TAX MANAGEMENT

MULTISTATE TAX REPORT

BNA Employee-Owned Since 1947

VOL. 14, NO. 8 AUGUST 24, 2007

Tax Policy

Paul H. Frankel, partner in Morrison & Foerster and chairman of the Multistate Tax Advisory Board, is a leading authority on state tax issues. Each year, he and his colleagues prepare this list of important developments in state taxation.

2007 Hot Topics in State Taxation: Nexus, Discrimination, Combined Reporting, Apportionment Are Dominant Issues

BY PAUL H. FRANKEL, CRAIG B. FIELDS, AND MITCHELL A. NEWMARK

This year has been marked by a series of promising developments and a few deeply disappointing ones, not the least of which was the U.S. Supreme Court's denial of review in *Lanco v. New Jersey*. Once again, the court has bypassed the opportunity to bring clarity to a highly confusing and conflicted area of state tax law. But there have been developments on other fronts that taxpayers and tax practitioners will find heartening—particularly on the procedural front.

PROCEDURAL PROGRESS

Pennsylvania. Effective in 2008, Pennsylvania will discontinue its unique procedure under which every corporate return is ''settled'' (*i.e.*, receives a desk audit) by the state, every year. Instead, under Act 119 (enacted Oct. 18, 2006), the Department of Revenue will follow the traditional path of audits and (if appropriate) assessments within three years of the filing of a corporate net income tax return.

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Texas. On Jan. 3, 2007, the new Texas Comptroller of Public Accounts, Susan Combs, took the necessary steps to transfer administrative tax hearings—and the administrative law judges that conduct those hearings—from the comptroller's office to the State Office of Administrative Hearings. In announcing the move, the comptroller said: ''When a taxpayer disagrees with the Comptroller's office, that taxpayer is entitled to a fair and impartial hearing. It is imperative to move tax hearings out of the Comptroller's office, to remove any appearance of bias and ensure that the integrity of the hearing process is beyond question.''[1]

Prior to the move, the comptroller's employees and agents served as prosecutor, judge, and jury, as do the internal hearing officers still remaining in some jurisdictions. Of that prior unfair process, the comptroller said: ''That is inappropriate. It's like having the police, the prosecutors and the judges working in the same office. It is not the legal system I know and respect.'' The next step in Texas should be the end of pay-to-play. We applaud the first step.

NEXUS

Alabama—Lanzi. In *Lanzi v. Alabama Dept. of Rev.*,[2] the Alabama Court of Civil Appeals held that a nonresident limited partner did not have sufficient nexus

[1] Press Release, Tex. Comp. of Pub. Accts. (Jan. 9, 2007).
[2] *Lanzi v. Alabama Dept. of Rev.*, No. 20440298 (Ala. Civ. App. June 30, 2006), *cert. denied* (Ala. Apr. 13, 2007).

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with Alabama for the state to impose an income tax on his earnings from the partnership that was doing business in Alabama without violating the U.S. Due Process Clause. The court found that a limited partnership interest ''is directly analogous'' to the ownership of stock in a corporation, and thus, the Due Process Clause requirements should apply equally to both. Since the ownership of stock in a corporation doing business in a state is not, by itself, sufficient to create nexus with a state, the same should apply for ownership of a limited partnership interest.

The decision's application is limited to the tax statutes in effect before 2001. It does not address the post-2000 Alabama law that:

- allows a nonresident partner to consent to personal jurisdiction in Alabama for paying taxes on Alabama source income; or
- requires the partnership to pay the income tax on behalf of the nonresident partner on a composite income tax return.

Alabama—Union Tank Car. An Illinois corporation that manufactured rail cars in Illinois and Texas and subsequently leased the railcars to Alabama-based customers was not subject to Alabama tax, the Alabama Civil Court of Appeals held.[3] All leasing agreements were executed in Illinois with lease amounts remitted to the company in Illinois. Further, the railcars were picked up in either Illinois or Texas and returned to locations in Illinois or Texas. All repairs, except for emergency repairs performed by a third party, were made outside of Alabama.

The Court of Civil Appeals affirmed the decision of the Alabama Circuit Court, which affirmed an administrative law judge's determination that the corporation was neither doing business in Alabama nor deriving income from sources in Alabama. Therefore, the corporation was not subject to Alabama income tax on the railcars leased to Alabama customers.

