State + Local Tax Insights

State + Local Tax Group

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State Tax Issues in Mergers, Acquisitions and Restructurings: Food for Thought

By Mitchell A. Newmark and Richard C. Call

Business mergers, acquisitions and restructurings involve legal, regulatory and tax components. Important among the tax components are various state tax issues that may include corporate income and franchise taxes, sales and use taxes ("sales tax"), as well as other taxes. In addition to considering taxes on the transactions, other state tax issues to be considered include potential liability for a seller's unpaid taxes, changes to a company's nexus and changes to reporting income. In this article, we highlight six state tax issues to consider: (1) tax bulk sales laws; (2) nexus; (3) instant unity; (4) state treatment of Internal Revenue Code ("I.R.C.") Section 338(h)(10) transactions; (5) sales taxes; and (6) real estate transfer taxes. The foregoing six considerations are several, but not all, of the myriad state tax issues to consider when engaging in such transactions.[1]

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Tax Bulk Sales[2]

Many states have adopted tax bulk sales laws that may hold a purchaser of assets liable for a seller's unpaid state tax liabilities.[3] Such laws are intended to: (1) minimize the risk that a seller will sell some or all of the company's assets without paying its outstanding state tax liabilities; and (2) provide an alternative means of recovery against the assets that may have contributed to the unpaid liability of the seller. The tax bulk sales laws should not be confused with the Uniform Commercial Code's bulk sales laws that address non-tax liabilities.[4] Under the tax bulk sales laws, purchaser liabilities can include sales taxes, corporate income taxes and property taxes that remain unpaid by the seller. However, mechanisms exist to reduce a buyer's potential tax liability.

State Variations in the Types and Amount of Liability

For the most part, bulk sales laws operate by requiring an asset purchaser to withhold from the purchase price an amount equal to the seller's unpaid state tax liabilities for taxes that are subject to that state's bulk sales laws, including penalty and interest.[5] If such amounts are not withheld (typically in escrow), the purchaser will be liable for the unpaid liability.[6] The amount of a seller's liability that a purchaser may inherit varies by state. Some states limit a purchaser's liability to the amount of the purchase price, while in other states the liability for unpaid taxes may exceed the purchase price of the purchased assets.[7] Some states apply bulk sales laws to "trust fund" taxes, *e.g.*, sales taxes or withholding taxes.[8] Other states apply bulk sales laws to additional taxes, including corporate income taxes.[9] Moreover, the states are not uniform in their triggers for bulk sales laws. Some states' bulk sales laws apply when a business transfers a substantial amount of assets.[10] In other states, the bulk sales laws are triggered if even an insubstantial amount of a company's assets are sold.[11]

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STATES PROVIDE MECHANISMS FOR PROTECTING A PURCHASER FROM BECOMING SUBJECT TO THE SELLER'S LIABILITIES. COMPLYING WITH THESE MECHANISMS MAY BE THE RESPONSIBILITY OF THE PURCHASER OR SELLER OF THE ASSETS.

Containing or Reducing Transferee Liability

States provide mechanisms for protecting a purchaser from becoming subject to the seller's liabilities. Complying with these mechanisms may be the responsibility of the purchaser or seller of the assets, but typically is not imposed on both the buyer and the seller. If the state imposes the filing duty on a purchaser, the purchaser may be able to avoid liability by timely filing a notice of the transaction with the state and withholding an amount equal to the seller's unpaid state taxes from the purchase price.[12] In Colorado and Mississippi, the responsibility is imposed on a seller, yet the purchaser can also be liable for the seller's unpaid state tax obligations if the purchaser does not obtain a receipt from the seller showing that the seller has paid its tax obligations.[13] Moreover, deadlines for complying with such mechanisms vary and may precede the closing date of the transaction, making it important that bulk sales issues be addressed as early as possible in a transaction.[14]

Nexus – Corporate Income, Corporate Franchise and Sales Taxes

Business transactions may result in changes to the states with which a company has nexus or is subject to tax. Inasmuch as the corporate income, corporate franchise and corporate gross receipts taxes have similar considerations, they are referred to together as "corporate income taxes."

Business Form May Affect the Nexus Consequences

The decision to operate a newly acquired company as a separate entity or as a division of the acquirer may have significant nexus consequences for purposes of corporate income taxes and sales taxes. For instance, take the example that prior to a transaction, Company A does not have nexus with State X, a separate entity reporting state. Company A acquires Company B, which has employees located in State X. Outside of the agency or affiliate nexus context, choosing to operate Company B as a division of Company A would result in Company A having nexus with State X.[15] On the other hand, operating Company B as a separate entity should allow Company A to continue to not have nexus with State X.

The nexus consequences of operating a newly acquired business as a division or as a separate entity may affect corporate net income tax or gross receipts tax apportionment in combined reporting states. For instance, assume that under the above facts, Company A makes sales into State X, but is not subject to tax in State X because of Public Law 86-272. Assume for this example that State X is a combined reporting state, Company B

Upcoming 2012-2013 Speaking Engagements

November 6
The Michigan Association of Certified Public Accountants Tax Conference
Novi, Michigan
- "Beyond the Basics: Sourcing Sales of Services & Intangibles"
  Hollis L. Hyans
- "State of the States"
  Craig B. Fields

November 14 – 15
Vanderbilt University Law School's 19th Annual Paul J. Hartman State and Local Tax Forum
Nashville, Tennessee
- "Justice vs. Injustice"
  Hollis L. Hyans
- "State and Local Tax Implications of Business Restructurings"
  Craig B. Fields
  Philip M. Tatarowicz
- "Top Ten Cases to Watch in State Taxation Today"
  Hollis L. Hyans

November 15
The 2012 New England State and Local Tax Forum
Needham, Massachusetts
- "Current Developments in State and Local Taxation"
  Craig B. Fields

November 29 – 30
New York University's 31st Institute on State and Local Taxation
New York, New York
- "Combined Reporting-Policy and Accounting Issues as well as Hot Topics in the Mechanics of Combined Reporting"
  Philip M. Tatarowicz
- "Issue Potpourri: Qui Tam and Class Action Suits"
  Hollis L. Hyans
- "Due Process—Significant Current Issues"
  Craig B. Fields
- "What's Happening Everywhere Today?"
  Andres Vallejo
- "Current Developments"
  Paul H. Frankel

December 12
Tax Executives Institute
New York, New York
- "Current Developments"
  Paul H. Frankel

January 15
Tax Executives Institute
Dallas, Texas
- "Update on East Coast Developments"
  Hollis L. Hyans

January 29 – 30
Ohio Tax Conference
Columbus, Ohio
- "Advanced: Issues in Alternative Apportionment, the MTC's Three-Factor Formula & The Gillette Decision"
  Craig B. Fields
- "Combined Reporting Issues Panel"
  Mitchell A. Newmark
- "Nexus Developments . . . Is There Any Place Left to Hide?"
  Craig B. Fields

SAVE THE DATE
MoFo Annual State + Local Tax East and West Coast Events

East Coast Event
November 8, 2012
8:00 a.m. – 12:30 p.m.
New York, NY

West Coast Event
December 6, 2012
8:00 a.m. – 12:30 p.m.
San Francisco, CA

For more information, see page 21.

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is subject to tax in State X and when Company A acquires Company B the two companies conduct a unitary business. If State X uses a *Finnigan* rule, State X would require inclusion of Company A's sales into State X in the sales factor numerator, regardless of whether Company B was operated as a division or separate entity.[16] However, if State X uses a *Joyce* rule, Company A's sales would not be included in the State X sales factor numerator if Company B is operated as a separate entity.[17]

Agency and Attributional Nexus Principles May Override Separate Entity Structures

The nexus consequences of operating a newly acquired company as a division or a separate entity may also depend on the extent to which agency or affiliate nexus principles apply. Several states assert agency or affiliate nexus theories as the basis for requiring a company that is not physically present in the state to collect sales tax or pay corporate income taxes. For instance, some states' taxing authorities have asserted that certain activities conducted by third parties with whom a company had no contractual relationship established a sales tax collection requirement for a company that was not physically present in the state.[18] One of the broadest sales tax collection statutes was enacted in Oklahoma, which provides that an entity is presumed to have a sales tax collection requirement if the entity is a member of a controlled group of corporations (as defined for federal income tax purposes) where that controlled group of corporations has a component member (as defined for federal income tax purposes) that is a "retailer engaged in business in [Oklahoma]."[19] The Oklahoma statutes define a retailer engaged in business in Oklahoma broadly to include:

> [a] retailer [that] holds a substantial ownership interest in, or is owned in whole or in substantial part

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> by, a retailer maintaining a place of business within this state, and . . . the retailer sells the same or a substantially similar line of products as the related Oklahoma retailer and does so under the same or a substantially similar business name, or the Oklahoma facilities or Oklahoma employees of the related Oklahoma retailer are used to advertise, promote or facilitate sales by the retailer to consumers,[20]

as well as:

> [a] retailer [that] holds a substantial ownership interest in, or is owned in whole or in substantial part by, a business that maintains a distribution house, sales house, warehouse or similar place of business in Oklahoma that delivers property sold by the retailer to consumers.[21]

Franchise Tax Consequences

Franchise tax issues are also important to consider. For income tax purposes, a state's combined reporting rules may reduce the effects of exposing a company's income to tax as a result of a merger or acquisition, *e.g.*, through statutes that eliminate intercompany transactions or assign sales under a *Joyce* rule. Unlike corporate income taxes, however, many state franchise or net worth taxes are imposed on a separate entity basis.[22] Accordingly, intercompany elimination statutes and *Joyce* principles would not apply to mitigate exposure of the value of the merged companies to taxation in such a state.

Instant Unity – When, If Ever, Does an Acquired Company Become Unitary?

Another issue to consider in mergers and acquisitions is whether a newly acquired company has "instant unity" with the acquiring company. Two merged companies could become unitary the day of the merger or at a later date, depending on when the companies have functional integration, economies of scale and centralized management.[23] Importantly, state statutes that provide a list of activities that necessitate a combined report, or contain elections to file combined or consolidated reports, may allow companies to achieve increased certainty with respect to their reporting positions.[24]

UNITY DISPUTES TEND TO BE HIGHLY FACT INTENSIVE. DUE TO THE TIMING QUESTION, INSTANT UNITY CASES TEND TO BE EVEN MORE FACT DEPENDENT.

Statutory mechanisms that permit increased certainty with respect to the question of instant unity include a Colorado statute that permits combination only when at least three of the six statutorily enumerated criteria are satisfied for the current tax year and the two preceding years.[25] These criteria allow taxpayers to size up their operations against a specific list before filing returns. Also, some states, such as Massachusetts, allow taxpayers to elect to file a consolidated return that is based, at least in part, on the taxpayer's federal consolidated group regardless of whether a unitary business is conducted.[26] Such elections also allow companies to achieve certainty with respect to their positions, but such elections may be accompanied by certain requirements regarding inclusion of nonapportionable income and duration of the election that merit consideration.

