



2009 Annual Ohio Tax Course
Cherry Valley Lodge, Granville, Ohio
August 14, 2009

Hot Multistate Tax Issues to Watch

Fred Nicely
COST

Diann Smith
Sutherland Asbill & Brennan LLP



Agenda

- US Supreme Court (Decisions, Denials of Cert)
- Income Tax Developments
 - Dividend Received Deduction
 - Forced Combination /Unitary Reporting
 - Add-Back Statutes
 - Apportionment/Sales Factor
 - Procedure
- Transaction Tax Developments
 - Nexus
 - Use Tax Collection
 - Miscellaneous
- Streamlined Sales Tax
- UDITPA
- Unclaimed Property
- Amer. Recovery & Reinv. Act & Pending Federal Legislation



Is Ohio's Budget This Bad?

- **Today's political news**
- Starbucks might welcome this development, but some Ohio Department of Transportation employees will not.
- **Employees who collectively contributed hundreds of dollars to a "coffee fund" -- used to buy coffee and snacks for employees at an ODOT warehouse in Lima -- have been told that the fund is being dissolved.**
- The decades-old fund helped employees avoid expensive trips to such vendors by purchasing coffee and sundries that employees and others visiting the warehouse could buy under an honor system. ODOT does not provide coffee for employees.
- The system apparently ran afoul of ODOT rules governing funds.
- "There was no impropriety in setting this up, but it really did create a lot of gray," ODOT spokesman Scott Varner said last week.
- For example, Varner said, there might be questions about whether money from the coffee fund could be used for an employee's farewell party.
- Varner said he doesn't know how much money was in the fund when ODOT bureaucrats zeroed in on it. **But it was more than \$1,000, he said.**
- **The money will go into the general fund.**

Article from James Nash, Columbus Dispatch



US Supreme Court: Pending Cases Cert. Granted

- *Hemi Group. LLC v City of New York*, Appeal from 2nd Circuit, cert. granted 5/4/2009 (Case No. 08-969)
 - Does RICO (federal Racketeer Influenced and Corrupt Organizations Act) apply to unpaid cigarette taxes?
 - New York City sued Hemi for intentionally not complying with federal Jenkins Act
 - Complaint originally dismissed by district court, advertised “tax free” cigarettes
- *Bilski v. Doll*, Appeal from Fed. Circuit, cert granted 6/1/2009 (Case No. 08-964)
 - Can tax strategies be patented? ABA and AICPA have been critical of attempts to patent tax planning methods
 - Senate has failed to pass legislation (H.R. 1908 died, introduced in 2007)
 - Does “business method” require tie-in to a machine or transformation of an article?



US Supreme Court: Pending Cert.

- *Missouri Gas Energy v. Woods County Assessor*, Appeal from Oklahoma Supreme Court, pending cert. (Case No. 08-1458)
 - Can a person be subject to tax on stored natural gas using an allocation formula?
 - Commerce Clause issues (stream of commerce & allocation formula)
- *Pooh Bah Enterprises, Inc. v. Cook County and City of Chicago*, pending cert. (Case No. ___-____)
 - Cook County and the City of Chicago impose an amusement tax on entertainment
 - Beginning in 1999, the amusement tax was amended to exempt live musical, theatrical, or other cultural performances that have a maximum seating capacity of 750 people
 - Exemption specifically bars “adult entertainment cabarets” – defined as entertainers that display specified anatomical areas
 - Illinois Supreme Court reversed the appellate court’s determination that the tax was facially unconstitutional based the county and city’s goal of encouraging fine art performances in small venues



US Supreme Court: Apportionment/Throwout

Valdez v. Polar Tankers, Inc., 182 P.3d 614 (Alaska 2008), ____
U.S. ____, 2009 U.S. LEXIS 4319 (6/15/09)

- City of Valdez imposed an ad valorem property tax on oil tankers that docked in their port
 - Tax apportioned based upon a days-in-port formula
 - Numerator in the formula is the number of days in Valdez; denominator is the number of days the tanker spent with a tax situs in other ports
 - Thus, the formula “throws out” from the denominator days spent in locations in which it did not obtain a tax situs
- Taxpayer challenged the tax under the Tonnage Clause, the Due Process Clause and the Commerce Clause
 - Tonnage Clause: No state shall lay any duty of tonnage
 - U.S.S.Ct. ruled ordinance was unconstitutional under this Clause
 - Commerce Clause and Due Process Clause
 - Court found it unnecessary to reach these arguments