New Jersey. Nearly a decade after our case began, the New Jersey Supreme Court held in *Lanco Inc.*[4] that the physical presence requirement of *Quill Corp. v. North Dakota*,[5] does not apply in the context of New Jersey's assertion of an income tax on a remote licensor of intangibles used in retail operations of affiliates in the state. The court found that *Quill* was not intended to establish a ''universal physical-presence requirement'' and that the *Quill* holding was limited to sales and use tax. The New Jersey Tax Court had it right in 2003 when it ruled in favor of the company.

On June 18, the U.S. Supreme Court denied certiorari in this case and in MBNA. We are confident that the court will eventually take this issue and the taxpayer will win. *Quill* will, at that point, apply to all taxes.

West Virginia. The dissent in *West Virginia Tax Comr. v. MBNA* said it best. The dissent noted that the majority did not rely on constitutional principles or established legal precedent and that the majority contradicted the U.S. Supreme Court's precedent in *Complete Auto* and *Quill*, among other decisions. The dissent reasoned that there exists no significant difference between a use tax collection obligation and the liability for income taxes. The same nexus standard should apply under the U.S. Commerce Clause. The dissent is correct.

The majority of the highest court of West Virginia held that the *Quill* physical presence standard applies only to state sales and uses taxes and not to state business, franchise, and corporation net income taxes. The court affirmed a West Virginia Circuit Court ruling that a bank had nexus with West Virginia based upon a statutory presumption of nexus for financial institutions that arises when gross receipts attributable to West Virginia sources exceed $100,000 even though the bank lacked any physical presence in the state. The court favored an economic presence test and concluded that MBNA ''continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia'' and cited MBNA's multi-million dollar gross receipts attributable to West Virginia residents.

Wyoming. In *Buehner Block Co. v. Wyoming Dept. of Rev.*,[6] the Wyoming Supreme Court held that an out-of-state seller of concrete blocks with no offices or employees in Wyoming had nexus with Wyoming for purposes of the sales and use tax. Title to the blocks passed outside Wyoming, and the blocks were delivered by common carrier. Nevertheless, the court found that the company was a vendor under the state sales and use tax and held that because *the company had voluntarily registered* for and received a sales tax license, collected and remitted tax under that license, and delivered blocks by common carrier, that it had sufficient presence in Wyoming.

Louisiana. In a terrific sales tax opinion, *St. Tammany Parish Tax Collector v. Barnesandnoble.com*[7] _ the U.S. District Court for the Eastern District of Louisiana held that an Internet retailer did not have nexus with a Louisiana parish sufficient to subject the retailer to an obligation to collect sales and use taxes because it had no physical presence in Louisiana except for the use of common carriers to deliver merchandise from out of state that was ordered online. The court held that the physical presence in Louisiana of its affiliate, a bricks and mortar retailer, would not be attributed to the Internet retailer.

New Mexico. An internal hearing officer for the New Mexico Department of Taxation and Revenue held that in-state repair services provided by a third-party warranty service provider on behalf of Dell Catalog Sales L.P. were sufficient to create ''substantial nexus'' in New Mexico requiring Dell's collection of use tax on its sales into the state. In *In re Dell Catalog Sales*,[8] the hearing officer found that it was not necessary that the

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[3] *Alabama Dept. of Rev. v. Union Tank Car Co.* No. 2050652 (Ala. Civ. App. Apr. 13, 2007).

[4] *Lanco Inc. v. Director, New Jersey Div. of Taxn.*, 908 A.2d 176 (N.J. 2006), *cert. denied*, (U.S. June 18, 2007) (No. 06-1236).

[5] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[6] *Buehner Block Co. v. Wyoming Dept. of Rev.*, 139 P.3d 1150 (Wyo. 2006).

[7] *St. Tammany Parish Tax Collector v. Barnesandnoble.-com LLC*, No. 05-5695 (E.D. La. Mar. 22, 2007).

[8] *In re Dell Catalog Sales L.P.*, No. 06-11 (N.M. Taxn. & Rev. Dept. June 22, 2006).

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in-state repair provider be soliciting sales in order to create nexus for the out-of-state seller. The hearing officer also concluded that it was not necessary that the repair provider be acting as the seller's agent in the state to create nexus. Rather, the hearing officer focused on Dell's control over the warranty services.

