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EDWIN P. ANTOLIN AND TROY M. VAN DONGEN, CO-EDITORS
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STATE & LOCAL TAX GROUP

SAN FRANCISCO

Thomas H. Steele	(415) 268-7039 tsteele@mofo.com
Charles J. Moll III	(415) 268-7045 cmoll@mofo.com
Peter B. Kanter	(415) 268-6005 pkanter@mofo.com
Edwin P. Antolin	(415) 268-6497 eantolin@mofo.com
Andres Vallejo	(415) 268-6793 avallejo@mofo.com
Pilar M. Sansone	(415) 268-6125 psansone@mofo.com
Troy M. Van Dongen	(415) 268-6721 tvandongen@mofo.com

DENVER

Thomas H. Steele	(303) 592-2243 tsteele@mofo.com

NEW YORK

Paul H. Frankel	(212) 468-8034 pfrankel@mofo.com
Hollis L. Hyans	(212) 468-8050 hhyans@mofo.com
Craig B. Fields	(212) 468-8193 cfields@mofo.com
Irwin M. Slomka	(212) 468-8048 islomka@mofo.com
Michael A. Pearl	(212) 468-8135 mpearl@mofo.com
Amy F. Nogid	(212) 468-8226 anogid@mofo.com
Roberta Moseley Nero	(212) 506-7214 rnero@mofo.com
Behir Sabban	(212) 258-5843 bsabban@mofo.com

SACRAMENTO

Eric J. Coffill	(916) 325-1324 ecoffill@mofo.com
Carley A. Roberts	(916) 325-1316 croberts@mofo.com

WASHINGTON DC

Linda A. Arnsbarger	(202) 887-1598 arnsbarger@mofo.com

NEW JERSEY'S BUSINESS TAX REFORM ACT: THE ISSUES ABOUND

By Hollis L. Hyans (HHyans@mofo.com) &
Amy F. Nogid (ANogid@mofo.com)

In one of the most comprehensive pieces of state tax legislation to be passed in recent memory, New Jersey enacted the Business Tax Reform Act ("BTRA") in 2002. P.L. 2002, ch. 40. Rarely has a state legislature paid less heed to constitutional constraints. There is no question that many of the BTRA's provisions will not only give rise to litigation, and, given the tenuous legal bases for some of the provisions, also likely be declared unconstitutional.

Nevertheless, the BTRA may have benefits to neighboring states. While the Legislature agreed with the Division of Taxation's conclusion that increasing taxes would not lead to a mass exodus of businesses and jobs from the State, as corporations discover the magnitude of the tax effect of the legislation, corporations may well curb their plans for expansion, if not consider outright relocation. The negative impact of this legislation was borne out in a study that concluded that 13,500 jobs would be lost and companies will limit their spending as a result of the BTRA. Michael L. Diamond, *Study: Tax Hike Threatens Jobs,* South Jersey News, Apr. 29, 2003. Other commentators have opined that corporations seldom leave states for tax purposes and that the "relative disadvantage" of doing business in New Jersey will decline "as other states address their own budget deficits." *See, e.g.,* Robert Tannenwald, *Business Tax Climate:*

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How Should It Be Measured and How Important Is It? 96 STN 98-14, May 20, 1996. Whether the State's gamble will pay off is unclear and may take years to assess.

Background and Legislation's Goals

The message sent to the Legislature by the State Treasurer was clear — the State's tax system was "broken" and could no longer curb the "runaway erosion of the CBT [Corporation Business Tax] revenue base" caused

> *The State is codifying an economic nexus standard consistent with its regulatory provision, which was promulgated in 1996 in response to* Geoffrey

by the "proliferating loopholes" that allow corporations to avoid paying tax to the State. Testimony of John E. McCormac before the Assembly Budget Committee (May 30, 2002). While the Treasurer stressed the importance of "level[ing] the playing field for all businesses" by eliminating the ability of multistate corporate taxpayers to "export" their profits, *id.*, in actuality, the legislation goes far beyond the purported loophole closing by importing income into New Jersey that is wholly unrelated to a corporation's operations in the State.

Significant Provisions

The BTRA is an ambitious piece of legislation that touches on a wide-range of tax-related issues and so called "loophole closers." Senate Budget and Appropriations Committee Statement to Senate No. 1556. Expansion of nexus, add back of related party expenses, adoption of a throwout rule to be used in computing the sales factor, enactment of an additional method for computing the CBT, *i.e.*, the alternative minimum assessment, grant of authority to the Director to force consolidated reporting, passthrough entity fees and withholding requirements, limitation on the amount of the dividends received deduction, increase of the minimum tax, and changes in the estimated tax provisions, are just a few of the issues raised by the BTRA. This article considers just the first four.

