify legitimate related member transactions. Those characteristics include whether: (a) the related member is subject to tax in another jurisdiction; (b) the related member acts as a conduit in paying the interest or intangible expenses to an unrelated third-party; (c) the related member transaction has a valid non-tax business purpose; (d) the related member transaction is at an arm's-length consideration; and (e) where the taxpayer enters into a written agreement with the taxing authority. Many states have also enacted a catch-all exception for cases where the add-back otherwise would be "unreasonable."

B. Constitutionality of add-back statute upheld by Alabama Supreme Court

1. The U.S. Supreme Court recently denied the petition for a writ of certiorari filed by VFJ Ventures, Inc. ("VFJ"), thereby allowing the Alabama Supreme Court's controversial decision in Ex parte VFJ Ventures, Inc[47] to stand. That decision affirmed and adopted in its entirety the opinion of the Court of Civil Appeals that Alabama's intangibles and interest expense add-back statute did not violate the Commerce and Due Process Clauses of the U.S. Constitution.

2. The taxpayer's first argument was that the add-back statute is effectively an attempt to tax the out-of-state intangibles management companies that do not have nexus with Alabama, in violation of the Commerce Clause. The intermediate appellate court held, however, that the add-back statute merely denies a deduction to the in-state taxpayer, again siding with the Department of Revenue

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[46] This portion of the outline was adapted from a paper presented at the annual ABA/IPT Advanced Income Tax Seminar, "Add-Back Statutes: The Construction of Exemptions, the Disappointing Decision in VFJ Ventures, Other Pending Litigation and Similarly Annoying Issues," March 22, 2010, presented by Christopher R. Grissom and David J. Shipley.

[47] 8 So. 3d 983 (Ala. 2008), cert. denied, 129 S. Ct. 2051 (2009).

and its amici—the powerful Alabama Education Association and the Multistate Tax Commission. The intermediate appeals court similarly rejected the taxpayer's argument that the add-back statute is not fairly apportioned and lacks external consistency. According to the Court, the record did not show that the add-back statute resulted in taxing income fairly attributable to other states. It also concluded that the add-back statute is not facially discriminatory, nor does it benefit in-state corporations disproportionately or to the detriment of out-of-state taxpayers. These conclusions were affirmed by the Alabama Supreme Court. It should be noted, however, that neither court addressed the taxpayer's arguments concerning the disparate treatment applied to intangibles holding companies or finance companies that pay income tax in combined or consolidated reporting states (which would not meet the "subject-to-tax" exception) as opposed to separate reporting states.

3. The denial of certiorari by the U.S. Supreme Court is a tremendous disappointment for many taxpayers and trade associations who had hoped that the strong support of several very prominent amici, including the state of Delaware, would convince the Supreme Court to grant VFJ's petition and issue a definitive ruling on the constitutionality of these statutes. In addition, the Council On State Taxation ("COST"), the National Association of Manufacturers, the Tax Executives Institute, the Institute for Professionals in Taxation, and the U.S. Chamber of Commerce filed amicus briefs in support of VFJ's petition.

C. Recent legislative developments

1. Oregon. Effective for tax years beginning on or after January 1, 2010, taxpayers are required to add back deductions for intangible expenses "[t]hat have been received by one or more related members that are not included in the same [Oregon income] tax return as the taxpayer" and directly or indirectly paid, accrued or incurred in connection with transactions between related members.[48] Prior to the passage of this law, the Oregon DOR disallowed deductions for certain intercompany transactions by regulation.[49] Oregon's new add-back statue expands the scope of the regulation. Both the statute and regulation are unusual in that Oregon is a combined reporting state and almost all of the other states discussed herein are separate reporting states. Most combined reporting states see no need for such a rule because the transactions would likely be eliminated in consolidation. In addition to the definitional exception that applies if the taxpayer and the related member recipient are included in the same Oregon combined return, the following add-back exceptions are available:

a. *Subject to Oregon Tax*. A taxpayer is allowed a credit if the related member is subject to Oregon income tax on the transaction giving rise to the add-back; the credit is equal to the greater of (a) tax paid by the related member as a result of the subject transaction or (b) tax that would have been paid by the related member as a result of the subject transaction had it not been reduced by other expenses, losses or credits; the credit is then multiplied by the taxpayer's apportionment factor and may not exceed the amount of the taxpayer's liability created by the add-back statute.

b. *Payment to Unrelated Third Party*. There is also an exception for any portion of the intangible expense that the related member directly or indirectly paid to a person that is not a related member, provided the transaction has a valid business purpose (apart from the tax consequences).

2. District of Columbia. While originally only applying to royalties when enacted in 2004, the 2009 Budget Support Act expanded D.C.'s add-back statute to apply to both royalties and interest expenses, effective for all tax periods beginning after December 31, 2008.[50] However, if the

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[48] S.B. 181, 75th Leg. Assem., Reg. Sess. (Or. 2009).
[49] Or. Admin. Rule 150-314.295.
[50] D.C. Code Ann. § 47-1803.03(d).

subject transaction did not have a principal purpose the avoidance of tax and was paid pursuant to an arm's length contract and rate, the statute provides for exceptions to any portion of the expense when:

a. *Payments to Unrelated Third Parties*. The related member during the same taxable year directly or indirectly paid, accrued, or incurred the amount of the obligation to or from a person or entity that is not a related member.

b. *Subject to Tax*. The related member receiving the royalty or interest payments is subject to a tax measured by its net income or receipts in a state or possession of the U.S., or a foreign nation that has entered into a tax treaty with the U.S., imposing an aggregate effective tax rate of at least 4.5% on the amounts received by the related member; provided, that a related member receiving the royalty or interest payment shall not be considered to be subject to a tax merely by virtue of the related member's inclusion in a combined or consolidated return in one or more states.

D. Recent administrative developments

1. Georgia. The Georgia Department of Revenue has promulgated Regulation 560-7-3-.05 to provide guidance on the statutory provisions requiring add-backs of interest/intangible expenses and costs paid to related members. The regulation provides examples of when a cost or expense is deemed indirect and when the Commissioner has authority to reverse an add-back by entering into a written agreement with the taxpayer. Additionally, the regulation addresses exceptions to the add-back provision including when income is allocated or apportioned by other states, when expenses are paid, accrued, or incurred to related members domiciled in foreign nations, and when expenses are paid, accrued, or incurred to a related member who then pays, accrues, or incurs expenses to a non-related member. The regulation was adopted June 8, 2009 and is effective June 28, 2009

2. Tennessee. Tennessee technically requires an add-back of related party intangible expenses.[51] However, if the taxpayer discloses such intangible expenses on the face of the franchise and excise tax return, such transaction is exempt from add-back.[52] The Tennessee Department of Revenue has indicated that, depending on the facts and circumstances, the Department may require add-back of intangible expenses notwithstanding the above disclosure if they determine the transaction lacks a true business purpose. The authors are aware of approximately 60 assessments issued by the department in December 2009 alleging that add-back was required due to lack of business purpose.

3. Indiana. The Indiana Department of Revenue determined that certain interest and royalty payments paid by a restaurant chain franchisor to related members resulted in deductions that did not fairly reflect the franchisor's income derived from Indiana sources. "In effect, Taxpayer's royalty payments reflect payments for intellectual property which it once owned but which it transferred in a three-step transaction . . . . The Department is prepared to agree that Taxpayer's business structure is more than an empty business shell created simply as an imaginative—if overly complex—business structure. However the Department is unable to attach the same economic substance to the royalty payments and underlying interest payments as Taxpayer does."[53] The Department concluded that the Taxpayer failed to overcome its burden that the proposed assessment was wrong and that add-back was "narrowly tailored" in order to fairly reflect Indiana source income. The Department did sustain the franchisor's request to abate the 10% negligence penalty.

[51] Tenn. Code Ann. § 67-4-2006(b)(1)(K).
[52] Id. at § 67-4-2006(b)(2)(N).
[53] Tenn. Letter of Findings No. 09-0446, Jan. 27, 2010.

4. Virginia. The Virginia Department of Revenue denied the requested refund claim and held that the Taxpayer's intangible expenses did not qualify for the "third party revenue" exception that applies when a related member derives at least one-third of its intangible revenues from unrelated parties and the related party transactions were made on similar terms.[54] The Taxpayer operated and franchised restaurants throughout the United States and abroad. In 2001, the Taxpayer formed a wholly owned subsidiary ("IHC") for the purpose of holding its intangible property. The Taxpayer entered into a licensing agreement with IHC and paid royalties equal to 3% of its gross sales to IHC.

a. The Taxpayer's franchisees, who were unrelated third parties, also entered into licensing agreements with IHC for the use of trademarks and trade names. However, the franchisees paid royalties equal to 4% of their gross sales to the Taxpayer, who retained 1% of the franchisee royalties and remitted the remaining 3% to IHC. The Taxpayer argued that all of its royalty payments to IHC were exempt under the third party revenue exception because IHC derived approximately 70% of its gross revenues during the periods in question from the indirect royalties paid by the unrelated franchisees and IHC received the same royalty rate from the franchisee and Taxpayer-operated restaurants.

b. The Department agreed that if the franchisees were in fact licensed through IHC, the royalty expenses indirectly received by IHC would be from unrelated parties. However, the Department determined that under the franchise agreement, the franchisees' were licensing the intellectual property from the Taxpayer, not IHC, because the Taxpayer had the right to license and the right to control IHC's trademarks. The Department held that "[b]ecause the trademarks were licensed to the franchisees by the Taxpayer, IHC did not receive the trademark licensing revenue from the unrelated franchisees. Instead, all the revenues generated by IHC were received from the Taxpayer. Accordingly, the Taxpayer does not meet" third party revenue exception.

c. Alternatively, the Department noted that if the exception did apply to the Taxpayer, it would invoke its power under Virginia Code § 58.1-466 and combine IHC with the Taxpayer for purposes of properly reflecting the Taxpayer's income and activities in Virginia.[55]

d. In a separate public document ruling, the Department held that only the "portion" of intangible expenses included in the related member's post-apportionment taxable income qualified for Virginia's subject-to-tax exception.[56] The Department also noted that, in the alternative, if the Taxpayer qualified for the exception with respect to 100% of the added back royalty expense, the Department may invoke its power under Virginia Code § 58.1-466 to either combine the related entities or disallow a deduction for amounts paid to a related member.[57]

i. The Taxpayer also argued that the Virginia add-back statute violates the Due Process and Commerce Clauses of the U.S. Constitution. The Department rejected these arguments, but only addressed the apportionment and discrimination prongs of the Complete Auto test. The Department concluded the add-back statute was fairly apportioned because the amount added back was apportioned twice: first, in computing the subject-to-tax exception; and second, when apportioning and allocating the Taxpayer's income to Virginia.

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[54] Va. Public Document Ruling No. 09-14, Feb. 4, 2009.
[55] See P.D. 96-310 (Oct. 31, 1996).
[56] Va. Public Document Ruling No. 09-49, Apr. 27, 2009.
[57] The Department reached the same two conclusions in Virginia Public Document Rulings No. 09-96, June 11, 2009, and No. 09-115, July 31, 2009.

ii. The Department concluded the add-back statute was internally consistent and thus did not discriminate against interstate commerce, because "[t]he add-back statute only requires the taxpayer to add-back royalties deducted to the extent that the affiliate's income from those royalties it is not apportioned to another taxing jurisdiction."[58] The Department did not address the substantial nexus prong in the ruling.

E. Recent judicial developments

1. New Jersey. The New Jersey Tax Court held that two software corporations were not required to add back income earned outside the United States to their net incomes for state corporation tax purposes. The relevant statute, N.J. Stat. Ann. section 54:10A-4(k), couples a corporation's entire net income to its federal taxable income. Because "federal law excluded extraterritorial income from federal taxable income during the period at issue," and because "there was no exception to the federal statute in New Jersey law," the court concluded that the "Director, Division of Taxation, therefore, acted outside his statutory authority when he issued final determinations including in plaintiffs' entire net income for CBT purposes the extraterritorial income they excluded on federal tax returns."[59]

IV. FEDERAL ANTI-ABUSE DOCTRINES

A. Background

1. Five common-law tax doctrines have been developed at the federal level that are "used to deny taxpayers of a desired tax result, most notably with respect to abusive tax shelters."[60] These anti-abuse doctrines are: (1) economic substance, (2) business purpose, (3) sham transaction, (4) substance over form, and (5) step transaction.

2. States are becoming increasingly aggressive in their application of these doctrines to "undo the state tax benefits of business transactions." Not only are more states adopting these doctrines, but they are also applying them in the context of more types of state taxes.

3. Compounding the problem of this increased aggressiveness for taxpayers is the lack of uniformity in states' adoption and application of these doctrines, particularly with respect to non-income taxes. Applying these doctrines "has become another area where states have created inconsistencies among themselves," and some states have even "been guilty of inconsistent application within their own jurisprudence."[61] As a result, taxpayers are left with "unclear guidance regarding exactly how these doctrines are to be analyzed."

4. The remainder of this section addresses recent developments in three of the more prevalent anti-abuse doctrines as applied by states: economic substance, substance over form, and step transaction.[62]

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[58] Id.
[59] Int'l Bus. Machines Corp. v. Dir., Div. of Taxation, Dkt. No. 011795-2009 (Tax. Ct. N.J. Jan. 26, 2011).
[60] Jeffrey C. Glickman & Clark R. Calhoun, "The 'States' of the Federal Common Law Tax Doctrines," The Tax Lawyer, Vol. 61, No. 4, at 1183 (2008).
[61] Id. at 1182.
[62] Internal Revenue Service Chief Counsel Donald L. Korb has identified the "sham transaction and economic substance doctrines as 'different ways of describing the same thing.'" Id. at 1192. Further, "[t]he substance over form and step transaction doctrines are not based on the lack of economic substance and are applied using tests that are different from the test applied under the sham transaction and economic substance doctrines." Id. Finally,

B. Economic substance

1. The basic premise of the economic substance doctrine as it existed at common law was that "a court may deny the tax benefit achieved by a business transaction where the transaction itself lacks any economic benefit without regard to the tax benefits."[63]

2. Although bills have been proposed in each Congress since 1999, economic substance was finally passed into law by Congress in the 2010 session. It was enacted as part of the Health Care and Education Reconciliation Act of 2010.[64]

a. Under the Act, the economic substance doctrine will apply to transactions entered into after March 31, 2010.

b. The Act establishes a conjunctive test for economic substance. In order for a transaction to satisfy the test, the taxpayer must show (i) that the transaction changes in a meaningful way the taxpayer's economic position, apart from federal income tax effects, and (ii) that the taxpayer has a substantial purpose for entering into such transaction, apart from federal income tax effects.

c. Significantly, the Act provides that any state or local income tax effect related to a federal income tax effect shall be treated in the same manner as a federal income tax effect. Traditionally, for federal income tax purposes, "the saving of state and local taxes was a valid business purpose for entering into various transactions."[65] As such, the economic substance doctrine could impact the validity of a state tax planning mechanism for federal income tax purposes.