Cert Denied: Income Tax Nexus

Capital One Bank v. Comm'r of Rev., 899 N.E.2d 76 (Mass. 2009), ___ U.S. ___, 2009 U.S. LEXIS ___ (6/22/09)

- Massachusetts Supreme Judicial Court concluded the taxpayer's deliberate and targeted exploitation of the Massachusetts economic marketplace constituted substantial nexus
- Taxpayers engaged in following activities:
 - targeted Massachusetts customers through advertising campaigns
 - used their intangible property (Capital One logo) in state
 - received hundreds of millions of dollars from Massachusetts customers
 - used Massachusetts governmental infrastructure to collect delinquent accounts
- Appealed to United States Supreme Court
 - Virginia and South Dakota filed an *amicus* asking the Court to take the case



Cert Denied: Income Tax Nexus

Geoffrey v. Comm’r of Rev., 899 N.E.2d 87 (Mass. 2009), ____
U.S. ____, 2009 U.S. LEXIS ____ (6/22/09)

- Out-of-state corporation licensing intangibles in Massachusetts subject to corporation excise tax
- Based on its holding in *Capital One*, the Court concluded the physical presence requirement in *Quill* applied only for sales tax purposes
- Court concluded Geoffrey had substantial nexus with Massachusetts
 - Geoffrey purposefully derived substantial economic gain (\$33 million) from the Massachusetts market
- Appealed to United States Supreme Court; cert denied on 6/22/09
- WILL THE SUPREME COURT EVER REVIEW AN INCOME TAX NEXUS CASE?



Cert Denied: AL Add-Back

VFJ Ventures Inc. v. Surtees, 2008 Ala. LEXIS 197 (9/19/08),
cert. den., ___ U.S. ___, 2009 U.S. LEXIS 3238 (4/27/09)

- Alabama Supreme Court held add-back statute did not violate Commerce Clause of U.S. Constitution
- Ala. Code § 40-18-35 requires corporate taxpayers to add back otherwise deductible interest and intangible expenses paid to or incurred with respect to related members unless it was unreasonable
- VFJ raised Due Process and Commerce Clause challenges primarily on the issue of deductions being based on other states tax policies – the “subject to tax” provision
- Numerous prominent organizations, including COST and the State of Delaware, filed amicus briefs in support of VFJ’s petition for certiorari



Cert Denied: Sales Tax Nexus

Dell Catalog Sales LP v. Taxation and Rev. Dep't, 199 P.3d 863(N.M.App. 6/3/08), *cert. den.*, ___ U.S. ___, 2009 U.S. LEXIS 2259 (3/23/09)

- Dell Catalog Sales had no property, sales agents or employees in New Mexico
- New Mexico DOR assessed gross receipts taxes on Dell's mail-order computer sales (and compensating taxes on its use of distributed catalogs)
- Appeals Court held that Dell's use of third-party service provider and control over in-state catalogs satisfied Due Process and Commerce Clause nexus standards
 - Court held that Dell possessed substantial nexus with New Mexico through its third-party repair and installation service provider
 - The presence of the service provider, to which nearly three-quarters of Dell's New Mexico customers subscribed, resulting in 1,300 service calls and installation visits, established the requisite substantial nexus



Cert Denied: CA LLC “Fee”

Ventas Finance I, LLC v. Franchise Tax Bd., 165 Cal. App. 4th 1207 (Cal. App. 1st Dist. 2008), *cert. den.* ___ U.S. ___, 2009 U.S. LEXIS 26 (2009)

Court of Appeal held that the LLC fee is actually a tax, and tax violates Commerce Clause under *Complete Auto* because tax fails both the internal and external consistency tests

- Internal consistency test violated because the tax is not apportioned and if all states imposed a similar tax, the maximum tax would be paid to all the states
- External consistency test violated because the tax is measured by income earned everywhere and not just what is earned in California
- Refund limited to difference between amount Ventas actually paid and amount Ventas could have been taxed without violating the Commerce Clause using a fair method of apportionment
- In *Ventas*, the court held the statute could not be judicially reformed because legislators rejected apportionment



Income Tax: CA Dividend Received Deduction

Abbott Laboratories v. FTB, ___ Cal. App. 4th ___ (Ct. App. 2nd Dist. 7/21/09)