Tennessee. In *Arco Bldg. Sys. Inc. v. Chumley*,[9] the Tennessee Court of Appeals held that a Georgia seller of metal buildings with no property or employees in Tennessee had nexus in Tennessee for sales and use tax purposes based on its use of a Tennessee manufacturer that drop shipped the completed buildings to the building seller's Tennessee customers. The court determined that the activities of the Tennessee manufacturer on behalf of the building seller were sufficient to create nexus for the out-of-state company. The court found that the manufacturer functioned as the seller's in-state representative.

Texas. The Texas Comptroller of Public Accounts reviewed a matter involving the holding of a membership interest in a single-member limited liability company that did business in Texas. In Comptroller's Letter, No. 200606695L (June 1, 2006), the comptroller determined that an out-of-state LLC that owned a single-member LLC doing business in Texas that was disregarded for federal income tax purposes did not have nexus with Texas based solely on the holding of the membership interest in the single member LLC doing business in Texas.

DISCRIMINATION

Alabama—Still No Refunds. An Alabama Circuit Court judge held that notwithstanding that the franchise tax computation discriminated against foreign corporations, as held by the U.S. Supreme Court in *South Central Bell Telephone Co. v. Alabama*,[10] the taxpayer was not entitled to a refund because it did not prove that it was discriminated against as it did not demonstrate that it had domestic corporation competitors.[11] The taxpayer has appealed to the Alabama Court of Civil Appeals.

In *AT&T Corp. v. Surtees*,[12] the Alabama Court of Civil Appeals modified its earlier finding in favor of the company, remanding for further determination rather than a refund. The court held that the deductions from the business privilege tax and corporate shares tax that were allowed only for investments in the equity of an entity doing business in Alabama were facially discriminatory and that the burden was on the state to prove that the deductions were constitutional. The court remanded the case to the Alabama Circuit Court for further proceedings and withdrew its June 23, 2006, opinion, in which it had held that the deductions were discriminatory and that a refund should be granted to the company.

California. In *Macy's Dept. Stores Inc. v. San Francisco*,[13] the California Court of Appeal held that where a taxing regime for the City and County of San Francisco was discriminatory, because a taxpayer located only in the city could be subjected to either a payroll tax or a gross receipts tax, but a taxpayer doing business both within and outside the city could be subjected to multiple taxes, the taxpayer was only entitled to a refund of the amount the taxing agencies determined was over the amount that would have been paid if the dual base system was not in place.

Kentucky. The plaintiffs challenged the constitutionality of a Kentucky tax that exempted interest derived from bonds issued by Kentucky or its subdivisions, but required that tax be paid on interest derived from bonds issued by sister states or their subdivisions.[14] The Kentucky Court of Appeals determined in *Davis* that Kentucky's system of only taxing extraterritorial bond interest violated the U.S. Commerce Clause because Kentucky's tax afforded more favorable tax treatment to bonds issued in Kentucky than those bonds issued out of state.

New Hampshire. In *General Electric Co. v. New Hampshire Comr. of Rev.*, [15] the New Hampshire Supreme Court held that the provision of the business profits tax that allowed a dividends received deduction for dividends from a subsidiary that is subject to tax in New Hampshire did not discriminate against interstate commerce in connection with the department's denial of the deduction for dividends from foreign corporation subsidiaries that were not subject to tax in New Hampshire. A petition for certiorari has been filed in the U.S. Supreme Court. On May 21, the court invited the U.S. Solicitor General to file a brief in this case.

ISSUES IN APPORTIONMENT

California. The San Francisco Superior Court issued a tentative decision that followed its prior decision in *Northwest Energetic Services* and determined that the state's limited liability company levy is not a fairly apportioned tax.[16] Thus, the tax violates the U.S. Commerce Clause and the U.S. Due Process Clause. In *Northwest Energetic Svcs. LLC v. California Franch. Tax Bd.*,[17] the San Francisco Superior Court held that California's levy on limited liability companies is a tax and that as a tax, the levy violates the fair apportionment requirements of both the Commerce and Due Process clauses. The bases of the *Ventas* and *Northwest*

[9] *Arco Bldg. Sys. Inc. v. Chumley*, 209 S.W.3d 63 (Tenn. Ct. App. 2006), *appeal denied*, M2004-01872-SC-R11-CV (Tenn. Oct. 30, 2006).

[10] *South Central Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999).

[11] *Vulcan Lands Inc. v. Surtees*, CV 2001-1106 (Ala. Cir. Ct. Mar. 12, 2007)), *appeal filed* (Apr. 6, 2007).