3. An increasing number of states have also adopted or applied economic substance by statute or regulation.

a. These statutes or regulations commonly provide revenue departments the authority to adjust taxpayers' income "when a business arrangement or organizational scheme does not properly reflect income."[66]

i. For example, Wisconsin recently enacted an economic substance statute. For tax years beginning on January 1, 2009, "if any person, directly or indirectly, engages in a transaction or series of transactions without economic substance to create a loss or to reduce taxable income or to increase credits allowed in determining Wisconsin tax, the department shall determine the amount of a taxpayer's taxable income or tax so as to reflect what would have been the taxpayer's taxable income or tax if not for the transaction or transactions without economic substance causing the reduction in taxable income or tax."[67] The statute incorporates the two-prong test to economic substance as established in the federal common law.

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business purpose is generally one of the two prongs of economic substance tests. Id. at 1189. Accordingly, we chose to focus on the stated doctrines.

[63] Id. at 1183.

[64] Pub. L. No. 111-152 § 1409; I.R.C. § 7701(o).

[65] Giles Sutton et al., "The State Implications of the Codification of Economic Substance," State Tax Notes, July 12, 2010, p. 87.

[66] Glickman & Calhoun, supra note 53, at 1193.

[67] Wis. Stat. § 71.10(1m).

ii. By regulation, Connecticut provides that for purposes of determining "whether an arrangement under which related companies may operate results in the improper or inaccurate reflection of the activity, business, income, or capital of the companies," the commissioner shall consider whether "the separate business of the companies have economic substance because a reasonable possibility of obtaining a profit exists, apart from achieving tax benefits."[68]

b. The legislative approach taken by California with respect to economic substance is unique in that it is punitive in nature.

i. California has enacted state tax shelter legislation that imposes additional penalties for understatements of income that are "attributable to transactions that lack economic substance."[69]

ii. More specifically, California applies an additional forty percent penalty to an understatement concerning a noneconomic substance transaction, which is defined as "the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance."[70]

iii. The statute clarifies that "[a] transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into" it.[71]

4. Additionally, states are increasingly applying the economic substance doctrine to business transactions through judicial and administrative rulings.

a. The Massachusetts Appellate Tax Board has recently concluded that cash management transactions entered into by a taxpayer and its affiliates were not subject to the royalty payment expense deduction. The board held that the transactions lacked economic substance based on the: "circular flow of funds surrounding the transfer and license back arrangement; the absence of third party license agreements negotiated by [a subsidiary]; unexplained inconsistent treatment of the Patents and the Trademarks; and specific acknowledgement of significant tax savings attendant to the 1996 reorganization."[72]

b. Further, as of 2008, the New York Department of Revenue and Taxation has expressly incorporated economic substance principles into its combined reporting guidelines.

i. New York's combined reporting guidelines require taxpayers that are business corporations to file on a combined basis with related corporations for franchise tax purposes "if there are substantial intercorporate transactions among the related corporations."[73]

ii. The department has provided that "[i]n determining whether the substantial intercorporate transactions requirement has been met, the Tax Department will consider the materiality of the transactions and whether the transactions have economic substance, including the extent

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[68] Conn. Agencies Regs. § 12-226a-1(c)(2).
[69] Glickman & Calhoun, supra note 53, at 1193.
[70] Cal. Rev. & Tax Code § 19774(a), (c)(2).
[71] Id.
[72] Kimberly-Clark Corp. v. Comm'r of Revenue, Dkt. Nos. C282754, C295077, C299008 (Mass. App. Tax Bd. Jan. 31, 2011).
[73] N.Y. Tax Law § 211.4(a)

to which the motivation of the taxpayer in undertaking the transaction was to affect the membership of the combined group."[74]

c. Recent rulings have applied economic substance (and other anti-abuse doctrines) to taxes other than income taxes, such as sales and use taxes, property taxes, and real estate transfer taxes.

i. For example, a 2009 Texas Policy Letter Ruling concluded that the state comptroller may invoke the economic substance doctrine to deny a claim for a sales tax exemption.[75]

ii. The facts in the letter pertained to an aircraft transaction, whereby a broker sold an aircraft outside of Texas to X, an individual. X, who does not hold a sales tax permit and does not make sales of tangible personal property, sold the aircraft to Y, who also does not have a Texas sales tax permit. Y subsequently brought the aircraft into Texas and hangars it there, claiming an occasional sale exemption.

iii. The letter reasoned that "[t]he series of transactions may meet the literal requirements for the occasional sale exemption" under Texas law, but nonetheless "may be disregarded under the economic substance doctrine if the transactions are nothing more than a vehicle for tax avoidance, with no business purpose, substantial economic effect or economic risk separate and apart from the avoidance of sales or use tax."[76]

C. **<u>Substance over form</u>**

1. Essentially, the premise underlying the substance over form doctrine is that "the tax results of a particular transaction should be evaluated based on the substance of what took place rather than the formal steps the taxpayer took to achieve a particular result."[77]

2. States and the federal government alike have applied the doctrine to counteract the possibility that two different transactions could be taxed differently, if they achieve the same economic result for the taxpayers.

3. Numerous examples of substance over form as applied to state taxes have involved determining whether transfers of ownership have occurred and the validity of sale-leaseback transactions.[78] Like in the case of economic substance, these examples can be found in statutes, regulations, administrative rulings, and judicial decisions.

a. South Carolina, for example, provides a statutory example of substance over form being applied in the context of determining whether a transfer of ownership has occurred for property tax purposes. Under the statute, the revenue department is authorized to "examine the substance, rather than merely the form of the transfer," and it may "use the step transaction, economic reality . . . and

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[74] N.Y. Dep't of Rev. & Tax., TSB-M-08(2)C, March 3, 2008.
[75] Tex. Pol'y Letter Ruling No. 200908387L (2009).
[76] <u>Id.</u>
[77] Jeffrey C. Glickman & Clark R. Calhoun, "The 'States' of the Federal Common Law Tax Doctrines," The Tax Lawyer, Vol. 61, No. 4, at 1185 (2008).
[78] <u>Id.</u>

other judicially developed doctrines in determining whether the requisite assessable transfer of interest has occurred."[79]

b. States have also applied substance over form for purposes of determining whether a sale-leaseback transaction is really a nontaxable financing arrangement.

i. For example, an Alabama revenue ruling has declared that "it is the Department's position that the substance over form controls in determining whether certain property is subject to ad valorem tax."[80]

ii. In the ruling, the revenue department concluded that although the taxpayer, who was the lessor, was the legal owner of the property, the lessee should be treated as the owner for property tax purposes, because "it will be in possession of the property, bear all costs of taxes, maintenance, repair and insurance, bear all risk of loss, and enjoy the benefits of ownership of the property."[81]

D. Step transaction

1. Although the step transaction doctrine has been "generally viewed as a subset or extension of the broader substance over form doctrine," it has been applied frequently by states, particularly in the contexts of sales and use taxes, property taxes, and real estate transfer taxes.[82]

2. A concise explanation of the step transaction doctrine comes from the U.S. Tax Court. Basically, the step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[83] In other words, states may apply the doctrine "in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C," if the sole purpose of the intermediate stops at points B and C was to achieve more favorable tax treatment.[84]

3. It is important to note that "courts have upheld or recognized as valid the application of the [step transaction] doctrine even in cases where the steps have economic substance and the taxpayer has provided valid non-tax business reasons for them."[85]

4. Recently, the California Board of Equalization applied the step transaction doctrine against a taxpayer in a corporate franchise tax assessment, which had the effect of reducing the taxpayer's basis in the stock of a sold subsidiary by $490 million.[86]

a. After agreeing to sell its subsidiary to a third party, the taxpayer in the hearing engaged in a series of transactions with the subsidiary and affiliates that increased the taxpayer's basis in the subsidiary by $490 million.

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[79] S.C. Code Laws § 12-37-3160(A).
[80] Ala. Rev. Ruling 03-002 (2003).
[81] Id.
[82] Glickman & Calhoun, supra note 69, at 1186.
[83] Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).
[84] Smith v. Comm'r, 78 T.C. 350, 389 (1982).
[85] Glickman & Calhoun, supra note 69, at 1188.
[86] In the Matter of Novartis Vaccines and Diagnostics, Inc., Dkt. No. 397618 (Cal. Bd. of Equal. 2009).

b. The board applied the step transaction doctrine and concluded that "the asserted $490 million increase in basis should not be respected for tax purposes."[87] The series of transactions failed both the "interdependence test" and the "end result test" under the doctrine.[88]

i. According to the board, "the steps at issue had business purposes that were irrelevant in light of the end result" since the taxpayer had already agreed to sell the subsidiary to the purchase before entering into the transactions in question.[89]

ii. Further, the board found that the steps did not reflect "the type of business activity we would expect to see in a bona fide, arm's length business deal between unrelated parties" and did not make sense "standing alone without contemplation of the subsequent steps in the transaction."[90]

5. However, fortunately for taxpayers, states have not always been successful in persuading courts or administrative judges that they should adopt the step transaction doctrine sua sponte.

a. In Department of Revenue v. "Puffnstuff, Inc.", for example, the Illinois department of revenue urged the administrative law judge to apply the doctrine to view two sales by the taxpayer as one for purposes of determining business and non-business income.[91]

i. The sales in question were as follows. In 1992, the taxpayer transferred all of the assets of its minerals division (all located outside Illinois), along with the stock of its wholly-owned subsidiaries engaged in that division to a wholly-owned subsidiary. That same year, the taxpayer's board of directors voted to spin off the subsidiary by selling 60% of its shares in an IPO. The taxpayer then sold the remaining minority interest in the subsidiary in 1993. As a result, the taxpayer claimed its sale in 1993 was non-business income which was allocable outside of Illinois.[92]

ii. The administrative law judge declined to adopt the department's application of step transaction, reasoning that the department's argument "ignores the fact that the two transactions that the Department seeks to treat as a single event were not components of a single transaction."[93] The judge concluded that neither test for step transaction would be adopted in the case.

b. Thus, although it is a possibility, taxpayers should not assume that the revenue department will prevail in actions against them based on the step transaction doctrine (and other doctrines), especially if the revenue department is not relying on any statutory enactment of the doctrine in question, but rather, is persuading the court or administrative body to adopt it.

E. Conclusion

1. Although they have their origins in federal tax common law, the anti-abuse doctrines are becoming increasingly popular options for state legislatures and revenue departments to apply to business transactions that have state tax benefits.

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[87] Id.
[88] Id.
[89] Id.
[90] Id.
[91] Dkt. No. IT 01-18 (Ill. Decisions in Dep't of Rev. Hearings 2001).
[92] Id.
[93] Id.

2. Making things more difficult for taxpayers is the fact that states are not uniform in their application of the doctrines, and some states apply the doctrines without statutory or regulatory guidance

3. When confronted with a lack of guidance, revenue departments frequently attempt to persuade courts or administrative judges to adopt one or more of the doctrines sua sponte. Although such adoption is a possibility, revenue departments are not always successful in doing so.

4. Thus, it is crucial taxpayers to be prepared to argue against the application of these doctrines in the course of disputes with state revenue departments, especially in states that have not yet enacted some form of the doctrines by statute or regulation.

V. IN TERROREM TAX AMNESTIES

A. Tax amnesties generally

1. Tax amnesties are periodic programs sponsored by state and local revenue departments that incentivize taxpayers to come forward voluntarily and pay outstanding tax liabilities. They have become increasingly popular ways for state and local governments to generate income in an economic climate in which state budget deficits are increasing while state revenues are decreasing.[94]

a. To participate in an amnesty program, taxpayers must admit that they owe taxes that they have not yet paid or that they owe more taxes than previously reported, and pay those outstanding taxes. Taxpayers must usually pay the interest associated with the outstanding liability, as well.

b. In return, the sponsoring state or local revenue department usually agrees to waive or reduce penalties that the taxpayer would normally face for such under-reporting or non-reporting of the tax in question. Additionally, some amnesty programs even reduce or eliminate the interest owed by a taxpayer.[95]

c. Further, and possibly more important for taxpayers, governments sometimes agree not to pursue criminal prosecution for participating taxpayers.[96]

2. There are three main functions of tax amnesty programs: generating revenue, adding new taxpayers to the tax rolls, and encouraging compliance.[97]

a. The primary incentive for the sponsoring government entity is the influx of revenue that these amnesty programs provide. State and local amnesty programs have increasingly been massive sources of income for taxing jurisdictions that are desperately in need of money. Some have even exceeded the program's initial projections.[98] Although a sponsoring government gives up the

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[94] Karen Setze, "More States Considering Tax Amnesties," State Tax Notes, Oct. 16, 2009, p. 155.

[95] LeAnn Luna et al., "State Tax Amnesties: Forgiveness is Divine—and Possibly Profitable," State Tax Notes, Aug. 21, 2006, p. 497.

[96] Id. See also Fl. Laws Ch. 2010-166 (establishing a tax amnesty program in Florida in 2010 that relieves participating taxpayers of criminal liability and penalties and also reduces interest owed).

[97] Parker Sinclair, "The Case Against Tax Amnesties," State Tax Notes, June 21, 2010, p. 953.

[98] Cara Griffith, "The Pros and Cons of Tax Amnesty," State Tax Notes, May 17, 2010, p. 531 (reporting that New Jersey collected $725 million during a six-week amnesty program, which was over three times greater than initial projections).

opportunity to get additional amounts in the form of penalties and sometimes interest from taxpayers, it is getting the opportunity to collect tax dollars that it may never have reached but for the program in return, which is arguably an even exchange.

b. Second, tax amnesty programs allow revenue departments to identify and keep track of participating taxpayers that, until the amnesty program, had yet to pay taxes to that particular jurisdiction.[99] By doing so, the revenue department will be able to add hundreds if not thousands of new names to the state or local tax rolls, which serves to enhance future collection efforts.[100]

c. Further, state and local revenue departments use amnesties to "improve compliance rates overall . . . by encouraging those who are not in compliance to come forward voluntarily in hopes that coming into current compliance will results in continued future compliance with state tax laws."[101] Amnesties, therefore, have an eye to the future as well as the present.