- On Court's own decision that the case be resubmitted, it held that Section 24402 – the DRD statute that the Ct. of Appeal determined was facially discriminatory in *Farmer Brothers* – could not be judicially reformed so as to permit Subsection (b) of Sec. 24402 to continue to operate and afford Abbott the benefit of a DRD
- Ct. of Appeal rejected Abbott's assertions that
 - Trial court erred in holding that *Farmer Bros.* only invalidated Sec. 24402(a), which disallowed a DRD to a corporation which received a dividend declared from income of a corporation that was not subject to California tax
 - Trial court erred in failing to sever the unconstitutional limitations on DRDs from the valid portion of Section 24402
 - Section 24402, and the Legislature's intent, can be preserved by applying it in a non-discriminatory fashion



Income Tax: NC Forced Combination

Wal-Mart Stores East, Inc. v. Hinton, Ct. App., No. COA08-450 (5/19/09; consolidated with Sam's East, Inc. v. Hinton, Ct. App., No. COA08-453 (5/19/09)

- Court of Appeals upheld Revenue Secretary's forced combination of Wal-Mart and Sam's real estate investment trusts ("REITs") with the operating companies of the parent
- Secretary had authority to combine if "he 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 the state"
- Court held that the "essential meaning" of the phrase "true earnings" is the limit on state taxation found in the U.S. Constitution
- Court rejected every constitutional argument of the taxpayers:
 - Art. I, Sec. 16 of N.C. Const., which prohibits retroactive taxation
 - Due Process Cl. of the U.S. Constitution
 - Uniformity requirement of N.C. Const. and Equal Protection Cl. of U.S. Constitution
- Court affirmed assessment of penalties finding that negligence not a requirement for imposition of penalties and taxpayers had understated their tax liability by more than 25%



Income Tax: NC Forced Combination

Delhaize America, Inc. v. Hinton, 07 CVS 020801 (pending before Wake County N.C. Super. Ct.)

- NC DOR combined taxpayer's NC and FL entities with intercompany payments in order to “reflect true net earnings”
- DOR assessed tax and imposed penalties
- Taxpayer paid assessment and filed a refund claim. The allegations include:
 - DOR misinterpreted the combination law
 - DOR violated Commerce Clause and Due Process
 - DOR violated the NC uniformity rule and Equal Protection
- After conducting discovery, Taxpayer uncovered documents indicating a concerted effort to conceal from taxpayers the standard for combination
 - Former T.C. told COST members he would not issue guidelines because taxpayers would just “argue that their activities do not meet those criteria”
 - DOR e-mails expressed concern that guidelines would fall into the hands of the “dreaded” taxpayers
- Taxpayer amended complaint alleging additional violations of:
 - Administrative Procedures Act; and
 - Deprivation of constitutional rights under 42 U.S.C. § 1983



Income Tax: MA Unitary Group

W.R. Grace & Co. v. Mass. Comm’r of Rev., Mass. App. Tax Bd., No. C271787 (4/6/09)

- Grace was a Connecticut corporation with its headquarters, commercial domicile and principal place of business in Florida, it conducted business worldwide and throughout the U.S., and was principally in a specialty chemical business
- Grace had a subsidiary that specialized in chocolate production and had a plant in MA
- In preparing its combined return, Grace excluded dividends and interest income from the chocolate subsidiary’s income that was received as part of a financing transaction with its parent Grace
- The Appellate Tax Board held that the dividend and interest income was not taxable because Grace and its subsidiaries were not engaged in a unitary business
 - According to the Board, there was no:
 - functional integration
 - centralized management
 - economies of scale



Income Tax: MA Add-Back

TJX Cos. Inc. v. Mass. Comm’r of Rev., Mass. App. Ct., No. 07-P-1570 (3/3/09)

- TJX transferred certain trademarks and service marks to several intangible holding companies (“IHCs”)
- IHCs licensed marks to TJX and some of its subsidiaries, then loaned a substantial portion of the royalties back to TJX at an interest rate set by TJX
- TJX treated the royalty and interest payments as deductions from net income on its combined corporation excise tax returns
- Mass. Appeals Court affirmed holding of Appellate Tax Board that the “transfer license-back” arrangements were sham transactions
- The Court held the arrangements lacked economic substance and were for the sole purpose of avoiding tax



Income Tax: CA Sales Factor

General Mills v. Calif. Franch. Tax Bd., Cal. Ct. App., No. A120492 (4/15/09)