[12] *AT&T Corp. v. Surtees*, 953 So. 2d 1240 (Ala. Civ. App. Sept. 8, 2006).

[13] *Macy's Dept. Stores Inc. v. San Francisco*, 143 Cal. App. 4th 1444 (2006), *review denied* S148342 (Cal. Jan. 17, 2007), *petition for cert. filed* (U.S. Apr. 12, 2007) (No. 06-1360).

[14] *Davis v. Kentucky Dept. of Rev.*, 197 S.W.3d 557 (Ky. Ct. App.), *review denied* (Ky. Aug. 17, 2006), *cert. granted* (May 2007) (No. 06-666).

[15] *General Electric. Co. v. New Hampshire Dept. of Rev.*, 914 A.2d 246 (N.H. 2006), *petition for cert. filed* (U.S. Mar. 22, 2007) (No. 06-1210).

[16] *Ventas Fin. I LLC v. California Franch. Tax Bd.*, No. CGC-05-440001 (Cal. Super. Ct. Nov. 7, 2006).

[17] *Northwest Energetic Svcs. LLC v. California Franch. Tax Bd.*, No. CGC-05-437721 (Cal. Super. Ct. Apr. 13, 2006),

Energetic Services decisions included the courts' determinations that an interstate LLC with the same total income as the LLC in this case would pay the maximum levy in every jurisdiction in which it registered to do business, while an LLC operating wholly within a single jurisdiction would pay the maximum levy, but only in the single jurisdiction in which it was operating.

Apportionable vs. Allocable Income

Illinois. In *Mead Corp. v. Illinois Dept. of Rev.*,[18] the Illinois Appellate Court held that the gain from the sale of a separate division produced apportionable income on the theory that there was an operational relationship. Mead and Lexus/Nexus were not unitary. They were not functionally integrated, did not share centralized management, and no economies of scale were realized. We have filed a petition for certiorari with the U.S. Supreme Court.

In *National Holdings Inc. v. Zehnder*,[19] the Illinois Appellate Court held that the gain from the sale of the taxpayer's supermarkets was nonbusiness income under the business-liquidation exception to the functional test, because all of the liquidation proceeds were distributed to the parent company and were not reinvested in the ongoing retail grocery business of the taxpayer.

Maryland. In *Science Applications Int'l. Corp. v. Maryland Comp. of Treas.*,[20] a parent corporation that conducted business in Maryland realized gain on the sale of stock in its subsidiary. The Maryland Tax Court held that the gain was not apportionable by Maryland because the subsidiary was not part of a unitary business and because it served an investment function. This was because the parent and subsidiary were in separate businesses and the subsidiary was managed independently, had its own treasury function and cash management system, and made its own acquisitions, and the parent maintained its interest in the subsidiary as an investment for profit—which it realized by selling the subsidiary's stock in a public offering. The tax court also held that the state's attempted taxation of the gain resulted in a tax that was disproportionate to the parent's business activities in Maryland and led to a grossly distorted result.

I.R.C. §338(h)(10) Transactions

Illinois. In *Nicor Inc. v. Hamer*,[21] the Illinois Circuit Court determined that a deemed sale of assets, pursuant to I.R.C. §338(h)(10), constituted a complete liquidation and cessation of business, such that the gain from the deemed sale of the assets constituted nonapportionable, nonbusiness income. Although the Illinois Department of Revenue urged the court to reject prior Illinois court decisions finding a liquidation exception to the functional test, the court declined.

Missouri. In our *ABB C-E Nuclear Power* case,[22] the Missouri Supreme Court held that the gain recognized by a corporation from a sale of a subsidiary in an I.R.C. §338(h)(10) transaction constituted nonbusiness income for Missouri tax purposes.

Utah. In *Chambers v. Utah State Tax Comn.*,[23] the Utah District Court held that gain on the sale of a corporation in which an election was made under I.R.C. §338(h)(10) was nonbusiness income for Utah tax purposes.

COMBINED/CONSOLIDATED RETURNS

Combination is a hot area for 2007, and the heat will continue in 2008. There have been developments in states that require combined returns, there have been several Departments of Revenue that have recently been authorized to pursue combination, and a number of governors have sought the power to force combination. Stay tuned to next year's article for further developments in this area.