Nexus Expansion

The first instance of constitutional infirmity is the State's expansion of its subjectivity provisions to reach corporations "deriving receipts from sources within the State" and "engaging in contacts within this State." N.J. Stat. Ann. § 54:10A-2. Basically, the State is codifying an economic nexus standard consistent with its regulatory provision, which was promulgated in 1996 in response to *Geoffrey,* a case whose constitutional analysis is suspect and is therefore of dubious value. N.J. Admin. Code tit. 18, § 7-1.9(b)*; Geoffrey, Inc. v. S.C. Tax Comm'n,* 437 S.E.2d 13 (S.C. 1993). The regulation, and the State's attempt to adopt an economic nexus standard, have been challenged in a case that remains pending in the New Jersey Tax Court. *Lanco, Inc. v. Dir., Div. of Taxation*, No. 005329-1997 (N.J. Tax Ct. 1997). Despite the absence of a decision in *Lanco*, the Division cites the case to support its position that an out-of state finance company would have nexus for both the CBT and the alternative minimum tax because of its lending activities with in-State affiliates. *Questions & Answers Regarding the Business Tax Reform Act 2002*, Question No. 46(e), 2003 N.J. Tax Rep. (CCH) ¶ 400-876 (Div. of Taxation Jan. 9, 2003).

The adoption of an income tax nexus standard based solely upon receipt of income ignores the U.S. Supreme Court precedent set out by *Quill* requiring that physical presence exist before a state can require an entity to collect sales or use taxes. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Although commentators and practitioners debate whether the *Quill* physical presence standard applies to income or business activity taxes, several courts and tribunals have already held that it does (*see, e.g., In re Cerro Copper Prods., Inc.,* No. F-94-444, 1995 Ala. Tax LEXIS 211 (Dep't of Revenue Dec. 11, 1995);

In re Dial Bank, Nos. INC. 95-289, F 95-308, 1998 Ala. Tax LEXIS 196 (Dep't of Revenue Aug. 10, 1998); *In re Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000); *SYL, Inc. v. Comptroller*, No. 24-C-99-002389 AA (Md. Cir. Ct. Mar. 17, 2000); *Guardian Indust. Corp. v. Michigan*, 499 N.W.2d 349 (Mich. Ct. App. 1993); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000)) while others have gone the other way (*Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. 2000); *Truck Renting & Leasing Ass'n v. Comm'r of Revenue*, 746 N.E.2d 143 (Mass. 2001); *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225 (Ohio 1996); *Geoffrey Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001)). New Jersey has now by statute joined a growing cadre of states that seek to shift tax burdens to out-of-state entities. We anticipate that U.S. Supreme Court intervention will be necessary to resolve this issue.

Many States, like New Jersey, have relied upon technological and business changes to justify their expansive nexus positions. However, such reliance upon the "tremendous social, economic, commercial, and legal innovations" as a basis for rendering the physical presence standard obsolete has already been soundly and decisively rejected by the U.S. Supreme Court in *Quill*. *Quill*, 504 U.S. at 301 (citation omitted).

Other grounds asserted by States to justify taxation based solely on mere economic presence include the argument that they are providing the customer base or "an economic climate that fosters demand." *Id*. at 304 (citation omitted). *Quill* likewise rejected this argument. In fact, during oral argument in *Quill*, North Dakota's Attorney General was asked, in response to North Dakota's attempt to impose a use tax collection responsibility despite the company's lack of substantial in-State physical presence, "What do you want for nothing?"

Upcoming Conferences

Following is a list of major open conferences through December 31, 2003, in which Morrison & Foerster attorneys will be participating.

July 29, 2003
Denver State & Local Tax Breakfast Club
Denver, Colorado
Speaker: Thomas H. Steele
Contact: Tammy W. Stockton
(303) 290-1613

August 23, 2003
PLI's State & Local Taxation Program
New York, New York
Speaker: Hollis L. Hyans
Contact: Customer Relations
(800) 260-4754

September 3, 2003
Morrison & Foerster Property Tax Conference
San Francisco, California
Speakers: Thomas H. Steele, Charles J. Moll III, and Peter B. Kanter
Contact: Troy M. Van Dongen
(415) 268-6721

September 30, 2003
NESTOA Annual Conference
Baltimore, Maryland
Speaker: Paul H. Frankel
Contact: (410) 767-1555

