State + Local Tax Insights

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Should Filmmakers Be Content to Have Taxing Authorities Judge Their Content?

By Hollis L. Hyans and Open Weaver Banks

The vast majority of states have enacted tax incentive programs for qualifying motion picture and television productions. These tax incentives are available in many forms, including income tax credits (typically transferable), sales tax exemptions, hotel tax exemptions and cash rebates of qualified expenditures. Although the features of each state's program vary, the common purpose of these programs is to spur local economic growth by incentivizing the motion picture and television industries to locate their productions in the state offering an incentive program.

So what happens when a production company meets all the eligibility requirements for a tax credit, but cannot get past the state's censors? As we learned recently in New Jersey, the shooting location of the reality television series *Jersey Shore*, tax credits might be revoked if the state decides that the television program makes the state look bad.[1] On September 26, 2011, Governor Christie informed the New Jersey Economic Development Authority that he vetoed its award of $420,000 in tax

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credits to the producers of *Jersey Shore*.[2] Governor Christie explained: "I have no interest in policing the content of such projects; however, as Chief Executive I am duty bound to ensure that taxpayers are not footing a $420,000 bill for a project which does nothing more than perpetuate misconceptions about the State and its citizens."[3]

State Review of Motion Picture and Television Production Content

While Governor Christie's veto of the *Jersey Shore* tax credits made national news, New Jersey is not the only state that reviews the content of productions before granting tax incentives. In 2010, the *New York Time*s reported the statements of Michigan's Film Commissioner in connection with the denial of tax incentives for the motion picture, *The Woman*. Noting the film's subject matter, "namely realistic cannibalism; the gruesome and graphically violent depictions described in the screenplay; and the explicit nature of the script," the Michigan Film Commissioner stated, "[t]his film is unlikely to promote tourism in Michigan or to present or reflect Michigan in a positive light."[4] Similarly, the Texas Film Commission refused to pay $1.75 million in tax incentives to the producers of the motion picture *Machete*, citing a state law that allows the state to refuse to pay incentives for content that portrays Texas or Texans in a negative fashion.[5]

The producers of *Jersey Shore* could not have anticipated that their tax credits would be revoked because New Jersey's incentive program, like the programs in most states, does not disqualify productions that make the state look bad. However, a handful of states, like Texas, have enacted such criteria into their laws or created similar standards in their application review guidelines.[6] Utah's Motion Picture Incentive Fund application instructions provide that the state is not required to grant incentives to projects that include "inappropriate content" or "content that portrays Utah or Residents of Utah in a negative way."[7]

THE TEXAS FILM COMMISSION REFUSED TO PAY $1.75 MILLION IN TAX INCENTIVES TO THE PRODUCERS OF THE MOTION PICTURE *MACHETE*, CITING A STATE LAW THAT ALLOWS THE STATE TO REFUSE TO PAY INCENTIVES FOR CONTENT THAT PORTRAYS TEXAS OR TEXANS IN A NEGATIVE FASHION.

In Wisconsin, a production will not qualify if it will hurt the reputation of the state.[8] A production with content that portrays West Virginia in a "significantly derogatory manner" is ineligible for West Virginia film credits.[9] Wyoming limits the definition of a "qualified production" to filmed entertainment that would likely encourage members of the public to visit the state of Wyoming.[10] Similarly, Kentucky's program requires a determination that the production will not negatively impact the tourism industry of the Commonwealth and Pennsylvania's application guidelines indicate that the Pennsylvania Film Office may consider whether the project will tend to foster a positive image of Pennsylvania.[11]

The majority of state motion picture and television production incentive programs have not openly expressed a similar concern about productions that may portray a state in a negative fashion. However, states normally carve out broad categories of productions that do not qualify for tax incentives, such as news, sports events, award programs and even documentaries and reality television shows.[12] It is also typical for incentive programs to contain some manner of prohibition on productions that contain sexually explicit or obscene material.[13] By requiring tax incentive applicants to submit a script, screenplay or synopsis of the production, state film commissions charged with administering incentive programs are also able to review the content of proposed motion picture and television productions. Some state incentive programs actually require production companies to submit a copy of the final version of the production to qualify for tax incentives.[14]

First Amendment Principles

Although the producers of *Jersey Shore* may have more than one avenue for challenging Governor Christie's veto of their tax credits, the interesting question with multistate ramifications is whether Governor Christie crossed a First Amendment line when he denied tax credits to *Jersey Shore* based upon the content of the production.[15] The First Amendment provides that Congress shall make no law abridging the freedom of speech and is made applicable to the states through the Fourteenth Amendment.[16] First Amendment jurisprudence recognizes:

> Under our system of government there is an accommodation for the widest varieties of tastes and ideas. What is good literature, what has educational value, what is refined public information, what is good art, varies with individuals as it does from one generation to another. . . . But a requirement that literature or art conform to some norm prescribed by an official smacks of an ideology foreign to our system.[17]

If we assume that the First Amendment protects the right of a filmmaker to produce a motion picture that features cannibalism or that portrays Texas in a negative

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Upcoming 2012 Speaking Engagements

January 17
Tax Executives Institute (TEI)
Dallas, *Texas*
Eric J. Coffill
Hollis L. Hyans

January 18
Tristate CPA Conference
New York, *New York*
Paul H. Frankel

January 23
2012 Council on State Taxation (COST) Basics School
Atlanta, *Georgia*
Andres Vallejo

January 24
New York State Bar Association
New York, *New York*
Hollis L. Hyans

January 25
Ohio Tax Conference
Columbus, *Ohio*
Paul H. Frankel

February 2 – 3
The National Multistate Tax Symposium
Orlando, *Florida*
Craig B. Fields
Paul H. Frankel
Hollis L. Hyans

February 17
ABA Section of Taxation, 2012 Midyear Meeting
San Diego, *California*
Debra S. Herman

February 29
New York City Bar Association
New York, *New York*
Hollis L. Hyans
Debra S. Herman

March 5
Council on State Taxation (COST) Sales Tax Conference
Austin, *Texas*
Paul H. Frankel

March 19 – 21
2012 ABA/IPT Advanced Income Tax Seminar
New Orleans, *Louisiana*
Craig B. Fields
Paul H. Frankel

May 3
Council on State Taxation (COST) Advanced Tax School
Atlanta, *Georgia*
Paul H. Frankel

May 11
New Jersey Tax Executives Institute (TEI) State Tax Day
Morristown, New Jersey
Paul H. Frankel

June 14
University of Wisconsin SALT Conference
Milwaukee, *Wisconsin*
Paul H. Frankel

August 7
Georgetown SALT Conference
Washington, *D.C.*
Paul H. Frankel

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fashion, or both, is that right violated by Texas' refusal to award tax incentives to that filmmaker? What about restrictions in state statutes denying tax incentive program eligibility for productions that are sexually explicit or contain obscene material? Is the answer different if states use a "carrot" rather than a "stick"? For example, Florida offers an additional 5% tax credit for "family-friendly productions."[18]

Obscenity Is Not Protected Speech

In the area of First Amendment jurisprudence, one thing that is clear is that obscenity is not protected speech.[19] Nonetheless, the Supreme Court recognizes that state statutes designed to regulate obscene materials must be carefully limited.[20] Provided that states adopt the proper First Amendment standards for determining whether particular material is obscene, motion picture and television production incentive programs that deny tax benefits to productions containing obscene material are probably facially constitutional.[21] In an individual case, however, it would be necessary to consider the application of the relevant standard to the production seeking to qualify for tax benefits.

Many states rely on the federal standard set forth by the Child Protection and Obscenity Enforcement Act of 1988 to define the category of sexually explicit content that is not eligible for motion picture and television production incentives.[22] Other states have their own definition of "obscene material" or "obscene content."[23] Any definition will likely be interpreted and applied by a relatively small group of people who form the local film commission that is charged with reviewing and approving tax incentive applications. As evidenced by a recent scandal in Iowa's Film Office involving improperly awarded

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credits, state film commissions have a tremendous amount of discretion and are susceptible to errors in judgment.[24]

Supreme Court Cases Considering the First Amendment and State Taxes

Outside of obscene material, the state of constitutional law when First Amendment rights are impacted by government funding (or denial thereof) is somewhat unclear. On one end of the spectrum are two United States Supreme Court cases extending First Amendment protection in the area of tax exemptions.

In *Speiser v. Randall*, the Court reviewed a California rule enacted in 1954 that required veterans seeking property tax exemptions to sign a declaration stating that they did not advocate the forcible overthrow of the Government of the United States or of California.[25] Veterans who refused to execute the oath were denied the exemption. The Supreme Court struck down the oath requirement, stating "when the constitutional right to speak is sought to be deterred by a State's general taxing program due process demands that the speech be unencumbered until the State comes forward with sufficient proof to justify its inhibition."[26] In *Speiser*, the Supreme Court concluded that California lacked a compelling interest that would justify suppressing the speech at issue. In reaching this decision, the Supreme Court specifically rejected California's argument that because a tax exemption is a privilege or bounty, its denial does not infringe speech.[27] The Supreme Court stated that "[to] deny an exemption to claimants who engage in certain forms of speech is in effect to penalize them for such speech. Its deterrent effect is the same as if the state were to fine them for this speech."[28]

Nearly thirty years later, in *Arkansas Writers' Project, Inc. v. Ragland*, the Supreme Court held that Arkansas' selective application of its sales tax to magazines violated the First Amendment's guarantee of freedom of the press because it differentiated between magazines based on their content.[29] The Arkansas statute provided an exemption for religious, professional, trade and sports publications. According to the Supreme Court, "[r]egulations which permit the Government to discriminate on the basis of the content of the message cannot be tolerated under the First Amendment."[30] In order to justify such differential taxation, the Supreme Court stated that Arkansas must show that its regulation was necessary to serve a compelling state interest and was narrowly drawn to achieve that end.[31] Arkansas was unable to meet this standard.

STATE GOVERNMENTS WANDER INTO DANGEROUS TERRITORY WHEN THE GRANT OF A TAX EXEMPTION REQUIRES GOVERNMENT SCRUTINY OF THE CONTENT OF SPEECH.

Arkansas Writers' Project was technically not a "freedom of speech" case. Rather, the Supreme Court decided that the Arkansas sales tax scheme violated freedom of press. Nonetheless, *Arkansas Writers' Project* is cited in cases evaluating freedom of speech claims and stands for the principle that state governments wander into dangerous territory when the grant of a tax exemption requires government scrutiny of the content of speech.[32] The reasoning of *Arkansas Writers' Project* is particularly relevant to state motion picture and television production incentive programs because the Supreme Court has held that expression by means of motion pictures is included within both the free speech *and* the free press guarantees of the First and Fourteenth Amendments.[33]

Supreme Court Cases Considering the First Amendment and Government Spending

On the other end of the spectrum are non-tax cases in which the Supreme Court has upheld government review of the content of speech when the government is the speaker or when the government acts as a patron. At the outset it is important to note that the following cases both involved facial challenges to laws involving speech and, therefore, the challengers of these laws faced a heavier burden. We do not know how these cases would have been decided if a challenger presented an "as applied" situation for the Supreme Court's review.

In *Rust v. Sullivan*, the Supreme Court considered a facial challenge to federal regulations that prohibited counseling concerning the use of abortion in federally funded family planning programs.[34] Petitioners, grantees and doctors who supervised the family planning funds, argued that the regulations violated their First Amendment rights by impermissibly imposing viewpoint discriminatory conditions on government subsidies and thus penalizing certain speech.[35] In a controversial 5-4 decision, the Supreme Court rejected the First Amendment challenge, finding "[t]he Government can, without violating the Constitution, selectively fund a program to encourage certain activities it believes to be in the public interest, without at the same time funding an alternative program which seeks to deal with the problem in another way."[36]

Rust is distinguishable from the *Jersey Shore* situation because New Jersey

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MOFO ATTORNEY NEWS

Morrison & Foerster's State & Local Tax Group would like to welcome Debra S. Herman. Ms. Herman joins us as Of Counsel in the New York office.

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did not enact its film production credit in order to establish a program for funding motion picture and television productions that make New Jersey look good. New Jersey's incentive program, like those of other states, was enacted to spur economic development in the state.

If New Jersey decides to hire a production company to make a film for the express purpose of portraying New Jersey in a positive light, then under *Rust*, New Jersey can exert some level of control over the content of the film. However, this does not mean that states such as Texas or Utah can constitutionally deny film credits to productions that portray the states or their residents in a negative manner simply because their incentive programs have identified such content as a basis for denial of incentives. The decisive inquiry should be whether the incentive program represents "government speech" in which the state should have some say about the message that is being conveyed.