3. The IRS has also sponsored tax amnesties for federal tax obligations, although such amnesties are usually for a particular purpose. For example, in 2009, the IRS initiated a program for the disclosure of income from offshore bank accounts.[102]

a. State and local tax amnesties are typically broader and more general than the IRS's. They do not usually target a specific type of tax obligation, but rather, apply to any taxes owed to a state or local government.[103]

b. Some states, however, are beginning to mimic the IRS and initiate amnesties for a particular purpose. Minnesota (along with many others) initiated a program for disclosing offshore accounts in 2010 that operates in conjunction with the IRS's program.[104]

c. Further, some states exclude certain types of taxes from the scope of their amnesty programs. The current trend, however, is for state and local governments to include all types of taxes in the program.[105]

4. Amnesties have become popular and "politically palatable" means of generating revenue for states, because they allow state officials to collect tax dollars without having to actually raise taxes or enact new taxes by statute.[106] The efforts of the programs result in the collection of taxes that are already owed by taxpayers under existing laws and regulations. Thus, they present a win-win situation for legislators wary of the unpopular stigma associated with taxes.

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[99] Id.
[100] Id. (noting that revenue departments strive to keep these participating taxpayers on the tax roll in order to enhance future receipts).
[101] Sinclair, supra note 89, at 953 (quoting Brandee A. Tilman, "Federal and State Constitutional Challenges to State Tax Amnesty Programs," 11 State & Local Tax Law. 61, 62 (2006)).
[102] IRS.gov, "Voluntary Disclosure: Questions and Answers," Sept. 21, 2009, http://www.irs.gov/newsroom/article/0,,id=210027,00.html.
[103] See Pa. Stat. Ann. sec. 9901-F (defining "eligible tax" as "[a]ny tax administered by the department of revenue").
[104] Minn. Revenue, "Minn. Offshore Voluntary Disclosure Program Notice," available at http://www.taxes.state.mn.us/corporatefranchise/other_supporting_content/offshore%20voluntary%20disclosure%20notice.pdf.
[105] See Kendall L. Houghton & Maryann H. Luongo, "State Tax Amnesty Programs: Smaller Carrots, Bigger Sticks," State Tax Notes, Jan. 18, 2010, p. 213 (noting that New Jersey excluded local property taxes, realty transfer fees, and payroll taxes from its 2009 amnesty program).
[106] Sinclair, supra note 89, at 953.

B. In terrorem amnesties

1. Despite the positive benefits that amnesty programs can offer to both revenue departments and taxpayers, a recent trend has been for governments to attach severe penalties at the back end of these programs in order to encourage—or force—taxpayers to participate.

a. Thus, a revenue department will sponsor an amnesty program but announce to taxpayers that if they do not participate, they will face additional civil and/or criminal penalties if the department later determines that the taxpayer could have participated but chose not to.

b. These additional penalties have been referred to politely as the "amnesty penalty."[107]

2. Taxpayers may have legitimate reasons for not participating in an amnesty program, even in light of the benefits that it provides.

a. For example, a taxpayer could dispute that it owed the tax in question, either based on an argument that the tax is unconstitutional, or that the taxpayer lacks nexus with the particular state or local jurisdiction.

b. However, with an amnesty penalty in place, many taxpayers may be dissuaded from challenging a state or local government's authority to tax it.

c. Further, many more taxpayers may be assessed additional penalties on top of existing taxes, interest, and standard civil penalties.

C. Examples of in terrorem amnesties

1. **California**. The California Franchise Tax Board administered a corporate franchise tax amnesty program in 2005. The program allowed taxpayers to pay taxes and interest for tax years 2002 and prior in exchange for the waiver of penalties and criminal prosecution.[108]

a. This amnesty program introduced a staggering amnesty penalty. It was imposed at the rate of 50% of the existing unpaid interest amount on years for which the taxpayer could have applied for amnesty but did not.[109] The amnesty penalty applied to tax obligations that became due during the amnesty program, as well as to those that became final after the amnesty program had concluded.[110] Further, the amnesty penalty held taxpayers strictly liable—there is no requirement that the failure to participate in the amnesty program be a result of recklessness or even negligence on the part of the taxpayer.

b. The amnesty program statute also increased the applicable accuracy penalty for taxpayers that did not participate in the amnesty. For all taxpayers, California imposed an accuracy penalty of 20% for negligence or disregard of rules or regulations, any substantial understatement of income tax, and other reasons. The law implementing the amnesty program, however, increased this penalty to 40% for new assessments of non-participating taxpayers.[111]

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[107] Houghton & Luongo, supra note 97, at 215.
[108] Cal. Rev. & Tax. Code §§ 19731-19732.
[109] Id. § 19777.5(a)(1).
[110] Id. § 19777.5(a)(2).
[111] Id. § 19164(a)(1)(B)(i).

2. **Oregon**. In 2009, Oregon instituted a tax amnesty program for taxpayers that owed personal income, corporate income, corporate excise, and self-employment taxes in any open tax year. By participating, taxpayers are eligible to receive a waiver of penalties and 50% of interest due.[112]

a. This amnesty program had a 25% amnesty penalty attached to it for both participants and non-participants in the amnesty program.

i. Like in California, if a taxpayer failed to file a return and failed to apply for the amnesty, "[f]or any tax that was due for a tax year for which amnesty could be sought," the state added 25% off the unpaid tax amount to the taxpayer's outstanding tax liability.[113]

ii. Additionally, if the Department of Revenue issued an assessment for an under-payment or non-payment of taxes as shown on a tax return filed in conjunction with the amnesty program following the close of the amnesty period, "an amount equal to 25% of the total amount of unpaid tax that is otherwise due will be added to the amount of outstanding tax liability."[114]

b. Unlike in California, the penalty here was measured by the amount of the *tax* owed rather than the amount of *interest* owed on that tax. As such, Oregon's amnesty program penalty was arguably more punitive.

3. **New Jersey**. New Jersey's Division of Taxation instituted a tax amnesty program in 2009 for all taxes due on or after February 2002 and before February 2009. Taxpayers could receive amnesty for any eligible tax that the division was required to collect. In exchange for paying the taxes owed, taxpayers would receive a penalty waiver and would have their interest reduced by half.[115]

a. This amnesty program had an independent amnesty penalty also, but at only "5% on the outstanding tax amount due."[116]

b. Although New Jersey's amnesty penalty is more reasonable in comparison to California and Oregon, it still could be a significant enough threat for some taxpayers so as to force—rather than encourage—them to participate in the state's amnesty program.

D. <u>Summary</u>

1. Tax amnesty programs can be beneficial to taxpayers, especially those with clear outstanding tax liabilities and those facing stiff civil penalties (and possibly criminal prosecution) if identified.

2. Tax amnesty programs can also be beneficial to state and local governments, as they can provide a much-needed influx of tax dollars for increasingly revenue-starved governments.

3. However, taxpayers should be aware that these so-called optional programs may be decidedly mandatory based on the existence of "amnesty penalties," which can be significant.

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[112] L. 2009 S880, § 3.
[113] Id. § 4.
[114] Id.
[115] N.J. Admin. Code 18:39-1.1, -1.2.
[116] N.J. Div. of Tax., "2009 Tax Amnesty FAQ for Special Situations and Tax Practitioners," April 17, 2009.

VI. ALTERNATIVE APPORTIONMENT/UDITPA SECTION 18 CHALLENGES

A. Introduction

1. The Uniform Division of Income for Tax Purposes Act (UDITPA) was promulgated in 1957 by the National Conferences of Commissioners on Uniform State Laws in order to bring uniformity to the amount the states can impose when taxing multistate corporate income. In creating its role, UDITPA sought to avoid the application of an arbitrary or unreasonable apportionment formula.

2. Per UDITPA § 18, if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, *or the tax administrator may require*: (A) separate accounting; (B) the exclusion of any one or more of the factors; (C) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (D) the employment of any other method to effectuate an equitable allocation and allocation and apportionment of the taxpayer's income. The Multistate Tax Commission ("MTC") issued regulations interpreting UDITPA § 18 stating that UDITPA § 18 is designed to serve as an exception. It should only apply in limited factual situations when deviation from the standard formula is necessary to fairly reflect the taxpayer's activities in the state.

B. Carmax Auto (South Carolina)

1. South Carolina courts have had two recent rulings interpreting the South Carolina Department of Revenue's alternative apportionment authority under S.C. Code § 12-6-2320. In Carmax Auto v. South Carolina Department of Revenue, the court upheld the Department forcing Carmax to bifurcate how it apportioned its income to South Carolina.[117] The taxpayer in question was an East-West company that, in addition to engaging in retail sales of cars, engaged in intercompany royalty and financing activities. The Department successfully argued that the standard apportionment formula did not fairly reflect the taxpayer's income attributable to the state. Accordingly, the Court required the taxpayer to "bifurcate" its apportionment. Income from retail sales was apportioned per the standard provisions but licensing and royalty receipts were apportioned using a single factor sales approach with market sourcing.

2. The Court rejected the taxpayer's argument that the unitary business principle required that all of the taxpayer's income from a unitary business be included in apportionable income. The Court also rejected the taxpayer's arguments that licensing receipts should be sourced based on cost of performance and that the bifurcation violated the external consistency test of the "fair apportionment" requirement of the Commerce Clause.

C. Media General (South Carolina)

1. In Media General Communications, Inc., et al. v. South Carolina Department of Revenue, the South Carolina Supreme Court held that the Department of Revenue may permit or require a unitary group of corporations to use combined reporting under the state's alternative apportionment provisions when necessary to fairly reflect income attributable to the state.[118]

D. Bellsouth (Tennessee)

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[117] Docket No. 09-ALJ-17-0160-CC (April 22, 2010).
[118] Opinion No. 26828 (June 14, 2010).

1. In Bellsouth Advertising & Publishing Corp. v. Chumley, the Tennessee Court of Appeals upheld a forced alternative apportionment provision.[119] The taxpayer in that case was based in Georgia but published yellow pages in Tennessee. The taxpayer did not have any property or employees in Tennessee. The state employs the standard UDITPA "majority cost of performance" sourcing methodology for receipts from other than the sale of tangible personal property. Based on this sourcing methodology, the taxpayer did not have any apportionment factors in Tennessee.

2. On assessment, the Department forced the taxpayer to use market sourcing of its receipts under Tennessee's alternative apportionment provisions in order to more fairly reflect the taxpayer's income in the state. The taxpayer argued that the "safety valve" function of UDITPA § 18 was only intended to apply to unusual fact circumstances, and there was nothing unusual about the taxpayer's circumstances. In other words, the taxpayer argued that the "all of nothing" approach of the majority cost of performance method was by design, not an unusual circumstance calling for alternative measures. Accordingly, it was improper to allow alternative apportionment. Amazingly, the court rejected this argument.

3. The court has arguably opened the floodgates for refund claims by taxpayers with the opposite set of facts (i.e., taxpayers engaged in service or intangible property industries that are based in Tennessee). Such taxpayers may now arguably seek refund claims to the extent that the majority cost of performance method of sourcing receipts resulted in their sourcing an unfair amount of their receipts to Tennessee.

VII. EXPANSION OF BUSINESS ACTIVITY TAX BASE

State income taxes have been criticized by some state tax policy makers for factors including (i) loss of control over the state tax base by adoption of federal taxable income as the starting point for state taxable income, (ii) ability to reduce taxable income through tax planning, (iii) complexity in the income tax code, (iv) revenue instability in the face of economic downturns, exacerbated by net operating loss carryback and carry forward provisions, (v) applicability of P.L. 86-272 to taxes based on net income, (vi) non-taxation of flow-through entities and resulting loss of income distributed to nonresidents, and (vii) income sourced "nowhere" as a result of majority cost of performance receipt sourcing . As a result, certain states have recently adopted broad-based "replacement" taxes that are effectively market-sourced gross receipts taxes. These taxes have been touted as being "flatter," "simpler" and more stable in terms of annual revenues.

A. Ohio Commercial Activity Tax

1. Ohio enacted its commercial activity tax ("CAT") effective July 1, 2005. The CAT is an annual privilege tax based on gross receipts. The tax applies to almost every business activity (excluding insurance companies, utilities, and financial institutions) and every type of business entity or sole proprietorship. Certain receipts are not subject to the CAT, including interest income, dividends, capital gains, wages reported on a W-2, or gifts. Ohio effectively uses a market sourcing method to determine Ohio gross receipts. Consolidated return filing is an election.

B. Texas Gross Margin Tax

1. Effective for tax years beginning on or after January 1, 2008, Texas effectively replaced its franchise tax based on the higher of a net income or net worth base with a gross margin tax.

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[119] No. M2008-0129-COA-R3-CV (Tenn. Ct. App. 2009).

2. **Base**. The tax is based on one of several alternative tax bases: (1) total revenues minus cost of goods sold, (2) total revenues minus compensation, or (3) 70% of total revenues with no deductions.

3. **Choice of Entity**. The tax applies to all types of business entities other than sole proprietorships, general partnerships comprised of natural persons, REMICS and REITS, certain unincorporated "passive entities," and certain grantor trusts and estates of natural persons.

4. **Apportionment**. Texas has adopted mandatory unitary combined reporting. The tax is largely apportioned as before (single sales factor) except throw-back of receipts has been repealed.

5. **Tax Rate**. The rate is 1% for most taxable entities and 0.5% for companies primarily engaged in retail and wholesale trades.

6. **Applicability of P.L. 86-272**. Per the Texas Comptroller, P.L. 86-272 does not apply to the gross margin tax.[120] However, this position is likely subject to challenge.

C. Michigan Business Tax

1. The Michigan Business Tax ("MBT") replaced the Michigan Single Business Tax ("SBT") effective January 1, 2008. The MBT is comprised of a tax on net income and a modified gross receipts tax. The starting point for the net income tax is federal taxable income. The modified gross receipts tax is imposed on gross receipts less purchases from other firms. Michigan has adopted mandatory unitary combined reporting for the MBT.

VIII. EXCHANGE OF INFORMATION AGREEMENTS

A. As the IRS and states constantly look for new ways to enforce tax laws and increase revenue collections, agreements to exchange information are becoming increasingly common between the IRS and states, between different states, and between states and local tax jurisdictions. Examples of state information exchange agreements include (1) the MTC, currently comprising over 20 members, (2) regional state tax administration groups like SEATA, NESTOA, etc., and (3) the Streamlined Sales & Use Tax Agreement compact members.

B. In addition to sharing tax information to increase compliance, these organizations may share information related to voluntary disclosure agreements and multijurisdictional sales tax exemption certificates.

IX. STATE USE OF FEDERAL UNCERTAIN TAX POSITION REPORTING

A. On January 26, 2010, the IRS issued Announcement 2010-9, which proposed a new disclosure regime under which large business taxpayers would be required to report uncertain tax positions on their income tax returns. In April of 2010, the IRS promulgated a specific form for such disclosures and instructions. The form requires the taxpayer to list (i) a statement for the rationale behind uncertain tax positions, (ii) a statement of the reasons why a tax position is uncertain, and (iii) a quantification of the maximum adjustment associated with the position.