October 23, 2003
Chicago Tax Club Fall Seminar
Rosemont, Illinois
Speaker: Paul H. Frankel
Contact: Robert Berls
(312) 798-1249

October 24, 2003
Tenth Annual Vanderbilt-Paul J. Hartman SALT Forum
Nashville, Tennessee
Speaker: Paul H. Frankel
Contact: Donna Smith
(615) 822-6960

November 7, 2003
California Tax Policy Meeting
San Francisco, California
Speakers: Paul H. Frankel and Charles J. Moll III
Contact: Charles J. Moll III
(415) 268-7045

December 11–12, 2003
Institute on State and Local Taxation at NYU
New York, New York
Speakers: Paul H. Frankel, Thomas H. Steele, Craig B. Fields, and Hollis L. Hyans
Contact: (212) 998-7171

Quill Corp. v. North Dakota, No. 91-194, 1992 U.S. TRANS LEXIS 189, at *28 (U.S. Jan. 22, 1992). The answer in New Jersey and the other states that are attempting this ploy is obviously "as much as we can get away with."

Disallowance of Related Member Interest and Interest and Intangible Expenses and Costs

Not content with simply expanding its taxpayer base through its expansive nexus provision, the State also expanded its tax base by disallowing deductions for particular types of expenses paid to a related member. N.J. Stat. Ann. § 54:10A-4.4. The motivation for New Jersey's "anti-PIC" (passive investment company) legislation was what the Division termed "*Geoffrey* situations," even though *Geoffrey* involved the assertion of nexus over a PIC and not the disallowance of expenses. Summary to Regulations; *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993). The Division also refers to the recent Massachusetts decisions in *Sherwin-Williams* and *Syms* as presenting the factual situations that the legislation was targeting. *Sherwin-Williams Co. v. Comm'r of Revenue*, 778 N.E.2d 504 (Mass. 2002); *Syms Corp. v. Comm'r of Revenue,* 765 N.E.2d 758 (Mass. 2002). However, while the New Jersey legislature and the Division look askance at the creation of special-purpose intellectual property companies, as was done in *Geoffrey*, in *Sherwin-Williams* the Massachusetts Supreme Judicial Court recognized that such corporate structures can involve the "creation of a viable business entity engaged in substantive business" and that if the "benefits and burdens of owning the [intangible property]" transferred to the new company, the owner of the intangible property is entitled to receive royalties from those who use the value of the intangible property. *Sherwin-Williams Co.*, 778 N.E.2d at 517-18.

New Jersey has enacted two different types of deduction disallowance provisions, containing similar but not identical exceptions to their application. The first disallowance provision applies solely to interest payments that are made to a related member and requires that all interest expenses paid to related parties be added back to the payor's income. As the Treasurer stated, the interest addback provision was intended to combat the sheltering of income "by sending it to subsidiaries or affiliated companies in other states that have less tax or no tax. This is done under the guise of 'interest' being paid by the New Jersey company on a 'loan' from an out-of-state affiliate." Testimony of John E. McCormac before the Assembly Budget Committee (May 30, 2002). The second addback provision covers expenses related to intangible property, and requires that interest and intangible expenses and costs paid to related parties be added back in computing the taxpayer's New Jersey entire net income. Even though both addback provisions were intended to address the purported "sheltering" of income, the exceptions to the interest addback are nonetheless more generous than those that apply to the intangible expenses provision.

In order for the exception to the interest addback to apply, five requirements must be met: (1) "a principal purpose of the transaction giving rise to the payment of interest was not to avoid taxes otherwise due;" (2) "the interest is paid pursuant to arm's length contracts at an arm's length rate of interest; and (3)(i) "the related member was *subject to tax* on its net income or receipts" (emphasis added); (ii) the interest income is included in the measure of the tax; and (iii) "the rate of tax applied to the interest received by the related member is equal to or greater than a rate three percentage points less than the rate of tax applied to taxable interest in this State." N.J. Stat. Ann. § 54:10A-4(k)(2)(I).

The requirements are not as straightforward as they might seem, and even the Division has shifted its position "[a]s a result of further review." N.J. Div. of Taxation Web Site Notices (updated May 1, 2003), *available at* http://www.state.nj.us/treasury/taxation/webnotice.htm. For example, the original version of the regulations provided that "subject to tax," in exception 3(i) above, means to "actually pay tax." Summary to Regulations at 10. Thus, if the related member has no net income and therefore pays no tax, the interest would be disallowed, even though the interest is included in the measure of the tax in another state. However, upon reflection, the Division adopted "a lower threshold," apparently recognizing correctly that its original position is egregious in effect and constitutionally questionable. N.J. Div. of Taxation Web Site Notices, *supra.* The Department's position now is that the related member must only include the interest in the calculation of its tax, to meet that element of the exception requirements.