In *National Endowment for the Arts v. Finley*, the Supreme Court upheld a 1990 amendment to federal law requiring the chairperson of the National Endowment for the Arts ("NEA") to take into consideration general standards of decency and respect for the diverse beliefs and values of the American public when judging the artistic merit of grant applications.[37] The legislative history indicated that the change in law was at least in part due to a Congressional reaction to the use of NEA grant money to fund a 1989 retrospective of the works of controversial photographer Robert Mapplethorpe.

Originally, in *Finley*, a group of artists who were denied NEA grants challenged the law as being both unconstitutional as applied to them, as well as unconstitutional on its face. However, during the course of the litigation the as applied constitutional claims were settled (with the plaintiffs receiving the amount of the vetoed grants, damages and attorney's fees) and the case proceeded solely as a facial challenge to the law under the First Amendment.

NEW JERSEY'S INCENTIVE PROGRAM, LIKE THOSE OF OTHER STATES, WAS ENACTED TO SPUR ECONOMIC DEVELOPMENT IN THE STATE.

Expressing reluctance to invalidate legislation on the basis of its hypothetical application to situations not before the Court, the Supreme Court in *Finley* found that the new requirement to *take into consideration general standards of decency* seemed unlikely to introduce any greater element of selectivity than the determination of "artistic excellence" already required by the law for the judging of applications for artistic grants.[38] The Supreme Court also recognized that any content-based considerations that may be taken into account in the NEA grant-making process are a consequence of the subjective nature of arts funding.[39] The NEA has limited resources and it must deny the majority of the grant applications that it receives, including many that propose artistically excellent projects.[40] Ultimately, the majority opinion in *Finley* held that the government may take into consideration general standards of decency and respect for the diverse beliefs and values of the American public in connection with allocating competitive funding, even though such criteria might be impermissible were direct regulation of speech or a criminal penalty at stake, because Congress has wide latitude to set spending priorities.[41] In effect, the federal government in *Finley* was "acting as patron rather than as sovereign."[42]

After *Finley*, can a production company challenge the denial of specific tax incentives based on the content of the production? The answer should be "yes." While *Finley* acknowledges that some level of content review is permissible when the government funds the arts, state motion picture and television incentives programs were not enacted to support the arts, but to encourage the creation of jobs and spending in the enacting state. New Jersey should not be considered a "patron" for *Jersey Shore* or any other production applying for New Jersey tax credits. The end result may be an artistic production, but the purpose of motion picture and television incentive programs is to bring a production to the state to further the state's own economic interests. Thus, eligibility for credits should be based on such factors as the number of persons employed in the production and spending levels within the state, not on the content of the production.

Additionally, a key component of the *Finley* analysis was the limited number of grants available for NEA applicants and the fact that many, if not most, applicants were rejected for wholly subjective reasons. Although states may have more applicants for film tax credits than they can honor, it is not uncommon for states to administer their programs on a first-come, first-served basis.[43] For example, in New Mexico, tax credits are awarded on a first-come, first served basis and when the program's $50 million cap is reached, the remaining amounts are placed at the front of a queue and awarded in the next fiscal year.[44]

States like New Mexico do not look at the entire pool of applicants to determine which productions are most worthy of a grant, as was the case in *Finley*. Thus, the highly selective nature of the NEA grants that made content review a permissible factor in *Finley* does not exist in motion picture and television production incentive programs with a first-come, first-served feature.

Even when the state may be considered a patron of the arts, a post-*Finley* decision involving an as applied challenge to the denial of arts funding by New York City interpreted *Finley* as upholding the

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"decency" and "respect" considerations only by reading them, on their face, as not permitting viewpoint discrimination.[45] In that case, then-Mayor Giuliani advanced arguments similar to those raised by Governor Christie, stating that New York City did not have to fund an art exhibit at the Brooklyn Museum that it found to be offensive and that while the exhibit could be shown privately, "the taxpayers don't have to pay for it."[46] The federal district court rejected this argument, concluding that where the denial of a benefit, subsidy or contract is motivated by a desire to suppress speech in violation of the First Amendment, that denial will be enjoined.[47]

Conclusion

Until courts are asked to decide the extent of First Amendment protection in the area of state motion picture and television production incentive programs, the industry will have to operate in an area of uncertainty. In the meantime, the lesson for filmmakers who want to portray Texas or Utah in a negative fashion is to film your movie in New Jersey. Maybe there is a part for Governor Christie in a remake of *A Fistful of Dollars*. It worked for Ronald Reagan, why not Chris Christie? ■

1 New Jersey suspended its film production tax credit program for fiscal year 2011. N.J. Stat. Ann. § 54:10A-5.39a. The temporary suspension of tax credits applies to the authorization of new credits and the application of previously authorized credits in the 2011 fiscal year. It does not, however, affect the carryover of unused tax credits previously allowed or which may be allowed following the suspension. Assembly Budget Committee Statement to Assembly No. 3011 (June 24, 2010).

2 http://www.state.nj.us/governor/news/news/552011/approved/20110926b.html.

3 *Id*.

4 Michael Cieply, *State Backing Films Says Cannibal is Deal-Breaker*, N.Y. TIMES, June 14, 2010, http://www.nytimes.com/2010/06/15/movies/15credits.html.

5 Russell Gold, *Vigilante Justice? Texas Refuses to Pay 'Machete' Producers*, WALL STREET JOURNAL, Dec. 9, 2010, http://blogs.wsj.com/washwire/2010/12/09/vigilante-justice-texas-refuses-to-pay-machete-producers/.

6 Tex. Gov't Code Ann. § 485.022(e).

7 State of Utah Motion Picture Incentive Fund Fiscal Year 2011 Information and Application, http://film.utah.gov/documents/MPIF-FY2011.pdf.

8 Wis. Admin. Code § 133.30(4).

9 W. Va. Code § 11-13X-3(b)(8)(F).

10 Wyo. Stat. Ann. § 9-12-403(a)(v).

11 Ky. Rev. Stat. Ann. § 148.546(9); Film Tax Credit Program Guidelines October 2009, http://filminpa.com/wp-content/uploads/2009/07/Film-Tax-Credit_Guidelines-09.pdf.

12 *See*, *e.g.*, Cal. Rev. & Tax. Code § 23685(b)(15)(D). The statute states that

> "Qualified motion picture" shall not include commercial advertising, music videos, a motion picture produced for private noncommercial use, such as weddings, graduations, or as part of an educational course and made by students, a news program, current events or public events program, talk show, game show, sporting event or activity, awards show, telethon or other production that solicits funds, reality television program, clip-based programming if more than 50 percent of the content is comprised of licensed footage, documentaries, variety programs, daytime dramas, strip shows, one-half hour (air time) episodic television shows, or any production that falls within the recordkeeping requirements of Section 2257 of Title 18 of the United States Code.

Id.

13 *See*, *e.g.*, N.J. Stat. Ann. § 54:10A-5.39.e (excluding productions containing obscene material, as defined under state law, from the definition of "film").

14 *See*, *e.g.*, Connecticut guidelines published by the Office of Film, Television & Digital Media, http://ct.gov/ecd/lib/ecd/3-5-10_IMediaMotionPictureTaxCreditGuidelines.pdf (requiring submission of a copy of the final version of the production in DVD format). In North Carolina, qualifying expenses are subject to audit before the credit is allowed. N.C. Gen. Stat. § 105-130.47(d). According to North Carolina Film Office guidelines, a copy of the production (rough-cut or finished copy DVD) will be requested at audit.

See http://www.ncfilm.com/uploads/downloads/Film%20Incentive%20Documents/NCFilmIncentive_Rev2010.pdf.

15 It is questionable whether Governor Christie has a veto power to revoke film credits. New Jersey regulations provide that only the members of the New Jersey Economic Development Authority ("EDA") can deny an applicant's eligibility for the program. N.J. Admin. Code § 18:7-3B.5(c). When the members of the EDA deny a request for film credits their decision is submitted to the Governor and the EDA's action is effective 10 days after the Governor's receipt of the minutes, provided no veto has been issued. N.J. Admin. Code § 18:7-3B.5(d). Based on the plain language of the regulation, the Governor did not have the power to veto the grant of the film credit to *Jersey Shore*'s producers. By regulation, he only had the power to veto a film credit *denial* by the EDA. However, in vetoing the *Jersey Shore* credits, Governor Christie relied upon a conflicting statute providing general veto power for actions taken at EDA meetings. N.J. Stat. Ann. § 34:1B-4(i).

16 *Gitlow v. New York*, 268 U.S. 652, 666 (1925).

17 *Hannegan v. Esquire*, 327 U.S. 146, 157 (1946).

18 Fla. Stat. § 288.1254(4)(b)(4). The statute states that

> family-friendly productions are those that have cross-generational appeal; would be considered suitable for viewing by children age 5 or older; are appropriate in theme, content, and language for a broad family audience; embody a responsible resolution of issues; and do not exhibit or imply any act of smoking, sex, nudity, or vulgar or profane language.

Id.

19 *Miller v. California*, 413 U.S. 15, 23 (1973).

20 *Id*.

21 According to the Supreme Court, the standards for determining whether material is obscene are: (a) whether the average person, applying contemporary community standards, would find that the work, taken as a whole, appeals to the prurient interest; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value. *Id*. at 24.

22 *See*, *e.g.*, Ala. Code § 41-7A-42(8)(b); Ark. Code Ann. § 15-4-2003(8)(b)(iv); Cal. Rev. & Tax. Code § 17053.85(b)(15)(D); Conn. Gen. Stat. § 12-217jj(a)(3)(B); Ill. Comp. Stat. § 16/10(7); Me. Rev. Stat. Ann. § 13090-L(2-A)(D)(6); Md. Code Ann. Tax-Gen. § 10-729(a)(4); Mich. Comp. Laws Ann. § 207.803(j)(1); Ohio Rev. Code Ann. § 122.85(A)(5); R.I. Gen. Laws § 44-31.2-2(4); and S.C. Code Ann. § 12-62-20(3).

23 *See*, *e.g.*, Fla. Stat. § 288.1254(1)(i)(2); Ind. Code § 6-3.1-32-5(c); Iowa Code § 15.393(4); Ky. Rev. Stat. Ann. § 148.542(15); Mo. Rev. Stat. § 135.750(1)(2)(h); Mont. Code Ann. § 15-31-903 (2)(b)(i); and Pa. Stat. Ann. § 8702-D.

24 On October 18, 2011, an Iowa District Court sentenced the former director of the Iowa Film Office to two years' probation for felonious misconduct in office arising in connection with his attempts to secure tax incentives for a motion picture production company. *Iowa v. Wheeler*, Iowa Dist. Ct., No. CR-FECR-243355 (Oct. 18, 2011).

25 *Speiser v. Randall*, 357 U.S. 513 (1958).

26 *Id*. at 528-529.

27 *Id*. at 518.

28 *Id*.

29 *Arkansas Writers' Project, Inc. v. Ragland*, 481 U.S. 221 (1987).

30 *Id*. at 230.

31 *Id*. at 221.

32 *See*, *e.g.*, *Simon & Schuster v. Members of the New York State Crime Victims Board*, 502 U.S. 105, 115 (1991).

33 *Joseph Burstyn v. Wilson*, 343 U.S. 495, 502 (1952).

34 *Rust v. Sullivan*, 500 U.S. 173 (1991).

35 *Id*. at 192.

36 *Id*. at 193.

37 *National Endowment for the Arts v. Finley*, 524 U.S. 569 (1998).

38 *Id*. at 584.

39 *Id*. at 585.

40 *Id*.

41 *Id*. at 587-88.

42 *Id*. at 589 (wherein the Court also denied the *Finley* plaintiffs' vagueness challenges to the new law).

43 *See*, *e.g.*, Ark. Stat. Ann. § 15-4-2008(c)(2); Cal. Rev. & Tax. Code § 23685(g)(1)(D); Fla. Stat. § 288.1254(4)(a); W. Va. Code St. R. § 110-13X-4.2; and Wis. Admin. Code § 133.34(1)(c).

44 http://www.nmfilm.com/filming/downloads/nm25PercentTaxCredit.pdf.

45 *The Brooklyn Institute of Arts and Sciences v. City of New York*, 64 F.Supp.2d 184, 202 (E.D.N.Y. 1999).

46 *Id*. at 200.

47 *Id*.

Individual Liability for Company Taxes

By Mitchell A. Newmark and Richard C. Call

Individuals that have "responsible" positions in a company could be found to be personally liable for the company's unpaid taxes in certain states. State taxing jurisdictions are increasingly turning to responsible person laws to collect unpaid liabilities.[1] This trend is due in part to the increase in company bankruptcies during the last few years. From 2007 to 2010, the number of U.S. companies filing for Chapter 7 or Chapter 11 bankruptcy almost doubled.[2]

Responsible person liability may apply in the context of sales and use taxes, withholding taxes and corporate income taxes, as well as all other taxes administered by a state taxing authority. Although responsible person issues often arise following bankruptcy, such issues may also present themselves following dissolutions and liquidations. The topic is important for officers, members and employees who may be personally liable for such taxes as well as for in-house tax department personnel who manage tax reporting and payment.