Unity disputes tend to be highly fact intensive. Due to the timing question, instant unity cases tend to be even more fact dependent. For example, in *Appeal of Dr. Pepper Bottling Company*, a bottling company and Dr. Pepper Co. ("DPC") were found to be instantly unitary when, for many years preceding the acquisition, the bottling company had been a licensee of DPC, had purchased a majority of its concentrate and syrup from DPC, more than half of the bottling company's sales were of Dr. Pepper and DPC replaced all of the bottling company's officers and directors with DPC personnel immediately after the acquisition.[27] By contrast, in *Appeal of ARA Services, Inc.*, a service management corporation was not instantly unitary with a trucking company, child care center and coin-operated laundry service that it acquired at different times, because the parent did not participate in the acquired companies' day-to-day operations and the businesses of the subsidiaries were substantially different from those of the parent at the time of acquisition.[28]

Because of the fact intensive nature of the instant unity question, companies should consider analyzing and documenting pre-merger and post-merger activities to sufficiently support their positions. Such analyses and documentation could demonstrate both whether the companies intend to operate as a unitary business as well as the actions taken towards or opposed to that objective. Alternatively, such documentation could explain business reasons and memorialize decisions to allow newly acquired businesses to continue to run independently. Careful memorialization of such activities should assist companies in defending their positions at a later date with respect to instant unity.

I.R.C. Section 338(h)(10) Transactions

Another issue to consider is the state treatment of transactions that qualify for

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the I.R.C. Section 338(h)(10) election. I.R.C. Section 338(h)(10) provides for a joint election when 80% or more of the stock of a corporation is purchased by another corporation. For federal income tax purposes, the actual stock sale is "deemed" a fictional sale of assets by the target corporation to a deemed "new" fictional corporation, with the fictional asset sale deemed to occur while the target was still owned by the selling shareholder. The buyer then purchases and owns the "new" fictional corporation, which has "purchased" all of the assets of the target corporation at fair market value, thereby resulting in a step-up in the basis of the assets.

State treatment of the gain from an I.R.C. Section 338(h)(10) transaction varies. Some state courts have held that such gain is nonapportionable income, reasoning that such transactions are equivalent to actual liquidations of a business or because the income was considered investment income.[29] By contrast, in at least one case, the California State Board of Equalization has held that such gain was business income that was apportionable.[30]

Additionally, the New York State treatment of an I.R.C. Section 338(h)(10) election for purposes of S-corporations has recently changed. In 2009, the New York State Tax Appeals Tribunal held that a sale of S-corporation stock by the individual non-resident shareholders should be treated as the sale of stock (as the transfer is in actuality) rather than a fictional deemed sale of assets and, consequently, the individual shareholders were not required to treat such gain as New York source income for income tax purposes.[31] However, unhappy with the consequences of that decision for purposes of taxing non-residents, the New York Legislature subsequently amended New York law so that I.R.C. Section 338(h)(10) stock sales would be treated as asset sales (as the transaction is deemed as a matter of federal tax law fiction) and gain or loss from such sales would be allocated by non-residents to New York accordingly.[32]

Sales Tax

Many sales tax statutes are broadly written and could encompass mergers, acquisitions or restructurings unless a specific exemption applies. States may exempt sales made as part of such transactions from sales tax either by excluding such transactions from the definition of the word "sale" (on which the tax is imposed) or by exempting certain "sales" from the imposition of sales tax. For instance, California exempts "occasional sales" from the sales tax and defines occasional sales to include a "sale of property not held or used by a seller in the course of activities for which he or she is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state."[33]

MANY SALES TAX STATUTES ARE BROADLY WRITTEN AND COULD ENCOMPASS MERGERS, ACQUISITIONS OR RESTRUCTURINGS UNLESS A SPECIFIC EXEMPTION APPLIES.

Some states exempt transactions that are related to federal income tax-free reorganizations, mergers or restructurings. The mechanisms for exemption vary by state. For example, the Maryland statutes exempt all transfers pursuant to transactions that are tax-free reorganizations for federal income tax purposes under I.R.C. Section 368.[34] Oklahoma exempts transfers of tangible personal property in a "reorganization" and defines "reorganization" as "a statutory merger or consolidation or the acquisition by a corporation of substantially all of the properties of another corporation when the consideration is solely all or a part of the voting stock of the acquiring corporation, or of its parent or subsidiary corporation."[35]

The states have varied positions on whether and the extent to which sales of tangible personal property are exempt from sales tax. Illinois exempts sales of tangible personal property of a type that the seller is not engaged in the business of selling.[36] Under this statute and its accompanying regulation, it is possible that all of the seller's tangible personal property except its inventory qualifies for an exemption to sales tax, because only the inventory would be the type of property that a business is engaged in the business of selling. However, inventory may nevertheless qualify for exemption to the sales tax as a sale for resale.[37] By comparison, some states may exempt sales of assets occurring as part of the "liquidation" of a company.[38]

Real Property Transfer Tax Considerations

Another set of taxes to consider are state and locality transfer taxes on sales or transfers of real property that is located in a state. Such taxes may be based on the amount paid for, or the value of, the property.[39] A transfer tax may be primarily imposed on a seller; however, buyers of real property should be aware that a jurisdiction may impose secondary liability for the tax on the buyer.[40] Because some states do not impose transfer taxes on sales of an interest in a business entity that owns real property, a sale of an entity owning real property may be treated differently from the sale of the property itself. Some states impose transfer taxes on transfers of controlling interests in entities such as corporations and partnerships that own real property.[41] Still others will strictly scrutinize transfers of real property to separate entities for purposes of the sale of the real property.

Sales to third parties are not the only triggers of some real property transfer

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taxes. Internal reorganizations can create opportunities for "foot faults" and should be specifically considered. For example, although New York expressly exempts sales from real estate transfer tax when there is no change in the beneficial owner of the real property, the New Jersey statutes have no such express exemption and the New Jersey Division of Taxation interprets its law to have no such exemption.[42]

INTERNAL REORGANIZATIONS CAN CREATE OPPORTUNITIES FOR "FOOT FAULTS" AND SHOULD BE SPECIFICALLY CONSIDERED.

Conclusion

The above considerations are just food for thought with respect to the many state tax issues that can arise in the context of mergers, acquisitions and restructurings. The number of, complexity of and potential liability from such state taxes make such issues important to consider throughout the process of a merger, acquisition or restructuring particularly because many of the potential liabilities can be reduced or eliminated with careful forethought. ■

1 Additional explanation of the complex state tax issues related to such transactions can be found in the series of articles that commenced this summer. *See* Craig B. Fields and Philip M. Tatarowicz, *State and Local Tax Implications of Reorganizing Business Enterprises*, 65 State Tax Notes 329 (July 30, 2012).

2 For a deeper discussion of tax bulk sales, *see* Craig B. Fields, Richard C. Call and W. Justin Hill, *Caveat Emptor, Let the Buyer Beware*, Morrison & Foerster LLP's State + Local Tax Insights, Fall 2011, at 5-6, 9-11.

3 *See*, *e.g.*, Ga. Code Ann. § 48-8-46; N.Y. Tax Law § 1141(c).

4 *See* U.C.C., Art. 6.

5 *See*, *e.g.*, Cal. Rev. & Tax. Code § 6811; Tex. Tax Code Ann. § 111.020. Texas law provides that a "purchaser of a business or stock of goods who fails to withhold an amount of the purchase price [sufficient to pay the seller's unpaid state tax obligations] is liable for the amount required to be withheld to the extent of the value of the purchase price." Tex. Tax Code Ann. § 111.020(b).

6 *Id.*

7 *Compare* Cal. Rev. & Tax. Code § 6812(a) (liability imposed to the extent of the purchase price), and Tex. Tax Code Ann. § 111.020(b) (liability imposed to the extent of the purchase price) *with* N.J. Stat. Ann. § 54:50-38(c) (liability imposed for "any such taxes . . . determined to be due to the State from the seller . . .").

8 *See*, *e.g.*, N.Y. Tax Law § 1141(c) (covering "any tax pursuant to this article," *i.e.*, Article 28, Sales and Compensating Use Taxes).

9 *See*, *e.g.*, N.J. Stat. Ann. § 54:50-38; N.M. Stat. Ann. § 7-1-61.

10 *See*, *e.g.*, S.C. Code Ann. § 12-54-124.

11 *Matter of Prestige Pool & Patio Corp.*, DTA No. 822713 (N.Y.S. Div. of Tax App., Aug. 19, 2010). New York Administrative Law Judge decisions are not precedential. *See* N.Y. Comp. Codes R. & Regs. tit. 20, § 3000.15(e)(2).

12 *See*, *e.g.*, Md. Code Ann., Tax-Gen. § 11-505. In Maryland, a purchaser that files a bulk sale notice with the state is no longer liable for the seller's unpaid Maryland sales and use tax obligations. *Id.* After receiving the bulk sale notice, the Maryland Comptroller of Revenue will inform the purchaser if the seller has unpaid Maryland sales and use tax obligations and the purchaser must withhold that amount from the purchase price. *Id.*

13 *See*, *e.g.*, Colo. Rev. Stat. § 39-26-117(1)(d) & (e); Miss. Code Ann. § 27-65-55(1). Colorado and Mississippi require the purchaser to withhold sufficient funds from the purchase price to cover the seller's unpaid sales tax obligations and do not offer the purchaser the option of filing a bulk sale notice for the purchaser to use as a complete defense to avoid personal liability. *Id.* These states require the seller to obtain a receipt from the states' respective Department of Revenue showing that the seller has paid its tax obligations and provide the receipt to the purchaser. However, the purchaser is liable if it does not obtain the receipt from the seller. *Id.*

14 *See Successor Liability for Sales and Use Taxes and Admissions and Dues Tax, Informational Publication 2002(16)* (Conn. Dep't of Revenue Servs. Sept. 15, 2002); N.J. Stat. Ann. § 54:50-38; N.Y. Tax Law § 1141(c); *see*, *e.g.*, Hawaii Rev. Stat. § 237-43(a) (requiring the seller to file a bulk sale notice within 10 days after the closing date).

15 *See Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977).

16 *See Appeal of Finnigan Corp.*, No. 88-SBE-022 (Cal. St. Bd. Equal., Aug. 25, 1988), *on reh'g*, No. 88-SBE-022 A (Cal. St. Bd. Equal., Jan. 24, 1990).

17 *See Appeal of Joyce, Inc.*, No. 66-SBE-069 (Cal. St. Bd. Equal., Nov. 23, 1966).

18 *See Scholastic Book Clubs, Inc. v. Comm'r of Revenue Servs.*, 38 A.3d 1183 (Conn. 2012), *cert. denied*, No. 11-1532 (U.S., Oct. 9, 2012) (activities of third parties created nexus); *Scholastic Book Clubs, Inc. v. Farr*, No. M2011-01443-COA-R3-CV (Tenn. Ct. App., Jan. 27, 2012), *petition for cert. filed* (Sept. 20, 2012) (No. 12-374) (activities of third parties created nexus); *Troll Book Clubs, Inc. v. Tracy*, No. 92-Z-590 (Ohio Bd. Tax. App. Aug. 19, 1994) (activities of third parties created nexus); *cf. Pledger v. Troll Book Clubs, Inc.*, 871 S.W.2d 389 (Ark. 1994) (activities of third parties did *not* create nexus).

19 Okla. Stat. tit. 68, § 1401(9).

20 *Id.*

21 *Id.*

22 *See*, *e.g.*, N.C. Gen. Stat. § 105-122.

23 *See Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980).

24 *See*, *e.g.*, Colo. Rev. Stat. § 39-22-303(11)(a) (listing prerequisites for filing a combined return); Mass. Gen. Laws ch. 63, § 32B(g)(ii) (providing for a filing election that is based in part on the federal consolidated group).