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[120] 34 TAC § 3.586.

B. This latest development comes on the heel of the adoption of Sarbanes-Oxley, FIN 48, and the initiation of reportable transaction penalty regimes by the IRS and certain states. This is yet another step in the direction of linking financial accounting principles with income tax reporting. This trend raises troubling questions over whether such reported information will become a "roadmap" for state auditors and whether states will adopt similar reporting requirements (like some states adopted Circular 232 and federal reportable transaction concepts).

X. EXPANSION OF SALES & USE TAXES

A. Generally

1. Every state but five—Delaware, New Hampshire, Montana, Oregon, and Alaska—imposes some form of a state-wide sales and use tax. The states that do impose sales and use taxes are highly dependent on them, as they represent "the second largest single source of state tax revenue, behind the individual income tax."[121]

2. Traditionally, states imposed sales and use taxes on the sale and use of tangible personal property only.[122] However, as states become increasingly starved for revenue, more and more kinds of retail sales and services are being subjected to sales and use taxes by states, including repair services, digital goods, software, and items regarded as "sinful" or unhealthy, such as cigarettes, alcohol, candy, carbonated beverages, and even marijuana.

B. Services

1. Most service transactions remain untaxed by the states. More specifically, "a majority of states apply their sales tax to less than one-third of 168 potentially taxable services."[123] Further, five states impose sales taxes on twenty or fewer categories of services.[124]

2. Lately, though, "[s]tates are . . . considering expanding their sales and use tax bases to incorporate service transactions (e.g., accounting and other professional services, advertising, information services) that historically had not been subject to tax."[125]

a. **Maine**. One recent example of this expansion came from Maine. In 2009, the Maine legislature passed, and the governor signed into law, LD 1495, which was "perceived widely as the most significant tax reform in Maine of the last 40 years."[126]

i. Although the bill reduced the state's income tax rate from 8.5 percent to 6.5 percent, it expanded the state's sales tax to apply to numerous services, including amusement and entertainment services, repair services, dry-cleaning services, house-cleaning services, pet services, transportation and courier services, and long-distance telephone services, among others.[127]

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121 John L. Mikesell, "State Sales Taxes in the Great Recession," State Tax Notes, July 19, 2010, p. 145.
122 Susan S. Jones & Marilyn A. Wethekam, "Sales and Use Taxes: Retail Sales Issues," in Tax Management Multistate Tax Portfolios (BNA 2003) at 1360:0101.
123 Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," State Tax Notes, Aug. 24, 2009, p. 517.
124 Id.
125 Helen Lemmon et al., "Are You Prepared for the Feeding Frenzy? States are Starving for Revenue," J. of Multistate Taxation & Incentives 20, 24 (Feb. 2010).
126 Frank Shafroth, "Tax Reform Down East," State Tax Notes, July 19, 2010, p. 179.
127 Id.

ii. The law, however, was repealed by voters in a "people's veto" in June of 2010, and therefore the changes did not go into effect.

b. Michigan. Michigan's governor also made the expansion of sales tax to services a top priority in 2010, proposing to lower the state's sales and use tax rate a half a percentage point while expanding the tax base to include consumer services.[128] The legislature never seriously considered the proposal and the governor later admitted that she was abandoning it.

c. Despite the lack of success of these particular reforms, they illustrate the general principle that state officials are becoming increasingly willing to eschew the political stigma associated with raising taxes for sake of balancing state budgets and avoiding cuts in state services.

3. New York. A final example of expanding sales and use taxes to services comes from New York, where the state's Division of Taxation and Finance has been "aggressively target[ing] service providers, particularly digital service providers, trying to tax them as furnishing information services."[129] As a result, the state has been taxing "a number of services that have long been exempt when delivered through traditional means but are now recast as information services simply because they are being provided electronically."[130]

a. The traditional test utilized by the division to determine whether a service qualified as a taxable information service is the "primary function" test, which is a factual, two-part determination.[131]

b. On July 19, 2010, the Division of Taxation and Finance issued an advisory memorandum clarifying the taxability of information services. The memorandum stated that specified services would be considered taxable as an information service, if the particular service was its primary function. Included on the list were "Internet-based data and Web search services," "newsletter subscriptions," "online telephone or address directory services," "credit monitoring services," "consumer product reports," "patent search services," "public records furnished by a private entity," "real property information databases," "reporting services that compile news stories," and "sports statistics or athletic performance reports."[132]

c. Effectively, then, the division is concluding "without further analysis of the primary function of the service itself, that a transaction composed of a particular activity is automatically deemed an information service."[133]

d. Thus, in New York, the revenue department is taking an aggressive stance regarding the taxability of information services despite the existence of a clearly established test.

C. Digital goods

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[128] John Buhl, "Michigan Governor Proposes Sales Tax on Services, MBT Surcharge Repeal," State Tax Notes, Feb. 22, 2010, p. 524.
[129] Michael W. McLoughlin & A. Sonali Carlson, "New York Issues Questionable Guidance on Taxation of Information Services," State Tax Notes, Aug. 2, 2010, p. 323.
[130] Id.
[131] N.Y. Div. of Tax. & Fin., TSB-M-10(7)S, July 19, 2010. Under the test, for a service to be taxable as an information service under New York law (i) the customer must be furnished information, and (ii) the information is "personal or individual in nature and cannot be incorporated into reports furnished to others." McLoughlin & Carlson, supra note 121, at 323.
[132] TSB-M-10(7)S, supra note 123.
[133] McLoughlin & Carlson, supra note 121, at 325.

1. A common trend among states recently has been to expand their sales and use tax laws by enacting statutes that explicitly subject digital goods to tax. In fact, fifteen states have done just this since 2008. These states are Indiana, Kentucky, Louisiana, Mississippi, Nebraska, New Jersey, North Carolina, North Dakota, South Dakota, Tennessee, Utah, Vermont, Washington, Wisconsin, and Wyoming. As can be expected, these state provisions vary in both scope and definitions, with some applying to more types of digital goods than others.

a. Kentucky, for example, enacted a broad and encompassing digital goods sales tax statute in 2009. Kentucky's statute imposes sales tax on the retail sale of all "digital property," which is defined to include the following, if delivered electronically: "digital audio works," "digital books," "finished artwork," "digital photographs," periodicals, newspapers, magazines, "video greeting cards," "audio greeting cards," video games, electronic games, and "any digital code related to this property."[134]

b. Similarly (but less specifically), South Dakota applies its sales tax to all "products transferred electronically."[135]

c. Other states have more restrictive definitions of digital goods, such as Indiana. Under an Indiana statute enacted in 2008, "specified digital products" are subject to sales and use tax and include digital audio-visual works, digital audio works, and digital books, if transferred electronically.[136]

2. A few other states have not yet passed statutes specifically providing for the taxation of digital goods, but they have applied their sales and use tax laws to the electronic delivery of certain goods by administrative ruling or regulation.

a. Recently, the Colorado Department of Revenue has held that the sale of downloaded documents is taxable, because such documents are considered "tangible personal property."[137] The department defined tangible personal property as "corporeal property." Since "[e]lectronic data is corporeal property," the letter concluded that sales tax applied to the sale of such data.[138]

b. By regulation, Louisiana defines tangible personal property as "personal property that can be seen, weighed, measured, felt, touched, or is perceptible to the senses."[139] The regulation further specifies that "on demand" audio and video downloads, as well as "electronic files," are included in this definition.[140]

c. Additionally, in 2006, an Alabama administrative law judge addressed the issue of whether the sale of digitized photographs delivered electronically was subject to the state's sales tax. The ALJ admitted that treating these goods as "a taxable sale of tangible personal property pushes the bounds of what has traditionally been viewed as the sale of tangible goods."[141] Despite this

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134 Ky. Rev. Stat. Ann. §§ 139.010, 139.200.
135 S.D. Cod. Laws § 10-45-2.4.
136 Ind. Code §§ 6-2.5-4-16.4, -1-26.5.
137 Colo. Gen. Info. Letter No. GIL-09-25 (2009).
138 Id.
139 La. Admin. Code § 61:I.4301(C).
140 Id.
141 Robert Smith v. Alabama Dep't of Revenue, Dkt. No. S. 05-1240 (Admin. L. Div. 2006).

reservation and the fact that Alabama's laws were silent as to the treatment of digital goods, he ultimately concluded that these photographs should be subject to sales tax, as there was "no principled reason why the retail sale of goods that can now be delivered electronically due to advances in technology, i.e., software, photographs, music, movies, books, etc., should be taxed any differently than the sale of those goods delivered by traditional means."[142]

3. Note that a few states have declared that the sale of digital goods is *not* subject to state sales and use tax. New York, for example, has separately stated that: the sale of alphanumeric code providing that right to download audio files is not taxable[143]; the sale of a video delivered electronically over the Internet is not taxable[144]; and the sale of a photograph delivered electronically is not taxable.[145]

4. Finally, in June 2010, federal legislation was introduced in Congress addressing state taxation of digital goods. Among other things, the legislation would prohibit multiple or discriminatory taxes on digital goods and services and allow tax to be imposed only by the jurisdiction or jurisdictions encompassing the customer's address.[146]

D. <u>Software</u>

1. Expanding or applying sales and use tax laws to software represents an even bigger trend for states than does doing so for digital goods.

2. However, there is significant variation among states with respect to software depending on whether the software is custom or prewritten, and depending on how the software is delivered to the end customer.

a. For instance, as of August 2010, every state with a state-wide sales and use tax imposes that tax on the sale of prewritten (or "canned") computer software delivered in a tangible medium.

i. A handful of these states exempt the sale of prewritten software if delivered electronically or via a "load and leave" transaction.

ii. Arkansas, for example, excludes from its definition of computer software "software that is delivered electronically or by load and leave."[147] Load and leave is defined as "delivery to the purchaser by use of a tangible storage media in which the tangible storage media is not physically transferred to the purchaser."[148]

iii. New Jersey also exempts the sale of prewritten software delivered electronically from sales and use tax, as long as "the software is to be used directly and exclusively in the conduct of the purchaser's business, trade, or occupation."[149] Note that this exemption does not apply when the software is delivered via load and leave, unlike in Arkansas.

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[142] <u>Id.</u>
[143] N.Y. Div. of Tax. & Fin., TSB-A-07(14)S (2007).
[144] N.Y. Div. of Tax. & Fin., TSB-A-08(22)S (2008).
[145] N.Y. Div. of Tax. & Fin., TSB-A-09(56)S (2009).
[146] Digital Goods and Services Tax Fairness Act of 2010, H.R. 5649, 111th Cong. §§ 3, 4 (2010)
[147] Ark. Code Ann. § 26-52-304(a)(1)(B)(ii)(b).
[148] <u>Id.</u> § 26-52-304(a)(1)(B)(v).
[149] N.J. Div. of Tax. Tech. Bulletin No. TB-51R (2007).

iv. Other states that generally exempt electronically delivered prewritten software include California, Florida, Georgia, Iowa, Maryland, Missouri, Nevada, Oklahoma, Rhode Island, South Carolina, Virginia, and Vermont.

b. On the other hand, a majority of states do not apply their sales tax laws to "custom" computer software. California, which does not tax custom software, defines it as "a computer program prepared to the special order of the customer and includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer."[150] Only the District of Columbia, Hawaii, Mississippi, Nebraska, New Mexico, South Carolina, South Dakota, Tennessee, Texas, and West Virginia tax such software.[151]

E. "Sin taxes"

1. As state revenue collections dwindled throughout 2009, 2010, and the first part of 2011, many states attempted to expand their taxing efforts by either (i) increasing the rate of sales and use taxes, or (ii) imposing those taxes on an increasing number of goods. Enacting so-called "sin taxes" emerged as a trend during this period, as state legislatures decided it was politically palatable to impose sales and use or excise taxes on goods considered to be unhealthy, such as cigarettes, candy, and soda.

2. Numerous states expanded their cigarette taxes during 2009, 2010, and 2011.

a. Among the more drastic increases in cigarette tax rates include Delaware (from $1.15 per pack of twenty to $1.60),[152] Hawaii (from $2.60 per pack to $3.20 by July 1, 2011),[153] Mississippi (from $0.18 per pack to $0.68),[154] New York (from $2.75 per pack to $4.35, making it the highest in the nation),[155] South Carolina (from $0.07 per pack, the lowest in the nation, to $0.50 per pack),[156] and Washington (from $2.025 per pack to $3.025).[157]

b. Further, states such as Pennsylvania expanded their definition of "cigarette" to include other previously untaxed goods, such as "unstampable little cigars."[158]

3. In 2010, the state of Washington enacted a few uncommon sin taxes when it extended the state's sales and use tax to candy and bottled war and passed a separate carbonated beverage tax.

a. Washington Senate Bill 6143 was signed into law on April 23, 2010. Among other things, the bill modified the existing sales and use tax exemptions for "food and food ingredients" by providing that candy and bottled water were taxable until July 1, 2013. After July 1, 2013, candy remains subject to sales and use tax.

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[150] Cal. Rev. & Tax Code § 6010.9(d).
[151] South Carolina exempts custom software if delivered electronically. See S.C. Rev. Ruling No. 05-13 (2005);
[152] Del. H.B. 211, 2009 sess.
[153] Lowell L. Kalapa, "Hawaii Governor Approves Cigarette Tax Increase," State Tax Today, June 1, 2010, available at 2010 STT 104-19.
[154] Miss. H.B. 364, 2009 sess.
[155] Nicola M. White, "New York Governor Approves Highest Cigarette Tax in Nation," State Tax Today, June 23, 2010, available at 2010 STT 120-28.
[156] Victoria Johnson, "South Carolina Lawmakers Override Veto; Cigarette Tax Increase Now Law," State Tax Today, May 14, 2010, available at 2010 STT 93-28.
[157] "Washington DOR Announces Increases in Business and Occupation, Cigarette Taxes," State Tax Today, April 20, 2010, available at 2010 STT 80-26.
[158] Pa. Dep't of Revenue, "Cigarette Tax Bulletin 09-21," Dec. 24, 2009.

b. That bill also created a new, temporary "carbonated beverage" tax, which is imposed on all nonalcoholic carbonated beverages at the rate of $0.02 per twelve ounces of beverage. This is in addition to sales and use taxes that are already assessed against "soft drinks."[159]

c. Notably, these Washington measures were repealed by referendum in November 2010.[160]

4. Additionally, although alcohol excise and sales taxes have historically existed, states are increasing the rate of them and expanding their application in a similar approach to cigarette taxes.

a. Recently, Kentucky enacted legislation subjecting the sale of alcohol to the state's six percent sales and use tax.[161] Previously, tax was imposed only on sales of alcohol by the drink. This sales tax on alcohol is in addition to the existing wholesale tax on packaged alcohol of eleven percent.

b. Similar increases were considered but ultimately not acted upon in Maryland, North Carolina, and Indiana during the last two years.