In this article, we address: (1) the types of taxes and penalties that could be at issue; (2) the types of individuals who have been found to be responsible persons; and (3) procedural issues that may arise. One thing is certain. That is, the states are not uniform in the taxes for which an individual could be responsible, the individuals who could be responsible persons and the applicable procedure.

Applicable Taxes and Penalties

States may hold individuals liable for sales and use taxes, withholding taxes, corporate income taxes and even, in some states, all taxes administered by the state taxing agency. Individuals may also incur civil penalties or criminal penalties. Furthermore, joint and several liability may apply to multiple responsible persons within a company.

Sales and Use Taxes

State responsible person laws often apply to sales and use taxes. For example, California holds responsible persons liable for "any unpaid [sales and use] taxes and interest and penalties on those taxes, if the [responsible person] willfully fails to pay [those] taxes."[3] In addition to liability for the California sales tax that should have been collected on a company's sales, an individual may be responsible for sales and use taxes that the company was responsible for paying as a consumer on its purchases.[4]

Other states, such as Connecticut, New Jersey, New York and North Carolina, do not use language that is as succinct as the California language to impose personal liability, but provide for liability by including responsible persons in the definitions of persons required to collect sales and use tax.[5]

Withholding Taxes

Responsible person laws may also apply to withholding taxes. For example, the Massachusetts tax statutes provide that any officer or employee "who fails to withhold [personal income taxes] shall be personally and individually liable therefore to the commonwealth."[6] In South Carolina, a responsible person may be "individually liable for the amount of [personal income tax] not withheld or paid."[7]

All Taxes

In some states, individuals may be liable for *all* taxes of a company. For example, Virginia law provides that any officer or employee who willfully fails to pay "any tax administered by the Department" may be liable for the tax.[8] The Virginia Department of Taxation administers 23 taxes including corporate income tax, sales and use tax, withholding tax, bank franchise tax, cigarette excise tax and telecommunications tax.[9]

The Colorado statute is similarly worded and applies responsible person liability to any tax administered by Article 21.[10] The Colorado Department of Revenue administers 13 taxes under Article 21 including corporate income tax, sales and use tax, withholding tax, cigarette tax and gasoline tax.[11]

[IN COLORADO], A RESPONSIBLE PERSON MAY BE SUBJECT TO A PENALTY OF 150% OF THE TAX DUE.

Penalties and Interest

In addition to the tax liability, a state may provide that responsible persons can be liable for penalties and interest that would otherwise be assessed on the company.[12] For example, in the sales tax context, Connecticut expressly holds responsible persons liable for the 15% late filing penalty that is typically asserted against the company.[13] A responsible person under Connecticut law is also liable for interest at the rate of 1% per month running from the due date.[14]

States may also impose penalties that are specific to responsible persons. If a responsible person willfully fails to remit Colorado taxes, such as the corporate income tax or sales and use tax, a responsible person may be subject to a penalty of 150% of the tax due.[15]

Joint and Several Liability

A state may assert joint and several liability for a company's unpaid taxes. New York case law provides for joint and several liability for responsible persons.[16] The Rhode Island Division of Taxation's position is also one of joint and several liability.[17]

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Individual Liability

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Thus, responsible persons may be fully liable for the unpaid taxes to the extent that the tax liability has not been satisfied by another responsible person. For instance, a New York State Administrative Law Judge rejected the argument that, because there were three other officers that were also responsible for submitting the unpaid taxes, a responsible person should be held liable for only 25% of a company's unpaid New York withholding tax.[18]

Criminal Penalties

Beyond financial penalties, some states impose criminal liability on responsible persons who knowingly fail to collect and remit a company's taxes to the state. It is a Class D felony in Indiana, for example, for a responsible person to knowingly fail to remit sales taxes to the state.[19] A Class D felony in Indiana may result in imprisonment of up to three years.[20]

In Virginia, a willful failure to remit sales or withholding tax could result in an individual being found guilty of a misdemeanor.[21] Certain persons who willfully fail to file a Wisconsin corporate income tax return may be guilty of a misdemeanor in that state.[22]

Who Could Be a Responsible Person?

The states vary in their definitions of a responsible person. The determination of who is a responsible person may depend merely on the person's title or may be a fact-intensive inquiry.

Title-Based Liability

Some states consider only an individual's title in a company to determine potential individual responsibility. States may also look to whether an individual is a partner or member in a flow-through entity (for income taxes) to determine whether the individual could be liable for unpaid taxes. For example, the Maryland statutes extend the liability for Maryland sales and use taxes to "any president, vice president or treasurer."[23] The Maryland statutes do not contain language that would require such officers to oversee or manage financial or tax matters of the corporation.[24]

Also title-based, the Ohio regulations provide that officers of a corporation who own, collectively or individually, more than a 50% interest in the corporation are liable for Ohio withholding payments and sales tax if the corporation failed to file withholding reports or sales tax returns or failed to remit payment with a filed report or return.[25]

IT IS A CLASS D FELONY IN INDIANA, FOR EXAMPLE, FOR A RESPONSIBLE PERSON TO KNOWINGLY FAIL TO REMIT SALES TAXES TO THE STATE. A CLASS D FELONY IN INDIANA MAY RESULT IN IMPRISONMENT OF UP TO THREE YEARS.

Under the New York statutes, a partner (whether general or limited) of a partnership and a member of a limited liability company may be held strictly liable for the company's New York sales tax obligations even if the partner or member did not have a duty to remit the tax on behalf of the company.[26] Recently, the New York State Department of Taxation and Finance adopted a policy that relieves qualifying limited partners and members of limited liability companies from *per se* liability for some or all of the unpaid New York sales and use taxes of the limited partnership or limited liability company if specific conditions are met.[27]

Defenses to Title-Based Liability

In states in which responsible person liability is based solely on a person's title, state or federal constitutional protections may be available as a defense to personal liability. For example, West Virginia statutes impose liability on corporate officers for unpaid and unremitted West Virginia sales taxes and do not contain language setting forth any other standards for imposition of such liability.[28] Nevertheless, the West Virginia Supreme Court of Appeals, the state's highest court, stated that due process protections in the West Virginia Constitution may absolve a corporate officer from personal liability for a company's unpaid and unremitted sales taxes, as follows:

> [I]n the absence of statutory or regulatory language setting forth standards for the imposition of personal liability for unpaid and unremitted sales taxes on individual corporate officers . . . such liability may be imposed only when such imposition is in an individual case not arbitrary and capricious or unreasonable, and such imposition is subject to a fundamental fairness test.[29]

Recently, a West Virginia administrative law judge applied this fundamental fairness test and relieved an individual of personal liability where it was shown that the individual was released from his position as a vice-president before the West Virginia tax liability was incurred and the individual had no financial responsibilities in the company.[30]

Responsibility-Based Liability

In some states, a person's title is not determinative of whether the individual may be a responsible person; rather, an officer or employee could be held liable for the company's unpaid tax if the individual is "under a duty" to act for the company in complying with its tax payment obligations.[31] Whether an individual is under a duty to act may be a fact-intensive inquiry and may involve the question of whether the person had knowledge of, or intent to evade, the tax liability.

Duty to Act?

Courts may look to a variety of factors to determine if a taxpayer has a duty to act.

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Individual Liability

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Courts may also look to other states that have similar provisions.

The Tax Court of New Jersey, in *Cooperstein v. Director, Division of Taxation*, looked to the following nine factors to determine whether the person in question has a duty to act:

(1) the contents of the corporate bylaws;
(2) status as an officer and/or stockholder;
(3) authority to sign checks and actual exercise of this authority;
(4) authority to hire and fire employees and actual exercise of this authority;
(5) responsibility to prepare and/or sign tax returns;
(6) day-to-day involvement in the business or responsibility for management;
(7) power to control payment of corporate creditors and taxes;
(8) knowledge of the failure to remit taxes when due; and
(9) derivation of substantial income or benefits from the corporation.[32]

The *Cooperstein* Tax Court adopted the aforementioned factors from New York case law.[33] The New York case law relied upon factors set forth by a federal district court.[34]

States other than New Jersey have relied on factors that include whether the individual is responsible for maintaining the corporate books[35] or whether the individual had knowledge of the tax liability through an educational background or work experience.[36]

Knowledge May Not Be Required and May Trump Good Intentions

Knowledge of, or intent to evade, a tax liability may be a factor in determining whether an individual is a responsible person.

The Tax Court of New Jersey considers knowledge to be one factor in the analysis, but does not consider knowledge to be a necessary indicia of a responsible person liability. For example, the Tax Court of New Jersey found that two corporate officers were unaware of the outstanding sales tax liability and did not have an intent to evade the sales tax law.[37] Nevertheless, it found the individual officers liable for a company's outstanding sales tax obligations.[38]

By contrast, Texas law imposes liability on an individual for a company's unpaid sales tax obligations *only* if the individual willfully fails to pay the tax.[39] A responsible person acts "willfully" if the person:

THE COURT WAS NOT PERSUADED BY THE TRUSTEE'S "GOOD INTENTIONS" INASMUCH AS THE TRUSTEE KNEW OF THE SALES TAX LIABILITY AND CHOSE TO PAY OTHER CREDITORS IN ORDER TO KEEP THE COMPANY OPERATING AS A GOING CONCERN.

(1) "has knowledge" that taxes are owed and yet pays other creditors; or
(2) "recklessly disregards the risk" that the taxes may not be paid to the state.[40]

In 2010, the federal Fifth Circuit Court of Appeals applied Texas law and found the trustee of a company in bankruptcy liable for the bankrupt company's unpaid sales tax despite the trustee's argument that his duty to maximize the estate's value superseded his duty to timely pay the sales tax liability.[41] The court was not persuaded by the trustee's "good intentions" inasmuch as the trustee knew of the sales tax liability and chose to pay other creditors in order to keep the company operating as a going concern.[42]

Procedural Issues

Two procedural issues merit consideration: (1) extended statutes of limitations periods for assessments against responsible persons; and (2) the identification of responsible persons on forms and reports.

Statute of Limitations

The limitations period applicable to responsible person assessments may exceed the period within which a tax authority may assess the company for that same liability.

The California sales tax limitations period for a company is three years from the date that the return is filed (except in enumerated situations).[43] However, the California statutes authorize assessments against a responsible person within eight years from a company's dissolution date if the California State Board of Equalization does not have actual knowledge of the company dissolution.[44]

North Carolina has a more generally applicable extension that applies for a shorter period than California's extension period. The North Carolina statutes permit the Department to assess a responsible person during a period that extends one year from the expiration of the company's limitations period.[45]

Self-Identification as a Responsible Person

Some state tax forms and returns require that the preparer identify responsible persons. For example, California requires identification of corporate officers for sales and withholding taxes.[46] In Michigan, if the company hires a payroll provider to remit payroll taxes, the company must file Form 3683, which must be signed by the corporate officer on a line that reads "[s]ignature of Corporate Officer, Partner, or Member responsible for reporting and/or paying Michigan taxes."[47] Furthermore, New York auditors have requested that companies complete responsible person questionnaires after sending assessment notices to companies.[48]

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Individual Liability

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Conclusion

Individual liability for company taxes is a great concern that should not be overlooked. We encourage companies to closely review the responsible persons provisions in the states in which they conduct business. As discussed above, the factors to be considered for individual liability and the taxes for which an individual could be liable vary by state. Responsible person laws are likely to continue to be used often by state taxing agencies to pursue individuals for company liabilities. ■

1 Although state statutes that impose individual liability for a company's unpaid taxes use varying terms, we will refer to such laws as "responsible person laws" and the liable individuals as "responsible persons," unless referring to a state's specific laws. *Compare* N.Y. Tax Law § 1131(1) (providing that a corporate officer or employee is liable for sales tax if the individual is under a "duty to act" for the corporation in complying with its sales tax obligations), *with* Tex. Tax Code Ann. § 111.016 (providing that an individual who "controls or supervises the collection of tax" from another person (*e.g.*, sales tax, withholding tax) is liable as a "responsible individual").

2 American Bankruptcy Institute, U.S. Bankruptcy Filings 1980-2010, www.abiworld.org (last visited Dec. 29, 2011).

3 Cal. Rev. & Tax. Code § 6829(a). *See also* Fla. Stat. § 213.29; La. Rev. Stat. Ann. § 47:1561.1.

4 Cal. Rev. & Tax. Code § 6829(c).

5 *See* Conn. Gen. Stat. § 12-414a; N.J. Stat. Ann. § 54:32B-2(w); N.Y. Tax Law §§ 1131(1) & 1133(a); N.C. Gen. Stat. § 105-242.2(b).