25 Colo. Rev. Stat. § 39-22-303(11)(a); Colo. Code Regs. § 39-22-303.11(A).

26 Mass. Gen. Laws ch. 63, § 32B (g)(ii).

27 *Appeal of Dr. Pepper Bottling Co. of S. Cal.*, No. 90-SBE-015 (Cal. St. Bd. Equal., Dec. 5, 1990).

28 *Appeal of ARA Servs., Inc.*, No. 93-R-0262 (Cal. St. Bd. Equal., May 8, 1997) (nonprecedential decision).

29 *Nadler v. Comm'r of Revenue*, No. 7736 R (Minn. Tax Ct. 2006) (gain considered investment income); *Canteen Corp. v. Commonwealth*, 818 A.2d 594 (Pa. Commw. Ct. 2003), *aff'd*, 854 A.2d 440 (Pa. 2004) (gain treated as nonbusiness income because the transaction was treated as equivalent to a liquidation).

30 *Appeal of Imperial, Inc.*, Nos. 472648 and 477927(Cal. St. Bd. Equal., July 13, 2010) (nonprecedential summary decision).

31 *In re Baum*, DTA Nos. 820837 and 820838 (N.Y.S. Tax. App. Trib. Feb. 12, 2009).

32 2010 N.Y. Laws, c. 57, Part C.

33 Cal. Rev. & Tax. Code § 6006.5(a).

34 Md. Code Ann. Tax-Gen. § 11-209(c)(1)(i).

35 Okla. Stat. tit. 68, § 1360(1)(a).

36 35 Ill. Comp. Stat. 120/2; Ill. Admin. Code tit. 86, § 130.110(a).

37 35 Ill. Comp. Stat. 120/1.

38 Ga. Comp. R. & Regs. 560-12-1.07(2)(c).

39 *See*, *e.g.*, Ga. Code Ann. § 48-6-1; N.C. Gen. Stat. § 105-228.30.

40 *See* N.Y.C. Admin. Code § 11-2104.

41 *See*, *e.g.*, D.C. Code § 42-1102.02(a); N.Y. Tax Law § 1401(e).

42 *See* N.Y. Tax Law § 1405(b)(6); N.J. Stat. Ann. § 45:15-1 *et seq.*; N.J. Admin. Code § 18:16-6.1.

The Due Process Clause as a Bar to State Tax Nexus

By Paul H. Frankel, Craig B. Fields and Richard C. Call

In May of this year, the Oklahoma and West Virginia Supreme Courts held that Due Process bars the imposition of a state tax on a company. These decisions illustrate the U.S. Constitution's Due Process Clause restraints on states' taxing jurisdiction. Both are supported by U.S. Supreme Court precedent, including *Quill Corporation v. North Dakota*[1] and *J. McIntyre Machinery, Ltd. v. Nicastro*.[2] In 1992 in *Quill*, the U.S. Supreme Court emphasized a two part Constitutional nexus framework–nexus under the Due Process Clause and nexus under the Commerce Clause. Over the years, much attention has been given to Commerce Clause nexus because *Quill* articulated a physical presence standard for purposes of the Commerce Clause, but not for purposes of the Due Process Clause. In this article, we focus our attention on the Due Process elements of the two state court decisions from Oklahoma and West Virginia, as well as the holdings in *Quill* and *McIntyre*, and analyze the Due Process Clause constraints on states' imposition of taxes.

As discussed in more detail below, the cases addressed herein support the following four conclusions: (1) the Due Process Clause purposeful availment test applies to all taxes; (2) Due Process may prohibit a state's imposition of tax on an entity even though the entity targets a nationwide market; (3) arguments for nexus based on a "stream of commerce" theory are suspect; and (4) courts tend to apply a facts and circumstances test for determining whether the requirements of the Due Process Clause are satisfied. Moreover, unlike Congress' power with respect to the Commerce Clause restraints reiterated in *Quill*, Congress may not pass laws that would lower the Due Process restraints on the states' imposition of tax on companies.

Scioto Insurance Company v. Oklahoma Tax Commission

In May 2012, in *Scioto Insurance Company v. Oklahoma Tax Commission*, the Supreme Court of Oklahoma held that Oklahoma could not impose a corporate income tax on our client, Scioto Insurance Company ("Scioto"), as a result of its licensing of intellectual property to a related party.[3] Scioto was organized as an insurance company under the laws of Vermont.[4] It licensed intellectual property to Wendy's International, Inc. ("Wendy's International") pursuant to a licensing contract that was executed outside of Oklahoma.[5] Wendy's International then sublicensed the intellectual property to Wendy's restaurants, including restaurants located in Oklahoma.[6]

CONGRESS MAY NOT PASS LAWS THAT WOULD LOWER THE DUE PROCESS RESTRAINTS ON THE STATES' IMPOSITION OF TAX ON COMPANIES.

Scioto "ha[d] no say where a Wendy's restaurant [would] be located, including Oklahoma."[7] The amount of money that Scioto received from Wendy's International for use of the intellectual property was "based on a percentage of the gross sales of the Wendy's restaurants in Oklahoma."[8] Wendy's International's obligation to pay Scioto was "not dependent upon the Oklahoma restaurants actually paying Wendy's International."[9]

The Oklahoma court held that "due process is offended by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . who has a bona fide obligation to do so under a contract not made in Oklahoma."[10] The court found no "basis for Oklahoma to tax the value received by Scioto from Wendy's International under a licensing contract . . . no part of which was to be performed in Oklahoma."[11]

Griffith v. ConAgra Brands, Inc.

Just a few weeks after *Scioto* was issued, the Supreme Court of Appeals of West Virginia (the State's highest court) held that Due Process prohibited the imposition of tax on ConAgra Brands, Inc. ("ConAgra") in *Griffith v. ConAgra Brands, Inc.*[12] ConAgra licensed intellectual property to licensees that manufactured products bearing the trademarks, some of which were eventually sold in West Virginia.[13]

ConAgra licensed its intellectual property to related and unrelated parties and derived royalties from such licensing.[14] ConAgra did not manufacture or sell products that bore the intellectual property.[15] All such products were manufactured by ConAgra's licensees in facilities that were located outside of West Virginia.[16]

Some of ConAgra's licensees sold or distributed products bearing the intellectual property to wholesalers and retailers located in West Virginia and such licensees provided services in West Virginia to clients and customers.[17] Notably, products that bore the ConAgra intellectual property were "found in many, if not in most, retail grocery stores in [West Virginia]."[18] However, ConAgra did not direct or dictate the licensees' distribution of products bearing the intellectual property and did not provide services to the wholesalers and retailers

Due Process Clause

that were located in West Virginia.[19]

ConAgra centrally managed and provided for uniformity in brand image and brand presentation for its intellectual property. It paid the expenses related to defending its intellectual property and national marketing.[20] ConAgra would have brought legal actions to protect its intellectual property rights exclusively in federal courts under federal laws that protect intellectual property, even if such actions "ar[ose], entirely or in part, from conduct occurring in West Virginia."[21]

The West Virginia court found for ConAgra, holding that tax assessments against a foreign licensor "on royalties earned from the nation-wide licensing of food industry trademarks and trade names [did not] satisfy . . . '*purposeful direction*' under the Due Process Clause."[22] In doing so, the court rebuffed the State's assertions based on a "stream of commerce" theory that Due Process was not offended by noting the U.S. Supreme Court's lack of consensus regarding the "stream of commerce" theory and distinguishing ConAgra's facts from the facts of an earlier West Virginia decision that applied the "stream of commerce" theory.[23]

The U.S. Supreme Court Has Held That Due Process Requires Purposeful Availment

Quill Due Process

In *Quill*, the U.S. Supreme Court explained that the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[24] In analyzing Due Process, the focus of the Court is "whether a defendant had minimum contacts with the jurisdiction 'such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.'"[25] Furthermore, the U.S. Supreme Court explained that a foreign corporation without physical presence in a state may be subject to the state's jurisdiction if it "purposefully avails itself of the benefits of an economic market in the forum State."[26] The *Quill* Court found that Due Process did not prohibit the imposition of a sales and use tax collection obligation on a "mail-order house that is engaged in continuous and widespread solicitation of business within a State" inasmuch as such a corporation "clearly has 'fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign.'"[27]

Due Process Under *McIntyre*

In 2011, in *McIntyre*, the U.S. Supreme Court overturned a decision of the New Jersey Supreme Court and held that Due Process prohibited New Jersey's assertion of jurisdiction over a corporation that was not physically present in New Jersey.[28] *McIntyre* involved a tort action in the New Jersey courts against a manufacturer located in England with no physical presence in New Jersey, but that had products that ended up in New Jersey.[29]

McIntyre was a British manufacturer that had no office in New Jersey, owned no property in New Jersey, did not send employees into New Jersey and did not advertise in New Jersey.[30] McIntyre held United States patents.[31] It had an agreement with a distributor in the United States.[32] That distributor "'structured [its] advertising and sales efforts in accordance with [the manufacturer's] 'direction and guidance whenever possible'" and "'at least some of the machines were sold on consignment to'" the distributor.[33] Regarding its connection to New Jersey, the New Jersey courts stated that McIntyre's only contact with New Jersey was that it had products ending up in New Jersey.[34]

In holding for McIntyre, the *McIntyre* Court reiterated a Due Process analysis that is similar to the analysis set forth in *Quill*. The U.S. Supreme Court explained that "[t]he Due Process Clause protects an individual's right to be deprived of life, liberty, or property only by the exercise of lawful power" and applies "to the power of a sovereign to prescribe rules of conduct for those within its sphere."[35] The Court then reiterated the notions of fair play and substantial justice, as it did in *Quill*, as well as the fact that purposeful availment of the economic market of a state is necessary to satisfy Due Process standards.[36] Applying this precedent, the *McIntyre* Court found that Due Process was not satisfied despite the fact that the foreign manufacturer "directed marketing and sales efforts at the United States."[37]

The Due Process Clause as a Bar to State Taxation

Scioto and *ConAgra* are examples of the fact that the Due Process Clause serves as a barrier to states' taxing authority. To the extent that *Scioto* and *ConAgra* are based on a lack of purposeful availment of a state's market by the entity at issue, these decisions are consistent with *Quill* and *McIntyre*. The following are a few points to consider:

First, a purposeful availment analysis should apply to all state taxes. *Quill*'s physical presence rule, which some argue applies only to sales and use taxes, was articulated only in the context of the Commerce Clause.[38] *Quill*'s Due Process analysis provides no basis for asserting that the purposeful availment standard only applies to one type of tax.

Second, Due Process may prohibit a state's imposition of tax on an entity even though the entity targets a nationwide market. ConAgra licensed intellectual property nationwide. In *McIntyre*, the manufacturer "directed marketing and sales efforts at the United States."[39] The *McIntyre* Court explained that "a defendant may in principle be subject to the jurisdiction of the courts of the United States but not of any particular State" and that "jurisdiction requires a forum-by-forum . . . analysis."[40] Regarding McIntyre's operations, the U.S. Supreme Court stated that "[t]hese facts may reveal an intent to serve the U.S. market, but they do not show that J. McIntyre purposefully availed itself of the New Jersey market."[41]

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Third, arguments that Due Process permits taxation of an entity by a state that are based on a "stream of commerce" theory are suspect. As noted in *ConAgra*, the "stream of commerce" theory is not supported by a consensus of the U.S. Supreme Court.[42] In *McIntyre*, four Justices of the U.S. Supreme Court, *i.e.*, not a majority, emphasized that, in their view, placing goods in the stream of commerce may indicate purposeful availment.[43] However, the Justices stressed that "transmission of goods permits the exercise of jurisdiction only where the defendant can be said to have targeted the forum; as a general rule, it is not enough that the defendant might have predicted that its goods will reach the forum State."[44]

ARGUMENTS THAT DUE PROCESS PERMITS TAXATION OF AN ENTITY BY A STATE THAT ARE BASED ON A "STREAM OF COMMERCE" THEORY ARE SUSPECT.