- General Mills engaged in futures trading as a hedge against the risk of fluctuation in the price of agricultural commodities used in its business
- Per GAAP and SEC, futures reported as adjustments to cost of sales
- When General Mills originally filed California returns, receipts not included in denominator; amended returns sought refunds
- California Court of Appeal held full sales prices of commodity futures sales used to hedge against price fluctuations are gross receipts within meaning of UDITPA, and therefore, properly included in denominator of sales factor



Procedure: Kentucky Refund Claim

Federal Relief – *Johnson Controls, Inc. v. Kentucky*, No. 3:07-CV-65-KKC (U.S.D.C., E.D. Ky. 2/29/08)

- Court held that a group of taxpayers was not barred from seeking federal review of legislation designed to extinguish taxpayers' refund claims
- Kentucky 2007 HB 316 attempts to revoke the state's waiver of sovereign immunity for refunds filed after 12/22/94 for periods prior to 12/31/95 based on a change from an initially filed separate return to a unitary combined return
- The court held that federal jurisdiction over the taxpayers' claims for relief against state officers responsible for administering and enforcing corporate income tax laws was not barred by the Eleventh Amendment, the Tax Injunction Act, or federal principles of comity
- State Supreme Court decision pending on same question



Income Tax: CA 20% Understatement Penalty

California Taxpayers' Association v. FTB, Sacramento Superior Court Case no. 34-2009 80000168 (filed 2/17/2009)

- Issue: Challenge to California's 20% understatement penalty (CA R&T 19138)
- Is it a Tax or a Penalty?
- Can the unabatable penalty be abated after all?



Amnesty v. Shamesty

13 States, thus far, have amnesty programs in 2009 (ties 2002 record)

- Alabama (expired)
- Arizona (expired)
- Connecticut (expired)
- **Delaware (first amnesty – 9/1 to 10/30)**
- Hawaii (first amnesty - expired)
- Kansas – settlement initiative
- Louisiana (9/1 to 10/31)
- Maine (9/1 to 11/30)
- Maryland (9/1 to 10/30)
- Massachusetts (expired)
- New Jersey (expired)
- **Oregon (first amnesty – 10/1 to 11/19)**
- Vermont (7/20 to 8/31)

Cities w/current amnesties:

- Oakland (CA)
- Colorado Springs (CO)



Sales/Use Tax: NY “Amazon” Nexus

Amazon.com/Overstock.com, __ N.Y.S. 2d __, 2009 WL 69336 (N.Y. Sup. Ct. 1/12/2009)

- Trial court dismisses challenge to “Amazon Law”
 - Rejects facial challenge: The law “is carefully crafted to ensure that there is a sufficient basis for requiring collection of New York taxes and, if such basis does not exist, it gives the seller an out”
 - Rejects as-applied challenge: Amazon chooses to utilize New York associates and should not be permitted to escape tax collection indirectly, use of associates vs. employees
- Various states have enacted or are considering similar proposals, including:
 - California
 - Connecticut
 - Florida
 - Hawaii (vetoed)
 - Illinois
 - Maryland
 - Minnesota
 - **North Carolina (enacted)**
 - **Rhode Island (enacted)**
 - Tennessee
 - Texas
 - Wisconsin



Transaction Tax: MA Sourcing Rule

Town Fair Tire Center (Mass. App. Tax Board, 2008);
appeal pending, Mass. Supreme Judicial Court

- Does ultimate destination control use tax collection duty?
- Tire store with locations in Mass. and N.H.
- Massachusetts assesses use tax on sales delivered at N.H. store to customers with Massachusetts addresses
- Appellate Tax Board sustains assessment
 - Constitutional arguments
 - SSUTA provision for sourcing over-the-counter sale