6 Mass. Gen. Laws ch. 62B, § 5. *See also* Ariz. Rev. Stat. Ann. § 43-435; N.C. Gen. Stat. § 105-242.2(b); Utah Code Ann. § 59-1-302(2).

7 S.C. Code Ann. § 12-8-2010(A) & (D).

8 Va. Code Ann. § 58.1-1813.

9 Va. Code Ann. 58.1, Subtitle I. The telecommunications tax is the Virginia Communications Sales and Use Tax imposed by Virginia Code Annotated section 58.1-648.

10 Colo. Rev. Stat. § 39-21-116(2).

11 Colo. Rev. Stat. § 39-21-102(1) & (2).

12 State statutes regarding penalties for responsible persons should be read carefully inasmuch as a state statute may use the term "penalty" to refer to the actual tax liability that is imposed on responsible persons. *See*, *e.g.*, Ala. Code §§ 40-29-72(b) & 40-29-73(a).

13 Conn. Gen. Stat. §§ 12-414a; 12-419(a). The Commissioner may waive all or any part of the penalties if "failure to pay any tax was due to reasonable cause and was not intentional or due to neglect." Conn. Gen. Stat. § 12-419(c).

14 Conn. Gen. Stat. §§ 12-414a; 12-419(a).

15 Colo. Rev. Stat. § 39-21-116.5.

16 *See Matter of Marchello*, DTA No. 821443 (N.Y.S. Tax Appeals Tribunal, Apr. 14, 2011) (interpreting N.Y. Tax Law §§ 1131(1) & 1133(a)).

17 *See* Rhode Island Admin. Hearing Decision, 2011-03 (Feb. 11, 2011) (interpreting Rhode Island General Laws Section 44-19-35 to provide for joint and several liability on responsible persons).

18 *See*, *e.g.*, *Matter of Weinblatt*, DTA No. 819934 (N.Y.S. Div. of Tax App., Jan. 19, 2006) (stating that the New York Division of Taxation could pursue collection from one or all of the responsible persons so long as the Division did not attempt to collect more than the total amount of tax owed). Although determinations of New York State administrative law judges are not precedential and may not be cited in New York, they do reflect the views of an administrative law judge who is knowledgeable of the New York Tax Law and are indicative of how an administrative law judge may rule on an issue. *See* N.Y. Tax Law § 2010.5; N.Y. Comp. Codes R. & Regs. tit. 20, § 3000.15(e)(2).

19 Ind. Code § 6-2.5-9-3(2).

20 Ind. Code § 35-50-2-7(a).

21 Va. Code Ann. § 58.1-1815.

22 Wis. Stat. § 71.83(2)(a).

23 Md. Code Ann., Tax-Gen. § 11-601(d). *See Fox v. Comptroller*, 728 A.2d 776, 779 (Md. Ct. Spec. App. 1999).

24 Md. Code Ann., Tax-Gen. § 11-601(d).

25 Ohio Admin. Code 5703-7-15(F) (withholding liability); 5703-9-49(F) (sales tax liability).

26 N.Y. Tax Law § 1131(1).

27 *New Policy Relating to Responsible Person Liability Under the Sales Tax Law*, TSB-M-11(17)S (N.Y.S. Dep't of Taxation & Fin. Sept. 19, 2011). For additional analysis and insight on the New York Department of Taxation and Finance's new policy, *see* Irwin A. Slomka, *Update on Partial Relief from Responsible Person Liability for Limited Partners & LLC Members*, Vol. 2, iss. 10 MOFO NEW YORK TAX INSIGHTS p. 2 (Morrison & Foerster LLP, New York October 2011); Irwin A. Slomka, *New Policy Offers Partial Relief from Controversial Responsible Person Liability*, Vol. 2, iss. 5 MOFO NEW YORK TAX INSIGHTS p. 1 (Morrison & Foerster LLP, New York May 2011).

28 W. Va. Code § 11-15-17.

29 *Schmehl v. Comm'r*, 222 W. Va. 98, 108 (1998).

30 West Virginia Administrative Decision 10-332 W, WV St. Tax Rep. (CCH) P 2001621029 (May 27, 2011) (finding verbal release from his position was a sufficient release).

31 *See*, *e.g.*, Mass. Ann. Laws Ch. 64H, § 16; N.J. Stat. Ann. § 54:32B-2(w); N.Y. Tax Law § 1131(1); *Matter of Cohen*, TSB-H-85(234)S (N.Y.S. Tax Comm., Oct. 3, 1985) (stating that for New York State sales and use tax purposes, "the holding of corporate office does not, *per se*, impose personal liability upon the office holder").

32 *Cooperstein v. Director, Div. of Taxation*, 13 N.J. Tax 68, 88 (Tax Ct. 1993), *aff'd*, 14 N.J. Tax 192 (App. Div. 1994).

33 *Id*.

34 *Id*. at 84.

35 20 N.Y. Comp. Codes R. & Regs. 526.11(b (2); *Matter of Steinberg*, DTA No. 822971 (N.Y.S. Div. of Tax App. Sept. 9, 2010) (finding personally liable a CEO who was the chairman of the board of directors, was a "major stockholder" of the corporation, was responsible for the management of the company's operations, had access to the books and records, had the authority to hire and fire employees and had the authority to sign tax returns and checks on behalf of the company). For additional analysis on *Matter of Steinberg*, *see* Hollis L. Hyans, *Executives Beware: Responsible Officer Liability*, Vol. 1, iss. 1 MOFO NEW YORK TAX INSIGHTS p. 3 (Morrison & Foerster LLP, New York Nov. 2010).

36 *Dellorfano v. Comm'r of Revenue*, Mass. ATB Findings of Fact and Reports 2010-972, 993 (Mass. App. Tax Bd. Oct. 27, 2010) (considering it relevant that an officer had an LL.M. in taxation and had previously worked as a tax counsel for a certified public accounting firm in determining whether the individual had a duty to act).

37 *Skaperdas v. Director, Div. of Taxation*, 14 N.J. Tax 103 (Tax Ct. 1994), *aff'd*, 16 N.J. Tax 454 (App. Div. 1996).

38 *Id*.

39 Tex. Tax Code § 111.016(b).

40 *State v. Crawford*, 262 S.W.3d 532, 542 (Tex. Ct. App. 2008).

41 *Tex. Comptroller of Pub. Accounts v. Liuzza*, 610 F.3d 937 (5th Cir. 2010).

42 *Id*. at 942.

43 Cal. Rev. & Tax. Code § 6487(a).

44 Cal. Rev. & Tax. Code § 6829(f). The limitations period is limited to three years from the date that the California State Board of Equalization obtains actual knowledge of the dissolution. *Id*. *See also Ilko v. California State Board of Equalization*, BAP No. SC-09-1119-JuRMo, 2009 Bankr. LEXIS 4541 (B.A.P. 9th Cir. 2009), *aff'd without op.*, 651 F.3d 1049 (9th Cir. 2011) (upholding a responsible person assessment made more than two years after the company dissolved and more than eight years after the sales tax returns were due).

45 N.C. Gen. Stat. § 105-242.2(e).

46 California Seller's Permit Application, *available at* http://www.boe.ca.gov/pdf/boe400spa.pdf; Registration for Commercial Employers, *available at* http://www.edd.ca.gov/pdf_pub_ctr/de1.pdf.

47 Michigan Tax Form 3683, *available at* http://www.mi.gov/documents/3683f_2907_7.pdf.

48 *See*, *e.g.*, *Matter of Crescent Beach*, DTA No. 822080 (N.Y.S. Tax Appeals Tribunal, Sept. 22, 2011) (the auditor requested that the company's CPA submit a responsible person questionnaire for four specific employees at the company after issuing a Statement of Proposed Audit Change); *Matter of Grillo*, DTA No. 823237 (N.Y.S. Div. of Tax App., Nov. 3, 2011) (the auditor requested the completion of a responsible person questionnaire for a number of the company's executive officers).

Potential Unity and Business Income in California

By Eric J. Coffill and Timothy A. Gustafson

"Business income" has been a statutorily defined concept since California's adoption of the Uniform Division of Income for Tax Purposes Act ("UDITPA") in 1965.[1] By way of three classic decisions from the California State Board of Equalization ("SBE"), this article explores the relationship between business income and the unitary business concept in the context of the disposition of assets that had only the "potential" to be incorporated into a unitary business. Finally, this article discusses recent California decisions and developments in the area.

The definition of "business income" found in California Revenue and Taxation Code Section 25120 provides:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.[2]

This definition has not been amended by the California Legislature since its adoption. Administrative and judicial decisional law has made clear that this statutory definition contains two separate and independent tests for business income: a "transactional" test and a "functional" test.[3] Rarely does the transactional test cause difficulties in its application, as it is usually clear whether or not income arises "from transactions and activity in the regular course of the taxpayer's trade or business."[4] In comparison, problems abound in applying the separate functional test to determine if and when income arises from the acquisition, management and disposition of property which "constitute integral parts of the taxpayer's regular trade or business operations."[5] Recall that UDITPA is a model apportionment formula which contains no provisions addressing the tax base. Accordingly, that apportionment formula is equally applicable to a single corporation, a consolidated group of corporations or a unitary group of corporations. In California, a fiercely unitary state, an especially troublesome problem arises at the convergence of the functional test with the unitary business concept where assets have been acquired with the intent, albeit ultimately frustrated, to integrate them into a unitary business.

Three Classic California State Board of Equalization Decisions

Three decisions illustrate this "potential" to integrate issue.

The first decision is *Appeal of Standard Oil*, decided by the SBE in 1983.[6] There the taxpayer received approximately $160 million of dividends from two entities. The first entity was Arabian American Oil Co. ("Aramco"), in which the taxpayer owned a 30% interest. The second entity was P. T. Caltex Pacific Indonesia ("CPI"), in which the taxpayer owned a 50% interest. Since 1958, the taxpayer's production entitlements in Aramco and CPI represented at least 50% of the taxpayer's worldwide supply.

Relying upon the California Franchise Tax Board's ("FTB") regulations and case law, the SBE held in *Standard Oil* that the dividends were business income under the functional test. The SBE explained the functional test requires an examination of the relationship between the intangible property and the taxpayer's unitary business:

> If the income-producing property in question is integrally related to the unitary business activities of the taxpayer, the income is business income . . . *if the income-producing property is unrelated to the unitary business activities of the taxpayer, the income is nonbusiness income subject to specific allocation*.[7]

The SBE then proceeded to point out the taxpayer's "fundamental purpose" in creating the Aramco and CPI operations was to ensure an available supply of crude oil and natural gas liquids for its worldwide petroleum operations, that the taxpayer's "regular use of these crude oil supply rights embodied in its Aramco and CPI stockholdings provided a necessary and essential element of its worldwide oil operations," that without these interests, the taxpayer's "competitive position in the petroleum industry and its ability to effectively utilize its refining and marketing capacities would have been substantially impaired," and that the taxpayer's interest in these two operations "contributed materially to the production of operating income from the rest of appellant's unitary business and clearly served to further the operations of the integrated petroleum enterprise conducted within and without this state."[8]

Thus, *Standard Oil* framed the business income inquiry by juxtaposing it against the unitary business inquiry: income "unrelated" to the unitary business is not business income.

The second classic SBE decision on this issue is *Appeal of Occidental Petroleum Corporation*, which was decided less than four months after *Standard Oil*.[9] The significance of *Occidental Petroleum* is that it took the *Standard Oil* "related-unrelated" link between the business income issue and the unitary business issue and applied it in the context of assets which had only the "potential" to be part of the unitary business.

The relevant facts in *Occidental Petroleum* are as follows: In keeping

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with its expansion program in the natural resources area, Occidental was interested in combining the business of Kern County Land ("KCL") with its own. After failing to induce KCL's management to discuss a merger, Occidental initiated a tender offer for a portion of KCL's stock. Although Occidental ultimately acquired over 20% of KCL's outstanding stock, KCL thwarted Occidental's takeover by agreeing to be acquired by Tenneco. As a result of that takeover, Occidental received Tenneco stock in exchange for its KCL stock. Occidental then sold the Tenneco stock for a gain so that it could redeploy its assets into other ventures.

Occidental also undertook a friendly acquisition of Island Creek Coal Co. ("Island Creek"). Prior to the acquisition, Occidental had acquired some of Island Creek's stock. In order to ensure that the Internal Revenue Service would classify the merger as a tax-free reorganization for federal tax purposes, Occidental was required to dispose of its Island Creek stock prior to consummating the merger. After Occidental sold the stock for a gain, the merger with Island Creek was successfully consummated.