New York. An administrative law judge held that a taxpayer could be forced to file a combined corporation franchise tax return including its out-of-state affiliate with which it had substantial intercorporate transactions as a result of its payment of a royalty to the affiliate for the use of the affiliate's intellectual property.[24] The Division of Taxation asserted that the company failed to prove that the royalty was paid at an arm's-length rate, that the license agreement lacked economic substance, and that the licensor was formed for tax avoidance purposes. The ALJ determined that if either the royalty rate was not arm's-length or the licensor lacked a business purpose or economic substance, then the structure was distortive and combination would be proper to cure the distortion. The ALJ found that the affiliate's ownership of the intellectual property served no business purpose apart from tax avoidance and that there was no economic substance in the transaction due to the circular flow of funds created by the loan of the royalty payments back to the payor. The ALJ determined that, notwithstanding that the taxpayer met its burden to prove that the royalties were paid at an arm's-length rate, combination was proper.

New York—Hallmark. We won *In re Hallmark Mktg. Corp.*[25] The taxpayer successfully rebutted the presumption of distortion by showing that its intercompany pricing was consistent with I.R.C. §482 principles, consistent with a contemporaneous transfer pricing study, and supported by expert testimony. Hallmark should help all taxpayers facing forced combination in New York for all periods prior to 2007.

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[18] *Mead Corp. v. Illinois Dept. of Rev.*, 861 N.E.2d 1131 (Ill. App. Ct.), *review denied*, 862 N.E.2d 235 (Ill. 2007), *petition for cert. filed* (U.S. Apr. 20, 2007) (No. 06-1413),

[19] *National Holdings Inc. v. Zehnder*, 369 Ill. App. 3d 977 (2007).

[20] *Science Applications Int'l. Corp. v. Maryland Comp. of Treas.*, No. 04-IN-OO-0632 (Md. Tax Ct. May 11, 2006).

[21] *Nicor Inc. v. Hamer,* No. 05 L 01306 (Ill. Cir. Ct. Apr. 19, 2007).

[22] *ABB C-E Nuclear Power Inc. v. Missouri Dir. of Rev.*, 215 S.W.3d 85 (Mo. 2007).

[23] *Chambers v. Utah State Tax Comn.*, No. 050402915 TX (Utah Dist. Ct. Jan. 25, 2007).

[24] *In re The Talbots Inc.,* DTA No. 820168 (N.Y. Div. Tax App. Mar. 22, 2007).

[25] *Hallmark Mktg. Corp.*, DTA No. 819956 (N.Y. Div. Tax App. Jan. 26, 2006), *affirmed,* (N.Y. Div. Tax. App. July 19, 2007).

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New York—The New Law. Beginning in 2007, a taxpayer corporation is required to file a New York state combined corporation franchise tax return with an affiliate if there is:

- common ownership and control (generally 80 percent direct or indirect ownership),
- a unitary business, and
- substantial intercompany transactions even if there is no distortion.

However, in the case of corporations where one corporation is paying a royalty to the other corporation, if the corporations are forcibly combined, the payor of the royalties does not have to add back the royalties as would otherwise be required by the state's add-back statute.[26]

Texas. Effective for tax years beginning on or after Jan. 1, 2008, a taxpayer that is part of an affiliated group of entities that are engaged in a unitary business must file a combined return. An affiliate will not be combined with the taxpayer if the affiliate conducts its business outside the United States and has more than 80 percent of its property and payroll outside the United States or has no property or payroll, but 80 percent or more of its gross receipts are assigned to locations outside the United States.[27]

Vermont. Effective for tax years beginning on or after Jan. 1, 2006, for a taxable corporation that is a member of an affiliated group and that is engaged in a unitary business with one or more other members of that affiliated group, Vermont net income is the allocable share of the combined net income of the group.[28]

West Virginia. Effective for tax years beginning on or after Jan. 1, 2009, for purposes of the corporation net income tax, a taxpayer that is engaged in a unitary business must report income and the allocation and apportionment thereof on a combined basis with the members of its unitary business.[29]

Various States. At the urging of Professor Richard Pomp, of the University of Connecticut Law School, governors of Iowa, Massachusetts, Michigan, North Carolina, and Pennsylvania have requested that their states enact required combined reporting.

