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Planning Perspective

Proposed Section 108 Regulations May Result in Disparate Treatment of S Corporation Shareholders

By Jeanne Sullivan (KPMG LLP)

On August 6, 2008, Treasury published proposed regulations under section 108 on the reduction of tax attributes for S corporations (73 FR 45656-01). The proposed regulations provide guidance on the manner in which an S corporation applies the rules of section 108(b) in a year in which the S corporation has discharge of indebtedness income (COD income) that is excluded from gross income under section 108(a). In particular, the proposed regulations address situations in which S corporation losses and deductions that are treated as net operating losses (NOLs) for purposes of section 108 exceed the amount of the S corporation's excluded COD income (Excess Deemed NOL). The proposed regulations provide rules whereby the Excess Deemed NOLs are apportioned among the S corporation's shareholders after tax attribute reduction. As we shall see, the rules may result in potentially disparate treatment of the S corporation shareholders.

Subchapter S generally provides simplified pass-through treatment for corporations that meet its eligibility requirements. To avoid the complexities that can result from the variations in economic rights associated with partnerships, subchapter S requires that each shareholder be allocated a pro rata share[1] of an S corporation's items of income (including tax-exempt income), loss, deduction and credit as well as a pro rata share of nonseparately computed income and loss (section 1366(a)) and that the S corporation issue only a single class of stock (section 1361(b)(1)(D)). Nevertheless, the S corporation is a separate entity that also retains certain corporate characteristics and the rules of section 108 are applied at the corporate entity level.

In this article, we will first review the authorities relating to COD income and the potential for exclusion of that income under section 108. Then we will examine the recently proposed regulations under section 108 that apply these principles to S corporations and their shareholders.

Jeanne Sullivan (jsullivan@kpmg.com) is Senior Manager of KPMG's National Tax Practice in the Washington, D.C. office.

Discharge of Indebtedness and Section 108

In *U.S. v. Kirby Lumber*, 284 U.S. 1 (1931), the Supreme Court ruled that gross income includes income from the discharge of indebtedness. The reasoning underlying this decision has been called the "freeing-of-assets" theory. See *Commissioner v. Tufts*, 461 U.S. 300, 310 n. 11 (1983). Under this theory, a debtor's net asset value increases when some or all of the debtor's assets are no longer subject to creditors' claims. Subsequently, a judicially-developed insolvency exception to the *Kirby Lumber* rule was adopted on the theory that, if a taxpayer is insolvent both before and after debt discharge, no assets have been "freed" by the reduction in liabilities and the taxpayer has experienced no increase in wealth. See *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934). Congress codified the *Kirby Lumber* rule relating to COD income in 1954 (see section 61(a)(12)) and added the insolvency exception to COD income in the Bankruptcy Tax Act of 1980 (see section 108(a)(1)(B)).

In order to mitigate unintended consequences, S corporations and their shareholders should take the requirements of section 108(d) and the proposed regulations into account when restructuring the corporation's debt.

Section 108(a) provides exclusions from gross income for COD income incurred if the discharge occurs in a title 11 case or when the taxpayer is insolvent, or if the indebtedness discharged is qualified farm indebtedness, certain qualified real property business indebtedness, or certain qualified principal residence indebtedness. In the case of insolvency, the exclusion is limited to the amount by which the taxpayer is insolvent (section 108(a)(3)).

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New California Budget Suspends NOL Deductions, Allows Credit Assignment, Increases Penalties

By Robert Wells (PricewaterhouseCoopers LLP)

California Gov. Arnold Schwarzenegger (R) on September 23 signed into law budget legislation that will:

- suspend net operating loss (NOL) deductions for 2008 and 2009;
- conform to federal NOL carryover periods, effective for 2008, and carryback periods, effective for 2011;
- allow limited assignability of tax credits, effective beginning July 1, 2008;
- increase penalties for corporate franchise tax underpayments, applicable back to the 2003 tax year; and
- accelerate estimated tax payments, effective for 2009.

These provisions are included in A.B. 1452 passed by the California legislature, as amended by S.B. 28 as part of a budget agreement reached after the governor's veto threat. The new budget took effect on September 23.

Net Operating Losses

California currently allows NOLs to be carried over for 10 years and disallows NOL carrybacks.

New Carryover Rules

The new law disallows utilization of NOL deductions for any tax year beginning on or after January 1, 2008, and before January 1, 2010. For any NOL or carryover that is barred by the disallowance, the otherwise applicable carryover period is extended by one year for losses incurred in tax years beginning in 2008; and by two years for losses incurred in tax years beginning before 2008. Under the legislation, a deduction is allowed for the carryback of an NOL attributable to tax years beginning on or after January 1, 2011.

These provisions do not apply to franchise taxpayers with "income subject to tax under this part," and personal income taxpayers with net business income, of less than $500,000 for the tax year.

The new law conforms to the federal 20-year NOL carryover period for NOLs attributable to tax years beginning on or after January 1, 2008, and to the federal two-year carryback period for NOLs attributable to tax years beginning on or after January 1, 2011.

New Carryback Rules

NOL carrybacks are disallowed for NOLs attributable to tax years beginning before January 1, 2011. NOLs attributable to later tax years can be carried back to the two tax years preceding the year in which the loss was incurred. For an NOL attributable to a tax year beginning:

- on or after January 1, 2011, and before January 1, 2012, the carryback amount cannot exceed 50 percent of the NOL;
- on or after January 1, 2012, and before January 1, 2013, the carryback amount cannot exceed 75 percent of the NOL;
- on or after January 1, 2013, the carryback amount cannot exceed 100 percent of the NOL.

Under the legislation, a deduction is allowed for the carryback of an NOL attributable to tax years beginning on January 1, 2011.

In addition, the new law prohibits an NOL carryback to any tax year beginning before January 1, 2009.

The carryback amount limits apply to the special rules for REITs (IRC section 172(b)(1)(B)) and for corporate equity reduction interest losses (IRC section 172(h)).

Credit Limits

The new law caps the amount of business tax credits that can be claimed to 50 percent of a taxpayer's tax liability for tax years beginning on or after January 1, 2008, and before January 1, 2010. The legislation allows the amount of any franchise tax credit not permitted to remain as a credit carryover, and the carryover period for that disallowed credit is extended by the number of tax years for which the credit (or any portion of it) was not allowed. These provisions do not apply to franchise taxpayers with "income subject to tax under this part,"

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Robert Wells (robert.j.wells@us.pwc.com) is a Director with the Washington National Tax Services in the Washington, D.C. office of PricewaterhouseCoopers LLP.