Predicating the exception upon the effective rate paid on the interest in another jurisdiction is another example of the legislation's overreaching. In effect, New Jersey takes the position that if another state's tax rate is too low, New Jersey is entitled to tax the additional untaxed income. A taxpayer's New Jersey tax liability should not be based upon which jurisdictions outside of New Jersey a taxpayer or its affiliates choose to do business in. Thus, the fact that an affiliate does business in Nevada as opposed to New York, for example, should not effect the determination of the CBT liability of the taxpayer in New Jersey. Nonetheless, under New Jersey's interest addback scheme, that is precisely what can occur. Such a tax scheme obviously raises serious constitutional concerns.

In addition to the specific exception provision, the statute allows interest deductions where disallowance of the deduction would be "unreasonable," or the taxpayer is able to reach an agreement with the Director for the use of an alternative apportionment method. *Id.*

The exceptions to the intangible expense addback requirement are different from those provided for interest expenses. The exceptions apply when (1) the intangible expenses are paid to a related member in a foreign country that has a "comprehensive" treaty with the United States; or (2) the taxpayer can establish "by clear and convincing" evidence that a disallowance would be "unreasonable;" or (3) the taxpayer and the Director agree on the use of an alternative method. N.J. Stat. Ann. § 54:10A-4.4(c)(1). The statute provides that the exception provisions for the interest and intangible expense addbacks do not "limit or negate the director's authority to otherwise enter into agreements and compromises otherwise allowed by law." *Id.* In addition to the foregoing exceptions, "portions" of the intangible expenses are not required to be added back if a taxpayer establishes by a "preponderance" of the evidence that (1) the payor is acting as a conduit from an unrelated entity; *and* (2) the principal purpose of the transaction was not the avoidance of New Jersey taxes. N.J. Stat. Ann. § 54:10A-4.4(c)(3).

While addback provisions may not themselves be constitutionally infirm, the computation of the exceptions raises constitutional issues, particularly if a taxpayer's New Jersey tax liability is determined by reference to the business it does in another state. Furthermore, additional safety mechanisms should be enacted to ensure that multiple taxation does not occur when the addback and the expanded nexus provisions are viewed in tandem.

Throwout

Perhaps the Department's boldest attempt to tax income that is beyond its taxing jurisdiction is the new "throwout" rule. The throwout rule provides that receipts that are not "subject to a tax on … or measured by profits or income or business presence or business activity" in another jurisdiction are excluded from the denominator of the sales factor of the New Jersey apportionment formula. N.J. Stat. Ann. § 54:10A-6; N.J. Admin. Code tit. 18, § 7-8.7. Thus, if receipts are assigned to a state that has chosen not to assert a net worth, gross receipts or single-business tax, receipts that would otherwise be properly attributable to such jurisdiction would be thrown out from the denominator of the sales fraction. Again, New Jersey adopts the novel view that it may tax income attributable to another state if that state chooses not to tax such income.

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Recent California FTB Administrative Developments

By Eric J. Coffill (ecoffill@mofo.com)

Subsequent to the last issue of *Insights*, there have been a number of administrative developments regarding the California Franchise Tax Board (FTB) which should be of interest to taxpayers and practitioners.

FTB Notice 2003-3 (April 29, 2003) — Earlier MIC Ruling Is Withdrawn

FTB has announced it has withdrawn Legal Ruling 2001-4, in light of the FTB's loss last year before the California State Board of Equalization in *Appeals of Jon and Rita Minnis and Milpitas Materials Company*, 2002-SBE-003, June 20, 2002. The issue involves what constitutes "qualified property" under the California Manufacturer's Investment Credit (MIC). *Minnis* held that a ready mixer truck, comprised of a truck chassis and mixer barrel (including the accompanying components and hydraulic system) constitutes a "single integrated piece of manufacturing equipment," and thus the entire truck satisfied the requirement of "qualified property" for purposes of the MIC. The FTB's position in *Minnis*, as well as its position in (now withdrawn) Legal Ruling 2001-4 was that cement trucks should be treated as "dual-purpose assets," so that the concrete mixing drum and related truck-mounting equipment might qualify for the MIC, but that the cost of the truck or trailer chassis would not constitute "qualified property."