The SBE in *Occidental Petroleum* noted that the evidence clearly showed that both of the stock sales in question were "made pursuant to a specific corporate plan to consolidate or expand the unitary business in accordance with an established natural resources orientation."[10] However, even though Occidental's *purpose* in acquiring the KCL and Island Creek stock was to expand its unitary business, the SBE stated that

> neither the stockholdings nor the assets and activities they represented constituted integral parts of appellant's existing unitary operations at the times appellant decided to sell them. *In fact, at no time did they possess more than the potential for actual integration into appellant's ongoing business, and we believe that mere potential is insufficient to support a finding that the gains on these sales were business income under the functional test*.[11]

For this "potential" versus "actual" distinction, the SBE in *Occidental Petroleum* drew its support not only from *Standard Oil,* but also from *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, where the United States Supreme Court stated "the potential to operate a company as part of a unitary business is not dispositive when, looking at "the 'underlying economic realities of a unitary business,'" the dividend income from the subsidiaries in fact is "[derived] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'"[12]

The last of the three decisions is *Appeal of Mark Controls Corporation*, an SBE decision from 1986, which provides a classic illustration of the application of the *Occidental Petroleum* "potential" to integrate test.[13] In *Mark Controls*, the SBE determined that the taxpayer's purchase of stock in two corporations with the intent to integrate the companies into the taxpayer's core business was insufficient for a finding that income from the stock sales was business income when the taxpayer never possessed more than the potential for actual integration of the companies into the taxpayer's ongoing unitary business operations.

The relevant facts of *Mark Controls* are as follows: In 1971, Mark Controls purchased 49.5% of the stock of Weir Pacific Valves, Ltd. ("Weir") with an option to purchase additional shares owned by the Weir Group. Mark Controls acknowledged the purpose for the purchase was to allow it to expand its marketing and manufacturing operations to the United Kingdom. After the purchase, Mark Controls and Weir executed a licensing agreement that allowed Weir to manufacture some of Mark Controls' products and there were approximately $200,000 in annual intercompany sales. Mark Controls also received a seat on the board of directors of Weir. After acquiring the Weir stock, Mark Controls realized that Weir was mismanaged. Mark Controls then attempted to improve Weir's management and provided two executives in an attempt to improve Weir's performance. However, the efforts failed and Mark Controls sold its shares in 1976 for a gain.

In a separate transaction in 1975, Mark Controls purchased 20% of the outstanding shares of Walthon-Weir P.S.A. ("Walthon"). Mark Controls and Walthon executed a licensing agreement similar to the agreement with Weir. Mark Controls also received a seat on Walthon's board of directors. Concerned with the propriety of Walthon's business dealings, Mark Controls sold the stock in 1977 for a gain.

The SBE in *Mark Controls* began by analyzing the relationship between Weir and Mark Controls. While the SBE observed the purchase of a large minority block in a business similar to the business of Mark Controls superficially appeared to create an integrated operation, particularly coupled with the intent of Mark Controls to expand its business in the United Kingdom, the SBE concluded the actions and intent of Mark Controls "did not result in the stockholdings nor the underlying assets or activities of Weir becoming an integral part of appellant's business."[14] The SBE found that all of Mark Controls' actions "were, at most, preparatory to integrating Weir" into the unitary business.[15] While Mark Controls placed an employee on the board of directors of Weir, there was no evidence this employee had any influence over Weir's corporate policy or day-to-day operations. This was evident by the failure of attempts made to repair Weir's mismanagement. Intercompany sales between the two companies also failed to show any functional integration as there was no indication of "any special economic advantage gained" by Mark Controls by doing business with Weir.[16] As a result, the SBE found that "at no time did Weir possess more than the potential for actual integration into appellant's

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ongoing unitary business operations" and, citing *Occidental Petroleum*, found that "mere potential is insufficient to support a finding that the gains on these stock sales were business income under the functional test."[17] The SBE then concluded that the gain from the sale of Weir's stock was properly classified as nonbusiness income.

Similarly, the SBE found no integration between Mark Controls and Walthon. At no time during the ownership of the stock did Mark Controls attempt to control the day-to-day operations of Walthon and at no time did Mark Controls attempt to integrate Walthon's activities into its unitary business. The existence of the licensing agreement might have created a potential for actual integration with the ownership of the stock, but, again, the SBE repeated the rule of law from *Occidental Petroleum* that "mere potential is insufficient to support a finding that the gains on these sales were business income under the functional test."[18]

Accordingly, the SBE rule of law under *Occidental Petroleum* and *Mark Controls* is that income generated by an asset that has only the "potential" to operate as a part of a taxpayer's unitary business cannot be business income. The point made in *Occidental Petroleum* (as well as in *Mark Controls* and earlier by the United States Supreme Court in *Woolworth*) is that income from assets *not actually integrated* into the taxpayer's business does *not* give rise to business income. In other words, if the stock only has the potential to be integrated, but is *not* integrated, the stock is not an integral part of the taxpayer's regular trade or business. Thus, as in *Occidental Petroleum* involving Occidental's stock interests in KCL and Island Creek and in *Mark Controls* involving Mark Controls' stock interest in Walthon and Weir, a "potential" unitary asset produces nonbusiness income.

How are these classic decisions being applied by the SBE in more contemporary times? Two recent, nonprecedential SBE decisions, *Appeal of Crane Co.* (2009) and *Appeal of Rheem Manufacturing* (2011), provide some guidance.[19]

In *Crane*, the taxpayer, Crane Co. & Subsidiaries ("Crane"), was a diversified manufacturer operating in five major sectors: Engineered Materials, Merchandising Systems, Aerospace, Fluid Handling and Controls. In 1994, Crane acquired ELDEC Corporation ("ELDEC") as a wholly-owned subsidiary, which operated an industrial wireless business segment. ELDEC sought a strategic partnership with POWEC, a manufacturer of products and power systems. ELDEC entered into an agreement with POWEC, the terms of which provided that ELDEC would be POWEC's exclusive distributor and ELDEC would acquire a 47% interest in POWEC. The two companies also agreed to share technology, information and know-how and entered into a distribution and licensing agreement and a shareholders' agreement whereby ELDEC received the right to appoint two of POWEC's five board members. In 2000, ELDEC sold its interest in POWEC and Crane treated the gain on the sale as nonbusiness income. The FTB disagreed.

On appeal before the SBE, Crane conceded that both the acquisition and disposition of POWEC's stock were integral parts of its business under the functional test but argued the element of management was lacking because ELDEC held only a minority interest in POWEC and could only appoint two out of five POWEC board members. Thus, Crane argued, ELDEC never controlled POWEC's business such that it became interwoven with and inseparable from Crane's business. Crane also argued ELDEC's intention of accomplishing business integration never came to fruition and cited to both *Occidental Petroleum* and *Mark Controls* for the proposition that the mere potential for integration does not generate business income.

The SBE disagreed. The SBE concluded that "ELDEC generated business income as a result of [the] strategic business relationship" between ELDEC and POWEC.[20] Accordingly, the SBE found "the gain from the sale of the property used to generate the business income, *i.e.*, the POWEC stock, is also business income."[21] In distinguishing its former decisions, the SBE found "there [was] no indication . . . that ELDEC purchased its interest in POWEC as an initial step toward business integration with POWEC" and that "the evidence does not disclose an intention by [Crane] to integrate" the POWEC stock acquisition into its business.[22]

In *Rheem*, the taxpayer was a manufacturer of water heating, air conditioning and heating products that are sold through distributors to customers. Rheem and Watsco, Inc. ("Watsco") each acquired ownership interests in three other distributors. Rheem subsequently exchanged its interest in these three distributors for shares in Watsco. In 2003, Rheem sold its interest in Watsco for a gain of over $24 million, which it reported as nonbusiness income. The FTB subsequently audited and assessed Rheem and the appeal followed.

On appeal, Rheem argued the functional test was not met because Rheem and Watsco were not unitary, operated as separate companies and shared neither corporate officers nor employees. Rheem asserted it had no management or other decision-making control over Watsco, holding no more than a 4.3% ownership interest in Watsco at any time. While Watsco accounted for 24% of Rheem's air conditioning sales, Rheem stressed that Watsco entered into agreements with Rheem's competitors which resulted in a significant reduction of Watsco's purchases of Rheem's products. In its briefing, Rheem cited to both *Occidental Petroleum* and *Mark Controls* for the proposition that a sale of stock was nonbusiness income where the taxpayer had not integrated the stock into its unitary business at the time of sale.

The FTB responded that the functional test was met because Rheem's

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acquisition, management and disposition of the Watsco stock created a flow of value between the two companies. The FTB argued that Watsco's skill as a distributor led to increased sales of Rheem's products and because Watsco accounted for 24% of Rheem's air conditioning sales, the stock was integral to Rheem's business. The FTB asserted Rheem had no intention to acquire a controlling interest in Watsco and pointed to the long-standing operational relationship it had with Watsco and other distributors with exclusive distribution agreements.

The SBE ultimately rejected Rheem's contentions, finding there was ample evidence for concluding the stock was integral to Rheem's business.[23] The SBE noted the representations made by Watsco in documents filed with the U.S. Securities and Exchange Commission, including statements that Watsco "maintain[ed] a unique and mutually beneficial relationship" with Rheem and that Rheem had acquired an ownership interest in three distributors "as a joint venture partner" with Watsco.[24]

Observations and Themes

To some extent, the SBE's "potentiality" to integrate issue dating to *Standard Oil* and *Occidental* has now become usurped by the greater issue of unity. That is because, like beauty, "potentiality" is in the eyes of the beholder, especially when those eyes are at the FTB. The analysis now seems to focus more on a binary inquiry, *i.e.*, whether or not an asset is part of the taxpayer's unitary business, with the gray area of "potential" integration removed from the inquiry. Perhaps put differently, the FTB sees actuality where taxpayers see potentiality. Part of this shift may be explained by a 2001 decision by the California Supreme Court.

Subsequent to the three classic SBE decisions addressed above, the California Supreme Court decided *Hoechst Celanese Corp. v. Franchise Tax Board*.[25] There the Court reiterated the statutory standard that, "[u]nder the functional test, corporate income is business income 'if the acquisition, management and disposition of the [income-producing] property constitute integral parts of the taxpayer's regular trade or business operations.'"[26] The court went on to explain that the "critical inquiry" for purposes of the functional test is "the nature of the relationship between this property and the taxpayer's 'business operations.'"[27] The court explained that the statutory language of Section 25120 requires a two-part inquiry.[28] First, the statutory phrase "'acquisition, management and disposition' directs us to examine 'the taxpayer's interest in and power over the income-producing property.'"[29] If the taxpayer has a sufficient interest in the income-producing property under that standard, one then moves to the second inquiry which is whether "the taxpayer's control and use of the property [are] an 'integral part of the taxpayer's regular trade or business operations.'"[30]

So far, that analysis seems straightforward and consistent with the language of the statute defining business income. But the *Celanese* Court then went on to state "that 'integral' requires an organic unity between the taxpayer's property and business activities whereby the property contributes materially to the taxpayer's production of business income."[31] Thus, the business income analysis appears to come full circle back to unity, or whatever is meant by "organic unity" in the words of the *Celanese* Court.

Does *Celanese* change the analysis under *Standard Oil* and *Occidental*? The answer should be "no," because the same (un-amended) statute is the basis for and the subject of all these decisions. Plus, the "potential" standard did not originate with the SBE, but is rooted in the United States Supreme Court decision in *Woolworth*, which most certainly cannot have been changed or overruled by the California Supreme Court in *Celanese*. In any event, do not be surprised to find a discussion with the FTB regarding the business income "potential" issue to become littered with references to "flows of value" under *Container* and the relation between the income and the activities in the taxing state under *ASARCO* and *Allied Signal*.[32] Perhaps now every California *statutory* business income issue, including the "potentiality" issue, will become an issue of the FTB's constitutional power to tax. If so, then the specific language of Section 25120 no longer has meaning and the statute becomes only a "long-arm" statute interpreted by the FTB to mean it can tax corporate income on an apportioned basis to the fullest extent permitted under the Federal Constitution.

The most recent example of the issues brewing around the "potential" to integrate issue is the *Pacific Bell* case, which was decided by the SBE, without any written decision, in September 2011.[33]

In *Pacific Bell*, the taxpayer operated a regional domestic telephone company in 13 states. Pacific Bell began to invest in foreign telecommunications companies in the 1990s and sent approximately 60 employees to the foreign countries wherein those companies were located to function in an advisory capacity pursuant to arm's-length management agreements. Some of these agreements also provided for Pacific Bell to appoint members to a foreign company's board of directors. Pacific Bell began divesting itself of its foreign investments in the late 1990s and early 2000s because it needed capital to grow its domestic telecommunications business. At issue in this case were the gains from the sale of its investment in seven foreign companies during 2001 and 2002.