Pre-Packaged R&D Credit Refund Claims

By Jack Cummings and Timothy J. Peaden (Alston & Bird LLP)

Research Credit Claims Audit Technique Guide, LMSB-04-0508-030 (May 30, 2008), has been issued by IRS' Large & Mid-Size Business Division (LMSB) to the field auditors, in response to receipt by the IRS of numerous "pre-packaged research credit (RC) claim studies" that have generated claims for refunds late in audit cycles. LMSB issued this audit guidance to field agents because experience is showing the prepackaged claims to be difficult to audit. A common scenario features a lengthy methodology discussion and an absence of supportive facts.

Relationship of Expense to R&D

The guide indicates a common problem with the taxpayer's proof of linkage of the expense, which the taxpayer clearly incurred, and the qualified research activity, which also clearly existed. The issue is not whether there was expense and research, but the connection between the two.

A common example is when wages are incurred in a "cost center" that carried on a research activity, among other activities. The allocation of a portion of wages to the R&D activity may be based on the taxpayer's estimates. Problems that LMSB sees with estimates include (1) that the estimator may not have even been involved with the employees or the research at the relevant time, and (2) that she may have no objective data on which to base an estimate. LMSB views such cases as "arbitrary and unsupported allocations."

Substantiation

LMSB relies on *Eustace v. Commissioner*. T.C. Memo 2001-66, aff'd 312 F.3d 1254 (7th Cir. 2002), to reject the application of the "*Cohan* rule" to substantiation of the linkage of salaries to research activities. Under the *Cohan* rule, taxpayers used to be able to make ballpark estimates of the business usage of automobiles, etc., at some percentage. LMSB, however, states that "the taxpayer [is] required to tie salaries to qualified activities at the subcomponent level."

The examiner is to look for contemporaneous documentation and—if there is not documentation—at least oral testimony from persons who were actually on the job and involved in the research or management at the time.

Invalid 280C Election

Normally no deduction is allowed to the extent that a tax credit is claimed for the expenses. However, a taxpayer may elect a reduced credit and more deduction on a timely filed irrevocable election. Evidently, some elections have been invalid (for example, attempts to make them on an amended return) and may necessitate return amendments to increase the credit claimed, which the examiner should allow where appropriate.

The issue is not whether there was expense and research, but the connection between the two.

Scope of Examination

The taxpayer will be given the opportunity to show that only the additional credits reflected on an amended return need be examined, by differentiating the methodology for the original credit claim (if any) from the amended claim.

Mandatory RC Claim IDR

These Information Document Requests (IDRs) primarily will attempt to ascertain the existence of adequate substantiation; if the taxpayer cannot show such adequate substantiation, the claim may be denied at this point. Taxpayers would do well to immediately provide samples of clearly proper documentation to head off the IRS view that the claim is based entirely on "high level estimation." However, the guide warns that non-statistical sampling ultimately will not be sufficient. The guide requires "100 percent" documentation, which can be satisfied by valid statistical sampling.

Practice Pointers

Taxpayers may be, at all stages of dealing with the research credit, (1) incurring expenses, (2) filing

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Jasper (Jack) Cummings (jack.cummings@alston.com) is Of Counsel in the Research Triangle office, and Tim Peaden (tim.peaden@alston.com) is a Partner in the Atlanta office, of Alston & Bird LLP. Mr. Cummings' practice is focused on tax issues related to corporate mergers & reorganizations, and state and local tax litigation. He has served as associate chief counsel (corporate) of the Internal Revenue Service in Washington, D.C. Mr. Peaden specializes in federal, state and local tax disputes and litigation.

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original returns, (3) engaging advisors to file amended returns and (4) defending claims for refund on amended returns. Obviously, taxpayer flexibility to strengthen its position declines as it goes later into the process.

Taxpayers at steps (1) and (2), which should include most corporate taxpayers with active businesses, should take heed of the level of substantiation required in this guide and be prepared to gather it on the front end.

Taxpayers engaging advisors to prepare claims for refund should carefully consider the effectiveness of any claim that looks pre-packaged. Such a claim can be detected if it spends more time proving generic methodology than specific facts.

Finally, taxpayers with claims under audit should attempt to put themselves in the auditor's position of having to operate under this guide, and attempt to anticipate the auditor's needs. Even if further substantiation must be gathered during an audit, that may be better than losing the entire claim.

IRS Identifies Tier III Issues for Industry Issue Focus Program

By Brian Bernhardt, Douglas Charnas and Craig Bell (McGuireWoods LLP)

On September 16, 2008, the IRS identified ten Tier III issues under its "Industry Issue Focus" (IIF) program. The IRS established the IIF program in March of 2007 to improve consistency in issue resolution across industry lines, allow the IRS to focus on high risk areas, increase coverage of non-compliant taxpayers by maximizing limited resources, and provide greater oversight on and accountability for important issues.

In the IIF program, the IRS Large and Mid-Size Business Division (LMSB) identifies compliance issues through field examinations and prioritizes the issues into one of three categories (i.e., Tier I, Tier II, and Tier III) based on how prevalent they are across industry lines and the level of compliance risk they present. The IRS anticipated that Tier III issues would likely contain issues affecting fewer taxpayers than issues in Tiers I and II. Tier I and II issues address listed transactions and other issues of high potential non-compliance or significant non-compliance risk, with varying levels of discretion available to field examination agents.

Brian Bernhardt (bbernhardt@mcguirewoods.com), Douglas Charnas (dcharnas@mcguirewoods.com) and Craig Bell (cdbell@mcguirewoods.com) are Partners with McGuireWoods LLP. Mr. Bernhardt specializes in tax controversies, federal tax litigation and tax-exempt organizations. Mr. Charnas' practice is focused on tax issues including tax controversies, business formations, and mergers & acquisitions. Mr. Bell heads the firm's state and local tax, and tax litigation groups. He specializes in state and local taxation, civil and criminal tax litigation, and general business tax planning. Mr. Charnas is in the Washington office; Messrs. Bell and Bernhardt are in the Richmond, Virginia office.

Identified Issues

The ten Tier III issues identified by the IRS span each of the LMSB five industry focus groups. The ten issues include:

Launch Fees Paid to Cable Operators (Communication, Technology and Media Industries). The IRS is examining whether cable television operators who receive cash incentives (launch fees) in connection with the execution of long-term affiliation agreements may defer the launch fees and take them into income over the agreement period.

The identification of an issue as a Tier III issue does not necessarily mean that audits on these issues are automatic.

Amortization of Intangibles (Communication, Technology and Media Industries). The IRS is examining whether broadcasters and cable channel providers accrue liabilities for license fees for the rights to broadcast sporting events upon the execution of the broadcast rights contracts and amortize the fees over the term of the contract when they should, according to the IRS, accrue the liability as the games are played.