Fourth, the above cases indicate that courts apply a facts and circumstances approach for determining whether Due Process prohibits the imposition of a tax on an entity. Under such an approach, the presence or absence of certain facts may not be dispositive to determining whether Due Process is satisfied. For instance, ConAgra did not direct or control third party distributing. By contrast, McIntyre's third-party distributor in the United States structured its advertising and sales efforts in connection with McIntyre's direction and guidance. Entities should carefully consider their individual facts.

One additional point for taxpayers to consider regarding Due Process is that Congress is unable to pass laws that would lower the Due Process restraints on states' taxation of companies. In *Quill*, the U.S. Supreme Court reiterated that Congress had the "ultimate power" to nullify the U.S. Supreme Court's jurisprudence regarding nexus under the Commerce Clause.[45] Congress does not hold the same power with respect to the U.S. Supreme Court's Due Process analysis as set forth in *Quill*, *McIntyre* and other U.S. Supreme Court decisions.[46] Therefore, although Congressional action could nullify *Quill*'s Commerce Clause physical presence requirement, Congressional action cannot expand the states' ability to tax companies under the Due Process Clause.

COURTS APPLY A FACTS AND CIRCUMSTANCES APPROACH FOR DETERMINING WHETHER DUE PROCESS PROHIBITS THE IMPOSITION OF A TAX ON AN ENTITY.

Conclusion

In 1992, the *Quill* Court emphasized that Due Process jurisprudence had "evolved substantially" in the years leading up to that decision.[47] That evolution continues today with *Scioto*, *ConAgra* and *McIntyre*. These cases may lend support to a company's arguments that Due Process prohibits a state's imposition of tax on the company. ■

Previously published in substantially similar form in *State Tax Notes*, October 29, 2012.

1 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

2 *J. McIntyre Mach., Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011).

3 *Scioto Ins. Co. v. Okla. Tax Comm'n*, 279 P.3d 782 (Okla. 2012). Paul H. Frankel of Morrison & Foerster LLP argued the case before the Supreme Court of Oklahoma.

4 *Id.* at 783.

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.* at 784.

11 *Id.* at 783.

12 *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (W. Va. 2012).

13 *Id.* at 76-77.

14 *Id.* at 76.

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 *Id.* at 76-77.

21 *Id.* at 82.

22 *Id.* at 84 (emphasis added).

23 *Id.* at 82-83.

24 *Quill*, 504 U.S. at 306 (internal citations omitted).

25 *Id.* at 307 (citing *Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945)).

26 *Id.* at 307-308 (citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985)).

27 *Id.* at 308 (alterations in original and citations omitted).

28 *McIntryre,* 131 S. Ct. at 2782.

29 *Id.*

30 *Id.* at 2784.

31 *Id.* at 2786.

32 *Id.* at 2790.

33 *Id.* at 2786.

34 *Id.* at 2790.

35 *Id.* at 2786-87.

36 *Id.* at 2787.

37 *Id.* at 2790. One of the plurality opinions in *McIntyre* noted McIntyre's decision not to pay taxes as a fact supporting a finding that Due Process was not satisfied. *Id.* Such a fact would likely be irrelevant for determining whether Due Process bars the imposition of a state tax.

38 *Quill*, 504 U.S. 298.

39 *McIntyre*, 131 S. Ct. at 2790.

40 *Id.* at 2789.

41 *Id.* at 2790.

42 *ConAgra*, 728 S.E.2d at 82-83.

43 *McIntyre*, 131 S. Ct. at 2788.

44 *Id.* at 2788.

45 *Quill*, 504 U.S. at 318-319.

46 For a recent decision regarding the interplay between Congressional action and the Due Process Clause, *see Red Earth L.L.C. v. United States*, 657 F.3d 138 (2d Cir. 2011).

47 *Quill*, 504 U.S. at 307.

Business Income in California and Legal Ruling 2012-01

By Eric J. Coffill

A recent *State + Local Tax Insights* article discussed "Potential Unity and Business Income in California."[1] That article discussed 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. Subsequent to that article, in August 2012, the California Franchise Tax Board ("FTB") issued Legal Ruling 2012-01 ("Ruling"), the subject of which is the "Business/Nonbusiness Characterization on Sale of Stock." The Ruling presents the following Issue:

> If one corporation purchases stock in a corporation with which it has preexisting operational ties with the intent to integrate the target corporation into its unitary business operations, but the intended integration does not occur, does the later sale of the stock in the target corporation give rise to business or nonbusiness income?

The Ruling then posits three factual situations and provides "Holdings" for each situation. This article addresses the "potential" issue in the context of the Ruling and discusses the reasoning and application of the Ruling.

In California, all business income issues start with the statute. The statutory framework for determining business income is found in California Revenue and Taxation Code[2] Section 25120, which 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.[3]

This definition has not been amended by the California Legislature since its adoption in 1965. Administrative and judicial decisional law including, most notably, the California Supreme Court decision in *Hoechst Celanese Corp. v. Franchise Tax Board*, has made clear this statutory definition contains two separate and independent (*i.e.*, alternative) tests for business income: a "transactional" test and a "functional" test.[4] The Ruling, and, more broadly, the "potential" issue addressed in the Ruling, arises in the context of the functional test–that is, when income from the acquisition, management and disposition of property "constitute integral parts of the taxpayer's regular trade or business operations."[5]

HOECHST CELANESE PROVIDES ADDITIONAL, AND MORE MODERN, GUIDANCE ON THE STATUTORY MEANING OF BUSINESS INCOME.

Hoechst Celanese provides additional, and more modern, guidance on the statutory meaning of business income.[6] There, the California Supreme Court reiterated the statutory standard in Section 25120 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.'"[7] 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.'"[8] The court explained that the statutory language of Section 25120 requires a two-part inquiry.[9] First, the statutory phrase "acquisition, management and disposition" directs us to examine "the taxpayer's interest in and power over the income-producing property."[10] 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.'"[11]

However, *Hoechst Celanese* receives only passing mention in the Ruling. Instead, the Ruling correctly points out the most pertinent authorities on the potentiality issue addressed herein are a series of administrative decisions by the California State Board of Equalization ("SBE"), some of which date to the early 1980s. Those SBE decisions are *Appeal of Standard Oil*,[12] decided in 1983; *Appeal of Occidental Petroleum*,[13] also decided in 1983; *Appeal of Mark Controls Corporation*,[14] decided in 1986; and *Appeal of CTS Keene*,[15] decided in 1993.[16] Upon analyzing those decisions, the Ruling concludes the "common thread" running through them "is the Board's careful analysis of the underlying facts surrounding the relationship between the acquiring or parent corporation and the stock that was the subject of the inquiry in determining whether gain or loss on the disposition" is business income under the functional test.[17] That is essentially a correct

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statement and simply another way of saying the legal issue presented under Section 25120 is whether the acquisition, management and disposition of the property (*i.e.*, the stock) constituted an integral part of the taxpayer's regular trade or business operations. The Ruling then goes on to conclude that "[i]n those circumstances in which the Board found the gain or loss on disposition to be business income, the taxpayer and the entity represented by the stock at issue *had an actual operational business relationship of some significance*."[18] Note here how the Ruling departed from the language of Section 25120 by looking for "an actual operational business relationship of some significance" instead of looking to the language in Section 25120 for "an integral part of the taxpayer's regular trade or business operations." One can envision scenarios where an "actual operational" business relationship of "some significance" under the benchmark of the Ruling may not be an "integral" part of a taxpayer's "regular" trade or business operations under the standard adopted by the Legislature in Section 25120 and as interpreted by the court in *Hoechst Celanese*.

ONE CAN ENVISION SCENARIOS WHERE AN "ACTUAL OPERATIONAL" BUSINESS RELATIONSHIP OF "SOME SIGNIFICANCE" UNDER THE BENCHMARK OF THE RULING MAY NOT BE AN "INTEGRAL" PART OF A TAXPAYER'S "REGULAR" TRADE OR BUSINESS OPERATIONS UNDER THE STANDARD ADOPTED BY THE LEGISLATURE IN SECTION 25120 AND AS INTERPRETED BY THE COURT IN *HOECHST CELANESE*.

REMEMBER THAT A UNITARY BUSINESS AND BUSINESS INCOME ARE DIFFERENT CONCEPTS AND EMPLOY DIFFERENT LAW IN THEIR ANALYSES.

The Ruling goes on to state that the SBE has "consistently not focused on the taxpayer's frustrated intention to acquire majority ownership in its intended target *as determinative*" and although that intent "along with other factors, may support a determination that an operational relationship did or did not exist, it is the *actual operational ties and the significance of such ties that are most important*."[19] While these are essentially correct statements, they are clearly an oversimplification of the proper analysis.

Remember that a unitary business and business income are different concepts and employ different law in their analyses. Recall that the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which is the origin of the Section 25120 definition of business income, is a model apportionment formula that contains no provision addressing the tax base. But *Occidental Petroleum* and a number of other SBE decisions leap across that gap to connect the two concepts.[20] Indeed, *Occidental Petroleum* boldly states that "if the income-producing intangible [*e.g.*, stock] is integrally related to the unitary business activities, the income is business income subject to formula apportionment. If the intangible is unrelated to those activities, however, the income is nonbusiness income subject to specific allocation."[21] In the case of certain of the stock sales at issue in *Occidental Petroleum*, the SBE stated that business income was generated by those sales where "the stock had been acquired (or created) and managed in furtherance of the actual operation of appellant's unitary business."[22] But here, the Ruling takes an alternative route and instead bridges the gap by interpreting the SBE decisions to find that having an asset related simply to "actual operational ties"–not unity–is sufficient to result in business income.

Consider the Holdings in the three situations discussed in the Ruling. In Situation 1, Corporation A has no preexisting or ongoing business relationship or operations with Corporation B, but purchased 20% of Corporation B's stock "merely as part of its plan to acquire a majority interest" in Corporation B and "integrate" Corporation B into Corporation A's unitary business.[23] The Holding in Situation 1 states the gain or loss from Corporation A's subsequent sale of Corporation B's stock is nonbusiness income, because Corporation A's "intention" was frustrated.[24] This appears to be a clear-cut answer based entirely upon an assumption of the nature of the relationship between Corporation B's stock and Corporation A's business–that no unitary relationship existed between Corporation A and Corporation B and that there were no "actual operational ties" between Corporation A and Corporation B as provided in the language of the Ruling.

Situation 2 in the Ruling is more paradoxical. Under Situation 2, the only reason the parent purchased a minority stock interest in the target company was to gain information regarding the target's technology. The two companies had no preexisting relationship and the parent never had the intent to acquire a controlling interest in the target company.[25] The Holding in Situation 2 states the parent's subsequent sale of the target's stock generated business income; the rationale being that because of the technology information acquired by the stock purchase, which the Ruling identifies as an "operational factor," the target's stock was "integrated" into the purchaser's "unitary business."[26] Initially, note how Situation 2 is not responsive

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to the Issue identified in the Ruling. The Ruling was designed to address a situation where one corporation purchases stock of another corporation "with the intent to integrate the target corporation into its unitary business operations." [27] Situation 2 makes clear the purchaser had no such intent.