Transaction Tax: MO “Take No Prisoners” Resale Exemption

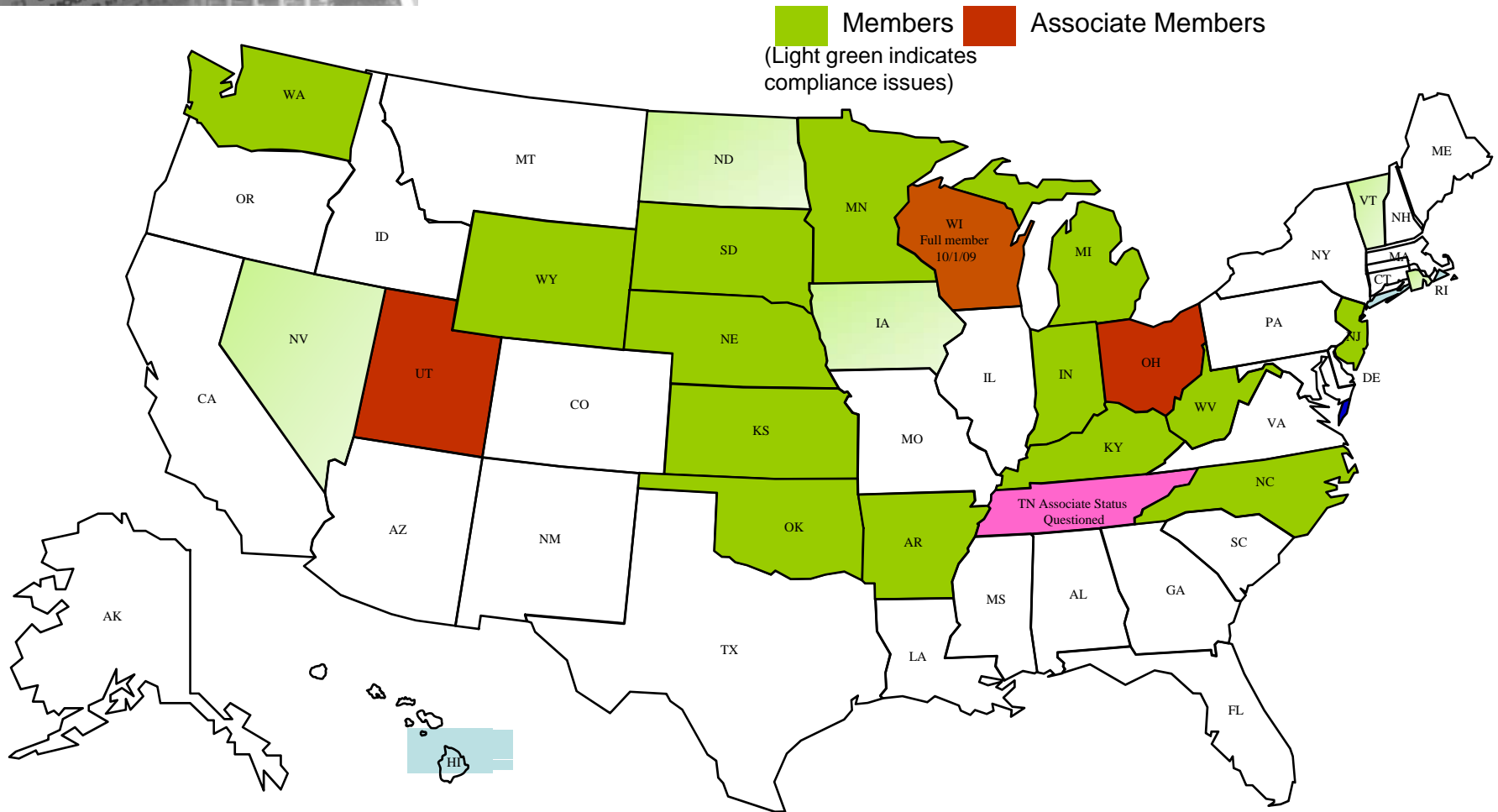
ICC Management v. Director, Mo. S. Ct. (6/1/2009)

- Private prison houses inmates on contract with local governments
- Sales to government agencies are exempt: prison bought food for inmates for resale
- S.Ct.: resale exemption applies only if subsequent sale is taxable
 - Grocery selling to church?
- A results-oriented decision/concurrence is curious:
 - “I concur in the principal opinion. However, the opinion seems to assume that the activities of ICC Management, Inc., a private corporation operating a jail, are not unlawful. Is there any constitutional or statutory authority for a private corporation to hold human beings in jail against their will?
 - I am not willing to assume that private jailing is lawful. **But whether the business of operating a private jail is lawful or not, I do agree it is not entitled to a tax exemption.”**
- In contrast, in *Sparks Nugget v. State Dept. of Taxation*, 124 Nev. Adv. Op. No. 15 (3/27/2008), court held food given away was not subject to Nevada’s sales tax



Streamlined Sales Tax States

19 full member & 3 or 4 Associate member states





Streamlined Sales & Use Tax Agreement (SSUTA)

- SSUTA approved November 2002 by the implementing states, and amended since - Agreement came into effect on October 1, 2005 (at least 10 states with 20% of the U.S. population)
- Provisions are based on simplification, uniformity and technology principles:
 - Simplification (e.g., state-level administration of tax)
 - Uniformity (e.g., uniform definition of "lease," lease sourcing rule)
 - Technology (e.g., certification of tax calculation software)