Real Estate Mortgage Investment Conduits (REMIC) (Financial Services Industry). The IRS is examining REMIC sponsors' potential understatement of reportable gain on the retention and the sale of regular

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interests. The IRS is reviewing the sponsors' economic models and assumptions used to value the residual interests in order to determine if the fair market value and basis allocations are appropriate for the retained regular interests.

Premium Deficiency Reserves (Financial Services Industry). This issue concerns a reserve required by health, life and property casualty companies to book additional liabilities and expenses associated with any contract that will produce a loss during the subsequent year.

Uniform Capitalization for Automobile Dealerships (Heavy Manufacturing and Transportation Industries). The IRS is examining whether retailers (including motor vehicle retailers) are properly applying the limitations imposed in 2007 on a variation of the simplified retail method allowed by the Uniform Capitalization (UNICAP) rules under Section 263A to calculate capitalized costs. The IRS is concerned with how it should apply a 2007 technical advice, inconsistent treatment by examiners, and its belief that the industry is "virtually completely non-compliant" with the 2007 technical advice.

Service Loyalty Programs (Heavy Manufacturing and Transportation Industries). The IRS is concerned about the appropriate tax treatment of loyalty programs such as frequent flyer programs in the air transportation industry and frequent stay programs in the hospitality industry, specifically whether revenues received as payment for these points are subject to deferral under either a 1971 or 2004 revenue procedure.

Delay Rental Payments (Natural Resources and Construction Industries). The IRS is examining whether delay rental payments are subject to capitalization under Section 263A as costs of producing property.

Environmental Remediation Costs under Section 198 (Natural Resources and Construction Industries). The IRS is examining whether taxpayers are complying with the requirements of Section 198 and related guidance,

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as well as the relationship between capitalization requirements of environmental remediation costs and the expensing of those costs.

Cost Segregation Studies (Retail Food, Pharmaceuticals and Healthcare Industries). The IRS is examining whether assets are Section 1250 property (generally subject to depreciation over 39 years) or Section 1245 property (generally subject to depreciation over five to seven years).

Vendor Allowances (Retail, Food, Pharmaceuticals and Healthcare Industries). The IRS is examining whether vendor allowances are properly characterized as gross income, trade or other discounts reducing the invoice price of merchandise, or the reimbursement of an expense, as may be appropriate. Vendor allowances include, but are not limited to, asset-based allowances, merchandise-based allowances, sales-based allowances, post acquisition-based allowances and can also include upfront payments.

Accounting Issues

Although many of these issues address accounting issues, the IRS has indicated that it is not specifically targeting accounting issues. However, due to the recent prevalence of accounting issues in examinations and the IRS' historic difficulty of handling accounting issues, the focus on these issues is not surprising.

The identification of an issue as a Tier III issue does not necessarily mean that audits on these issues are automatic. Instead, the IRS sees these issues as issues in need of national coordination, development, and potential guidance. Even so, taxpayers, and their advisors, with these issues should prepare themselves for potential examination by the IRS. ❑

The New Internet Tax Freedom Act

By James P. Kratochvill and Pilar M. Sansone (Morrison & Foerster LLP)

President George W. Bush signed into law on October 31, 2007, legislation (House Bill 3678,[1] the Internet Tax Freedom Act Amendments Act of 2007) that extends for another seven years, until November 1, 2014, the moratorium precluding state and local taxes on Internet access and multiple and discriminatory taxes on electronic commerce.[2] The new Internet Tax Freedom Act (2007 ITFA) also amends the previous law in several significant ways. Among the most important changes are that the 2007 ITFA: (1) amends the definition of "Internet access" to help clarify the nature and scope of services protected from state taxation under the moratorium; (2) extends for seven years but clarifies, both retroactively back to November 1, 2003, and going forward, the provisions grandfathering certain states that have historically taxed Internet access; and (3) excepts certain general business gross receipts taxes from the scope of prohibited taxes on Internet access.

James Kratochvill (jkratochvill@mofo.com) is Of Counsel with the Tax Department of Morrison & Foerster LLP. His practice is focused on state and local transaction tax matters, including advocacy, advice, and planning regarding all forms of high technology interstate transactions. He is former Chief Counsel for state & local taxes for AT&T. Pilar Sansone (psansone@mofo.com) is an Associate with the San Francisco office of Morrison & Foerster. She specializes in state and local tax controversies. Her practice focuses on franchise and income taxes, telecommunications taxes, and sales and use taxes, among others.

Definition of "Internet Access"

The definition of "Internet access" has evolved since the original Internet Tax Freedom Act was enacted in 1998 (1998 ITFA). The 1998 ITFA generally defined "Internet access" as a service that enables users to access content, information, electronic mail, or other services offered over the Internet, except for telecommunications services.[3]

The definition of "Internet access" was first amended in 2004, pursuant to the Internet Tax Nondiscrimination Act (2004 ITNA), to extend to telecommunications services purchased, used, or sold by an Internet Service Provider (ISP) to provide Internet access.[4] The 2004 amendment was made for two reasons. First, Congress sought to prevent states from taxing Internet access differently depending on how an ISP assembled and delivered the service to consumers (for example, some states previously taxed digital subscriber line (DSL) transmission services sold with Internet

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access but did not tax cable broadband transmission services sold with Internet access). Second, Congress sought to prevent states from taxing the "wholesale" purchase of "backbone" telecommunications services used to provide Internet access (i.e., the underlying telecommunications services purchased and used by ISPs to provide end users with Internet access).

The 2007 ITFA further amends the definition of "Internet access" to address numerous concerns raised by taxpayers and tax administrators regarding their understanding of the previous definition. The new definition provides that Internet access refers to the service that connects users to the Internet, and also includes closely related Internet communications services, such as electronic mail, home pages and instant messaging, whether provided as incidental to or separate from the core Internet access service.[5] Services and products sold by vendors over the Internet are not included within the definition of "Internet access."[6]

The new definition also more affirmatively clarifies Congress's intent to include "backbone" telecommunications services purchased and used by ISPs to provide Internet access services to consumers.[7] This clarification was made in response to a study issued by the Government Accounting Office (GAO) in 2006 in which the GAO took the position that the telecommunications services included within the definition of "Internet access" only included telecommunications services purchased and resold by the ISP to end users as part of the Internet access bundle, and that Internet access did not include other "backbone" telecommunications services purchased by the ISP.[8]

Finally, even though the 2004 ITNA provided that "nothing in this Act shall be construed to affect the imposition of tax on a charge for voice or similar service using Internet protocol,"[9] the new definition expressly removes from the scope of protected services voice, audio or video programming that utilizes Internet or successor protocols for which there is a charge, making it clear that states and localities will be free to tax Voice over Internet Protocol (VoIP) and similar services.[10]

Grandfather Provisions

Since its inception in 1998, the moratorium has grandfathered states that previously taxed Internet access. The 2007 ITFA extends these provisions but also clarifies them to address and correct conflicting interpretations that arose when the grandfather provisions were amended in 2004.