SEPARATE ASSETS SHOULD BE ANALYZED DIFFERENTLY UNDER SECTION 25120, UNLESS THE FTB BELIEVES BUSINESS INCOME IS CONTAGIOUS AND THE CHARACTER OF ONE ASSET SOMEHOW CONTAMINATES THE OTHER ASSET.

In any event, is the FTB saying here the target's *stock* is "integrated" into the purchaser's unitary business simply because of the technology gained? Apparently it is. Certainly the income from the technology gained may be business income, but why is the income from the sale of the target's stock also then business income, especially if the technology transfer agreements with the target continue after the sale? The technology transfer agreements and the target's stock are separate assets and each should be analyzed differently under Section 25120, unless the FTB believes business income is contagious and the character of one asset somehow contaminates the other asset.

Moreover, what does the FTB mean in its Holding in Situation 2 when it states the target's stock is "integrated" into the purchaser's "unitary business?" [28] Clearly, the Holding in Situation 2 assumes away the Issue in the Ruling which speaks of the situation where integration of the stock does *not* occur. If "unitary business" is used here in a combined reporting sense, then should not activities (*i.e.*, payroll, property and sales) of the "unitary" minority stock ownership somehow be reflected in the parent's combined report? If the term is not used in the combined reporting sense, how is the term used? To repeat: a business income analysis must remain true to the statute responsible for creating the need for that analysis. The language of Section 25120 does not speak of "unity" or "operational relationship." That statute speaks of whether the "acquisition, management and disposition" of the asset constitute "integral parts of the taxpayer's regular trade or business operations."[29] The FTB appears here to gloss over the terms of Section 25120 and use "unity" and "operational relationship" as a proxy for the language of the statute. While there certainly are similarities and commonalities among the terms, one must be careful when applying statutes. When interpreting a statute, "we must discover the intent of the Legislature to give effect to its purpose, being careful to give the statute's words their plain, commonsense meaning. If the language of the statute is not ambiguous, the plain meaning controls and resort to extrinsic sources to determine the Legislature's intent is unnecessary."[30]

Holding in Situation 3 is the most instructive as to the FTB's position regarding the stated Issue in the Ruling. Here, the parent and its 20% owned subsidiary had a *prior* agreement (*i.e.*, before the parent acquired ownership in the subsidiary) under which the parent is a "significant distributor" of the subsidiary's products.[31] *After* the purchase of the subsidiary's stock, the parent becomes the "predominant distributor" of those products. The FTB explains in its Holding that the gain on the parent's subsequent sale of the subsidiary's stock is business income because the "significant ongoing relationship" between the parent and subsidiary continued despite the parent's unsuccessful attempt to acquire a majority ownership interest "and integrate it" into the parent's "unitary business."[32] So, here, the Holding by the FTB is for business income, even *absent* integration of the stock into the parent's unitary business because of the "significant ongoing relationship."

A BUSINESS INCOME ANALYSIS MUST REMAIN TRUE TO THE STATUTE RESPONSIBLE FOR CREATING THE NEED FOR THAT ANALYSIS.

Recall that the Issue in the Ruling involves the business/nonbusiness treatment of gain on the sale of a minority stock interest where: (1) there are preexisting operational ties; (2) there is the intent to integrate the target corporation into the parent; (3) the integration does not occur; and (4) the stock is later sold. Situation 1 instructs that where there are no preexisting operational ties, but an intention to integrate that is subsequently frustrated, the gain on the stock is nonbusiness income. Situation 2 instructs that where there are no preexisting operational ties, *and no intention of acquiring control of the subsidiary*, the gain on the stock sale is business income where the stock is integrated into the parent's unitary business. While the reasoning of Situation 2 is interesting, for the reasons discussed above and for what it says about the FTB's view on the relationship between the business income analysis and the unitary analysis, it is puzzling what place Situation 2 has in this Ruling. The Ruling is intended to address the significance of the intent to integrate and there is expressly *no* intent to integrate under the facts of Situation 2. Situation 3 is, by far, the most interesting and most relevant of the scenarios because of the FTB's statement here on how strongly the FTB feels that *preexisting operational* ties justify business income treatment where there is a goal to integrate that is ultimately unrealized. One might read the Holding in Situation 3 to state that

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even where there is a frustrated intent to integrate the stock of a target corporation, the mere existence of some level of preexisting operational ties will be sufficient to make the gain on the sale of that stock business income. However, such a reading might do an injustice to the Ruling, because recall the factual scenario *also* involves the fact that after the purchase of the shares, the parent becomes the "predominant distributor" of the products of the target corporation. If the FTB is assuming here the stock ownership caused the parent to become the predominant distributor, and that but for the stock ownership, the parent would not have become the predominant distributor, then the FTB would seem to have the better side of the argument that the stock was acquired, managed and disposed of as an integral part of the parent's regular trade or business operations under Section 25120. However, in the absence of that assumption, the mere existence of "preexisting operational ties" that cannot be causally linked to the acquisition of the stock, but nevertheless continue after the acquisition, hardly seem sufficient grounds by themselves under the language of Section 25120 to cause the gain on the ultimate sale of that stock to be classifiable as business income.

ANY WRITTEN GUIDANCE FROM THE FTB ON THE BUSINESS INCOME ISSUE IS A POSITIVE DEVELOPMENT AND, CERTAINLY, IN THE CONTEXT OF THE "POTENTIAL" ISSUE, THERE ARE MANY UNKNOWNS ON WHICH GUIDANCE IS NEEDED.

IN THE AUTHOR'S OPINION, THE KEY TO PROPERLY WEIGHING THE IMPORTANCE OF PREEXISTING OPERATIONAL TIES IS EXAMINING WHETHER THOSE "PRE" EXISTING TIES INCREASE OR DECREASE AS A RESULT OF THE PURCHASE OF THE STOCK . . .

In summary, the FTB is to be commended for issuing the Ruling. Any written guidance from the FTB on the business income issue is a positive development and, certainly, in the context of the "potential" issue, there are many unknowns on which guidance is needed. The specific issue addressed in this Ruling, *i.e.*, the relationship between the "potential" issue and "preexisting operational ties," is a frequently recurring one. However, it is unfortunate that the three factual scenarios presented did not more forcefully address this relationship. In the author's opinion, the key to properly weighing the importance of preexisting operational ties is examining whether those "pre" existing ties increase or decrease as a result of the purchase of the stock, *i.e.*, the extent of the causal relationship between the stock ownership and increasing or decreasing "operational ties," to use the FTB's term. The Ruling falls short of addressing that key consideration. ■

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1 Eric J. Coffill and Timothy A. Gustafson, *Potential Unity and Business Income in California*, Morrison & Foerster LLP's State + Local Tax Insights, Winter 2012, at 11-15.

2 All statutory references herein are to the California Revenue and Taxation Code, unless otherwise noted.

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

4 *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 337 (Cal. 2001); *see also Appeal of Occidental Petroleum Corp.*, 83-SBE-119 (Cal. St. Bd. of Equal., June 21, 1983).

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

6 *Celanese*, 22 P.3d at 337.

7 *Id.* (alteration in original).

8 *Id.* (internal citations omitted).

9 *See id.* at 338; *see also Jim Beam Brands Co. v. Franchise Tax Bd.,* 133 Cal. App. 4th 514, 524 (2005).

10 *Celanese*, 22 P.3d at 338.

11 *Id.*

12 *Appeal of Standard Oil Co.*, 83-SBE-068 (Cal. St. Bd. of Equal., Mar. 2, 1983).

13 *Appeal of Occidental Petroleum Corp.*, 83-SBE-119 (Cal. St. Bd. of Equal., June 21, 1983).

14 *Appeal of Mark Controls Corp.*, 86-SBE-204 (Cal. St. Bd. of Equal., Dec. 3, 1986).

15 *Appeal of CTS Keene*, 93-SBE-005 (Cal. St. Bd. of Equal., Feb. 10, 1993).

16 For a thorough analysis of the SBE decisions on this issue, *see* Eric J. Coffill and Timothy A. Gustafson, *Potential Unity and Business Income in California*, Morrison & Foerster LLP's State + Local Tax Insights, Winter 2012, at 11-15.

17 Legal Ruling 2012-01 (Cal. Franchise Tax Bd., Aug. 2012), p. 5.

18 *Id.* (emphasis added).

19 *Id.* (emphasis added).

20 *Appeal of Occidental Petroleum Corp.*, 83-SBE-119 (Cal. St. Bd. of Equal., June 21, 1983).

21 *Id.*

22 *Id.*

23 Legal Ruling 2012-01 (Cal. Franchise Tax Bd., Aug. 2012), p. 6.

24 *Id.*

25 *Id.* at p. 2.

26 *Id.* at p. 6.

27 *Id.* at p. 1.

28 *Id.* at p. 6.

29 Cal. Rev. & Tax. Code § 25120(a).

30 *Kavanaugh v. West Sonoma Cnty. Union High School Dist.*, 62 P.3d 54, 59-60 (Cal. 2003) (internal citations omitted).

31 Legal Ruling 2012-01 (Cal. Franchise Tax Bd., Aug. 2012), p. 2.

32 *Id.* at p. 6.

"There you go again!": Kentucky's New Amnesty Program

By Thomas H. Steele, Andres Vallejo and Kirsten Wolff

Kentucky does not have a reputation as a taxpayer-friendly jurisdiction. Not so long ago, the State's Legislature took steps to deny taxpayers refunds plainly due under a Kentucky Supreme Court decision.[1] Now, the State Legislature has taken another step to alienate the taxpayer community by enacting a hopelessly complex "amnesty" program with ridiculously onerous penalties for failure to comply.

THE STATE LEGISLATURE HAS TAKEN ANOTHER STEP TO ALIENATE THE TAXPAYER COMMUNITY BY ENACTING A HOPELESSLY COMPLEX "AMNESTY" PROGRAM WITH RIDICULOUSLY ONEROUS PENALTIES FOR FAILURE TO COMPLY.

Kentucky's new amnesty program went into effect on October 1, 2012 and remains open until November 30, 2012. Like all amnesty programs, it is designed to motivate taxpayers to file and pay taxes for past periods with a "carrot and stick" approach. The "stick" Kentucky wields includes "fees" and penalties of up to 150% of the tax liability and additional interest. Unlike many amnesty programs, Kentucky's program not only requires taxpayers to file and pay for past periods, but also threatens to retroactively disqualify taxpayers that fail to pay taxes for future periods!

Whether or not the new program violates the Due Process Clause–and it may well do so–the program is certainly the wrong direction for a state that already draws animosity from a sizeable segment of the business community.

KENTUCKY'S NEW AMNESTY PROGRAM WENT INTO EFFECT ON OCTOBER 1, 2012 AND REMAINS OPEN UNTIL NOVEMBER 30, 2012.

In this article, we summarize the terms of Kentucky's amnesty program and outline the reasons why we believe the program goes too far. Then, we briefly review challenges taxpayers have brought to onerous penalties in other jurisdictions and offer a few reflections on a potential challenge to Kentucky's amnesty penalties, known in the statute as "cost-of-collection fees."