In arguing the facts of the case did not meet the functional test under *Celanese*, particularly with regard to the statutory term "integral," Pacific Bell claimed *Celanese* required an

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"organic unity" between the taxpayer's property and business activities such that the property contributes materially to the taxpayer's production of business income. Additionally, Pacific Bell argued *Celanese* held that the property must be so interwoven into the fabric of the taxpayer's business operations that it becomes "indivisible" from the taxpayer's business activities with both giving value to the other. Pacific Bell also argued it never had a plan to integrate the foreign investments into its regular business and that various regulatory, logistical and technological impediments prevented it from doing so if it had wanted to. Moreover, Pacific Bell argued that because it only had a minority interest in the foreign companies, it could not exercise sufficient control over the investments to integrate them into its domestic telephone operations. Also, Pacific Bell claimed it had no material intercompany sales or licensing agreements with the foreign entities.

The FTB responded in part that the investments were in the identical line of business as Pacific Bell's regular business operations (*i.e.*, the telecommunications industry) and as such were acquired, maintained and disposed of as an integral part of that business. The FTB also argued Pacific Bell, through its employees acting in advisory capacities and its representatives serving on the boards of the various foreign companies, was actively involved in the daily operations, including the management, of the foreign investments. Further, the FTB argued that Pacific Bell gained business advantages through its foreign investments, having entered into cooperation agreements and agreements regarding the sharing of information technology with the foreign entities and that such benefits constituted a flow of value between Pacific Bell and the foreign entities under the United States Supreme Court decision in *Container*.[34] Moreover, the FTB argued that Pacific Bell's relationship with the foreign entities was a unitary relationship and that Pacific Bell, as one of the world's largest telecommunications companies, was not a passive investor in these entities.

At the SBE hearing, the parties entertained questions from the Board Members on various issues, including: whether the foreign investments were in the same general line of business as Pacific Bell and whether and to what extent the foreign investments were indivisible and inseparable from Pacific Bell's business; the relationship between the foreign investments and Pacific Bell's activities in California; what was the appropriate legal standard under the language of *Celanese* and *Container*; and whether Pacific Bell's control and use of the foreign investments created a flow of value to Pacific Bell's production of business income. After a lengthy discussion of the facts and the law, the SBE voted 5-0 in favor of Pacific Bell on this issue.[35]

Interestingly, and despite the opportunity to provide much needed guidance on this issue, the SBE chose not to publish any written opinion, formal or otherwise, in *Pacific Bell*. Thus, taxpayers dealing with the "potential" to integrate issue are still left to speculate exactly which factual scenarios or legal arguments ultimately won the day. Anecdotally, at least two other cases are set for hearing in the upcoming months before the SBE on this issue. It remains to be seen whether the FTB or the SBE will take a more definitive position under the law going forward. ■

1 Cal. Rev. & Tax. Code §§ 25120-25139.

2 Cal. Rev. & Tax. Code § 25120(a). Conversely, nonbusiness income is defined as "all income other than business income." Cal. Rev. & Tax. Code § 25120(d).

3 *See Hoechst Celanese Corp. v. Franchise Tax Bd.*, 25 Cal. 4th 508, 526-527 (Cal. 2001); *see also Appeal of Occidental Petroleum Corporation*, Cal. St. Bd. of Equal., June 21, 1983.

4 Cal. Rev. & Tax. Code § 25120(a).

5 *Id.* The functional test "focuses on whether the property serves an operational function in the trade or business." Cal. Franchise Tax Bd., Legal Ruling 05-2 (July 8, 2005).

6 *Appeal of Standard Oil Company of California*, Cal. St. Bd. of Equal., Mar. 2, 1983.

7 *Id.* (emphasis added).

8 *Id.*

9 *Appeal of Occidental Petroleum Corporation*, Cal. St. Bd. of Equal., June 21, 1983.

10 *Id.*

11 *Id.* (emphasis added).

12 *Woolworth*, 458 U.S. 354, 362 (1982), quoting *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

13 *Appeal of Mark Controls Corporation*, Cal. St. Bd. of Equal., Dec. 3, 1986.

14 *Id.*

15 *Id.*

16 *Id.*

17 *Id.* (internal citations omitted).

18 *Id.*, *citing Appeal of Occidental Petroleum Corporation*.

19 *Appeal of Crane Co. & Subsidiaries*, Cal. St. Bd. of Equal., June 30, 2009 (nonprecedential summary decision); *Appeal of Rheem Manufacturing Company*, op'n on pet. for reh'g, Cal. St. Bd. of Equal., Apr. 27, 2011 (nonprecedential letter decision).

20 *Appeal of Crane Co. & Subsidiaries*, Cal. St. Bd. of Equal., June 30, 2009 (nonprecedential summary decision).

21 *Id.*

22 *Id.*

23 *Appeal of Rheem Manufacturing Company*, op'n on pet. for reh'g, Cal. St. Bd. of Equal., Apr. 27, 2011 (nonprecedential letter decision).

24 *Appeal of Rheem Manufacturing Company*, Cal. St. Bd. of Equal., hearing held May 25, 2010 (nonprecedential Hearing Summary).

25 *Celanese*, 25 Cal. 4th 508 (Cal. 2001).

26 *Id.* at 527.

27 *Id.* (internal citations omitted).

28 *See Celanese*, 25 Cal. 4th at 528; *see also Jim Beam Brands Co. v. Franchise Tax Bd.* 133 Cal. App. 4th 514, 524 (2005).

29 *Celanese*, 25 Cal.4th at 528.

30 *Id.*

31 *Id.* at 530.

32 *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983); *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982); *Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

33 *Appeal of Pacific Bell Telephone Company & Affiliates*, Cal. St. Bd. of Equal., Case No. 521312, heard Sept. 20, 2011 (nonprecedential decision).

34 *See Container*, *supra*, 463 U.S. at 179.

35 *Appeal of Pacific Bell Telephone Company & Affiliates*, Cal. St. Bd. of Equal., Case No. 521312, heard Sept. 20, 2011 (nonprecedential decision). The SBE voted against Pacific Bell on an unrelated treasury function gross receipts issue.

Managing Withholding for a Mobile Workforce: Special Treatment of Deferred Compensation and Stock Options

By Paul H. Frankel and Debra S. Herman

Tax managers and payroll administrators in companies with employees traveling to many states on business face a formidable burden in learning and complying with difficult withholding requirements in various states. State income tax statutes typically impose withholding and reporting obligations on employers whose employees travel to the state on business, even if the employees' visits to the state are infrequent. Although some states provide a de minimis threshold before requiring tax withholding for nonresidents (*e.g.*, 14 days or fewer in New York and 60 days or fewer in Hawaii),[1] such thresholds typically do not exempt employees from personal income tax. In addition, current safe harbors tend not to apply to situations involving deferred compensation or stock options inasmuch as that income typically relates to multiyear compensation arrangements.[2]

Determining the amount of withholding on income from deferred compensation and stock options is particularly challenging in the case of nonresidents given the difficultly in determining when income accrues relative to the period that the nonresident employee performs services in the state. States' approaches to allocating deferred income and stock option income vary and lead to conflicting results. In addition, in most cases, when individuals receive retirement and other kinds of deferred compensation, they are no longer employees of the company.

Congress is currently considering the Mobile Workforce State Income Tax Simplification Act of 2011, under which an employee's wages would not be subject to personal income tax or withholding and reporting requirements in any state other than the employee's state of residence and in a state in which the employee is present and performing employment for more than 30 days during a calendar year.[3] Unfortunately, the proposal does not adequately address the withholding (and personal income tax) complexities raised by deferred compensation and stock option income. Until federal legislation is enacted or model state rules are adopted, employers must understand varying state withholding requirements on deferred compensation and stock option income. In many states, in addition to being liable for the tax, an employer is potentially subject to penalties for failure to properly withhold[4] and employees, owners and officers may be held personally liable for the unpaid withholding taxes, interest and penalties.[5] However, employers can reduce their withholding tax exposure with careful monitoring of state income allocation approaches, management of employee movement, implementation of record keeping systems and communication with employees. This article brings you an update on the latest allocation approaches states are using to determine the amount of tax withholding and discusses the issues and practices corporate tax managers and payroll administrators should consider when managing this type of withholding for their mobile workforce.

Deferred Compensation

Deferred compensation is generally income that is paid at a later date than when it is earned. Common examples of deferred compensation include pension and retirement income and stock option income. There are two primary issues that arise at the state tax level with respect to deferred compensation. First is whether a state is prohibited from taxing such income under federal law. And, second, if a state is not prohibited from taxing the income, what is the proper timing for withholding and the proper amount of income that is subject to withholding?

EMPLOYERS MUST UNDERSTAND VARYING STATE WITHHOLDING REQUIREMENTS ON DEFERRED COMPENSATION AND STOCK OPTION INCOME.

Federal Preemption of Taxation of Certain Retirement Income

In 1996, Congress enacted a federal statute (P.L. 104-95) that prohibits states from imposing income tax on the "retirement income" of nonresidents.[6] Thus, under P.L. 104-95, the state where the income is earned (the "source state") may not tax (or require withholding for) someone who is a nonresident of the source state on "retirement income." "Retirement income" is broadly defined to include payments from several categories of federally qualified plans meeting the requirements of specific provisions of the Internal Revenue Code ("I.R.C."), including 401(k) and pension plans, annuities, IRAs, and deferred compensation of state and local governments and tax organizations.[7] In addition, protected "retirement income" includes benefits from nonqualified deferred compensation plans described in I.R.C. Section 3121(v)(2)(C), as defined for purposes of the FICA (social security) tax imposed with respect to employment, provided that the payments

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are part of a series of substantially equal periodic payments made at least annually for either the life or life expectancy of the recipient or a period of at least 10 years.[8] In 2006, 10 years after P.L. 104-95's enactment, Congress amended the law to cover payments received from nonresident retired partners, as several states took the position that the law as originally enacted did not prohibit a state from imposing its income tax on payments received by retired partners under deferred compensation plans.[9]

The New York State Department of Taxation and Finance ("Department") recently considered whether an employer had an obligation to withhold on distributions from a nonqualified deferred compensation plan to two nonresident former employees of the company.[10] As the employees elected to take annual distributions from the plan as part of a series of substantially equal installment payments over a 10-year period and the plan qualified as a plan described in I.R.C. Section 3121(v)(2)(C), the Department concluded that the distributions were not subject to New York State income tax and New York State income tax withholding. Instead, the employer would withhold in the two employees' states of residence.

In a letter ruling issued in Massachusetts, the Commissioner of the Department of Revenue advises employers that he requires them to obtain a Massachusetts Withholding Exemption Certificate for Pension, Annuity and Other Periodic Payments (Form M-4P) when determining if Massachusetts withholding is required for retirement payments.[11] The ruling further provides that an employer can rely on the information set forth in Form M-4P regarding state of residence, unless the employer has knowledge that such information is false.[12]

Employers should consider obtaining a ruling from relevant states on the issue of federal preemption. Although P.L. 104-95 covers income from most pension and retirement plans defined in the I.R.C., many types of deferred compensation income are not covered and are potentially subject to tax by states where the income was earned. Furthermore, when state taxation (and withholding) is not barred by federal law, employers should consider whether there are any state specific exemptions that could apply. For example, in New York, deferred compensation that qualifies as an annuity is not subject to personal income tax and withholding.[13] If no exemption applies, then employers should consider the proper timing for withholding and the amount of withholding.

Timing and Amount of Withholding

Most states follow the timing of income recognition used for federal income tax purposes. This is primarily because most states start with federal adjusted gross income when determining an employee's personal income taxes.[14] Many states also adopt the federal definition of wages for purposes of state income tax withholding and require withholding based on the same payroll period used for federal income tax withholding.[15] Thus, in most states, withholding of state personal income taxes is required when the deferred compensation is properly includable in the taxpayer's federal adjusted gross income. Usually this is when the deferred compensation is paid (*i.e.*, the stock is distributed to the employee). However, there are some exceptions. For example, in Pennsylvania, withholding may be required upon the deferral of the income (*i.e.*, when the contribution is made to the plan) under a constructive receipt theory.[16] As noted above, some states provide safe harbor provisions, based either on a threshold number of days an employee is present in a state or on dollar amounts, that relieve the employer of withholding obligations until the threshold is triggered.[17] Several states also have reciprocal agreements that exempt an employer from withholding tax on a nonresident employee who works in that state if the employee's home state has a reciprocal agreement with the state that the employee works in and that state exempts a similarly situated employer from a withholding requirement.[18]

The amount of deferred income subject to state withholding generally will conform to the amount includable in federal gross income. However, the portion of that amount that will be subject to personal income tax, and thus withholding tax, depends on whether the employee is a resident and where the employee earned the income. States generally tax residents on all income received, regardless of the source of the income (*i.e.*, where the income is earned).[19] Thus, the general rule is that withholding is required on all of a resident employee's compensation income. If the resident employee performed services partly within the resident state and partly within another state, the state of residence generally provides a credit for taxes paid to the source state and withholding is required only to the extent that the resident state's withholding tax liability is greater than the tax that has been withheld for the source state.