The 2004 ITNA included two grandfathering provisions allowing states that had taxed "Internet access" prior to certain dates to continue doing so for set periods of time.[11] The first grandfather provision applied to taxes on Internet access imposed and enforced prior to October 1, 1998 (the original date of the 1998 ITFA) and excluded such taxes from the moratorium until the 2004 ITNA's expiration on November 1, 2007 (2007 Grandfather). The second grandfather provision applied to taxes on Internet access imposed and enforced as of November 1, 2003 (the effective date of the 2004 ITNA's amendments), and excluded such taxes from the moratorium until November 1, 2005 (2005 Grandfather).

The legislative history and purpose of the 2004 ITNA's amendments indicate that the 2007 Grandfather was intended to apply to "Internet access" as that term was defined by the 1998 ITFA, and that the 2005 Grandfather was intended to apply to "Internet access" as that term was redefined and expanded in 2004. However, because both the 2007 Grandfather and the 2005 Grandfather used the same term, "Internet access," some states adopted a "plain-language" reading of the 2005 and 2007 Grandfathers and took the position that "Internet access" referred to "Internet access" as that term was redefined in 2004 with respect to both of these provisions. This plain-language reading of the 2005 and 2007 Grandfathers appeared to undermine Congress's entire purpose for expanding the definition of "Internet access" to include and protect telecommunications services purchased, used, or sold by an ISP, because the vast majority of taxes imposed upon such telecommunications services would be allowed until the 2004 ITNA expired.[12]

Services and products sold by vendors over the Internet are not included within the definition of "Internet access."

The 2007 ITFA expressly clarifies the definition of "Internet access" for each of these grandfather provisions in a manner consistent with the legislative intent of the 2004 ITNA. Specifically, the 2007 ITFA provides that, effective November 1, 2003, the term "Internet access" used in the 2007 Grandfather shall mean "Internet access" as defined in the 1998 ITFA[13] and that the term "Internet access" used in the 2005 Grandfather shall mean "Internet access" as that term was redefined by the 2004 ITNA.[14]

The 2007 ITFA makes two exceptions to this definitional clarification (the "excepted taxes"). First, excepted taxes include taxes on telecommunications services purchased, used or sold by ISPs if the state (or

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political subdivision) issued a public ruling prior to July 1, 2007, applying the tax to such services in a manner inconsistent with the definitional clarification.[15] Second, excepted taxes include taxes that were the subject of litigation instituted in a judicial court prior to July 1, 2007, where the state (or political subdivision) was seeking to enforce such taxes in a manner inconsistent with the definitional clarification.[16] Finally, with respect to such "excepted taxes," the 2007 ITFA states that "[n]o inference of legislative construction shall be drawn from this subsection or the [definitional clarification] for any period prior to June 30, 2008."[17]

It may appear at first under the 2007 ITFA exceptions that those states imposing excepted taxes will not have to defend their administrative positions to impose the excepted taxes after November 1, 2005. Although the legislative history of the 2007 ITFA suggests that Congress intended to hold those states harmless until November 1, 2007,[18] upon close reading, the new language does not appear to foreclose future taxpayer challenges to the "plain-language" interpretation by those states or court decisions rejecting such interpretation. Rather, the definitional clarification simply cannot be used to interpret the 2005 and 2007 Grandfathers prior to November 1, 2007. Thus, states imposing excepted taxes after November 1, 2005, may still have to sustain their plain-language interpretation based upon the language contained in the 2005 and 2007 Grandfather provisions, and taxpayers in those states are still entitled to argue that the 2005 and 2007 Grandfathers as enacted should be interpreted in a manner consistent with the legislative history and purpose of the 2004 ITNA.

Exception for Certain General Business Taxes

The other major change enacted by the 2007 ITFA is a specific exception to the scope of prohibited taxes on Internet access. The 2007 ITFA specifies that, effective November 1, 2007, prohibited taxes on Internet access shall not include recently enacted general business taxes in states meeting certain narrow criteria.[19] The legislative history explains that this provision was enacted in response to a small group of states that recently enacted gross receipts taxes that apply to almost all large businesses in the state, with the intention that such taxes apply to ISPs as well as other businesses.[20]

The new gross receipts taxes in these states, including Michigan, Texas, and Ohio, as well as the venerable Washington B&O tax enacted more than seventy years ago, either substitute for or supplement the corporate income tax currently in place in those states, whereas in most other states, the corporate income tax alone serves as the general business tax. The problem identified by Congress regarding those four states is that both the 1998 ITFA and the 2004 ITNA contained an explicit exception for corporate income taxes imposed on Internet access providers, but contained no exception for gross receipts taxes. Thus, it was thought that these states could suffer a disproportionate loss under the moratorium because their approach to general business taxation is not protected, while the more prevalent approach, a tax on corporate profits, was protected and could be used to tax profits earned from providing Internet access services.

The amendment addresses this problem by creating an exception for states that have enacted gross receipts taxes as a substitute for state corporate income taxes and not as taxes directed to Internet access. To be exempt, the state law must meet certain criteria. First, the law must have been enacted between June 20, 2005 and November 1, 2007, or, in the case of a state business and occupation tax (i.e., the Washington B&O tax), enacted after January 1, 1932, and before January 1, 1936.[21] Second, the law must replace, in whole or in part, a modified value-added tax or a tax levied upon or measured by net income, capital stock, or net worth.[22] Finally, the law must be imposed on a broad range of business activity and must not be discriminatory in its application to providers of communication services, Internet access, or telecommunications.[23]