5. Finally, in one of the more controversial pieces of sin tax legislation in 2010, the Colorado legislature passed a bill to both regulate and tax the sale of medical marijuana at retail.[162] Although the state legalized medical marijuana in 2000 by constitutional amendment, the legislature had not yet passed the implementing legislation. HB 1284 provides such legislation. It also extends the state's 2.9 percent sales tax rate to sales of medical marijuana, thus codifying "a potentially lucrative new revenue stream for the state."[163]

F. Summary

1. As states become more desperate for revenue in the midst of poor economic conditions, the trend of expanded sales and use taxes should continue.

2. Increasing sales and use taxes, especially on products such as cigarettes, is deemed by many to be a more politically palatable way of raising revenue than raising state income tax rates.

3. Thus, taxpayers that are retailers of goods and services should take note of these rapidly evolving additions to state sales and use tax laws so as not to fail to collect and remit the incorrect amount (or any amount at all).

XI. QUI TAM, RICO, AND CLASS ACTION SUITS

A. Qui tam suits

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[159] Wash. Rev. Code § 82.12.0293(2).
[160] Wash. Init. 1107 (2011).
[161] Charlie White, "Kentucky Governor Approves Tobacco, Alcohol Tax Increase," State Tax Today, Feb. 18, 2009, available at 2009 STT 30-28.
[162] Joe Hanel, "Colorado Lawmakers Approve Regulating, Taxing Medical Marijuana Sales," State Tax Today, May 13, 2010, available at 2010 STT 92-10.
[163] Id.

1. The federal government has created two statutory mechanisms by which private citizens may sue to enforce laws on behalf of the government: the Tax Relief and Health Care Act and the False Claims Act.

a. In 2006, Congress passed the Tax Relief and Health Care Act of 2006 (the "TRHCA"). This act amended the Internal Revenue Code to enable private citizens to blow the whistle on federal tax fraud in exchange for receiving a mandatory monetary award.[164] Previously, private citizens could bring blow the whistle tax fraud and receive such awards, but "the Treasury Secretary had complete discretion as to whether awards would be paid, and if so, in what amount."[165] The TRHCA requires, however, the IRS to ultimately decide whether to take action on the alleged tax fraud. Thus, "[n]othing in the TRHCA provides for a *qui tam* action or lawsuit, i.e., a whistleblower's private right to prosecute fraud on his or her own."[166]

b. The federal False Claims Act (the "FCA") is similar in that it enables private citizens to blow the whistle on government fraud. Under the FCA, plaintiffs can bring qui tam actions without the consent or cooperation of the government, unlike under the TRHCA.[167] Successful plaintiffs are entitled to monetary awards of between ten and thirty percent of the amount recovered by the government in the action. However, by its terms, the FCA "does not allow cases based on tax fraud," unlike the TRHCA.[168]

2. Currently, a majority of states either have enacted no version of the federal FCA, or have enacted an FCA allowing qui tam actions but explicitly preserving the federal act's exclusion for suits alleging tax fraud.[169]

3. However, six states—Delaware, Florida, Illinois, Indiana, Nevada, and Rhode Island—have enacted FCAs that do not expressly exclude qui tam actions regarding tax, or at the most, exclude only income tax actions.[170] Thus, in these states, FCAs have provided "a mechanism that allows private individuals to bring an action in court for tax fraud."[171]

4. Each of these state statutes allows private whistleblowers to receive a portion of the recovery in the action, which can vary depending on whether the state decides to intervene and prosecute the case itself. The amount of statutory recoveries range from fifteen to thirty percent, with some variation.[172]

5. Recent judicial decisions from Nevada and Illinois have confirmed the applicability of their particular FCAs to cases involving state tax fraud.

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[164] I.R.C. § 7623(b).
[165] John A. Bruegger, "Tax Whistleblower Proceedings at the State Level: Common Themes and a Call to Action," J. of Multistate Tax. & Incentives, Vol. 19, No. 2 (2009).
[166] Id.
[167] Id.
[168] Id. See also 31 U.S.C. § 3729(e) ("This section does not apply to claims, records, or statements made under the Internal Revenue Code of 1986.").
[169] Bruegger, supra note 156, at 16.
[170] Illinois, Indiana, and Rhode Island limit the reach of their FCAs to allow only non-income tax actions. Delaware, Florida, and Nevada, however, have no limitations on the type of tax action that can be brought under their FCAs.
[171] Id.
[172] See, e.g., Del. Code Ann. tit. 6, § 1205 (allowing a recovery of between 15% and 30%). Under Indiana's FCA, a successful plaintiff can potentially receive only 10%. Ind. Code 5-11-5.5-6. On the other hand, a successful plaintiff in Nevada is eligible to receive up to 50%. Nev. Rev. Stat. § 357.210.

a. In Nevada, for example, the state's FCA does not explicitly allow private citizens to bring qui tam actions based on alleged tax fraud.[173] However, the Supreme Court of Nevada has held that the FCA does in fact provide such for such actions.

i. In International Game Technology, Inc. v. Second Judicial District Court of Nevada, the court addressed two separate cases in which plaintiffs brought suits against various defendants for alleged fraud relating to state sales tax payments.[174]

ii. The state attorney general intervened in the qui tam actions, arguing that Nevada's FCA "does not apply to tax matters."[175] The Supreme Court of Nevada, however, rejected this argument. In its opinion, the court reasoned that the state legislature intended "to include tax liability matters within the realm of possible false claims," despite its failure to mention taxes in the act itself.[176]

iii. The defendants nonetheless prevailed in the case, as the court also held that the action should be dismissed for good cause, as the liabilities of the defendants for the taxes in question were issues that should not be decided it. The court concluded that "state law entrusts the primary responsibility for making factual evaluations under, and legal interpretations of, the revenue statutes to the expertise of Nevada's Department of Taxation."[177]

b. Similarly, in State ex rel. Beeler, Schad and Diamond, P.C. v. Ritz Camera Centers, Inc., the Appellate Court of Illinois held that the state's FCA could be used to support a qui tam action based on state tax fraud.[178]

i. The case involved a qui tam action brought by the same Chicago law firm responsible for one of the International Game cases against various remote retailers for failure to collect and remit use tax on sales to Illinois customers. Unlike in Nevada, however, the Illinois FCA *did* address taxation; Illinois's FCA exempted income taxes from the scope of qui tam actions but was silent as to other taxes.[179]

ii. The court of appeals rejected the defendants' argument that the FCA did not apply to the collection of use taxes, holding that "alleged use tax claims relating to Internet and/or catalog sales may be brought under the Act."[180] The intent of the legislature not to exclude use taxes from the scope of the act was demonstrated by the statute's "plain language," which did not contain "an additional statutory exclusion" for such taxes.[181] Thus, the court concluded that qui tam actions can be brought to enforce use tax collection in Illinois.[182]

iii. The court ultimately remanded the case back to the state trial court, but its damage had been done, at least from the perspective of the taxpayers.

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[173] See Nev. Rev. Stat. § 357.040.
[174] 127 P.3d 1088 (Nev. 2006).
[175] Id. at 1095.
[176] Id. at 1104.
[177] Id. at 1093.
[178] 878 N.E.2d 1152 (Ill. Ct. App. 2007).
[179] See 740 Ill. Comp. Stat. 175/3(d) ("The [Whistleblower Reward and Protection Act] does not apply to claims, records, or statements made under the Illinois Income Tax Act.").
[180] Beeler, Schad & Diamond, P.C., 878 N.E.2d at 1167.
[181] Id. at 1168.
[182] Id.

B. RICO suits

1. Congress enacted the Racketeer Influenced and Corrupt Organizations Act (the "RICO Act") in 1970 "in order to prevent and punish the financial infiltration by organized crime of legitimate business operations affecting interstate commerce."[183]

a. The overarching purpose of the Act is to punish "racketeering activity," which is defined broadly in the Act to include numerous acts indictable under specified provisions of federal criminal laws, including mail fraud and wire fraud.[184]

b. Although the RICO Act contains criminal penalties, it also "provides a number of civil remedies for RICO violations."[185] Included among those civil remedies is the authorization of a private cause of action "to recover damages from a defendant who has engaged in a pattern of racketeering activity."[186]

c. More specifically, the RICO Act provides that "[a]ny person injured in his business or property by reason of a violation of [the Act] may sue therefore in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee."[187] As such, a RICO suit presents itself as a tempting option for plaintiffs.

2. Two recent U.S. Supreme Court cases have addressed the application of the RICO Act to private suits based on alleged violations of state sales and use tax collection laws.

a. In Anza v. Ideal Steel Supply Corp., a seller of steel mill products sued the defendant, its chief competitor, under the RICO Act, alleging that the defendant engaged in an unlawful racketeering scheme by "failing to charge the requisite New York sales tax to cash paying customers."[188]

i. The Court held that the plaintiff failed to satisfy the proximate-cause requirement of maintaining a RICO action, as established in Holmes v. Securities Investor Protection Corp.[189]

ii. The Court reasoned that "[t]he direct victim" of the defendant's conduct of defrauding New York tax authorities was "the State of New York, not [plaintiff]."[190] Further, the cause of the plaintiff's alleged harms "is a set of actions (offering lower prices) entirely distinct from the alleged RICO violation (defrauding the State)."[191]

iii. As such, the Court concluded that the "attenuated connection" between the plaintiff's injury and the defendant's conduct warranted a dismissal of the suit.[192]

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[183] John A. Biek, "RICO Claims for Vendor Sales and Use Tax Collection Liabilities: A Step Too Far?," J. of Passthrough Entities 34 (May-June 2010).
[184] 18 U.S.C. § 1961(1).
[185] Biek, supra note 174, at 34.
[186] Id.
[187] 18 U.S.C. § 1964(c).
[188] 547 U.S. 451, 454 (2006).
[189] 503 U.S. 258 (1992).
[190] Anza, 547 U.S. at 458.
[191] Id.
[192] Id. at 459.

b. In Hemi Group, LLC v. City of New York, the plaintiff was the City of New York.[193] It asserted a RICO cause of action against the defendant, which sold cigarettes online to city residents. The city alleged that the defendant committed mail fraud and wire fraud by failing to file customer information with the state of New York as required of out-of-state cigarette vendors by federal law.[194] As a result, the city claimed that it lost "tens of millions of dollars in unrecovered cigarette taxes."[195]

i. Again, the Court held that the city's "theory of causation is far too indirect" to support a RICO claim.[196] Like in Anza, there was a disconnect between the conduct "directly responsible for the City's harm," which was "the customers' failure to pay their taxes," and the conduct "constituting the alleged fraud," which was defendant's failure to file reports as required by law.[197]

ii. Accordingly, the Court concluded that the city could not support its RICO claim against the plaintiff based on the proximate cause requirement as set forth in *Holmes* and affirmed by *Anza*.

3. Although these decisions represent corporate victories against plaintiffs due to a lack of direct causation, in both cases "the Supreme Court did not rule out the possibility of states utilizing the RICO Act as a sales/use tax collection tool."[198]

a. It appears then that based on Anza, business competitors should not be successful in maintaining a RICO claim against each other. According to one commentator, "[i]t is difficult to imagine other business competitors being able to succeed where [the plaintiff there] failed."[199]

b. However, it remains to be seen whether a state or municipality can be successful in bringing a RICO action against a vender "that has failed to collect and remit that government's *own* sales/use tax."[200] Since the defendant in Hemi Group only had an obligation to report, and not to actually collect and remit sales and use tax, the Court did not address this issue.

C. Class action suits

1. Another mechanism for enforcing state and local tax laws that has risen to prominence recently is the use of the class action. As in False Claims Act suits and RICO actions, the taxing authority is an unnecessary party to the private lawsuit, at least according to the plaintiffs. The class actions involve private plaintiffs suing for alleged violations, usually by a retailer, of state and local tax laws.

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[193] 130 S. Ct. 983 (2010).
[194] According to the city, it had an agreement with the State of New York whereby the state would share with it information submitted by out-of-state cigarette vendors for purposes of collecting the tax. Id. at 987.
[195] Id. at 986.
[196] Id. at 989.
[197] Id. at 990.
[198] Biek, supra note 174, at 34.
[199] Id. at 39.
[200] Id.

2. The more recent developments in this area have come in the context of transaction tax overpayments. In these cases, plaintiffs are typically customers suing defendant retailers for improperly collecting sales tax from them.

3. Luckily for taxpayers, several courts have held in recent cases that the class of customers did not have causes of action against the defendants, and that the customers' exclusive remedy was therefore a refund claim against the state or local taxing authority under the applicable law.

a. For example, in Loeffler v. Target Corp., the plaintiffs were customers of Target.[201] In their class action, the plaintiffs alleged that Target had charged them sales tax reimbursement on items that were not subject to the state's sales tax laws—specifically, hot coffee to go. The California court of appeals dismissed the lawsuit, holding that the only remedy for the plaintiffs was for the retailer to file a refund claim with the state Board of Equalization, which was in accordance with state law.[202] This was the outcome despite the fact that the customers themselves could not have directly sought a refund for the sales tax reimbursement under California law.

b. Similarly, in Kawa v. Wakefern Food Corp., a class of plaintiff customers sued the defendant supermarket operator.[203] The plaintiffs alleged that the defendant was improperly collecting sales tax on the full price of discounted or sale items. Unlike in California, the New Jersey Sales and Use Tax Act specifically allowed customers to seek direct refunds from the state for overpaid sales taxes. Thus, the New Jersey Superior Court, Appellate Division court concluded that seeking a refund from the division of taxation was plaintiffs' only available remedy and upheld the dismissal of the lawsuit.[204]

4. However, there have been other recent class actions that have not resulted in taxpayer victories.

a. In Volbers-Klarich v. Middletown Management, Inc., the plaintiffs were customers of a Hampton Inn owned and operated by the defendants. [205]

i. The plaintiffs alleged that the defendants had overcharged all customers sales and excise taxes by collecting certain city and county taxes. According to the plaintiffs, there was no city or county tax in place in the years in question. The Court of Appeals of Ohio had upheld the dismissal of the action, concluding that "when a consumer seeks a refund of taxes, even where they are nonexistent taxes, the consumer must apply to the taxing entity for a refund." [206]

ii. The Supreme Court of Ohio, however, reversed. The court held that "when a vendor charges its customer a nonexistent tax, the funds collected are not a tax collected for the benefit of the taxing authority."[207] Instead, the court concluded that "under these limited circumstances, the customer need not seek a refund from the government entity that purportedly imposed the tax, but may file suit directly against the vendor to recover the converted funds."[208]