Amnesty

- A company can register and receive amnesty for any prior uncollected sales tax
- Need to continue registration for 36 months.
- Current SSUTA Amnesty expires for these states:
 - Utah, Ohio (and Tennessee?)** – continues (associate member states)
 - Wisconsin** – July 1, 2009 to Sept. 30, 2010



What's Been Made Uniform

- Treatment of bank holidays
- Rules for sales tax holidays
- Drop shipment rule
- Rule for bad debt credits
- Rounding Rule
- Digital goods
- Food and food ingredients
- Prepared food
- Candy
- Soft drinks
- Dietary supplement
- Clothing
- Drugs
- Durable Medical Equipment
- Computer Software
- Prewritten Computer Software
- Delivered Electronically
- Load and Leave
- Sales Price
- Lease or rental
- Tangible personal property
- Bundled Transaction
- Exemption Certificate



Pending SSTP Issues

- Direct mail – sourcing and treatment of postage
- Sales price
- Sourcing of Services
- Alternative Sourcing (Origin) Provision
- Credit for tax legally imposed by another state
- States recertification of substantial compliance with all provisions of the SSUTA
- Simplified electronic return
- Vendor compensation
- Small seller exclusion
- Getting federal legislation “Main Street Fairness Act” introduced



The UDITPA Conundrum

- Originally Drafted in 1957
- Centerpiece of MTC Compact, 1966
- After More Than 40 Years, Decreased Uniformity
- MTC Asks ULC for Re-write of UDITPA
- SSF: Tax Incentive or Apportionment Statute?
- Should Federal Legislation Play A Role?



UDITPA – Problems And Other Issues

- Business / Nonbusiness Definition
- Throwback / Throwout
- Weighting of the Factors
- Components of the Factors
- Definition of “Sales” or “Receipts” in the Sales Factor
- Apportionment of Pass-Through Entities
- Combined Reporting / Nexus / Addback



NCCUSL Ten Criteria

1. Simple and workable?
2. Internally consistent?
3. Externally consistent
4. Reasonably reflects business activity?
5. Is income apportioned in relation to benefits received?
6. Non-discriminatory?
7. Minimizes opportunity for manipulation?
8. Acceptable fiscal impact?
9. Equitable apportionment of base?
10. Economically neutral?

NCCUSL decided not to go forward with the project – MTC is proceeding with its review



Unclaimed Property

- Overview: What is the current unclaimed property environment?
- Problems with current state statutes/model acts



COST's Goals and Advocacy On Unclaimed Property

GOALS

- ✓ COST believes that compliance with unclaimed property statutes depends on a system that holders perceive to be balanced, fair, and effective.

ADVOCACY

- ✓ COST works with state legislatures, state unclaimed property administrators, and others to develop an unclaimed property reporting environment that meets these objectives.



Federal Legislation

- Business Activity Tax Simplification Act of 2009, H.R. 1083
- Mobile Workforce State Income Tax Fairness and Simplification Act, H.R. 2110
- Main Street Fairness Act (former Sales Tax Fairness and Simplification Act), not introduced



Conformity to I.R.C. Section 108(i)

- **The American Recovery and Reinvestment Act (“ARRA”)**
 - Under ARRA taxpayers are permitted, by an election, to defer, until 2014, recognition of income that arises from the discharge of indebtedness (“COD”), through I.R.C. Section 108(i).
 - The deferral period is five taxable years (in the case of COD income generated in 2009) or four taxable years (in the case of COD income generated in 2010).
 - Following the end of the deferral period, the COD income will be taken into income ratably over the next five years.
- **Current Advantages**
 - The election may be made for a debtor to defer the recognition of COD income from the purchase, exchange, or forgiveness of a debt instrument of the debtor.
- **State Conformity to ARRA and Section 108(i)**
 - Floating Conformity (without decoupling) (i.e. Colorado).
 - Static Conformity to the I.R.C. and have updated conformity date to include ARRA/108(i) (i.e. Georgia).
 - Static Conformity to the I.R.C., but have not updated their conformity date to include the ARRA/108(i) (i.e. Maine).
 - Decoupled from 108(i) (i.e. Florida)..



Questions?

Fred Nicely

fnicely@cost.org

Diann Smith

diann.smith@sutherland.com