SALES FACTOR ISSUES

Gross Receipts vs. Net Income

California. In *Microsoft Corp. v. California Franchise Tax Bd.*,[30] the taxpayer asserted that the entire gross proceeds from certain treasury function transactions, which mainly included marketable securities held to maturity, must be included in its sales factor as "gross receipts" under Cal. Rev. & Tax. Code §25120. The California Supreme Court ruled that:

- the redemption of marketable securities at maturity does generate gross receipts for sales factor purposes; and
- the FTB met its burden to apply an alternative apportionment formula.

The taxpayer asserted in *General Motors Corp. v. California Franch. Tax Bd.*[31] that the entire gross proceeds from certain treasury function transactions, which included both marketable securities held to maturity and repurchase agreements, must be included in its sales factor as "gross receipts" under Cal. Rev. & Tax. Code §25120.

The California Supreme Court followed its ruling in *Microsoft* for marketable securities—that the redemption of marketable securities at maturity does generate gross receipts for sales factor purposes. It then held for repurchase agreements that only interest from repurchase agreements is to be included in gross receipts. The court reasoned that although a repurchase agreement is like both a sale and a loan—"for gross receipts purposes, a repo has the characteristics of a loan, not the sale of a commodity. In a repo, the amount paid depends not on the value of the surrendered security, but on the amount of money the repo buyer paid the repo seller in the front end of the transaction." The court remanded the case to the trial court to allow the FTB to pursue an argument for alternative apportionment as to the marketable securities held to maturity.

Other Sales Factor Issues

New Jersey. New Jersey enacted a throwout provision for periods beginning on or after Jan. 1, 2002. N.J. Stat. Ann. §54:10A-6(B)(6), effective July 2, 2002, applies to privilege periods beginning on or after Jan. 1, 2002. The New Jersey Division of Taxation's regulation interprets the throwout law to exclude receipts from the denominator of the sales fraction that are sourced to where the taxpayer is not "subject to a tax on or measured by profits or income or business presence or business activity."[32] The division has applied inconsistent positions regarding the nexus standard for nexus with New Jersey and for nexus with other states. The division has also improperly applied throwout to years prior to its enactment in 2002. The application of throwout to a single-entity taxpayer or to an affiliated group shall not increase the single taxpayer or the group's liability more than $5 million. The excess increase attributable to throwout is to be abated. We have several cases at various levels, including the Tax Court, challenging the constitutionality of throwout. We predict that the throwout law will be thrown out.

New Mexico. A New Mexico Department of Taxation and Revenue internal hearing officer found[33] that a trademark company:

- was not subject to the gross receipts tax pursuant to the New Mexico Court's ruling in *Kmart Props.*, but

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[26] S.B. 2110-C, Part J, Sections 1-4 (Enacted Apr. 1, 2007, as L. 2007, Ch. 60).
[27] Tex. Tax Code §171.1014.
[28] Vt. Stat. Ann. tit. 32 §5811(18).
[29] S.B. 749.
[30] *Microsoft Corp. v. California Franch. Tax Bd.*, 139 P.3d 1169 (Cal. 2006).
[31] *General Motors Corp. v. California Franch. Tax Bd.*, 139 P.3d 1183 (Cal. 2006).
[32] N.J. Admin. Code §18:7-8.7(d).
[33] *In re Wal-Mart Stores Inc.*, No. 02-344332-00 4 (N.M. Taxn. & Rev. Dept. May 1, 2006).

■ was subject to the corporate income and franchise taxes and applied alternative apportionment.

Although the corporation had stipulated that it had sufficient nexus with New Mexico to bring it within the state's taxing jurisdiction, the corporation argued that none of its income was attributable to New Mexico under the three-factor apportionment formula. The hearing officer held that the department could apply an alternative apportionment formula, which consisted of excluding the property and payroll factors and applying a receipts factor calculated by comparing the royalty income generated from the use of the corporation's marks in New Mexico to the royalty income generated from the use of its marks everywhere (rather than using the cost of performance standard). The hearing officer abated penalties as the corporation reasonably relied on the advice of accounting and legal staff and was not negligent in failing to pay New Mexico corporate income tax.

RETROACTIVITY

Kentucky. In a long battle for refunds due to taxpayers since 1995, the Kentucky Court of Appeals held that legislation enacted in 2000 to retroactively prohibit unitary refunds for corporations that initially filed separate Kentucky tax returns for pre-1995 years, and which subsequently filed amended unitary returns after our 1994 victory in *GTE*, violated the U.S. Constitution. In our *Johnson Controls Inc. v. Rudolph*,[34] case, the court held that the retroactivity period was so excessive that it violated due process.