States' personal income taxation and withholding for nonresidents are more complex. Most states tax nonresident individuals only on income that is derived from sources in the state ("source income").[20] With respect to wages, the inquiry is whether the income is attributable to services performed in the state. In most states, the portion of compensation that is attributable to services performed in the state is determined based on the ratio of days worked in the source state to the total days worked during the relevant period.[21] Of course, states vary in determining how a day should be calculated and the scope of the compensable period, in particular when stock options are involved.[22]

Stock Option Income

In general, there are two types of stock option plans: statutory and nonstatutory (from a federal tax perspective). Statutory stock options include incentive stock options.[23] Employees who receive statutory stock options do not realize income when they are granted the option or when they exercise the option. Instead, employees can defer tax until they sell or exchange the stock.[24] Nonstatutory stock

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options do not receive the same favorable timing and character of income treatment as statutory stock options, but employees who receive these options may be able to defer the tax under I.R.C. Section 83. In general, an employee recognizes gain on the grant of the nonstatutory stock options if the options have a readily ascertainable fair market value.[25] More commonly, employees recognize ordinary income upon the exercise of the stock options, measured by the excess of the fair market value of the optioned shares over the option exercise price.[26] Thereafter, the appreciation recognized on the sale of the stock is treated as gain derived from the sale of the stock (investment income) and is typically of no concern to the employer.[27] Most states' rules follow these federal principles; however, complexity arises over how to determine the proper amount of income that should be allocated to a particular state when the taxpayer is a nonresident and has performed services in multiple states over the years at issue.

Differing State Allocation Formulae

It should be no surprise that states have adopted various conflicting methods for determining the taxable portion of stock option income. For comparison sake, let's focus on nonstatutory stock options with no readily ascertainable fair market value.

New York State and City. In New York State, income from these options will be allocated based on where the employee worked during the period between the grant date and the vest date.[28] For example, if an employee has 200 New York workdays out of a total of 400 workdays from date of grant to date of vest, New York will tax 50% of the option income. Prior to 2007, New York employed a date of grant to date of exercise allocation approach, but such approach was rejected when New York promulgated its current regulatory regime, primarily because the approach was challenged and rejected by New York's Tax Appeals Tribunal in *In re Stuckless*.[29] As nonresidents are no longer subject to a New York City earnings tax, there is currently no New York City personal income tax or withholding obligation on deferred compensation income or regular wage income.

Arizona and California. Several states continue to employ New York's former date of grant to exercise approach, such as Arizona and California.[30] If we go back to our previous example and the same employee works 200 days in New York out of a total of 1,000 days between grant and exercise, Arizona and California would consider only 20% of the income as New York sourced (versus 50% under New York's rules). The mismatch also affects an employee's ability to obtain a credit for taxes paid to other jurisdictions, as most states apply their own source rules when calculating the amount of the allowable credit. Thus, in our example, 30% of the employee's income may be subject to double taxation.

Georgia. A significant change has recently occurred in Georgia. Effective January 1, 2011, Georgia law provides that, as well as other types of compensation,

> the income from the exercise of stock options received by a nonresident of Georgia, who engaged in employment, trade, business, professional, or other activity for financial gain or profit in a prior year within Georgia and whose income exceeds the lesser of five percent of the income received from all places during the taxable year or $5,000, shall be subject to taxation.[31]

For nonstatutory stock options with no readily ascertainable fair market value, the amount of income included in Georgia taxable income is computed based on the ratio of days worked in Georgia for the employer from the grant date to the vest date on or after January 1, 2011 to the total number of days worked for the employer during the time from the grant date to the vest date.[32] Thus, Georgia, like New York, employs a date of grant to date of vest allocation methodology. However, employees in Georgia effectively receive a pass for the days worked in Georgia prior to the effective date of the new law, as such days are not included in the numerator of the allocation formula, but are included in the denominator of the allocation formula, thereby diluting the amount of stock option income allocable to the state.[33]

Idaho. In Idaho, another state that employs the date of grant to date of vest approach, the state's regulations provide that "the granting of stock options shall be presumed to be intended as compensation for future services" and the "party alleging otherwise shall bear the burden of proving that the stock options were intended for services rendered before the date of grant."[34]

Ohio. In Ohio, the allocation is based on the Ohio-related appreciation.[35] "For purposes of determining the Ohio-related appreciation, the nonresident will treat as Ohio income the value of the unexercised stock option at the time the individual left Ohio minus the value of the unexercised stock option at the time the individual received the option."[36]

As can be seen, there are many options for allocating stock option income to a state. Juxtaposed with these rules, are the states' withholding tax rules, which generally provide that an employer is required to withhold an amount substantially equivalent to the amount of tax due. Yet New York requires an employer to withhold on 100% of the deferred compensation income unless:
(1) the employee submits a Form IT-2104.1 for the deferred compensation reflecting the proper allocation of the income; (2) the employer has a Form IT-2104.1 on file for an employee for the current year, the employee is still performing services in New York and the deferred compensation is less than $1,000,000 for the payroll period, in which case the employer may withhold based on the Form IT-2104.1 on file for the current year; (3) the employee is no longer employed by the employer or is no longer performing services in New York and the deferred compensation is

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less than $1,000,000 for the payroll period, in which case the employer may withhold based on the last Form IT-2104.1 on file for the employee; or (4) the employer has adequate records to determine the proper allocation of the deferred compensation income to New York.[37] What are adequate records? Records sufficient to enable the employer to determine the percentage of services performed in a state for all years in which the deferred compensation income is earned.

Record Keeping

An employer bears the burden of keeping track of the physical location of its mobile workforce's business activities and maintaining records that reflect this information for many years. Employers should consider implementing withholding systems that interact with expense reporting systems. Employers should also take steps to obtain and retain state specific forms from their employees for purposes of determining the proper allocation percentage and state of residence (*e.g.*, New York IT-2104.1 and Massachusetts Form M-4P). An employer may also wish to remind its employees to keep their own personal diaries, expense reports, and other records necessary to document their working days.

Conclusion

Employers should review and revise their practices to capture state specific allocation periods for determining the correct amount of withholding and implement internal mechanisms to track and retain information about their employees' business activities (*e.g.*, physical location where services are performed), including specific forms required by the states. Amounts calculated under one state's rules may not sufficiently satisfy an employer's withholding tax duties in other states. In our experience, penalties are less likely to apply when an employer has made a good faith effort to comply with the state's withholding tax rules. ■

1 New York has adopted an informal 14 days during the calendar year rule within the New York State Department of Taxation and Finance's Withholding Tax Field Audit Guidelines. N.Y. Dep't Tax'n & Fin., Income Franchise Field Audit Bur., *Withholding Tax Field Audit Guidelines*, pp. 50-52 (Mar. 27, 2009) ("*NY Withholding Tax Audit Guidelines*"). The guidance relieves employers from withholding on nonresident employees who are assigned to a primary work location outside of New York State and work in New York State 14 or fewer days in a calendar year. In contrast to New York, Hawaii's 60 days during the calendar year withholding tax safe harbor is set forth in the state's withholding tax regulations. *See* Haw. Reg. § 18-235-61-04(b)(1).

2 *See NY Withholding Tax Audit Guidelines*, *supra* note 1, pp. 50-51 (stating that "14 day guidance will not apply to employees who receive income in the current year that is related to service performed in New York in prior years," including income from "stock options and deferred compensation"); S.B. 2170, § 2 62nd Legislative Assembly of North Dakota (enacting a 20-day nonresident mobile workforce exception for employer withholding but excluding compensation paid to certain key employees "for the year immediately preceding the current tax year").

3 H.R. 1864, 112th Congress (2011-2012).

4 For example, in Pennsylvania, if an employer fails to withhold tax and thereafter the tax is paid, the tax that was required to be withheld will not be collected from the employer, but the employer remains liable for any penalties, interest or additions to tax with respect to the failure to withhold. 72 Pa. Stat. § 7321; Pa. Reg. § 113.12. The employer is potentially subject to penalties or additions to tax for the failure to properly withhold Pennsylvania personal income tax, including an addition to tax of 5% of the tax that should have been withheld, if failure to withhold is for not more than one month. The employer is liable for an additional 5% addition to tax for each additional month the income was not withheld, up to 25%, which may not be collected from the employee. If the failure to withhold is "willful," the employer is liable for a penalty of 100% of the tax that was not withheld. 72 Pa. Stat. § 7352(e).

5 In Pennsylvania, corporate officers or employees are personally liable for uncollected taxes and penalties if they had a duty to withhold tax. 72 Pa. Stat. § 7352(e). In New York, corporate officers or employees are personally liable for uncollected taxes if they are considered a "person required to collect, truthfully account for, and pay over the tax" and the failure to withhold was "willful." N.Y. Tax Law § 685(g).

6 4 USCS § 114.

7 *Id.*

8 *Id.*

9 H.R. 4019, 109th Congress (2005-2006). Congress made the retired partner amendments retroactive to payments received after December 31, 1995. *Id.*

10 N.Y.S. Dep't of Tax'n & Fin., TSB-A-11(10)I, (Nov. 17, 2011).

11 Mass. Dep't of Rev., Letter Ruling 00-1: Withholding on Nonperiodic Payments Made Under a Nonqualified Plan (Jan. 28, 2000).

12 *Id.*

13 20 NYCRR §§ 132.4(d), 132.20.

14 *See* Colo. Rev. Stat. § 39-22-104; D.C. Code Ann. § 47-1803.02; Ga. Code Ann. § 48-7-27(a); Ind. Code Ann. § 6-3-1-8; Kan. Stat. Ann. § 79-32,117; N.Y. Tax Law § 611.

15 *See* Conn. Agencies Regs. § 12-701(b)-1(a)(12) & 12-705(a)-1(a); Del. Division of Revenue, Withholding Regulations and Employer's Duties, available at http://revenue.delaware.gov/services/wit_folder/section1.shtml; D.C. Code Ann. § 47-1801.04(56) & D.C. Mun. Regs. § 9-130.2; 20 NYCRR §§ 171.1 & 171.3.

16 61 Pa. Code §§ 101.6(b)(8) & 101.7.

17 *See supra* note 1 (providing examples of thresholds based on calendar days); *see also* Idaho Income Tax Admin. Rules § 35.01.01.871 (providing that no withholding is required if a nonresident earns in-state wages less than $1,000 in a calendar year); Okla. Stat. tit. 68, § 2385.1(e)(4) (providing that no withholding is required if a nonresident earns in-state wages less than $300 in a calendar quarter).

18 For example, a reciprocal agreement exists between New Jersey and Pennsylvania. *See* 72 Pa. Stat. § 7356 (b). A Pennsylvania resident must submit an *Employee's Certificate of Nonresidence in New Jersey* (Form NJ – 165) to his employer.

19 *See* Conn. Gen. Stat. § 12-700(a); Ga. Code Ann. § 48-7-20(a); Mo. Rev. Stat. § 143.111; N.Y. Tax Law § 611.

20 *See* Conn. Gen. Stat. § 12-700(b); Ga. Code Ann. § 48-7-20(a); Mo. Rev. Stat. § 143.041; N.Y. Tax Law § 631.

21 *See* Conn. Agencies Regs. § 12-711(c)-5; 20 NYCRR § 132.18; *cf.* Ohio Rev. Code Ann. § 5747.05 (providing that a nonresident receives a credit on that portion of the adjusted gross income not earned or received in Ohio).

22 *Compare* 20 NYCRR § 132.18 (providing a work-day allocation based on convenience of employer rule where days worked outside New York are treated as New York work days unless the nonresident worked outside of New York by necessity) *with* Minn. Stat. § 290.17 (providing a work-day allocation based on performance of services within the state).

23 *See* I.R.C. § 423.

24 I.R.C. § 422(a)(1).

25 I.R.C. § 83(a).

26 *Id.*

27 I.R.C. §§ 1001, 1221, 1222.

28 20 NYCCR § 132.24; *see also* 20 NYCRR §§ 132.25; 154.6.

29 *In re Stuckless*, DTA No. 819319, 2006 N.Y. Tax LEXIS 171 (N.Y. Tax App. Trib. Aug. 17, 2006).