Tax Amnesty: Carrot and Stick

First, let's take a look at the carrot: when a taxpayer applies to the amnesty program, it is eligible for a waiver of all penalties and half of the interest for taxes[2] paid for the periods ending between December 1, 2001 and September 30, 2011 (the "Eligible Periods").[3]

In order to achieve this benefit, the taxpayer must make several significant concessions. The taxpayer must file returns and pay the tax due for the Eligible Periods and must pay any taxes "previously assessed by the department that are due and owing" when the taxpayer applies for amnesty.[4] In addition, the taxpayer must also file returns and pay the taxes due for periods *after* the Eligible Periods, beginning October 1, 2011 through the date that the amnesty is granted. Finally, the taxpayer must agree to file returns and pay the taxes due for the three years after the date that the taxpayer is granted amnesty.[5] Thus, for example, if a taxpayer applies for and is granted amnesty effective November 1, 2012, then the taxpayer must: (1) file returns and pay the taxes due for the Eligible Periods; (2) file returns and pay the taxes due for the 13 months after the Eligible Periods through the date that amnesty is granted (*i.e.*, October 1, 2011 through October 31, 2012); and (3) agree to file returns and pay the taxes due for the three years after amnesty is granted (*i.e.*, November 1, 2012 through October 31, 2015). In total, then, the taxpayer has filed returns and paid the taxes due for the nearly 10-year Eligible Periods, *plus* an additional period of approximately four years.

UNLIKE MANY AMNESTY PROGRAMS, KENTUCKY'S PROGRAM NOT ONLY REQUIRES TAXPAYERS TO FILE AND PAY FOR PAST PERIODS, BUT ALSO THREATENS TO RETROACTIVELY DISQUALIFY TAXPAYERS THAT FAIL TO PAY TAXES FOR FUTURE PERIODS!

Furthermore, the taxpayer waives all right to claim a refund of amounts paid under the amnesty program.[6] In this regard, the statute provides that: "Unless the department in its own discretion redetermines the amount of taxes due, no refund or credit shall be granted for any taxes paid under the amnesty program. Any administrative or judicial proceeding

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or claim seeking the refund or recovery of any amount paid under an amnesty program is hereby barred."[7]

In exchange, Kentucky will waive penalties and half of the interest for taxes paid for the Eligible Periods only.

Now, let's look at the stick: if a taxpayer elects not to participate in the amnesty program, then the taxpayer subjects itself to a series of additional impositions (called "cost-of-collection fees," but which are plainly penalties) and interest. First, all taxes "which are or become due and owing to the department for any reporting period" are subject to a 25% "cost-of-collection fee."[8] Second, any taxes that are assessed and collected after the conclusion of the amnesty program for tax periods during the Eligible Periods, are subject to another 25% "cost-of-collection fee."[9] Third, a taxpayer that fails to file a return for any of the Eligible Periods (*e.g.*, because it disputes nexus) is subject to an additional 50% "cost-of-collection fee."[10] It appears that each of these fees is assessable in addition to the other fees[11] and in addition to all of the State's normal penalties, which themselves can add up to 50% to the assessment.[12] Finally, the Department may also add 2% to the normal interest imposed on deficiencies.[13] The shocking math here can be illustrated in a simple example:

> Suppose Company A has concluded that it has no use tax collection responsibility on sales of products into Kentucky for tax year 2010. In 2013, the Department audits and imposes use taxes of $500,000. Taking the new amnesty statute at face value, the Department may now add cost-of-collection fees and penalties of up to $750,000 and impose interest at the normal rate (currently 6%) plus an additional 2%.[14]

Some amnesty program, huh? And, if you are still sanguine, consider that the taxpayer apparently has no right whatsoever to protest the cost-of-collection fees.[15]

KENTUCKY'S AMNESTY PROGRAM STANDS OUT AS A PARTICULARLY COERCIVE MEANS TO ENCOURAGE TAXPAYERS TO FILE AND PAY LIABILITIES FOR PAST AND FUTURE PERIODS.

These blows can be softened if the Department chooses to do so. The statutes provide that "[t]he commissioner shall have the right to waive any penalties or collection fees when it is demonstrated that any deficiency of the taxpayer was due to reasonable cause."[16] "Reasonable cause" is defined as "an event, happening, or circumstance entirely beyond the knowledge or control of a taxpayer who has exercised due care and prudence in the filing of a return or report or the payment of moneys due the department pursuant to law or administrative regulation."[17] But without some process for requiring the Commissioner to exercise this right, it's hard to feel confident that a taxpayer will avoid these onerous fees and penalties, given that taxpayers and tax collectors often disagree about what is "reasonable."

In sum, Kentucky's amnesty program stands out as a particularly coercive means to encourage taxpayers to file and pay liabilities for past and future periods. Because tax issues are often subject to good faith controversies, the interplay of onerous "fees" and interest and the prohibition against refund claims for taxpayers who submit to the program to avoid this exposure makes the program profoundly unfair. Certainly, we are not aware of any other state that has recently implemented an amnesty program that requires the taxpayer to: (1) file returns and pay the taxes that may not be due; (2) waive any right to a refund of those controversial taxes; and (3) pay all of the other taxes that may be due for a number of future years.[18] All of this is in order to avoid fees and penalties of up to 150% of the tax, plus additional interest.

Challenges to Other Onerous Penalties

In evaluating the prospects of challenging the Kentucky program, we should note that taxpayers have generally been unsuccessful in challenging onerous penalties imposed in connection with other amnesty programs. For example, in 2004, California implemented an amnesty program that required taxpayers to pay the tax and interest due for the eligible periods and also to pay the tax and interest *proposed to be assessed* for the eligible periods.[19] As in Kentucky's program, the taxpayer waived any right to a claim for refund for amounts paid under the program.[20] If a taxpayer elected not to participate, it was subject to an additional penalty in the amount of 50% of the accrued interest.[21] River Garden Retirement Home ("River Garden") challenged the program on various grounds. In that case, there was a tax liability for the eligible periods that was the subject of a pending administrative appeal during the period in which the amnesty

WE SHOULD NOTE THAT TAXPAYERS HAVE GENERALLY BEEN UNSUCCESSFUL IN CHALLENGING ONEROUS PENALTIES IMPOSED IN CONNECTION WITH OTHER AMNESTY PROGRAMS.

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program was in effect.[22] River Garden chose not to participate in the amnesty program. When River Garden lost its administrative appeal, the Franchise Tax Board imposed the amnesty penalties, in addition to the other penalties and interest, as part of the final assessment.[23] River Garden paid the assessment and sued for a refund, arguing, *inter alia*, that the penalties were "aimed at coercing taxpayers to pay liabilities before they are finally determined" and, therefore, were "contrary to a long-standing policy affording taxpayers an opportunity to challenge disputed assessments before paying."[24]

The court rejected this argument. It observed that River Garden "could have paid the proposed assessment [under the amnesty program] . . . , and pursued its administrative remedy without fear of accruing [the amnesty penalties]."[25] The court emphasized the purported voluntary nature of the amnesty program by stating that "River Garden seems to forget that this is an *amnesty* program – there are benefits to participating and adverse consequences for not participating, which means the taxpayer can undertake a cost-benefit analysis to determine if coming in under amnesty is worth it."[26] Thus, the court implied that the terms of the amnesty program at issue in that case were not so onerous as to be tantamount to an involuntary, coercive means to force taxpayers to pay outstanding liabilities.

In another California case, a taxpayer organization, California Taxpayers Association ("CalTax"), challenged California's "large corporate understatement penalty," which imposed a 20% penalty on any corporate underpayment of more than $1 million.[27] CalTax argued that the penalty violated the State constitution and also violated procedural due process because it did not afford taxpayers an adequate pre- or post-payment review process.[28] The court relied on the *McKesson* rule that, in order to "satisfy the commands of the Due Process Clause," a state must provide "a predeprivation or postdeprivation procedural safeguard against unlawful exactions."[29]

The court agreed with CalTax that the penalty statute, taken alone, did not provide a constitutionally adequate review process.[30] The statute provided that "[a] refund or credit for any amount[]… may be allowed *only on the grounds that* the amount of the penalty was not properly computed by the Franchise Tax Board."[31] Because the statutory remedy was so limited, the court held that it did not "satisfy th[e] due process mandate."[32] However, the court also found that the limitation on claims for refund applied only to *administrative* claims and that the generally applicable statutes permitting a taxpayer to sue for a refund in *court* applied and provided constitutionally adequate protection for the taxpayer.[33]

Although neither of the plaintiffs were successful in challenging the penalties at issue in *River Garden* and *CalTax*, the cases provide a few guidelines that are helpful in framing an analysis of the Kentucky amnesty program. First, under the terms of Kentucky's amnesty statutes, can it fairly be said that the taxpayer may perform a "cost-benefit" analysis and make a free choice as to whether or not to participate in the program? Second, does the taxpayer have access to a constitutionally adequate process to challenge the amnesty "fees," if they are imposed?

Is Kentucky's Amnesty Program Subject to Challenge?

As we noted above, Kentucky's amnesty program seems to impose particularly onerous penalties and fees (*i.e.*, of up to 150%) and a particularly harsh requirement that taxpayers waive their rights to challenge taxes paid both during the Eligible Periods and for approximately four years afterward. In light of these facts, we question whether a taxpayer can be characterized as having a choice as to whether to participate in the program.

For example, if a taxpayer has a potential tax liability for the Eligible Periods of approximately $1 million, but has a strong legal argument that the tax is not due, the taxpayer's "choice" is to: (1) participate in the amnesty program, pay $1 million and give up its right to challenge the tax; or (2) not participate in the program and risk being assessed $1 million in tax, plus $1.5 million in amnesty cost-of-collection fees and additional amnesty interest, in addition to the otherwise applicable interest and penalties. The costs associated with the taxpayer's challenge of the potential tax liability are vastly increased by the amnesty "fees," to such an extent that many taxpayers may be forced to forgo such challenges entirely. Can a taxpayer's decision to participate in the amnesty program under these circumstances be described as a free "choice"?

CLEARLY, AT SOME POINT AN AMNESTY "FEE" THAT FORCES THE PAYMENT OF TAXES THAT ARE NOT REFUNDABLE IS SO COERCIVE AS TO VIOLATE DUE PROCESS.

Clearly, at some point an amnesty "fee" that forces the payment of taxes that are not refundable is so coercive as to violate Due Process. In *River Garden*, the penalty was 50% additional interest. So, assuming that the interest was approximately 6%, the amnesty "fee" would have amounted to an additional 3%. In that case, the court found that this additional penalty was not coercive. But here the penalty may be as high as 150% plus additional interest, thereby more than doubling the tax due. Under such circumstances, we believe that a court should reach a different conclusion.

Moreover, the Kentucky amnesty statutes specifically deny the taxpayer the right

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to protest the imposition of the amnesty "fees."[34] As the court noted in *CalTax*, the U.S. Supreme Court has held that the Due Process Clause requires that the taxpayer be afforded either a pre- or post-deprivation remedy to challenge a tax.[35] This rule applies equally to penalties. Here, at least on the face of the statute, it seems that Kentucky's amnesty "fee" is not subject to challenge by way of a claim for refund. It is not clear how, if at all, a taxpayer might be able to challenge the penalty in a pre-payment action.

THE U.S. SUPREME COURT HAS HELD THAT THE DUE PROCESS CLAUSE REQUIRES THAT THE TAXPAYER BE AFFORDED EITHER A PRE- OR POST-DEPRIVATION REMEDY TO CHALLENGE A TAX.