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[201] 93 Cal. Rptr. 3d 515 (Cal. App. 2009).
[202] Id.
[203] 24 N.J. Tax 444 (N.J. Super. App. Div. 2009).
[204] Id.
[205] 2009 WL 903846 (Ohio Ct. App. 2009).
[206] Id. at *4.
[207] Volbers-Klarich v. Middletown Mgmt., Inc., Slip Op. No. 2010-Ohio-2057 (May 18, 2010 Ohio).
[208] Id.

iii. Thus, in Ohio, it is possible for plaintiffs to maintain class actions against defendant retailers in suits alleging improper sales tax collection, at least in the situation where a defendant has collected a tax under no existing law.

b. In Levy v. OfficeMax, Inc., the Court of Appeals of Texas considered whether the plaintiffs could maintain a class action for an injunction against several retailers for the assignment of the retailers' right to seek sales tax refunds.[209] Essentially, the retailers had collected sales tax on the full purchase price of goods sold to plaintiffs rather than the price ultimately paid by the plaintiffs after complying with applicable rebate programs.

i. The retailers' primary argument was that the Texas tax code explicitly provided for class actions in tax *protest* suits only; thus, class actions could not be utilized in tax *refund* suits.[210] The trial court agreed, and it dismissed all claims for class-wide relief in addition to plaintiffs' other causes of action.

ii. The court of appeals, however, disagreed with the retailers and the trial court. The court held that the plaintiffs could sue for an assignment of the right to seek a sales tax refund in a class action, since the procedures for seeking such assignment were not governed by the state tax code and were unrelated to the substantive tax issues involved.[211] The court also held that the fact the plaintiffs were seeking a class action did not "deprive the district court of jurisdiction."[212] Accordingly, the court concluded that "the district court has jurisdiction to consider appellants' claims against the Retailers to compel an assignment of refund rights and to consider whether a class should be certified."[213]

c. Finally, in Dell, Inc. v. Superior Court of the City and County of San Francisco, plaintiff consumers sued Dell, alleging that Dell improperly collected sales and use taxes on optional service contracts sold with computers.[214]

i. The court did not address the issue of whether the suit could proceed as a class action, but instead directly addressed the issue of whether Dell could collect the sales tax on these contracts on the merits.

ii. The court upheld the trial court's determination that the contracts were *not* properly taxable, therefore ultimately siding with the plaintiff-consumers. The court held that the optional contracts were sold as part of mixed transactions rather than bundled transactions, reasoning that they were "distinct consumer items," "a significant object of the transaction," and had "readily ascertainable values."[215]

iii. Accordingly, despite the fact that the optional contracts were sold "concurrently for an aggregate price" with the computers themselves, the court concluded Dell could not collect sales tax on the sale of them.[216]

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[209] 228 S.W.3d 846 (Tex. Ct. App. 2007). Texas law provides that only the party that pays the tax directly to the state may seek a refund. Tex. Tax Code § 111.104(b). The statute did allow an "assignee" to seek a refund. Id. Thus, plaintiffs were forced to seek an assignment of that right from the retailers.
[210] OfficeMax, Inc., 228 S.W.3d at 851.
[211] Id.
[212] Id.
[213] Id. at 852.
[214] 151 Cal. App. 4th 911 (2008).
[215] Id. at 917.
[216] Id. at 917, 931.

d. These cases illustrate that not all courts will summarily dismiss class actions in tax-related matters. Thus, taxpayers should be prepared to confront tax class actions brought against them on the merits rather than assume that they will not be allowed to go forward by the trial or appellate court.

D. Summary

1. Qui tam suits, RICO claims, and class action lawsuits are three steadily developing mechanisms by which private plaintiffs and state and local governments alike are utilizing to enforce state and local tax laws.

2. The potential financial incentive for bringing these actions is significant, which further incentivizes plaintiffs to use them against corporate defendants, especially those that are perceived as having deep pockets.

3. Although it is not the prevalent outcome in published decisions, plaintiffs have had some measure of success in pursuing these actions, particularly in the context of class actions.

4. Further, courts have left open the possibility that actions brought under state FCAs and the RICO Act could be successful in state tax conflicts.

5. Thus, taxpayers should be aware of these mechanisms and realize that state and local taxing authorities are not the only potential adversaries with respect to tax laws. Taxpayers may also be forced to defend against suits by private parties.

XII. ORDINARY AND NECESSARY BUSINESS EXPENSE

A. Background

1. Several states, typically those lacking an add-back statute or the power to force combination, or in instances where a taxpayer simply did not fit within the existing parameters of the state add-back statute, have attempted to argue that royalty or interest payments from one affiliate to another are not an "ordinary, necessary business expense" under the equivalent of Internal Revenue Code § 162. So far, that theory has not been well-received by the courts.

B. Massachusetts

1. For example, in Cambridge Brands, Inc. v. Commissioner of Revenue,[217] the Massachusetts Appellate Tax Board held that the Commissioner improperly disallowed deductions claimed by the taxpayer for royalties paid to its sister company for the use of its trademarks, and in addition, he improperly applied their throw-back rule for apportionment purposes.

a. Instead, the royalties were considered deductible as an ordinary and necessary business expense under the Massachusetts income tax code, which paralleled the Internal Revenue Code. The license fee was an "ordinary" expense because it allowed the taxpayer to turn a profit, and it was "necessary" because the use of the trademark allowed the taxpayer to realize a higher profit. Further, there was no evidence that the licensing arrangement was a tax scheme designed to create deductions. To that end, the assertion of a sham transaction doctrine was also rejected.

[217] 2003 WL 21665241 (Mass. App. Tax Bd. July 16, 2003), aff'd 820 N.E.2d 837 (Mass. App. Ct. 2005).

b. The Board held that the licensing arrangement had both a valid business purpose and an economic substance. The Board distinguished the Massachusetts Supreme Court's ruling in Syms Corp. v. Commissioner of Revenue,[218] where the Court concluded that the lease arrangement was a tax scheme designed to create deductions while creating a circular tax-free distribution back to the payor entity. In this case, both payor and payee were viable entities and a valid business purpose justified the taxpayer's payment of the license fee.

2. However, in The Talbots, Inc. v. Commissioner of Revenue,[219] the same Appellate Tax Board concluded that the taxpayer retained all the benefits and burdens of the intangible property transferred to its wholly-owned subsidiary, and thus the facts "closely aligned with those of Syms and TJX, in which the Board found, and the higher courts affirmed, that nothing changed with respect to the maintenance and protection of the Marks after their transfer to the wholly owned subsidiary.

a. Therefore, as the Supreme Judicial Court found in Syms, because "[t]he business operations of [the parent] did not change after the transfer and license-back of the marks," [the subsidiary] was not truly responsible for maintaining and protecting the Talbots Marks; these responsibilities remained with Talbots."[220]

b. The Board distinguished the facts presented in Cambridge because "[t]here was no mismatch of expenses where one entity paid licensing fees to an entity while still paying all of the expenses of maintaining the trademarks, no payment of dividends with the funds that had been previously paid as royalty expenses, and no other evidence suggesting that tax avoidance was the only, or even primary, consideration for the transaction."[221]

XIII. LEGISLATIVE DE-COUPLING/CASH FLOW ACCELERATION EFFORTS

A. Generally

1. A number of state legislatures have enacted various accounting gimmicks to accelerate the payment of corporate income taxes and other taxes (e.g., sales taxes) in times of a cash crunch. These items of legislation are often enacted in the name of a fiscal crisis but, alas, they are rarely repealed when the crisis subsides.

2. Several states, including California and Alabama, have enacted legislation that "suspended" net operating loss carryovers so that the hapless taxpayer is not permitted to deduct an otherwise valid NOL carryover against current year's income, resulting in the payment of unbudgeted income tax and some unforeseen adjustments to the taxpayer's reserve for valuation allowances. Such an effort in Alabama, i.e., suspending all corporate taxpayers NOL carryovers for one tax year, arguably created more problems than it solved and engendered litigation over how the rule would be applied, whether it should be applied to a taxpayer that liquidated and dissolved during the suspension year, and how the suspended NOL carryover would be utilized in subsequent years.

3. Several states have accelerated estimated income tax payments either for C-corporations or for pass-through entities with composite return or non-resident partner withholding obligations, including New Jersey.[222]

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218 765 N.E.2d 758 (Mass. 2002).
219 2009 WL 3162121 (Mass. App. Tax Bd. 2009).
220 Id. at *14 (citation omitted)
221 Id.
222 N.J. Admin. Code §18:35-5.2(g).

4. An even more popular item of cash flow acceleration legislation among the states is the effort to decouple the state income tax code from specified federal counterpart provisions, such as additional first year depreciation (I.R.C. § 179) or, more often, the deduction for "qualified domestic production activities" (I.R.C. § 199).

a. A non-exclusive listing of states that have de-coupled from specific provisions of the Internal Revenue Code include Alabama, Arizona, California, Connecticut, Florida, Georgia, Hawaii, Kentucky, Massachusetts, Maryland, Maine, Minnesota, New Jersey, Oklahoma, Tennessee, Virginia, and Wisconsin.

b. Similarly, many states do not have a provision that automatically updates their income tax code to reflect changes in the Internal Revenue Code but, instead, a special act must be passed by the state legislature to update their tax code. It is no surprise that whether the conformity act passes may depend on whether Congress has enacted some juicy new business deduction in the interim or whether the act carves out specified, budget-damaging I.R.C. sections. Some of the more painful examples are California (to the extent it hasn't already de-coupled from specific I.R.C. provision), Georgia, and Texas. Doing so creates tremendous accounting and tax headaches for taxpayers since they are forced to maintain a separate state-specific set of books and records, including depreciation schedules, to take into account these disconformities.

XIV. ENACTMENT OF COMPOSITE RETURNS/WITHHOLDING OBLIGATIONS ON PASS-THROUGH ENTITIES

A. In General

1. A growing number of states have identified a problem of nonresident owners of pass-through entities doing business in their state who fail to file individual income tax returns with that state's DOR. Absent such filings, a state would thus not receive income tax on income earned by the pass-through entity attributable to that state when neither the nonresident owner nor the entity itself (as a nontaxable pass-through entity) pays the tax. In addition to the question of whether the state has the power to tax a nonresident member with no other connection to the state, administrative and practical concerns often prevent state taxing authorities from auditing and obtaining tax from nonresident individuals and even non-domiciliary business entities located outside the state.

2. In response to the concerns mentioned above, most states (approximately 37) have now enacted one or more mechanisms that require the entity, in one form or another, to remit income tax to the state on behalf of the nonresident partners, LLC members or S corporation shareholders.

B. Compliance and enforcement mechanisms

1. Generally, withholding at the source is triggered when a pass-through entity with a nonresident owner either fails to file a composite income tax return that includes that owner or, alternatively, fails to maintain or submit to the state a written agreement from the nonresident owner consenting to the state's jurisdiction for purposes of collecting income tax, including penalties and interest, and agreeing to pay tax on that owner's distributive share of pass-through entity income.[223] Approximately 20 states fall into this category.

[223] For a detailed discussion of state withholding and composite return requirements for pass-through entities, see Fenwick, McLoughlin, et al., State Taxation of Pass-Through Entities and Their Owners (WG&L/Thompson Reuters, 2010), Ch. 5, 6.

2. When entity-level withholding is required, the entity must generally pay tax on behalf of the nonresident owner at the highest rate of tax applicable to individuals (if the owner is an individual) or corporations (if the owner is a corporation) multiplied by that owner's distributive share of income attributable to the state. A handful of states require withholding only in connection with the state's allocable share of a distribution to a nonresident owner. In addition, the type of owner for which withholding is required varies and occasionally does not include corporate owners (e.g., Missouri[224]).

3. There are generally four types of nonresident withholding provisions among the states:

a. Nonresident withholding is required unless the partnership files a composite return and/or the nonresident partner consents to income tax jurisdiction. A growing number of states have enacted what can be termed this conditional entity-level tax.

b. Nonresident withholding is required in many states. However, some states, like Alabama, merely authorize withholding, even though they require that the partnership file a composite return and remit tax, subject to certain exceptions.

c. Estimated tax payments are only required in three states.

d. The partnership is contingently liable for the taxes of its nonresident members or partners if the nonresidents fail to pay their taxes when due.

C. Types of entity-level withholding

1. Mandatory withholding unless partner consents to jurisdiction

a. California.

i. A pass-through entity may be required by state law to withhold upon a nonresident owner's distributive share of income.[225] This requirement also may apply to a SMLLC that is treated as a disregarded entity. If a pass-through entity fails to timely file a nonresident income tax agreement with the state, it must pay an amount of tax on behalf of the applicable nonresident member at the highest applicable tax rate multiplied by the member's distributive share of California source income. Amounts to be paid are due at the same time the pass-through entity's tax return is required to be filed (ignoring extensions). Amounts paid by the pass-through entity are considered to be paid by the applicable nonresident partner on account of income tax imposed by California on the partner for that taxable year.[226]

ii. Partnerships, including LLCs treated as partnerships, are required to withhold income tax at the rate of 7 percent on *distributions* of California-source income to a domestic (U.S.) nonresident owner if the total distributions to the owner are greater than $1,500 for the calendar year.[227] Withholding is not required if (1) the owner is a California resident; (2) the owner is an entity qualified to do business or has a permanent place of business in California; (3) the owner or entity receives a withholding waiver from the Franchise Tax Board; (4) the owner is a tax-exempt entity under either California or federal law; (5) the distribution is exempt income; (6) the distribution is California

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[224] See Mo. Rev. Stat. § 143.411(5); Mo. Code Regs. 12 § 10-2.190(4)(B).
[225] Cal. Rev. & Tax Code §18662.
[226] See Cal. Rev. & Tax. Code § 18633.5.
[227] Cal. Rev. & Tax. Code §§ 18662; Cal. Code Regs. tit. 18, §§ 18662-1, 18662-2, 18662-11, 18662-12; FTB Pub. 1017, Cal. Fran. Tax Bd., July 1, 1996.