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1 H.R. 3678, 110th Cong. (1st Sess. 2007).
2 47 U.S.C.S. 151 note Section 1100 et seq. (2000 & Supp. 4 2005).
3 Id. Section 1104(5).
4 47 U.S.C.S 151 note Section 1105(5) (2000 & Supp. 4 2005).
5 47 U.S.C.S. 151 note Section 1105(5)(C), (E) (2007).
6 47 U.S.C.S. 151 note Section 1105(5)(A) (2007).
7 47 U.S.C.S. 151 note Section 1105(5)(B)(i) (2007).
8 United States Government Accountability Office, Report to Congressional Committees GAO-06-273, Internet Access Tax Moratorium: Revenues Impacts Will Vary by State (Jan. 2006).
9 47 U.S.C.S 151 note Section 1108 (2000 & Supp. 4 2005).
10 47 U.S.C.S. 151 note Section 1105(5)(D) (2007).
11 47 U.S.C.S 151 note Section 1104(a)(1), (b)(1) (2000 & Supp. 4 2005).
12 For a detailed analysis of this issue, see J. Kratochvill and P. Sansone, "Too Many Grandfathers Spoil the Broth: The Failure of the Internet Tax Nondiscrimination Act?," 46 State Tax Notes 1 (Oct. 1, 2007).
13 47 U.S.C.S. 151 note Section 1104(c)(1)(A) (2007).
14 47 U.S.C.S. 151 note Section 1104(c)(1)(B) (2007).
15 47 U.S.C.S. 151 note Section 1104(c)(2)(A) (2007).
16 47 U.S.C.S. 151 note Section 1104(c)(2)(B) (2007).
17 47 U.S.C.S. 151 note Section 1104(c)(3).
18 H.R. Rep. No. 110-372 (2007).
19 47 U.S.C.S. 151 note Section 1105(10)(C) (2007).
20 H.R. Rep. No. 110-372 (2007).
21 47 U.S.C.S. 151 note Section 1105(10)(C)(i)(I) (2007).
22 47 U.S.C.S. 151 note Section 1105(10)(C)(i)(II) (2007).
23 47 U.S.C.S. 151 note Section 1105(10)(C)(i)(III), (IV) (2007). ❑

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Section 108(b)(1) provides that the amount excluded from gross income shall be applied to reduce the tax attributes of the taxpayer, and section 108(b)(2) stipulates the order in which those tax attributes are to be reduced. The first tax attribute to be reduced is any net operating loss for the taxable year of the discharge and any net operating loss carryover to such taxable year.[2] Section 108(d)(7) provides special rules for S corporations.

Section 108(d)(7)(A) provides that sections 108(a), (b), (c), and (g) are applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under section 108(a). As a result, the determination of insolvency for purposes of section 108(a) is made at the S corporation (and not the shareholder) level. Then, for purposes of the tax attribute reduction at the entity level (as required by section 108(b)(1)), section 108(d)(7)(B) provides that any loss or deduction which is disallowed under section 1366(d)(1) is treated as an NOL of the S corporation (Deemed NOL).[3] The proposed regulations under section 108 attempt to coordinate the shareholder-level rules of section 1366(d) with the entity-level rules of section 108(b)(1).

Section 1366(d) Suspended Losses

An S corporation shareholder's basis in stock is determined under general basis rules. When a taxpayer purchases stock from the S corporation, the stock basis equals its cost if section 351 does not apply (section 1012). If section 351 applies, the stock basis is determined by reference to the basis of the property transferred to the corporation, increased by any gain recognized by the shareholder on the transfer and decreased by any cash and the value of any other "boot" received (Section 358(a)(1)). If a taxpayer purchases stock from another shareholder, the shareholder obtains a cost basis in the stock under section 1012. Thus, the S corporation does not necessarily participate in the transaction by which a shareholder obtains stock and may not be aware of the shareholder's original basis in that stock.

Subsequently, under section 1367(a), the shareholder's basis is increased by items of income, nonseparately computed income and the excess of the deductions for depletion over the basis of property subject to depletion. Under section 1367(a)(2), the shareholder's basis is reduced by distributions by the corporation that were not includible in income by reason of section 1368, items of loss and deduction, nonseparately computed loss and deduction, any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

An S corporation shareholder also has basis in indebtedness of the S corporation to the shareholder. That basis can be reduced by losses, expenses that are nondeductible and not chargeable to a capital account, and depletion deductions. Debt basis is restored as provided in section 1367(b)(2)(B) and the regulations.

Section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under section 1366(a) (the shareholder's pro rata share of losses and deductions passed through by the S corporation) cannot exceed the sum of (A) the adjusted basis of the shareholder's stock in the S corporation for the taxable year and (B) the shareholder's adjusted basis in any indebtedness of the S corporation to the shareholder. Under section 1366(d)(2), any losses and deductions that are disallowed are treated as incurred by the S corporation in the succeeding taxable year *with respect to that shareholder.* Thus, any loss or deduction that is suspended under section 1366(d) is eliminated if the shareholder transfers the S corporation stock in a transaction that is not described in section 1041(a) (see section 1366(d)(2)(B) for exceptions for transfers between spouses or incident to divorce). See section 1.1366-2(b)(2).

The character of items included in the shareholder's pro rata share of income, loss, deduction or credit is determined as if such item were realized directly from the source from which realized by the corporation or incurred in the same manner as incurred by the corporation (section 1366(b)). If the aggregate amount of losses and deductions exceeds the shareholder's available basis, the limitation of section 1366(d) must be allocated among each loss or deduction such that a pro rata share of each loss or deduction is suspended. See section 1.1366-2(b)(3). As a result of these provisions, although the S corporation provides the information to the shareholder with respect to the basis adjustments provided in section 1367, the shareholder is responsible for determining the shareholder's basis in stock and debt that is available for the pass-through of losses and deductions and must calculate the amount of losses and deductions that may be suspended because of lack of basis.

Proposed Regulations under Section 108—The Mechanics

Prop. Treas. Reg. section 1.108-7(d) provides the

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special rules for S corporations. In general, the proposed regulations reiterate that, if an S corporation excludes COD income from gross income, the amount excluded is used to reduce the S corporation's tax attributes. For this purpose, the aggregate amount of the shareholders' losses or deductions that is disallowed for the taxable year of discharge,[4] including disallowed losses or deductions of a shareholder that transfers all of the shareholder's stock in the S corporation during the year of discharge, is treated as a Deemed NOL of the S corporation. If the amount of the S corporation's Deemed NOL exceeds the amount of the S corporation's COD income that is excluded under section 108, the Excess Deemed NOL is allocated back to the shareholders under the rules of the proposed regulations.

In the case of an S corporation with multiple shareholders, it is necessary to determine the amount of the Excess Deemed NOL to be allocated to each shareholder after reduction of the Deemed NOL for the excluded COD income. The proposed regulations provide that it is necessary to calculate with respect to each shareholder the shareholder's "excess amount." The excess amount is defined as the amount (if any) by which the shareholder's losses or deductions disallowed under section 1366(d)(1) (before any reduction for excluded COD income in the year of discharge) exceed the amount of COD income that would have been taken into account by the shareholder under section 1366(a) if the COD income had not been excluded under section 108(a). For example, assume an S corporation has two shareholders, A and B, each of whom owns 50 percent of the S corporation's stock. A has suspended losses of $40,000 and B has suspended losses of $20,000. The S corporation has COD income of $20,000 because of cancellation of the S corporation's debt to a bank. Under the rules of section 1366(a), A and B would each be allocated $10,000 of COD income if the S corporation is unable to exclude the COD income under section 108. If the income is excluded because the S corporation is insolvent, under the proposed regulations A's excess amount is $30,000 and B's excess amount is $10,000.