Conclusion

In summary, Kentucky's new "amnesty" program appears to be another legislative shakedown of taxpayers. While the Kentucky Department of Revenue has signaled, in informal comments, its intention to administer reasonably some of the more egregious provisions, the proper solution is for the Kentucky Legislature to restore some balance to the program by dramatically reducing the "fees" that may be imposed under the program and allowing taxpayers the right to obtain redress in the courts for any taxes, penalties or interest that are not reasonable and that are paid under the program that are not ultimately due. Until then, taxpayers are reminded by the Department's Tax Amnesty Countdown Clock that they have, as of the time of this writing, "44 days: 14 hours: 43 minutes: 53 seconds" to sign up for the program.[36] ■

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1 *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009), *cert. denied*, 130 S. Ct. 3324 (2010); Ky. Rev. Stat. Ann. §§ 141.200(17)-(18).

2 The amnesty program covers all taxes "subject to the administrative jurisdiction of the department," except ad valorem taxes on real property, personal property and motor vehicles and motorboats. Ky. Rev. Stat. Ann. § 131.400(4)(b)(1)-(3).

3 Ky. Rev. Stat. Ann. §§ 131.400(4)(b); 131.410(1)(a); 131.425(1)(b).

4 Ky. Rev. Stat. Ann. § 131.420(1)(a)-(c).

5 Ky. Rev. Stat. Ann. §§ 131.420(1)(d); 131.445(3)(a)(2).

6 The Department has taken the position, in informal advice, that a taxpayer who participates in the amnesty program does not waive the right to claim a refund of taxes paid for periods after the Eligible Periods. However, given the tension between this advice and the statutory language, discussed in footnote 7 below, taxpayers may wish to obtain a specific Department ruling before relying on that advice. Unfortunately, given that amnesty payments must be made prior to November 30, 2012, there is little time remaining to obtain such a ruling.

7 Ky. Rev. Stat. Ann. § 131.410(4). In another section, the statute provides that "participation in the program shall be conditioned upon the taxpayer's agreement that the right to protest or initiate an administrative or judicial proceeding or to claim any refund of moneys paid under the program is barred with respect to the amounts paid under the amnesty programs." Ky. Rev. Stat. Ann. § 131.420(2). This language appears in a subsection that discusses the participation in the amnesty program of taxpayers under audit. In informal advice, the Department has indicated that it takes the position that the prohibition on protests and claims for refund described in this section is limited to amounts paid pursuant to an audit or assessment, as described in that paragraph. In the same informal advice, the Department also noted that Section 131.410 generally prohibits claims for refunds for amounts paid pursuant to the amnesty program. With regard to that section, however, the Department noted that the prohibition on claims for refund is limited to taxes arising during the Eligible Periods. Thus, as noted above at footnote 6, the Department apparently interprets "amounts paid under the amnesty program" to mean only taxes arising during the Eligible Periods that are voluntarily paid pursuant to amnesty.

8 Ky. Rev. Stat. Ann. § 131.440(1)(b)(1)(a).

9 Ky. Rev. Stat. Ann. § 131.440(1)(b)(1)(b).

10 Ky. Rev. Stat. Ann. § 131.440(1)(b)(1)(c).

11 Ky. Rev. Stat. Ann. § 131.440(1)(b)(1)(a) (the 25% cost-of-collection fee "shall be in addition to any other applicable fee provided in this paragraph"). In addition, subsections (b) and (c) of Section 131.440(1)(b)(1), relating to the 25% fee for taxes paid after assessment and the 50% fee for failure to file returns, are connected with an "and." Accordingly, the statute seems to contemplate that one, two or all three of these separate penalties may apply to a single tax liability.

12 Ky. Rev. Stat. Ann. § 131.180(1)-(3) (imposing penalties that can aggregate to 50% for taxpayers who have filed returns); § 131.180(4) (imposing a penalty of 50% on taxpayers who have failed to file returns).

13 Ky. Rev. Stat. Ann. § 131.440(1)(b)(2). We also note that the Department's website lists a fourth separate "fee" for non-participation in the amnesty program, in addition to each of the "fees" listed here. The fourth "fee" is an "[a]dditional 25% on Amnesty-eligible liabilities discovered through audit." *See* Kentucky Tax Amnesty Website, http://www.amnesty.ky.gov/faqs/what-if-i-do-not-take-advantage-of-amnesty/ (last visited Oct. 19, 2012). We have been unable to identify the statutory authority for this last "fee."

14 Ky. Rev. Stat. Ann. § 131.183; Ky. Dep't of Rev. Memorandum, Annual Adjustment of Tax Interest Rate (July 5, 2012) available at: http://revenue.ky.gov/12tir.htm.

15 Ky. Rev. Stat. Ann. § 131.420(4).

16 Ky. Rev. Stat. Ann. § 131.440(2).

17 Ky. Rev. Stat. Ann. § 131.010(9).

18 The failure to pay for post-amnesty periods apparently does not forfeit amnesty if the additional taxes arose "as a result of an audit." *Id.*, §131.445(3)(d). This curious provision suggests that a taxpayer that discovers an underpayment of taxes for a year within the post three-year period could disclose and pay that liability (*e.g.*, by a qualified amended return) only at the risk of forfeiting amnesty for other qualifying payments.

19 Cal. Rev. & Tax. Code §§ 19733(a)(2), (3)(B).

20 Cal. Rev. & Tax. Code § 19732(e).

21 Cal. Rev. & Tax. Code § 19777.5(a).

22 *River Garden Retirement Home v. Franchise Tax Bd.*, 186 Cal. App. 4th 922, 933 (Ct. App. 1st Dist. 2010).

23 *Id.* at 932.

24 *Id.* at 955 (internal quotation marks omitted).

25 *Id.* at 955.

26 *Id.* at 955 (emphasis in original).

27 *Cal. Taxpayers Ass'n v. Franchise Tax Bd.*, 190 Cal. App. 4th 1139, 1143 (Cal. Ct. App. 3d Dist. 2010) (describing Cal. Rev. & Tax. Code § 19138).

28 *Id.* at 1151.

29 *Id.* at 1151 (*citing McKesson Corp. v. Div. of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 36-39 (1990)).

30 *Id.*

31 *Id.* (quoting Cal. Rev. & Tax. Code § 19138(e)) (emphasis added).

32 *Id.*

33 *Id.* at 1151-52.

34 Ky. Rev. Stat. Ann. § 131.420(4) ("With the exception of the cost-of-collection fee imposed under subsection (1) of K.R.S. 131.440, all assessments issued by the department . . . may be protested . . . .").

35 *Cal. Taxpayers Ass'n*, 190 Cal. App. 4th at 1151.

36 *See* Kentucky's Tax Amnesty Website, http://www.amnesty.ky.gov/ (last visited Oct. 19, 2012).

Recent California State Board of Equalization Legal Opinion Letter Could Create Confusion Regarding the Proposition 13 Change in Ownership Rules for Legal Entities

By Peter B. Kanter

On September 5, 2012, the California State Board of Equalization's ("Board") legal staff ("Staff") issued a legal opinion letter ("Letter") in which the Staff reversed a Proposition 13 ("Prop 13") property tax change in ownership rule for transfers of interests in legal entities that the Board had adopted and followed for more than 25 years. Although the Staff almost immediately recalled the Letter and said that it would more fully consider the proposed change in position and would likely present the issue to the Board for consideration, the proposed new rule, if adopted, would be a sea change in the Board's approach to the change in ownership rules governing legal entity transactions. If the Letter is republished adopting the new rule, it would create substantial uncertainty among taxpayers who need to determine the potential property tax effects of transfers and acquisitions of interests in legal entities, including corporate shares of stock and partnership or limited liability company interests. Moreover, because the Letter would not have the binding effect of a statutory or regulatory provision, the proposed change would create uncertainty among taxpayers, who would not know which of the rules would govern their transactions: the one the Board has followed since Prop 13's inception or the newly stated one?

Prop 13's Change in Ownership Rule

Under Prop 13 change in ownership system, real property assessments are capped by the property's "base year value."[1] Base year values were established by the assessed values for the 1975 tax year, but are reset upon any subsequent "change in ownership" of any real property.[2] (In addition, a property's base year value might be adjusted by the removal or new construction of improvements on the property, but those base year value adjustments are not at issue in the Letter.) Because the provisional language of Prop 13 did not define what a "change in ownership" includes, shortly after Prop 13 was passed by the voters in 1978 to amend the California Constitution, a task force ("Task Force") was convened to advise the Legislature on how it should define "change in ownership."

THE PROPOSED NEW RULE, IF ADOPTED, WOULD BE A SEA CHANGE IN THE BOARD'S APPROACH TO THE CHANGE IN OWNERSHIP RULES GOVERNING LEGAL ENTITY TRANSACTIONS.

One of the biggest questions the Task Force addressed was how to treat property held by legal entities, such as corporations and partnerships. The Task Force grappled with two distinct approaches: the "ultimate control" theory and the "separate entity" theory. In short, under the ultimate control theory, a change in ownership would occur when an investor obtained "majority control" of a legal entity that owned real property when the investor did not already have control over that entity. Under the separate entity theory, transfers of interests in legal entities would not trigger a change in ownership; only transfers of real property between legal entities would trigger a change in ownership, even if the entities were 100% affiliates. The Task Force recommended that the Legislature adopt the separate entity approach; however, the Legislature ultimately adopted a mixed separate entity and ultimate control approach.[3] The enacted rule generally follows the separate entity approach, but directs that a change in ownership occurs when an investor obtains majority ownership or control over a legal entity.[4]

Multi-tiered Legal Entities

In 1989, a case was decided by the California Supreme Court that addressed whether a transfer of shares of a parent corporation that caused an investor to obtain more than 50% of the voting stock of the parent would trigger a change in ownership of the real property held not only by the parent entity, but by its "controlled" subsidiaries. In *Title Insurance & Trust Company. v. County of Riverside* (the "TICOR" case), the court ruled:

> [I]f one corporation either directly or indirectly obtains control over another by the transfer or purchase of stock, a change of ownership occurs as to the real property owned by the corporation over which it has obtained direct or indirect control. Here, Southern Pacific obtained indirect control of TI as

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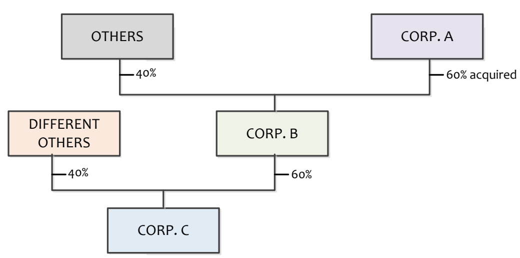
> a result of the purchase of Ticor stock, since the merger resulted in Southern Pacific's ownership of Ticor, a wholly owned subsidiary of Southern Pacific, and TI was Ticor's wholly owned subsidiary. Ergo, such indirect control over TI resulted in a change of ownership of TI's property for purposes of section 64(c).[5]

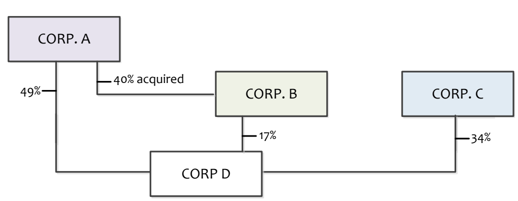
In the argument before the court in the TICOR case, *amicus curiae* supporting the taxpayer argued against a rule that would aggregate a parent entity's ownership interests in its subsidiaries to determine whether a Prop 13 change in ownership occurred because the parent held or obtained "control" of a subsidiary that owned California real property. The *amicus*, Institute of Property Taxation ("IPT"), presented a series of hypothetical transaction structures to the court in which a parent entity held varying percentage ownership of different levels of subsidiaries and posed the difficulties that might arise if assessors needed to aggregate interests in subsidiaries to determine whether a parent entity or investor ultimately obtained control over a property owning subsidiary. In response to these hypotheticals, the Board filed a reply brief in which it took the position that for purposes of determining whether a change in ownership has occurred, the property of a subsidiary, or the interests in another entity held by that subsidiary, would only be attributed to the subsidiary's immediate parent if the parent owned more than 50% of the subsidiary. Thus, according to the Board, if a corporation ("Parent") acquired 51% of Subsidiary 1, which held 51% of Subsidiary 2, Parent would obtain indirect control over Subsidiary 2 through its acquisition of majority interests in Subsidiary 1 and the property of both subsidiaries would be deemed to have undergone a change in ownership.