Not to be outdone by the Kentucky Court of Appeals, the Kentucky Legislature has enacted new legislation to bar the payment of refunds.[35] That law revokes any stated or implied consent of the Commonwealth of Kentucky to be sued for any legal, equitable, or other relief with respect to a refund or credit based on the change in filing status for years 1994 and prior.

Michigan. In *International Home Foods Inc. v. Michigan Dept. of Treas. and Lenox Inc. v. Michigan Dept. of Treas.*[36] the Michigan Supreme Court reversed, in a one-sentence decision, the Michigan Court of Appeals' ruling that that the Department of Treasury could not retroactively apply *Gillette Co. v. Michigan Dept. of Treas.*,[37] to years prior to the issuance of the decision because the department had previously issued revenue administrative bulletins providing that a corporation was protected from imposition of the single business tax by Pub. L. No. 86-272. The Michigan Supreme Court followed the dissent in the Court of Appeals that followed the decision in *Rayovac Corp. v. Michigan Dept. of Treas.*[38] Then, the Michigan Supreme Court amended its decision to reverse the Court of Appeals' ruling and to reinstate the trial court's decision and remanded the case to the appellate court for a determination as whether there is a genuine issue of material fact as to the amount of the liability.[39]

The majority in the Court of Appeals distinguished the decision in *Rayovac Corp.* on the basis that, while various challenges were considered regarding the retroactive application of *Gillette* (including U.S. Commerce Clause violations and the binding nature of guidelines under the Administrative Procedures Act), the decision did not address the issue of whether the department was bound by its official position. The dissent would have followed the decision in *Rayovac Corp.* In *Rayovac Corp.*, the Michigan Court of Appeals had held that the Department of Treasury was not barred from retroactively applying a new rule created by case law despite the fact that it had previously issued revenue administrative bulletins advising taxpayers to the contrary. The court found that retroactive application of the single business tax did not discriminate against or unconstitutionally burden interstate commerce. Moreover, the court held that the department's actions did not "bait and switch."

Oregon. On remand from *U.S. Bancorp v. Oregon Dept. of Rev.*,[40] the Oregon Tax Court held that although the revised regulation applied retroactively, the department did not meet its burden to show that the original return as filed in conformance with the then existing regulation did not fairly and accurately reflect the taxpayer's net income because the original returns were filed in accordance with the existing substantive rule.[41] Therefore, the department's adjustments purportedly under the retroactive regulation to include intangible property in the property factor were not allowed. In *U.S. Bancorp.*,[42] the Oregon Supreme Court concluded that the state Department of Revenue could require a financial institution to include intangible personal property in the computation of its apportionment factor by retroactively applying a regulation adopted in 1995 to the years 1988 through 1992. The court determined that the context of the provision made it clear that the department could apply the rule retroactively.

MISCELLANEOUS

Alabama. The Circuit Court of Montgomery County held that VFJ Ventures Inc. (VFJ), a clothing manufacturer and licensee of certain clothing brand name trademarks, was not required to add back royalty payments under Alabama's add-back statute.[43] In *VFJ Ventures v. Surtees*, the court found that the establishment of the trademark holding companies had beneficial tax effects, increased efficiency by concentrating management in one group of employees, and allowed third-party licensing efforts to be coordinated and managed. The trademark holding companies carried on substan-

[34] *Johnson Controls Inc. v. Rudolph*, No. 2004-CA-001566-MR (Ky. Ct. App. May 5, 2006) (petition for *cert.* pending).

[35] H.B. 316, L. 2007, ch. 22.

[36] *International Home Foods Inc. v. Michigan Dept. of Treas. and Lenox Inc. v. Dept. of Treas.*, 725 N.W.2d 458 (Mich. 2007).

[37] *Gillette Co. v. Michigan Dept. of Treas.*, 497 N.W.2d 595 (1993).

[38] *Rayovac Corp. v. Michigan Dept. of Treas.*, 691 N.W.2d 57 (Mich. Ct. App. 2004).

[39] Ill. Mar. 30, 2007.

[40] *U.S. Bancorp v. Oregon Dept. of Rev.*, 103 P.3d 85 (Or. 2004), *cert. denied*, 126 S. Ct. 48 (2005).

[41] *U.S. Bancorp v. Oregon Dept. of Rev.*, TC 4531 (Or. Tax Ct. Mar. 13, 2007).