The proposed regulations provide that the Excess Deemed NOL, if any, is allocated among the shareholders in accordance with the following calculation: for each shareholder with an excess amount, the Excess Deemed NOL is multiplied by a fraction, the numerator of which is the shareholder's excess amount and the denominator of which is the sum of all shareholders' excess amounts. Continuing with the example above, the Excess Deemed NOL equals $40,000 (the total Deemed NOL of $60,000 ($40,000 + $20,000) minus the excluded COD income ($60,000 - $20,000). A's share of the Excess Deemed NOL is $30,000 ($40,000 x $30,000/$40,000) and B's share of the Excess Deemed NOL is $10,000 ($40,000 x $10,000/$40,000).

Example 6 of Prop. Treas. Reg. section 1.108-7(e) illustrates a fact pattern in which the shareholders' shares of the Excess Deemed NOL is less than each shareholder's excess amount. This will occur if a shareholder's pro rata share of excluded COD income exceeds the shareholder's total suspended losses. In Example 6, A and B each own 50 percent of X, a calendar year S corporation. On June 30, 2008, A sells all of her shares of X stock to C in a transaction not described in section 1014(a). For 2008 X excludes from gross income $12,000 of COD income. Had it not been excluded, the COD income would have been allocated $3,000 to A, $6,000 to B and $3,000 to C. Prior to the attribute reduction for the taxable year of discharge, the shareholders had the following losses disallowed under section 1366(d): A—$9,000; B—$9,000, C—$2,000. The combined $20,000 of suspended losses are treated as a current year NOL for purposes of section 108(a). Under section 108(b)(2)(A), X's $12,000 of excluded COD income reduces the $20,000 Deemed NOL to $8,000. Therefore, X has an Excess Deemed NOL of $8,000. A's excess amount is $6,000 ($9,000 - $3,000); B's excess amount is $3,000 ($9,000 - $6,000) and C has no excess amount ($2000 - $3000).

Shareholders with suspended losses bear the burden with respect to tax attribute reduction under section 108 while those with few or no suspended losses may not.

The total of all shareholders' excess amounts is $9,000. Under Prop. Treas. Reg. section 1.108-7(d)(2), X will allocate $5,333 of the $8,000 Excess Deemed NOL to A ($8,000 x $6,000/$9,000) and $2,667 of the Excess Deemed NOL to B ($8,000 x $3,000/$9,000). Because A transferred all of her X shares in a transaction not governed by section 1041(a), A's $5,333 of section 1366(d) losses are permanently disallowed under Prop. Treas. Reg. 1.108-7(d)(2)(iii). Moreover, because C does not have sufficient suspended losses to absorb C's total share of excluded COD income, the methodology prescribed in the proposed regulations effectively eliminates an additional $1,000 of A's and B's suspended losses in order to reduce the total Deemed NOLs of the

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S corporation by the full amount of the excluded COD income.

Example 5 of Prop. Treas. Reg. section 1.108-7(e) illustrates the character of the NOLs that are reduced under section 108(b) and those that are allocated back to the shareholders under the proposed regulations. As noted earlier, a shareholder's losses or deductions that are disallowed under section 1366(d)(1) consist of a pro rata share of the total losses and deductions allocated to the shareholder and retain that character as suspended losses. Under the general rules of section 108(b)(2), a taxpayer's net operating loss is reduced before any other tax attributes, such as capital loss carryovers. In order to be consistent with this ordering, the proposed regulations provide that the S corporation's Deemed NOL is treated as reduced (with respect to each shareholder) first by ordinary suspended losses, then by section 1231 suspended losses (because it is generally unclear whether the loss ultimately would be characterized as ordinary or capital until determined at the shareholder level) and, finally, by suspended capital losses. The Excess Deemed NOL that is allocated to the shareholders is treated as having the character of the type of losses that remain after the reductions prescribed by the proposed regulations.

Assume B in the example above had suspended losses with the following character: $3,000 of capital losses, $2,000 of section 1231 losses and $4,000 of ordinary losses. B's share of S corporation's Deemed NOL is reduced first by ordinary losses, then by section 1231 losses and finally by capital losses. As a result, all $2,667 of the Excess Deemed NOL allocated to B will consist of capital losses.

Proposed Regulations Information Sharing Requirements

The proper operation of the proposed regulations will require information to be provided by both the S corporation and the shareholder. Under Prop. Treas. Reg. section 1.108-7(d)(4), if an S corporation excludes COD income from gross income under section 108(a) for a taxable year, each shareholder of the S corporation during the taxable year of discharge must provide to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of discharge under section 1366(d). In addition, the S corporation must provide to each shareholder the amount of the S corporation's Excess Deemed NOL that is allocated to that shareholder after the attribute reduction required under the regulations, even if theamount is zero.

Conclusion

Two aspects of the proposed regulations can be problematic. First, the proposed regulations require information sharing but provide no details or potential consequences if inadequate, incorrect or untimely information is provided to the S corporation or to the shareholder. For example, if even one shareholder incorrectly calculates the shareholder's suspended losses, all of the shareholders of the S corporation are potentially affected and the S corporation's attribute reduction may be incorrect. If the regulations are finalized in their current form, it may be appropriate for the S corporation to consider obtaining shareholder basis information when the shareholder first acquires stock. Accordingly, the S corporation can calculate or confirm the shareholders' suspended loss amounts. Another possibility to consider is negotiation of an indemnity agreement to compensate the S corporation and its shareholders if incorrect information leads to potentially costly adjustments.

More significant, however, is the potentially different tax treatment of S corporation shareholders under the proposed regulations. Shareholders with suspended losses bear the burden with respect to tax attribute reduction under section 108 while those with few or no suspended losses may not. For example, assume two equal shareholders (A and B) are allocated equal shares of a loss. A has a zero basis and suspended losses of $100. B has zero basis but has no suspended losses because of a loan to the S corporation. If the S corporation has $100 of COD income that is excluded under section 108, A will bear the entire burden of the attribute reduction under the proposed regulations.[5] In addition, if the S corporation also has losses in the tax year that COD income is excluded, a shareholder who has basis remaining in stock or debt in that year may be able to use some or all of the shareholder's pro rata share of the losses because the determination of the corporation's deemed NOL is made after basis adjustments under section 1367(a)(2). See section 108(d)(7)(B).