However, according to the Board's responses to IPT's hypotheticals, if under the same scenario Parent instead acquired only 49% of Subsidiary 1, this would not trigger a change in ownership of the property held by Subsidiary 2, because Parent would not be deemed to have obtained control (*i.e.*, more than 50%) of Subsidiary 1 and, therefore, its interests in Subsidiary 2 could not be attributed to Parent. The same result would be reached (*i.e.*, no change in ownership) even if Parent also had or obtained a direct 49% interest in Subsidiary 2. According to the Board, even though it would appear that Parent would then have most of the economic interests in Subsidiary 2, the 51% interest in Subsidiary 2 held by Subsidiary 1 could not be attributed to Parent because Parent held less than 50% of Subsidiary 1.

The following diagrams should help clarify the position the Board presented to the court in the TICOR case:



Result: Corp. A's acquisition of 60% of Corp. B causes an indirect change in control of Corp. C and, thus, a change in ownership of Corp. C's real property.



Result: No change in control caused by Corp. A's acquisition of 40% of Corp. B as Corp. A did not obtain greater than 50% of Corp. B, even if its economic interest in Corp. D has now risen above 50%.

Although the court in the TICOR case did not address whether the Board's position was the only appropriate method for calculating control, the Board's position–that a subsidiary's interests in property or in a lower tier entity could not be attributed to an investor in the subsidiary unless the investor held more than 50% of the subsidiary's interests–was expressed in various legal opinion letters dating back at least to 1986. However, this past September, the Staff issued the Letter in which it altered its longstanding 50% threshold position. In the Letter, the Staff opined that there should be two different ways of calculating whether a change in ownership is triggered by the acquisition of interests in multi-tiered affiliated entities, depending on whether the entities involved are corporations or other types of entities, such as partnerships and limited liability companies ("LLCs").

In essence, the Letter states that for partnerships and LLCs, only a "percentage attribution method" ("PAM") should be used to determine whether a change in control of a partnership or LLC has occurred, rather than a "full attribution method" ("FAM"), which the Letter acknowledges had been the method the Board previously prescribed in its opinion letters. The Letter argues that because the statutory provision and the regulation promulgated by the Board, both governing change in ownership for legal entities, direct that control of a partnership or LLC shall be measured by the interests in capital and profits and because partnerships and LLCs are "pass-through" entities for income tax purposes, the proper means for calculating whether an investor has obtained indirect control over such an entity should be through the PAM.[6] Under the PAM, the profits and capital interests are traced up through multiple tiers and attributed to the ultimate top tier investors to reflect the actual economic interests that the top tier investors have in the underlying property-owning entity. The example below illustrates the PAM method of calculating direct and indirect interest in

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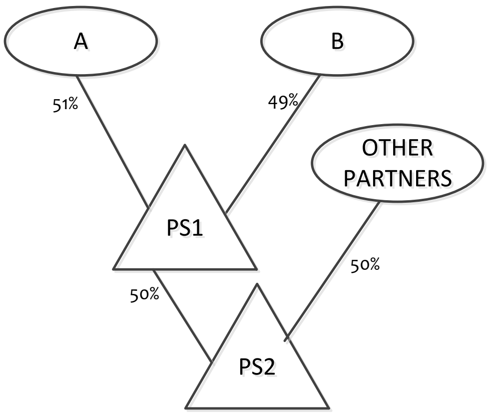
partnerships and LLCs as explained in the Letter:



According to the Staff's Letter, A should be deemed to have 25.5% interest in PS2, and therefore, there should be no change in ownership when it acquires 51% of PS1.

In the above example, taken from the Letter itself, the Staff concluded that under their newly proposed PAM, Investor A would be deemed to have acquired a 25.5% (*i.e.*, 51% of 50%) economic interest in PS2. The Staff noted that under the FAM that the Staff had previously endorsed, because A acquired more than 50% of PS1, *all* of PS1's interests in PS2 would be attributed to A. However, because PS1 held only 50% of PS2 (*i.e.*, not *more* than 50%), PS1 would not be deemed to have control of PS2 and, therefore, no interests in PS2 would be attributed to A. Under the FAM, had PS1 held 51% of PS2, then A's acquisition of 51% of PS1 would have triggered a change in ownership of real property held by PS2 because, under the FAM, once PS1's interests in PS2 rose above 50%, it would be deemed to control PS2 and any investor obtaining more than 50% of PS1 would be deemed to have obtained direct control of PS1 and indirect control of PS2.

The Letter then opined that although the PAM should be the only appropriate method for determining change of ownership by acquisition of indirect control over partnerships and LLCs, both the PAM and the FAM should apply for making change in ownership determinations for corporations. According to the Staff's reasoning in the Letter, the language of California Revenue and Taxation Code Section 64(c) specifies two ways that acquisition of interests in corporations could trigger a change in ownership of real property held by the corporation, because for corporations the statute states that a change in control occurs whenever a person or legal entity obtains "*control through direct or indirect ownership or control* of more than 50 percent of a corporation's *voting stock*."[7] Thus, starting from the example provided above, if PS1 and PS2 were corporations and A acquired 51% of PS1, which held 51% of PS2, there would be a change in ownership of real property held by PS2, because PS1 is deemed to *control* PS2 by virtue of holding more than 50% of the voting stock of PS2 and A is deemed to control PS1 for the same reason. However, if PS1 and PS2 are partnerships or LLCs, then under the reasoning of the Letter, A's acquisition of 51% of PS1 should not cause a change in ownership, because A would only have acquired approximately 26% of the economic interests (*i.e.*, ownership interests) in PS2.

Moreover, the Staff opines in the Letter that for corporations, if an investor obtains a greater than 50% interest in a corporation's voting stock under *either* the PAM *or* the FAM, it should trigger a change in ownership. Thus, if PS1 and PS2 are both corporations in the example above and PS1 holds 80% of PS2 and A acquires a 40% interest in PS1 and a direct 20% interest in PS2, there should be a change in ownership because, under the PAM, A would be deemed to have acquired a 52% direct and indirect ownership interest in the voting shares of PS2 (*i.e.*, 80% of 40% indirect, plus 20% direct).

The Letter clearly reflects a change in a longstanding Board position that the interests held by a legal entity in either real property or a lower tier entity should be attributed to an upper tier entity *only* if the upper tier entity holds directly more than 50% of the interests in the lower tier entity and the Letter acknowledges that change. While it is true that the language of the statute (*i.e.*, Section 64) and of the Board's rule (*i.e.*, Rule 462.180) do not expressly prohibit utilization of the PAM as the method for calculating indirect control, the Staff's newly proposed PAM would reflect a further shift away from the separate entity approach and it would introduce a different methodology for calculating changes in control for corporations than for partnerships and LLCs. Moreover, the proposed rule would likely lead to both administrative and compliance difficulties. For example, investors who make investments in large, multi-tiered funds and who also own direct investments in property owning entities, would have to track indirect proportional interests through all of their investments to determine whether they have indirectly acquired a greater than 50% economic interest in an entity. If such majority "ownership" is created through the acquisition of interests by a fund in which the investor holds only minor interests, this could be nearly impossible to monitor and identify. For assessors, identifying such acquisitions of indirect majority ownership through attribution of all indirect investments, even minor ones, would prove even more difficult.

EVEN MORE PROBLEMATIC WOULD BE THE UNCERTAINTY THAT WOULD BE CREATED… IF THE BOARD WERE TO REISSUE THE LETTER WITHOUT… PROPERLY PROMULGATING A REGULATION

But perhaps even more problematic would be the uncertainty that would be created among assessors and taxpayers if the Board were to reissue the Letter without adopting the change in its

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position through a properly promulgated regulation. Because the Board's current regulation fails to expressly address the question of whether the PAM or FAM should be used for corporations, partnerships or LLCs and because the Board's opinion letters are not binding authority for either the assessors or for the courts, if the Board changes its position, taxpayers would not know which method an assessor might choose to adopt for any specific transaction. In some instances, an acquisition of interests would lead to a change in ownership under the PAM but not under the FAM and vice versa. Without a clear authoritative statement in either a statute or a regulation, assessors could choose to follow either method and rely upon whichever Board position supports that method. If this were to happen, the Board would not be acting to fulfill its responsibility to clarify the property tax laws for assessors and taxpayers. To the contrary, it would be clouding those laws. ■

1 *See* Cal. Const. art. XIIIA, § 2.

2 *See id.*

3 Codified in part at California Revenue and Taxation Code Section 64, which states:

> (a) Except as provided in subdivision (i) of Section 61 and subdivisions (c) and (d) of this section, the purchase or transfer of ownership interests in legal entities, such as corporate stock or partnership or limited liability company interests, shall not be deemed to constitute a transfer of the real property of the legal entity.
>
> (c)(1) When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities, including any purchase or transfer of 50 percent or less of the ownership interest through which control or a majority ownership interest is obtained, the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained.

4 Cal. Rev. & Tax. Code § 64.

5 *Title Ins. Trust & Co. v. County of Riverside*, 767 P.2d 1148, 1152 (Cal. 1989).

6 *See* Cal. Rev. & Tax. Code § 64; Cal. Code Regs. tit. 18, § 462.180.

7 Opinion letter issued by staff of California State Board of Equalization regarding Counting Indirect Ownership and Control of Legal Entities, Assignment No.: 11-042, dated September 5, 2012 and subsequently withdrawn, emphasis in original.

SAVE THE DATE

MoFo Annual State + Local Tax East and West Coast Events

EAST COAST EVENT
November 8, 2012
8:00 a.m. – 12:30 p.m.
New York, NY

TOPICS INCLUDE:
- Qui Tam and Class Actions: Who's Suing You Now?
- Tri-State News: New York, New Jersey, Pennsylvania
- Mergers and Acquisitions: Avoiding Traps and Saving Taxes
- SALT Issues raised by Employee Presence: Telecommuters, Withholding, etc.
- Hot Issues and Questions in California

MCLE and CPE is currently pending in New York.

WEST COAST EVENT
December 6, 2012
8:00 a.m. – 12:30 p.m.
San Francisco, CA

TOPICS INCLUDE:
- Hot Issues and Questions in California
- National Developments in SALT
- Issues and Developments in the State Taxation of E-Commerce
- Current California Property Tax Issues
- Alternative Apportionment: Where We've Been, Where We Are, and Where We Might Be Going

MCLE and CPE is currently pending in California.

For more information on both events, contact Lauren Max at LMax@mofo.com or 212-336-4436.

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Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
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American Power Conversion Corp. v. Rhode Island
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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 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
IGT v. New Jersey
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
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R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation v. Maryland
Scioto Insurance Company v. Oklahoma
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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
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United States Tobacco v. California
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Wendy's International v. Virginia
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