[42] *U.S. Bancorp.*, 103 P.3d at 85.

[43] *VFJ Ventures Inc. v. Surtees*, No. CV-03-3172 (Ala. Cir. Ct. Jan. 24, 2007).

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tial activities in a working office, maintained thousands of trademarks, charged an arm's-length rate (5 percent) to related, as well as unrelated, licensees, and monitored for potential trademark infringements. The court held that the add back is unreasonable (and would not be required) because

> the purposes of the add-back statute are to prevent abusive deductions and to ensure that income fairly attributable to Alabama is taxed in Alabama . . . . Add-back is unreasonable in VFJ's case because VFJ's royalty payments are not abusive—they have economic substance and business purpose—and represent real and necessary costs of doing business in Alabama.

The court noted that: ''This conclusion is not altered by the fact that the transactions may have been motivated by tax considerations.'' Although the *VFJ* court found that the addback was unreasonable, it also stated that the subject to tax exception is satisfied for receipts attributable to post-apportionment and preapportionment combination states. The department's appeal from the Montgomery County Circuit Court's decision is pending in the Alabama Court of Civil Appeals.

New York. The New York Division of Taxation and Finance has promulgated a new regulation, Part 2500, which provides that taxpayers that participate in a New York reportable transaction must disclose its participation with the tax return for that taxable year.[44] A New York reportable transaction is one that has the *potential* to be a tax avoidance transaction. The three categories of New York reportable transactions are:

- New York listed transactions (any transaction that the Commissioner of Taxation and Finance has determined to be a tax avoidance transaction and has identified it as such by a notice or other published guidance);
- New York *confidential* transactions (involves transactions offered under conditions of confidentiality and for which an advisor fee is paid); and
- New York transactions with contractual protection (involves transactions with a right to a refund of fees if the tax treatment is not sustained or where the fee is contingent upon realization of tax benefits from the transaction).

Disclosure is to be made on two New York forms: Form DTF-686-ATT, New York Reportable Transaction Disclosure Statement and Request for a Determination; and Form DTF-686, Tax Shelter Reportable Transactions.

Maryland. After the Maryland Court of Appeals ordered the Comptroller of the Treasury to refund sales tax paid on a lease termination agreement (because the lease termination was not a sale) in *Maryland Comp. of Treas. v. Citicorp Int'l. Comm. Inc.*,[45] the comptroller asserted that the court's order did not specifically require that interest be paid on the refund and that he is not bound to pay interest on the refund. The company sought interest on the refund. The Maryland Tax Court heard the company's claim and determined that interest must be paid on refunds unless the refund claim is based on an error of the company. The Tax Court held that the comptroller must pay interest on the refund because the company did not voluntarily and erroneously pay the tax when the lessor required that the tax be paid under the lease agreement, *i.e.*, there was no mistake or error by the company when it paid the tax.[46] The comptroller has filed an appeal of this decision at the Circuit Court.

Massachusetts. The U.S. Court of Appeals for the Third Circuit, in *In re Valley Media Inc.*,[47] affirmed a decision of the U.S. District Court for the District of Delaware that the U.S. Bankruptcy Court properly held that a taxpayer was not liable for Massachusetts sales tax on drop shipments the taxpayer had sent to Massachusetts. The Bankruptcy Court held that tax was not due because delivery of the goods occurred in California when the goods were shipped F.O.B. from the taxpayer's warehouse. The federal district court reasoned that both title and risk of loss passed from the taxpayer upon transfer of the goods to the carrier in California and that delivery under the Uniform Commercial Code was made in California and not Massachusetts.

CONCLUSION

Despite the U.S. Supreme Court's reluctance to take on critical state tax cases, 2007 has been an exciting year. We expect 2008 to bring new issues, new challenges, and new ideas.

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[44] *New York Reportable Transactions*, TSB-M-07 (Mar. 8, 2007).

[45] *Maryland Comp. of Treas. v. Citicorp Int'l. Comm. Inc.*, 884 A.2d 112 (Md. 2005).

[46] *Citicorp Int'l. Comm. Inc. v. Maryland Comp. of Treas.*, Nos. 02-SU-OO-0068 and 05-SU-OO-0596 (Md. Tax Ct. Mar. 20, 2007).

[47] *In re Valley Media Inc.*, No. 06-2163 (3d Cir. Feb. 23, 2007).