Thus, despite the requirement of subchapter S that S corporations have a single class of stock and that each shareholder be allocated a pro rata share of income and loss, the proposed regulations effectively shift the burden of losses among the shareholders when COD income is excluded under section 108. In order to mitigate unintended consequences, S corporations and their shareholders should take the requirements of section 108(d) and the proposed regulations into account when restructuring the corporation's debt.

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[1]Section 1377(a)(1) provides the definition of "pro rata share"

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S Corporations *(from page 12)*

as the sum of the amounts with respect to the shareholder determined by assigning an equal portion of any item to each day of the taxable year and then by dividing that portion pro rata among the shares outstanding on that day.

[2]Section 108(b)(5) provides that the taxpayer may elect to apply any portion of the reduction first against depreciable property.

[3]In this connection, section 108(d)(7)(B) does not address the possibility that an S corporation may have a corporate net operating loss carryover from an earlier C year. It is unclear how such a carryover is treated for purposes of section 108(b) attribute reduction.

[4]Under section 1366(d)(2) any losses and deductions that are disallowed for a prior taxable year are treated as incurred by the corporation in the succeeding taxable year with respect to the shareholder.

[5]If B later contributes the S corporation debt to capital under section 108(e)(6), additional COD income may be avoided because section 108(d)(7)(C) provides that the shareholder's adjusted basis in indebtedness of the S corporation is determined without regard to adjustments under section 1367(b)(2).

CALIFORNIA

New Budget *(from page 3)*

and personal income taxpayers with net business income, of less than $500,000 for the tax year.

Assignment of Credits

The new law allows an "eligible credit" to be assigned by a taxpayer to a member of its combined reporting group for tax years beginning on or after July 1, 2008. The credit assigned can be applied by the eligible assignee only against the "tax" of the eligible assignee in a tax year on or after January 1, 2010. Generally, the eligible assignee is treated as if it originally earned the assigned credit. The election to assign any credit is irrevocable. The 50-percent credit cap imposed by A.B. 1452 applies to the assignee of credits.

The term "eligible credit" is defined to mean a credit earned by the taxpayer in a tax year beginning on or after July 1, 2008, or a credit earned in any tax year beginning before July 1, 2008, that is eligible to be carried forward to the taxpayer's first tax year beginning on or after July 1, 2008.

Penalties

The new law imposes a penalty of 20 percent of the amount of any corporate franchise tax underpayment in excess of $1 million. For taxpayers included in a combined report, the $1 million threshold applies to the aggregate combined group liability. The penalty applies to each tax year beginning on or after January 1, 2003, that remains open under the statute of limitations. The 20-percent penalty is in addition to any other penalty imposed.

The penalty will not be imposed on understatements attributable to a change in law (which includes regulation changes and rulings) that becomes final after the earlier of: (a) the date the taxpayer files a return for the tax year for which the change applies; or (b) the extended due date for the return of the taxpayer for the tax year for which the change applies. An additional safe harbor exists for understatements attributable to a taxpayer's reasonable reliance on a legal ruling by Chief Counsel of the Franchise Tax Board. For tax years beginning before January 1, 2008, the amount of tax paid on or before May 31, 2009, and shown on an amended return filed on or before that date, is treated as the amount of tax on an original return.

Observation. The 20-percent penalty, as applicable to franchise tax understatements for years beginning on or after January 1, 2003, and before January 1, 2008, can be avoided if the amount of the understatement is paid by May 31, 2009.

Refunds or credits of the 20-percent penalty will be allowed only on the grounds that the penalty was not properly computed.

Estimated Tax Payments

The new law accelerates the amount due on the first two installments of estimated tax payments. The required installments will be 30 percent of the tax due; 30 percent; 20 percent; and 20 percent, applicable to installments due for each tax year beginning on or after January 1, 2009. (Estimated taxes previously had to be paid in four equal installments.)

LLC Fee

The new law requires that the LLC fee under Cal. Rev. & Tax. Code section 17942 be estimated and paid by the 15th day of the sixth month of the current tax year.

Iowa Administrative Law Judge Applies Economic Nexus Standard and Imposes Tax on Royalty Income

By Bill Schenkelberg, Giles Sutton J.D., LL.M, and Chuck Jones (Grant Thornton LLP)

An Iowa administrative law judge has held that an intangible holding company that licensed trademarks to Kentucky Fried Chicken franchisees was subject to Iowa corporate income tax on the royalty payments that it received from Iowa franchisees even though the franchisor did not have a physical presence in the state.[1] In this case, the judge held that the franchise agreements created economic nexus with Iowa.

Background

The taxpayer was a Delaware corporation that maintained its principal place of business in Kentucky. The taxpayer's primary business was the ownership and licensing of restaurant trademarks and the related system designed to maintain a uniform restaurant product. Franchisees entered into franchise agreements with the taxpayer that authorized them to use the trademark and system[2] in connection with the operation of their restaurants. The taxpayer did not own any restaurants, offices, business locations, real property or employees located in Iowa. Further, the taxpayer did not perform any services in Iowa.

During the years in issue, the taxpayer received substantial royalties that were attributable to sales from franchisees located throughout the United States, including Iowa . The Iowa Department of Revenue argued that the taxpayer owed income tax on the royalties under Iowa law and Department administrative rules. The taxpayer argued that taxation of this income was unconstitutional because it did not have sufficient contacts with the state.

Nexus Statute and Rule

An Iowa statute imposes the corporate income tax on corporations doing business in the state or deriving income from sources within the state.[3] "Income from sources within this state" includes income from real, tangible or intangible property located or having a situs in Iowa.[4] A Department rule provides that "intangible property located or having a situs within Iowa" includes intangible property that has become an integral part of some business activity occurring regularly in Iowa regardless of where the corporation which owns the property has its commercial domicile.[5] The Department rule lists examples of intangible property, including copyrights, franchises and contracts. Further, the Department rule expressly cites to *Geoffrey, Inc. v. South Carolina Tax Commission*, a seminal economic nexus case.[6]

Franchise Agreements Created Economic Nexus with State

The administrative law judge held that the taxpayer owed Iowa corporate income tax under the existing Iowa nexus statute and the Department rule discussed above. The taxpayer derived income from the restaurants located in Iowa. The intangible franchise rights were enforceable in Iowa and clearly were from Iowa sources. The administrative law judge rejected the taxpayer's argument that taxation of the royalty income was unconstitutional. Citing *Quill Corp. v. North Dakota*,[7] the judge noted that the U.S. Supreme Court has held that physical presence is necessary for nexus only for sales and use tax purposes. The judge also explained

The taxpayer's franchise right was an intangible with a direct connection to the state.