source income previously reported on the owner's California tax return; (7) the distribution is a return of capital; or (8) the entity is a qualifying investment partnership.[228] With respect to foreign (non-U.S.) owners, tax is required to be withheld on any income that (1) is subject to withholding under I.R.C. § 1446 and (2) is from California sources.[229]

b. Colorado. A partnership, including an LLC filing as a partnership, is required to ensure that its nonresident owners file a Colorado income tax return to report their share of Colorado source income earned by the partnership or LLC. This is accomplished in one of three ways: (1) file a composite return on behalf of the nonresident owner; (2) file an agreement to file and pay tax for each owner; or (3) withhold for each nonresident partner or member.[230]

c. Georgia. Georgia generally requires that a partnership or LLC that is not treated as a corporation and does not file a composite return on behalf of a nonresident owner withhold income tax at the rate of 4 percent on any distributions paid to that owner or otherwise credited to that owner in lieu of an actual distribution. "Distribution paid or credited" is defined to mean a recognition or assignment of interest in proceeds or property of a partnership, S-corporation, or limited liability company, including a net *distributive share* of income which is passed through to members and which may be subject to Georgia income tax. This has been interpreted to include a nonresident owner's distributive share of the entity's Georgia-source income. In addition, under the revised rule, withholding may be required on guaranteed payments.[231]

d. Illinois. Illinois imposes a withholding requirement on partnerships operating in the state. For taxable years ending on or after December 31, 2008, every partnership must withhold from each nonresident partner in an amount equal to the distributive share (whether or not distributed) of the business income of the partnership apportionable to Illinois of that taxpayer multiplied by the applicable rates of tax for that partner. Such withholding is required regardless of whether the distribution is actually paid out. However, withholding is not required if the nonresident partner is included on a composite return filed by the entity.[232]

e. Kentucky. Effective for taxable years beginning on or after January 1, 2007, limited liability entities such as partnerships, including LLCs taxable as partnerships for federal income tax purposes, are required to withhold Kentucky income tax on the distributive share of income, whether distributed or not, apportioned to the state for each (a) nonresident individual owner, or (b) corporate owner that is doing business in Kentucky only through its ownership interest in the entity. The withholding amount is to be computed using the highest tax rate applicable to that owner.[233] Withholding is not required for a nonresident individual owner who elects to participate in a composite return filed by the entity.[234]

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[228] Cal. Code Regs. tit. 18, §§ 18662-1, 18662-2, 18662-3(b), 18662-11, 18662-12; FTB Pub. 1017, Cal. Fran. Tax Bd., July 1, 1996.
[229] Cal. Rev. & Tax. Code § 18666(a).
[230] Colo. Rev. Stat. § 39-22-601; Colo. FYI Tax Pub. Income 54, Aug. 1, 2009.
[231] Ga. Code Ann. § 48-7-129; Ga. Comp. R. & Regs. r. 560-7-8-.34.
[232] 35 Ill. Comp. Stat. 5/709.5(a); Illinois Dept. of Rev. Info. Bulletin FY 2009-02, Oct. 1, 2008; Ill. Admin. Code tit. 86 § 100.7035(a); Ill. Admin. Code tit. 86 § 100.7035(g).
[233] Ky. Stat. Ann. § 141.206(4)(b).
[234] 103 Ky. Admin. Regs. § 18:160 (Section 2(4)(d)).

f. **Louisiana**. A partner in a partnership that is a partnership itself is not included in a composite return. Such partners must separately file all applicable Louisiana tax returns and report all Louisiana source income, including income from the partnership, in their separate returns.[235]

g. **Massachusetts**. Effective for tax years beginning on or after January 1, 2009, a partnership, including an LLC treated as a partnership, that maintains an office or engages in business in Massachusetts must withhold and remit tax on a nonresident owner's pro rata share of Massachusetts-source income unless a composite return is filed by the entity.[236] The withholding requirement generally is applicable for all nonresident owners, defined to include: (1) an individual, estate, or trust that is not a resident or domiciliary of Massachusetts; (2) a pass-through entity without a usual place of business in Massachusetts; or (3) a corporation that does not file an income tax return in Massachusetts.[237] The amount required to be withheld is equal to the Massachusetts taxable amount of a nonresident owner's distributive share multiplied by the general individual income tax rate (for owners that are individuals, estates, trusts, or pass-through entities) or the applicable corporate income tax rate (for owners that are corporations).[238]

h. **Missouri**. A partnership, including an LLC treated as a partnership, is required to withhold income tax on behalf of a nonresident individual owner only if the entity fails to timely file a nonresident owner agreement with the state on behalf of that owner.[239]

i. **South Carolina**. Pass-through entities pay a 5 percent withholding tax on their nonresident corporate partners' or members' distributive shares of South Carolina-source income unless the nonresidents file a consent to pay the tax or a composite return is filed.[240]

j. **West Virginia**. Effective January 1, 2008, the income tax must be withheld at a rate of 6.5 percent, whether the income is actually (or deemed) distributed to the nonresident partner, shareholder, or beneficiary. However, withholding is not required for tax-exempt entities, nonresidents with distributee tax payment agreements, or upon a showing of undue hardship.[241]

2. <u>Mandatory withholding</u>

a. **Alabama**. Act 2009-144, effective January 1, 2009, provides that partnerships or LLCs, other than qualified investment partnerships (discussed below), are required to file an annual composite tax return and remit Alabama income tax on the distributive share of their nonresident owners (including corporate owners) at the highest marginal tax rate applicable to those nonresident owners.[242]

b. **Connecticut**. Effective for taxable years beginning on or after January 1, 2006, a partnership, including an LLC treated as a partnership, is required to pay income tax at the highest marginal rate on each nonresident partner's distributive share of Connecticut-source income from

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[235] La. Admin. Code § 61.I.1401.
[236] Mass. Gen. Laws. ch. 62B, § 2 ; Mass. Regs. Code tit. 830, § 62B.2.2(3).
[237] Mass. Regs. Code tit. 830, §§ 62B.2.2(2), 62B.2.2(3)(c).
[238] Mass. Regs. Code tit. 830, § 62B.2.2(4)(c).
[239] Mo. Rev. Stat. § 143.411(5).
[240] S.C. Code § 12-8-590.
[241] W. Va. Taxpayer Servs. Div. Pub. TSD-390 & TSD-391, Dec. 12, 2007.
[242] Ala. Code § 40-18-24.2(b)(1). However, a nonresident partner that has been included in a composite income tax return can file its own Alabama income tax return and claim credit for Alabama income tax paid on the partner's behalf by the partnership. Ala. Code § 40-18-24.2(b)(1).

the partnership, if the distributive share of income is $1,000 or more.[243] Connecticut no longer permits the filing of group income tax returns on behalf of qualifying nonresident owners.

c. **Pennsylvania**. The pass-through entity pays withholding tax on the nonresident corporate partner's or member's distributive share of Pennsylvania-source income at the applicable tax rate.[244] There are generally no exceptions.

d. **Utah**. Effective for taxable years beginning on or after January 1, 2009, Utah enacted the Pass-Through Entities and Pass-Through Entities Taxpayers Act,[245] which requires pass-through entities to pay or withhold tax on the business income of the pass-through entity and the non-business income of the pass-through entity derived from or connected with Utah sources on behalf of a nonresident pass-through entity taxpayer.[246] Pass-through entities are not required to pay or withhold tax on behalf of pass-through entity taxpayers who are resident individuals, pass-through entity taxpayers that are organizations exempt from corporate income tax, or pass-through entity taxpayers that are publicly-traded partnerships, classified as partnerships for federal income tax purposes that file an annual information return with the Commission that includes the partner's name, address, taxpayer identification number, and other information required by the Commission for each partner of the publicly-traded partnership with income derived from, or connected with, Utah sources in excess of $500 in a taxable year.[247]

e. **Virginia**. Pass-through entities doing business in Virginia and having taxable income derived from Virginia sources are required to pay a withholding tax equal to 5 percent of their nonresident owners' shares of taxable income from Virginia sources.[248] It should be noted, however, that the Virginia tax commissioner has ruled that a SMLLC, disregarded for federal tax purposes, is not subject to the pass-through entity withholding tax.[249]

f. **Wisconsin**. Effective for taxable years beginning on or after January 1, 2005, a partnership, including an LLC treated as a partnership, having Wisconsin income allocable to a nonresident owner is required to pay a withholding tax. A nonresident owner includes: (1) an individual who is not domiciled in the state; (2) a partnership, LLC, or corporation with a commercial domicile outside the state; and (3) a nonresident estate or a trust. The tax to be withheld for each nonresident owner is equal to the highest income tax rate for a single individual (for an individual, estate or trust) or the highest corporation income/franchise tax rate (for a partnership, LLC or corporation) multiplied by the nonresident owner's share of income attributable to Wisconsin. A pass-through entity, such as a partnership, that is an owner of another pass-through entity is required to withhold and remit tax on the distributable share of income of each of the entity's nonresident owners. An entity is not required to withhold tax on behalf of its nonresident owners if: (1) the owner is exempt from taxation in Wisconsin; (2) the owner's distributable share of the entity's Wisconsin income is less than $1,000 and the owner has no other Wisconsin source income; (3) the entity is a joint venture that has elected not to be treated as a partnership for federal income tax purposes; or (4) the entity is a publicly-traded partnership that files an annual information return. A nonresident owner may claim the withheld tax as a credit on its own Wisconsin income tax return.[250]

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[243] Conn. Gen. Stat. § 12-719(b) and (c); Connecticut Informational Publication 2006(22), Dec. 20, 2006.
[244] Pa. Stat. § 7324.
[245] L. 2009, S23, eff. May 12, 2009 and operative retroactive to taxable years beginning on or after Jan. 1, 2009.
[246] Utah Code Ann. § 59-10-1403.2(1)(a).
[247] Id. § 59-10-1403.2(1)(b).
[248] Va. Code Ann. 58.1-486.2(B)(1).
[249] Va. Pub. Document Ruling No. 09-20, Feb. 4, 2009.
[250] Wis. Stat. § 71.775.

3. Requirement of estimated tax payments

a. **New Jersey**. A recent Division of Taxation regulation requires quarterly estimates.[251]

b. **New York**. Pass-through entities are required to make quarterly estimated tax payments on behalf of nonresident corporate members or partners. Estimated tax payments are not required for: (1) any owner whose estimated tax required to be paid for the tax year by the entity is $300 or less; (2) any nonresident individual owner who elects to be included in a group (composite) return that the entity has been authorized to file; or (3) any owner that provides the entity with an exemption certificate certifying that the owner will comply in their individual or corporate capacity with the New York State estimated tax and tax return filing requirements.[252]

c. **Vermont**. Pass-through entities are required to declare and pay estimated income tax on behalf of their nonresident owners. An estimated payment is not required by the entity for a nonresident owner whose distributive share of the income attributable to Vermont does not exceed $100. The estimated tax payment requirement also does not apply to an entity engaged solely in the business of operating one or more affordable housing projects in Vermont, subject to certain restrictions.[253]

d. **Wisconsin**. Pass-through entities are required to make quarterly payments of estimated withholding tax on nonresident members' share of income attributable to Wisconsin.[254]

4. **Partnership is contingently liable**

a. **Idaho**. In Idaho, the pass-through entity is contingently liable for the income taxes of its nonresident members or partners if the nonresidents fail to pay their taxes when due.[255] Prior to 2009, this was also the rule in Alabama.

b. **New Mexico**. Effective January 1, 2011, flow-through entities are required to make quarterly withholding tax payments on net income distributed to their nonresident owners. The new legislation further provides that the flow-through entity remains liable for the tax if the owner does not pay it.[256]

XV. STATES THUMBING THEIR NOSES AT REFUND CLAIMS

A. Background

1. The economic climate over the past few years has presented new, and recurring, challenges for both taxpayers and state tax administrators in the face of massive budget deficits, unemployment, and slow economic growth. With both personal and corporate income tax revenues declining and increased savings reducing sales tax revenues, it comes as no surprise that state tax administrators may either refuse to pay refund claims citing budgetary concerns, or become increasingly aggressive and creative in their rationales for denying refund claims. Even state legislators may

[251] N.J. Admin. Code § 18:35-5.2(g).
[252] N.Y. Tax Law § 658(c)(4).
[253] Vt. Stat. Ann. tit. 32, § 5920; Vt. Dep't of Taxes, Tech. Bull. TB-05, May 5, 2005.
[254] Wis. Dept. Rev. Tax Pub. 119, Mar. 1, 2010.
[255] Idaho Code § 63-3022L.
[256] L. 2010, H120 (c. 53), eff. Jan. 1, 2011.

sometimes seek new ways to protect the fisc, for example, by passing retroactive tax measures in response to taxpayer refund claims.

2. In order to comply with federal due process requirements, however, these efforts must comply with the principles espoused by the U.S. Supreme Court in McKesson v. Div. of Alcoholic Beverages & Tobacco[257] and United States v. Carlton,[258] which required that a state to provide "meaningful backward-looking relief to rectify any unconstitutional deprivation" and that any retroactive legislation should be limited to a "modest period."[259] As illustrated by the two cases discussed below, in practice, these principles may be difficult to apply and enforce against state actions.

B. Recent examples

1. Kentucky. In Miller v. Johnson Controls, Inc.,[260] the Kentucky Supreme Court upheld retroactive tax legislation barring certain corporate income tax refunds that resulted from filing combined returns against the taxpayer's procedural and substantive due process challenges. The taxpayer filed refunds claims as a result of the Kentucky Supreme Court's earlier decision in GTE v. Kentucky Revenue Cabinet,[261] which permitted a group of corporations conducting a unitary business to file a combined Kentucky income tax return. The legislature responded to the GTE decision in 2000 by retroactively amending the statute to purportedly bar any refund claims as a result of filing a combined return. In Johnson, the Court upheld the retroactive legislation by concluding that the state had a "legitimate interest" in refusing to pay refunds in order to raise revenues. According to the indefatigable Paul Frankel, "[t]his is one of the many examples of why, when in doubt, a company should the follow the principle of 'don't pay? Don't Pay?? DON'T PAY!!!'"[262]

2. Alabama. On October 19, 2009, the Montgomery County Circuit Court finally granted a full refund of franchise taxes (plus interest) in Vulcan Lands, Inc. v. Russell,[263] the test case regarding Alabama's former franchise tax scheme that was held unconstitutional just a shade over a decade ago by the U.S. Supreme Court in South Central Bell Tel. Co. v. Alabama.[264] The circuit court held that the taxpayer was entitled to a refund equal to the difference between the tax liability it paid as a foreign corporation and the tax liability it would have paid as a domestic corporation (i.e., $50). The Alabama Department of Revenue did not appeal this ruling so it is now final, but despite both parties' characterization of this case as the "test case," the department argues that it can still attempt to prove that each of the remaining 150 or so refund claimants passed-on the tax to their customers or clients and therefore may nevertheless forfeit their refund claims. The Montgomery County Circuit Court has appointed several special masters to handle the remaining refund claims, so perhaps another round of litigation will not be necessary.