30 Ariz. Individual Income Tax Ruling, ITR 02-5 (Oct. 21, 2002); Cal. Franchise Tax Bd., FTB Publication 1004 (Oct. 2007) (stating that "you must allocate to California that portion of total compensation reasonably attributed to services performed in the state" if you performed services for the corporation both within and outside California and providing that one reasonable method is an allocation based on total amount of time worked in California from grant date to exercise date to total workdays from grant date to exercise date).

31 Ga. Rule of Dep't of Revenue, Income Tax Div. Ch. 560-7-4-.05(3)(b); *see also* Ga. Code Ann. § 48-7-1(11).

32 Ga. Rule of Dep't of Revenue, Income Tax Div. Ch. 560-7-4-.05(3)(b)(2)(i).

33 *Id.* at (3)(b)(3)(iv).

34 Idaho Income Tax Admin. Rule § 35.01.01.271.

35 Ohio Dep't of Tax'n, IT 1996-01 – Personal Income Tax Law Preempting State Taxation of Retirement Plan Income – Issued March 11, 1996; Revised May 2007.

36 *Id.*

37 *See NY Withholding Tax Audit Guidelines*, *supra* note 1, pp. 46-47.

California's Property Tax Exclusion for Solar Energy Power Plants: Waiting to Sell Until New Year's Day Might Produce a Huge Hangover

By Peter B. Kanter

The California Constitution generally requires that all privately held real property in the state must be taxed.[1] However, it permits exclusions or exemptions for specific types of properties under certain circumstances, including an exclusion of "active solar energy systems" from the definition of assessable new construction.[2] This exclusion effectively allows, under specific conditions, large solar energy fueled electricity power plants to be exempt from almost all real property tax on energy producing fixtures and equipment for as long as the plant's initial owner continues to own the property. However, as discussed in this article, the exclusion can easily be lost by developers of such plants who are unaware of the rigid requirements for maintaining the exclusion. And, according to the California State Board of Equalization's recent proposed guidance manual for the application of the exclusion, it can easily be lost if a developer completes construction of a plant before January 1, but does not transfer the plant to the first operator until after January 1.[3] The lesson for developers? Don't finish what you can't sell by the end of the year or your buyer may get stuck with a property tax hangover that will never go away.

The property tax exclusion for active solar energy systems, often referred to as the "Section 73 exclusion," has its origins in the California Constitution, article XIII A, which is the article added by the taxpayer referendum commonly known as "Prop 13."[4] As many know, Prop 13 established a "change in ownership" based property tax system in California, whereby assessments would be set and capped by the fair market value of the real property as of the date it undergoes a change in ownership. Under Prop 13, once that change in ownership "base year value" is set, the property's assessment value cannot increase by more than 2% per year thereafter, unless there is another change in ownership, at which time the base year value is reset to market value. However, if "new construction" is performed on the property, the value of the ongoing construction in progress ("CIP") can be added to the existing base year value on the January 1 lien date following the initiation of the new construction; and upon completion of a new construction project, the total value of the new construction gets added to the existing base year value to form a new composite base year value (*i.e.*, the change in ownership base year value set by the last transfer of the real property, plus the new construction base year value set by the value added by the new construction, minus the value removed by any demolition of pre-existing property).

A simple example helps to illustrate the typical base year value rules: if a house on an acre of land were purchased in an arm's-length transaction for $800,000 on March 1, 2011, the assessor would enroll the fair market value of the real property as of the March 1, 2011 change in ownership date. For this example, let's presume that the $800,000 purchase price was accepted as the fair market value. The assessor would be obligated to allocate the total value between land and improvements. Let's assume that the assessor allocated $500,000 to the land and $300,000 to the improvements. The assessor could then increase the assessment by no more than 2% per year thereafter until the property sells again or there is new construction (including demolition of existing improvements).

DON'T FINISH WHAT YOU CAN'T SELL BY THE END OF THE YEAR OR YOUR BUYER MAY GET STUCK WITH A PROPERTY TAX HANGOVER THAT WILL NEVER GO AWAY.

Continuing the example, in December 2012, the owner tears down a detached garage that had been on the property when purchased (presumed to be worth $25,000 at the time of purchase in this example) and starts to erect a small guest cottage in its place. The value of the guest cottage (usually determined by the costs to build it) is determined to be $100,000 when completed on May 1, 2014, with $50,000 in value added by new construction during the year 2013 and the remaining $50,000 in value added in the year 2014 when the cottage is completed. The property should be assessed as follows (assuming the property's market value has increased by at least 2% each year):

March 1, 2011
Land – $500,000; Improvements – $300,000; Total – $800,000

The base year value is set by the change in ownership and allocated between the land and improvements.

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January 1, 2012
Land – $510,000; Improvements – $306,000; Total – $816,000

The 2% per annum maximum assessment inflation factor is applied to both land and improvements base year values.

January 1, 2013
Land – $520,200; Improvements – $286,620; Total – $806,820

The land and improvements continue to trend up by 2%, but the $25,000 value of the demolished garage is removed from the improvements base year value as of the January 1 lien date.

January 1, 2014
Land – $530,604; Improvements – $342,352; Total – $872,956

The land and remaining improvements base year values continue to inflate at 2%, plus the $50,000 CIP in place as of the January 1 lien date is added to the improvements base year value.

May 1, 2014
Land – $530,604; Improvements – $392,352; Total – $922,956

Upon completion of construction, the improvements base year value is reset to add the total value added to the property by the new construction—in this case, the remaining $50,000 in value added after January 1, 2014, which was not included in the regular January 1, 2014 annual assessment.

January 1, 2015
Land – $541,216; Improvements – $400,199; Total – $941,415

This is the new "composite base year value" consisting of the base year value established by the March 1, 2011 change in ownership value, trended up by 2%, minus the value of the demolished garage, plus the value of the new construction, trended up by 2% since its completion.

February 1, 2015
Upon a hypothetical sale of the entire property for $1,100,000, a new change in ownership base year value would be set, allocating the $1,100,000 fair market value between the land and the improvements, *e.g.*, $600,000 for land and $500,000 for improvements.

Thus, as demonstrated in the example above, the value of new construction typically gets added to a property's base year value. If the construction project extends over a January 1 lien date, then the value of CIP gets added to the base year value for that upcoming assessment year. Once the project is deemed complete, which is usually determined by when the property is fully available for legal occupancy or use by the owner, then the total value of the new construction is formally added to the property's trended base year value, and that new composite base year value can then inflate by no more than 2% per annum, until there is another change in ownership of the property, at which time all of the property would be reassessed at its fair market value.

The Section 73 exclusion for active solar energy systems provides a significant exception to the general rules governing new construction. Deriving its authority from section 2(c) of article XIII A of the California Constitution, which states simply that "the Legislature may provide that the term 'newly constructed'" shall not include "[t]he construction or addition of any active solar energy system," Section 73 provides such an exclusion and provides definitions of what type of property is deemed to be part of an active solar energy system subject to the exclusion.[5]

The Section 73 exclusion has been interpreted to apply to all newly constructed property that meets the definition of "active solar energy system," including large scale solar power electricity production plants. However, until it was amended in 2008, Section 73's exclusion of active solar energy property from the definition of "new construction" did not provide any tax benefit to an owner who purchased the property from the prior owner-builder who completed the construction.[6] That was because upon the sale of the property to the new owner, all of the property was reassessed as a change in ownership, setting a new base year value at the then-current market value for both the land and the improvements (including all of the newly constructed active solar energy equipment that previously may have been excluded from the assessment). The 2008 amendment of Section 73 changed that for some "initial" buyers by allowing the exclusion to continue to apply to an initial purchaser who purchases a newly constructed active solar energy system from a developer, as long as all of the following occur: (1) the initial purchaser bought the building from the owner-builder who did not intend to occupy or use the building before selling it; (2) the owner-builder had not already received the Section 73 exclusion for the same active solar energy system; and (3) "the initial purchaser purchased the new building prior to that building becoming subject to reassessment to the owner-builder, as described in subdivision (d) of Section 75.12."[7]

Section 75.12 provides the rules governing the date of completion of construction for purposes of establishing the new construction base year value assessment.[8] As noted above, the general rule is that new construction is deemed to be complete as of the date when the new construction is *available* for legal use by the owner.[9] However, Section 75.12 provides what is commonly called "the builder's exclusion," which allows for building developers to put off the date of a completion of new construction assessment when the developer does not intend to ever occupy or use the newly built property, but intends to sell it after it is completed.[10] If the developer satisfies the builder's exclusion requirements of Section 75.12 (which include providing notice to the assessor of the developer's intent to claim the exclusion within 30 days of the initiation of construction), the completion of new construction reassessment is postponed from the date the newly constructed property is first *available* for

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use, to the date that the property is *actually occupied or used* with the owner's consent. In effect, if the developer properly claims the builder's exclusion and then does not use the newly built property neither after completion nor before the property is sold, the property's base year value will not be reassessed until the developer actually sells the property, which triggers a change in ownership reassessment of both the land and improvements (including the new construction) as of the date of the sale.

THE TAX LAWS ARE FILLED WITH ARBITRARY AND ARGUABLY UNFAIR REQUIREMENTS AND RULES, ESPECIALLY IN REGARD TO TIMING ISSUES.

However, subdivision (d) of Section 75.12, which is the subdivision cited in Section 73, states: "Nothing in this section shall preclude the reassessment of that property on the assessment roll for January 1 following the date of completion."[11] Subdivision (d) thereby requires that if the developer has completed the property prior to January 1, but has not sold the property prior to January 1, the value of the completed new construction will still be added to the annual assessed value for the real property, just as the value of CIP has been added as of each January 1 lien date during the course of construction (assuming the construction spanned prior lien dates).[12] And here's where the rub comes in for developers who have completed construction of active solar energy system properties, including solar energy based electricity plants: *If a developer completes construction of a project that includes active solar energy property, such that the property is ready and available for use before January 1, but the developer does not transfer the property to an initial buyer until after the January 1 date succeeding the completion of construction, the initial buyer may not be able to claim the Section 73 exclusion.*[13]

Thus, if a solar power plant is completed on December 15, 2011 and transfers to the first buyer on December 31, 2011, the buyer may claim the Section 73 exclusion to exclude all active solar energy fixtures and improvements from the buyer's property tax assessments for every year that the buyer continues to own the property, because the developer never received the exclusion. *However*, if the buyer waited until January 2, 2012 to close on the property, then the buyer could not claim the exclusion and would be assessed on the entire value of the plant, including all of the solar energy equipment and fixtures, because the developer would have received the benefit of the exclusion of the solar energy property reassessment of the new construction as of January 1. Indeed, that is exactly the example provided by the staff of the California State Board of Equalization in an October 2011 draft of the soon to be published *Guidelines for Active Solar Energy Systems New Construction Exclusion.*

Certainly, such a result may seem arbitrary and unfair. However, the tax laws are filled with arbitrary and arguably unfair requirements and rules, especially in regard to timing issues. And, as with most timing issues in the tax laws, a taxpayer, or in this case, the party trying to sell property to a taxpayer, has some control over the application of the rule. Thus, a developer of property that consists of or contains any significant amount of active solar energy property should make sure that the property is not "completed," *i.e.*, ready for legal use, before January 1 of any year if the developer does not have near certainty that the project will be sold to the first buyer before the end of the calendar year. And buyers should make sure that the developer is aware of this rule and can ensure that the property will not be completed before January 1 of any year if the buyer will not be acquiring the property before January 1 as well. Moreover, developers should make sure that they notify the county assessor that the developer intends to claim the builder's exclusion within 30 days of the initiation of the construction or they may not be able to pass on the Section 73 exclusion to a buyer.

With careful planning to ensure that the Section 73 exclusion can be maintained, buyers of solar energy properties should be able to benefit from the significant property tax reductions allowed by the Section 73 exclusion and avoid a New Year's property tax hangover that won't go away. ■

1 Cal. Const. art. XIII A, § 1.
2 Cal. Const. art. XIII A, § 2(c)(1).
3 Cal. SBE *Guidelines for Active Solar Energy Systems New Construction Exclusion* (draft Oct. 2011).
4 Cal. Rev. & Tax. Code § 73.
5 *Id.*
6 Cal. Rev. & Tax. Code § 73 (2007).
7 Cal. Rev. & Tax. Code § 73(e)(1).
8 Cal. Rev. & Tax. Code § 75.12.
9 *Id.*
10 *Id.*
11 *Id.* at (d).
12 *Id.*
13 Cal. Rev. & Tax. Code § 73.

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Express, Inc. v. New York
Farmer Bros. v. California
General Mills v. California
General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lanco, Inc. v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. NYS Division of Taxation
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Illinois
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Powerex Corp. v. Oregon
Reynolds Metals Company
v. Michigan Department of Treasury
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation
v. Maryland
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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