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Bill Schenkelberg (Bill.Schenkelberg@GT.com) is a Senior Manager, Giles Sutton (Giles.Sutton@GT.com) is a Partner, and Chuck Jones (Chuck.Jones@GT.com) is a Manager, with Grant Thornton LLP. Mr. Schenkelberg is head of the Wisconsin State and Local Tax Practice (SALT) in the Milwaukee office. Mr. Sutton is Practice Leader, State & Local Technical Services, in the Charlotte office. Mr. Jones manages the SALT practice in the Chicago office.

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that many nexus arguments concern the substantial nexus requirement expressed in *Complete Auto Transit, Inc. v. Brady*.[8] After agreeing with the Department that the physical presence requirement does not apply to income tax, the judge noted that the taxpayer had been skillful in arranging its business to avoid the bright-line nexus tests that apply to use tax.[9]

In finding that the taxpayer's royalty income was subject to Iowa tax, the administrative law judge explained that the royalty income was from business in Iowa. When a customer purchased items from a franchisee in Iowa, the franchisee was obligated to send part of the gross receipts to the taxpayer. The taxpayer's franchise right was an intangible with a direct connection to the state. Further, according to the judge, the taxpayer enjoyed all of the rights and privileges of conducting business in Iowa.

Commentary

The Iowa income tax nexus statute imposes the tax on corporations that derive business from sources in Iowa. The related Department rule expressly adopts an economic nexus standard. The administrative law judge found that both the statute and Department rule subjected the taxpayer's royalty income to tax. Further, the judge found that the imposition of the tax on this income was constitutional.[10] This decision follows the state court trend of finding that the physical presence requirement does not apply to income tax nexus.

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1 *KFC Corp. v. Department of Revenue*, Iowa Dept. of Inspections and Appeals, Administrative Hearings Division, No. 07DORFC016, Aug. 8, 2008.

2 In a franchising context, a "system" generally refers to a system of operation which impacts a number of operational touch-points including, but not limited to, store layout, common point of sale systems, training and, in many cases cooperative advertising spend.

3 IOWA CODE § 422.33.

4 IOWA CODE § 422.33(1).

5 IOWA ADMIN. CODE r. 701-52.1(1)d.

6 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). In *Geoffrey*, the South Carolina Supreme Court held that an intangible holding company had substantial nexus with the state for income tax purposes because it had an economic presence. According to this decision, physical presence is not required for income tax nexus.

7 504 U.S. 298 (1992).

8 430 U.S. 274 (1977). In *Complete Auto Transit*, the Court specified the following four rules that a tax must meet to satisfy the Commerce Clause: the tax (1) is applied to an activity with substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interest commerce and (4) is fairly related to the services provided by the state.

9 Under IOWA CODE § 423.29, "[e]very seller who is a retailer maintaining a place of business in this state and selling tangible personal property for use in Iowa shall, at the time of making the sale, whether within or without the state, collect the use tax."

10 The administrative law judge considered that the taxpayer's royalty income was derived from business in Iowa. Therefore, the decision seems to rest, in some measure, on the taxpayer "doing business" in the state. A Department rule provides that "[t]he term 'doing business' is used in a comprehensive sense and includes all activities or any transactions for the purpose of financial or pecuniary gain or profit. Irrespective of the nature of its activities, every corporation organized for profit and carrying out any of the purposes of its organization shall be deemed to be 'doing business.' In determining whether a corporation is doing business, it is immaterial whether its activities actually result in a profit or loss." IOWA ADMIN. CODE r. 701-52.1(1)a. ❑

Pennsylvania Expands Its Educational Improvement Tax Credit Program

By Stephen D. D. Hamilton and Drew A. Morris (Drinker Biddle & Reath LLP)

Tax incentives can be quite rewarding--especially if you can receive more than a dollar back from the government for each dollar you spend. The Commonwealth of Pennsylvania has a tax credit for contributions to educational institutions that has exactly that effect, and legislation enacted last month has now expanded the scope of the credit.

The Educational Improvement Tax Credit

Pennsylvania enacted an education tax credit for Pennsylvania corporate taxpayers in May 2001. The Educational Improvement Tax Credit is a tax credit granted to a taxpayer that donates to a qualifying scholarship organization or educational improvement organization, in an amount equal to 75 percent of the amount of such a donation. The amount of the tax credit is also increased to 90 percent of the donated amount if the taxpayer provides a written commitment to donate the same amount for two consecutive years. In either case, the combined effect of the Pennsylvania tax credit and the Federal income tax benefit resulting from the charitable contribution deduction for the same donation can quite easily exceed 100 percent of the donation amount.

The amounts of credits are subject to individual annual limitations, as well as a statewide cap on the total amount of credits that may be awarded. To receive tax credits, taxpayers must be approved to make contributions to scholarship organizations, educational improvement organizations or pre-K scholarship organizations that are on the list published by the Pennsylvania Department of Community and Economic Development. The current list of approved organizations and the necessary application form for applying for credit approval can be found on the Department's web site at www.newPA.com/EITC.

Recent Changes Expand the Educational Improvement Tax Credit

Gov. Edward G. Rendell signed into law a new act extending the Educational Improvement Tax Credit on July 9, 2008, making the tax credit available not just to corporate taxpayers, but also to pass-through entities such as partnerships, limited liability companies and S corporations. The act also provides that a pass-through entity that does not use all approved tax credits may elect, in writing, to transfer all or a portion of the credit to the entity's owners in proportion to their ownership percentages.

In addition, the new act increases the annual credit limits per taxpayer from $200,000 to $300,000 for donations to scholarship and education improvement organizations, and from $100,000 to $150,000 for donations to pre-kindergarten scholarship organizations. Moreover, for contributions to pre-kindergarten scholarship organizations a taxpayer may now receive a tax credit equal to 100 percent of the first $10,000 contributed and up to 90 percent of the remaining amount contributed, up to a maximum total credit of $150,000 per year.

Steve Hamilton (stephen.hamilton@dbr.com) is a Partner, and Drew Morris (drew.morris@dbr.com) is an Associate, in the Philadelphia office of Drinker Biddle & Reath LLP. Their practices focus primarily on business-related tax matters, including federal, state and local taxes with respect to corporations, partnerships, LLCs and individuals, including advice and representation with respect to mergers and acquisition transactions, formation of business entities, other tax planning matters, and tax litigation.