3. Illinois. In Exelon Corp. v. Dep't of Revenue, the taxpayer prevailed in its suit against the Illinois Department of Revenue, which contended that electricity was tangible personal

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[257] 496 U.S. 18 (1990).
[258] 512 U.S. 26 (1994).
[259] McKesson, 496 U.S. at 31; Carlton, 512 U.S. at 30-31. For an excellent article summarizing both of these cases, along with recent state court decisions faced with applying their principles, see Gregory A. Castanias, et al., "Retroactivity and Refunds: Can They Really Keep Your Money?," State Tax Notes, Aug. 16, 2010, p. 419.
[260] 296 S.W.3d 392 (Ky. 2009), cert. denied, 130 S. Ct. 3324 (May 24, 2010).
[261] 889 S.W.2d 788 (Ky. 1994).
[262] Paul H. Frankel & Craig B. Fields, "2010 Hot Topics in State Taxation: Nexus, Apportionment, Combined Reporting Continues to Dominate Tax Controversies," BNA Tax Management Weekly State Tax Report, Aug. 13, 2010.
[263] Case No. CV-2001-1106-PR (Mont. County Cir. Ct. Oct. 19, 2009).
[264] 526 U.S. 160 (1999).

property for purposes of the state's sales/use tax exemption.[265] However, in denying the departments petition for rehearing, the Supreme Court of Illinois stated that, contrary to its prior holding, the taxpayer was not eligible for a refund of the taxes that it had paid. The court provided three criteria for determining whether its decisions should be applied on a prospective basis only: (i) whether he decision establishes a new principle of law, by overruling past precedent or determining an issue of first impression; (ii) whether given its purpose or history, the decision's operation will be impeded or promoted by prospective application; and (iii) whether balance of the equities mandates prospective treatment.

XVI. CONTINGENT FEE AUDITORS

A. Background

1. At least five states allow private contract auditing firms to perform audits on their behalf under a contingent fee arrangement, including Arizona, Louisiana, North Carolina, Indiana, and Pennsylvania.[266]

2. Three of those states permit contingent fee audits by judicial dictate while two permit limited contingent fee audits by statute.

3. Conversely, several states expressly prohibit contingent fee audits either by statute or judicial dictate, including Alabama, Georgia, Kansas, and Hawaii.[267] Additionally, the issue of contingent fee audits has been addressed by state courts in Connecticut, Michigan and Wyoming, but these decisions are subject to varying interpretations as described in a useful Journal of Multistate Taxation article published in 1998.[268]

B. Recent examples

1. These arrangements seem to be popping up more frequently, and COST recently issued a helpful position paper explaining why the business community opposes these arrangements. The Tax Executives Institute has also issued position papers opposing various state efforts. We have witnessed recent attempts to affect legislation to permit these arrangements in Alabama, Georgia, Massachusetts, Arizona, and Oklahoma. Fortunately for taxpayers, only the effort in Oklahoma has so far succeeded.[269]

2. Several other states allow contingent fee audits by administrative practice with respect to a particular tax, such as Delaware in the context of its very lucrative and controversial unclaimed property "tax," while the State Treasurer of Alabama followed suit recently, employing an out-of-state contingent fee auditing firm to enforce the state's unclaimed property laws.

XVII. OTHER ATTACKS ON INTERCOMPANY DEALINGS

A. Background

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[265] 917 N.E.2d 899 (Ill. 2009).
[266] See Shop Talk, "Indiana High Court Approves Use of Outside, Contingent-Fee Auditors," 13 J. of Multistate Tax. & Incentives (Sept. 2003); John Coalson & Kendall Houghton, "Do Multijurisdictional Contingent-Fee Audits Violate Public Policy and Due Process?," 5 J. of Multistate Tax. & Incentives (Nov./Dec. 1998).
[267] Ala. Code § 40-2A-6; Sears, Roebuck & Co. v. Parsons, 401 S.E.2d 4 (Ga. 1991); Kan. Stat. Ann. § 79-2022; Haw. Rev. Stat. § 231-13.
[268] See Coalson & Houghton, supra note 256.
[269] Okla. H.B. 2359 (signed into law on June 9, 2010).

1. The Commissioner of Internal Revenue has long held the power to "distribute, apportion, and allocate gross income, deductions, credits, or allowances between or among" two or more organizations, trades or businesses owned or controlled, directly or indirectly, by the same interests under I.R.C. § 482. A number of states have possessed similar powers for many years, usually by incorporating Section 482 into their income tax codes by specific reference or by using federal taxable income as a starting point for their net income tax. It seems that the states have only recently begun flexing their muscles with their own Section 482 equivalent, or have added or broadened existing Section 482-like powers, as the Alabama legislature did in 2001.

2. The primary target of these enhanced Section 482 powers is transfer pricing among related companies. Transfer pricing audits and contrary studies performed by state DOR contractors have become the latest tool to challenge intercompany transactions.[270] In the face of this increased scrutiny from the states, taxpayers should take prospective measures and put documentation in place to evidence the legitimacy of their intercompany pricing arrangements.

B. Recent examples

1. **Alabama**. The Alabama DOR has engaged independent transfer pricing consultants to review certain taxpayer's intercompany transactions and propose adjustments pursuant to Alabama's IRC section 482 corollary.[271] Other states, including New Jersey, are employing the services of similar consultants, who may be compensated on a contingency fee basis – an arrangement expressly prohibited by Alabama law.[272] ADOR officials have assured us that their consultants are not being paid on a contingent fee basis.

2. **New York**. A taxpayer sought an advisory opinion from the Department of Taxation and Finance that would, in effect, have confirmed the propriety of the new method it intended to employ to determine its receipts on the sale of tangible personal property to an affiliate when it leases both TPP and real property to the same affiliate.[273] The petitioner-taxpayer was the subsidiary of a REIT. Unfortunately, the taxpayer's efforts essentially back-fired and its proposed method was rejected. The department held: "While the use of data from a reputable industrial publication to determine the charge for the lease of tangible personal property is not per se impermissible, Petitioner has not established that its proposed method of setting the lease price for tangible personal property is reasonable . . . . Finally, Petitioner has failed to explain how it will be accounting for indirect costs . . . . Therefore it will not be possible to opine on whether Petitioner's proposed method . . . is reasonable."[274] One can imagine what will happen next.

XVIII. ASSERTION OF ECONOMIC NEXUS

A. Introduction

1. "Nexus" is the requisite minimum contact with a state required in order for a state to impose tax upon a nonresident. The U.S. Supreme Court has held that both the Due Process and Commerce Clauses of the United States Constitution establish minimum contact standards in order for a state to assert personal jurisdiction and/or impose a tax return filing obligation on a nonresident taxpayer. Quill Corp. v. North Dakota.[275]

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[270] See Harold McClure, "Transfer Pricing for Domestic Sales Subsidiaries: Tropicana vs. Hallmark," 19 J. of Multistate Tax. & Incentives 10 (March/April 2010).
[271] Ala. Code § 40-2A-18(a).
[272] See Ala. Code § 40-2A-6(a).
[273] N.Y. Div. of Tax. & Fin., TSB-A-10(34)S, Aug. 3, 2010.
[274] Id.
[275] 504 U.S. 298 (1992).

a. In Quill, the issue was whether a nonresident taxpayer could be subject to North Dakota's sales/use tax reporting based on its mail order business with customers in the state. In Quill, the Court distinguished between the "minimum contacts" standard for personal jurisdiction over nonresidents under the Due Process Clause versus the "substantial nexus" standard to impose a tax filing obligation on nonresidents under the Commerce Clause.

b. The Court noted that the Due Process Clause is meant to ensure fairness and predictability with regard to the assertion of personal jurisdiction by states over nonresidents. In contrast, the Commerce Clause is meant to prevent states from imposing undue structural burdens on interstate commerce (i.e., preserving free trade).

2. With that background in mind, the Court held that the Due Process Clause's "minimum contacts" standard does not require a nonresident to have a physical presence in a state in order to be subject to tax, only purposeful availment of the state's markets.[276] However, the Commerce Clause requires something more. In the context of state sales and use taxes, the Quill court held that this "something more" was a non-*de minimis* physical presence in the state. In coming to this decision, the Court relied on (i) the structural burdens imposed on interstate commerce by state sales and use taxes, including monthly filing of returns, lack of uniformity, varying state and local rates, etc., and (ii) the historical reliance of the mail order industry on a previous decision that had established a bright-line physical presence test of nexus for sales taxes.[277] Because state income/franchise taxes (i.e., business activity taxes or "BAT") were not at issue in the case, the Court declined to address whether a similar physical presence standard exists for such taxes. Since then, as set out below, state courts have split on the issue and the Supreme Court has declined to review any state cases dealing with the issue.

B. Creation of "economic nexus" doctrine (South Carolina does it again)

1. In Geoffrey, Inc. v. South Carolina Tax Commissioner,[278] the South Carolina Supreme Court was faced with the issue of whether the state could require a nonresident licensing company to file income tax returns based on its licensing of intangible property to customers in the state. The licensing company was a captive of an affiliate that sold toys in the state. After the affiliate transferred all of its intellectual property (trademarks, etc.) to the licensing company, the licensing company licensed such property back to the affiliate. This created a deduction against taxable income for the affiliate in South Carolina. Further, the licensing company only had a physical presence in Delaware, which does not impose a corporate income tax upon passive activity holding companies.

2. Although the licensing company did not have any physical presence in the state, the Court held that the state could nonetheless impose income tax on the company because of the presence of its intangible property in the state and because it conducted business in the state. The Court did not specifically address whether the physical presence standard established by Quill applied to income taxes but rather relied on earlier constitutional case law as precedent. The fact that the licensing company structure was viewed as a state tax avoidance scheme by the state department of revenue may have been a factor in the court's analysis. Since Geoffrey, there have been a string of "intangible holding company" economic nexus cases lost by taxpayers in various states, including Michigan, North Carolina, New Mexico, Maryland, Massachusetts, New Jersey, Louisiana, and Oklahoma.

C. MBNA case (economic nexus outside the licensing company context)

[276] See, e.g., Burger King Corp. v. Rudzewics, 471 U.S. 462 (1985).
[277] See Nat'l Bella Hess, Inc. v. Dep't of Revenue, 386 U.S. 753 (1967).
[278] 437 S.E. 2d 13 (S.C. 1993).

1. Many of the state court decisions that followed Geoffrey also involved captive intangible licensing company arrangements (i.e., perceived state tax planning structures). However, in Commissioner v. MBNA America Bank, N.A.,[279] the West Virginia Supreme Court of Appeals applied an economic nexus standard outside of a licensing company context. In that case, the Court held that MBNA had substantial nexus with West Virginia for income tax purposes based on the bank issuing credit cards to customers in the state. MBNA had no substantive physical presence in the state.

2. The MBNA held that the physical presence standard established in Quill did not apply because (i) sales and use taxes impose a larger burden on interstate commerce than income taxes due to monthly filing, multiple rates, etc., and (ii) a physical presence test is outmoded given the development of business since the test was established in 1967. Accordingly, the court held that a "significant economic presence" test applied instead which examines the "frequency, quantity, and systemic nature" of a taxpayer's economic contacts with a state. The Court held that such a test was something more than the "purposeful availment" standard of the Due Process Clause.

D. Recent economic nexus developments

1. The New Jersey Supreme Court has previously rejected the physical presence standard for intangible holding company ("IHC") income tax cases.[280] Despite having adopted an economic nexus standard, the New Jersey Tax Court recently declined to subject two nonresident taxpayers to income tax under this standard because the companies' economic activities in the state were deemed to be *de minimis*.

a. In AccuZIP, Inc. v. Division of Taxation,[281] the N.J. tax Court held that a nonresident company selling software to customers in New Jersey through the internet and mail orders was not "doing business" in New Jersey. The Court held that the company's economic activity in the state did not rise to the level of substantial nexus because the company only had 93 customers in the state and sales from such customers were only 2% of the company's gross receipts. The Court may have based its decision in part on the fact that AccuZip was not licensing intangible property into the state and its facts were therefore distinguishable from the taxpayer in the Lanco decision. However, it is not clear if the Court was rejecting the physical presence standard in non-IHC cases or merely holding that there is a *de minimis* exception to the economic nexus standard.

b. In BIS LP, Inc. v. Division of Taxation,[282] the New Jersey tax court held that a nonresident company that owned a limited partnership interest in a partnership doing business in New Jersey did not have nexus with the state. The Court found that the partner's business was not unitary with the underlying partnership and therefore held that the partner was not doing business in New Jersey.

2. In Vonage America, Inc. v. City of Seattle,[283] the Court held that Vonage had substantial nexus with Seattle for utility tax purposes because Vonage licensed the rights to use certain phone lines (not owned by Vonage) in the state. Vonage did not have any property or employees in the city.

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[279] No. 33049 (W. Va. 2006).
[280] Lanco, Inc. v. Dir., Div. of Tax., 188 N.J. 380 (2006).
[281] 25 N.J. Tax 158 (2009).
[282] CCH 91 401-457 (N.J. Tax Ct. July 30, 2009).
[283] No. 63234-5-1 (Wash. Ct. App. 2009) (unpublished opinion).

3. The Kansas Department of Revenue issued an opinion letter stating that attending a trade show in the state does not establish nexus if no sales orders are taken or negotiated at the show.[284]

4. California passed an economic nexus bill in 2010.[285] Specifically, it provides that for tax years beginning on or after January 1, 2011, a taxpayer is doing business in California if the taxpayer actively engages in any transaction for the purpose of financial or pecuniary gain or profit or if any of the following bright-line factor-based thresholds are met:

a. The taxpayer has apportionable sales in California in excess of the lesser of $500,000 or 25% of the taxpayer's total sales determined using the rules for sourcing sales for the numerator of the sales factor, with the exception that all sales of services and intangibles are sourced using the market-based approach rather than the cost of performance method.

b. The taxpayer has real property and tangible property that exceeds the lesser of $50,000 or 25% of the taxpayer's total real property and tangible personal property.

c. The taxpayer pays compensation to employees in the state in excess of the lesser of $50,000 or 25% of the compensation paid by the taxpayer.

5. Connecticut passed an economic nexus bill in 2009.[286] It provides that: "Any company that derives income from sources within this state, or that has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, without regard to physical presence, and to the extent permitted by the Constitution of the United States, shall be liable for the tax imposed under this chapter of the general statutes. Such company shall apportion its net income under the provisions of this chapter."[287]

6. In 2002, the MTC proposed a "factor presence" standard of nexus for BAT. Under the standard, a nonresident is deemed to have substantial nexus with a state for BAT purposes if the nonresident has $50,000 or more in property or payroll in the state or $500,000 or more in sales in the state, physical presence in the state notwithstanding. Since then, certain states (e.g., Colorado, California, and Ohio) have adopted a factor presence standard of nexus for BAT taxes.

7. For several years, Business Activity Simplification Act bills have been introduced in Congress that would establish a bright-line physical presence standard for BAT by federal law. None of the BATSAs have been enacted.

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[284] Op. No. 02-2009-011 (Kan. Dep't of Rev. August 28, 2009).
[285] Cal. Rev. & Tax. Code § 23101(b).
[286] Conn. Gen. Stat. § 12-216a.
[287] Id.