FTB's track record before the SBE in MIC cases, at least so far, has been abysmal. Minnis was a clear statement by the SBE in 2002 (i.e., last year's Board), as the SBE had earlier stated in their decision in *Appeal of Save Mart Supermarkets & Subsidiary*, 2002-SBE-002, op. on rehg. February 6, 2002, that the MIC should be interpreted broadly in favor of taxpayers. Whether this same philosophy will carry over to the SBE, as reconstituted after January 1, 2003, is unclear.

FTB Notice 2003-4 (May 5, 2003) — Sourcing Gains from Intangible Property

FTB staff has prepared a discussion draft of proposed amendments to FTB Regulation 17952 to address the timing and sourcing of gains on the sale or transfer of intangible personal property by individuals who change residency. FTB proposes to amend the current regulation to include the following language:

The source of gains and losses from intangible personal property is determined at the time of the sale or transfer of the property. For example, if a California resident sells intangible personal property under the installment method, and subsequently becomes a nonresident, any later recognized gain attributable to any installment payment receipts relating to that sale will be sourced to California. Further, a full-year California nonresident who sells intangible personal property would be taxed by California on gain as it is recognized upon receipt of future installment payments if the intangible personal property had a business situs in California at the time of the sale.

This amendment is generally consistent with FTB's audit position, and appears consistent with the position taken by the FTB in *Venture Communications, Inc. et. al.*, 2003 Cal. Tax LEXIS 31, February 5, 2003, an unpublished, non-precedential SBE decision. There the SBE held a California non-resident shareholder of a C corporation, which converted to an S corporation, was not taxable under a "built-in gain" theory proposed by FTB, on income the shareholder received from the corporation's sale of a partnership interest (where the partnership had substantial activities in California). However, this amendment was not motivated by *Venture Communications*, but instead by the passage of AB 1115, which is discussed below. This proposed change should be of interest to California residents who sell intangible property and then change their residency to another state, e.g., Nevada.

FTB Notice 2003-5 (May 6, 2003) — Informal Claims for Refund

In 2001, the California Legislature amended the Revenue and Taxation Code to provide that a claim for refund which is otherwise valid, but is made before full payment of the disputed tax has been made, is sufficient to toll the statute of limitations. This "informal" claim for refund must later be perfected. This Notice provides guidance regarding how such informal refund claims should be filed with FTB.

FTB Notice 2003-6 (May 6, 2003) — Small Business Stock Deferral Election

In 2002, the California Legislature amended the Revenue and Taxation

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Code to expand the types of taxpayers that may elect to rollover gain from the sale of qualified "small business stock." This Notice explains the procedure (and forms) for making the election to defer such gains from the sale of qualified small business stock.

FTB Legal Ruling 2003-1 (April 7, 2003) — Sourcing Certain Gains for Part-Year Residents

In 2001, the California Legislature passed AB 1115 (Stats. 2001, ch. 920), which made significant changes to the calculation of California taxable income for taxpayers who changed from resident to nonresident status, or vice versa, for years beginning on or after January 1, 2002. AB 1115 was sponsored by the FTB, which characterized the bill in its analysis as making "comprehensive changes in the manner that nonresidents and part-year residents are taxed." This Legal Ruling provides guidance to taxpayers regarding the inclusion and sourcing of items to be reported from partnerships (including limited liability companies classified under federal and California tax law as partnerships), S corporations, and certain trusts when the partner, shareholder or beneficiary is a part-year resident during any part of its own or the partnership's, S corporation's, or trust's taxable year. FTB staff intends to propose regulations which are consistent with the principles set forth in the Ruling.

FTB Legal Ruling 2003-2 (May 6, 2003) — 936 Corporations and Profit Split

This Ruling addresses a corporate tax issue which only will be relevant if a California water's-edge election has been made or is being contemplated and a possessions corporation is involved. The Ruling states that California has not conformed to the federal "profit split" method of allocating income and deductions of a possessions corporation under IRC 936(h)(5)(C)(ii)(1). This means that a California water's-edge taxpayer does not have a right to use the federal profit split method to allocate income and deductions involving a 936 possessions corporation which was excluded from the unitary group under the election. This is a formalization of a position which FTB has taken informally for a number of years. However, as long as use of the profit split method meets the "clearly reflects income" requirement found in Revenue and Taxation Code section 25114, the argument still can be made that FTB need not make any adjustments to transactions between possessions corporations and their affiliates to place the transactions on an arm's-length basis.

The full text of all the above items can be found on the FTB website at www.ftb.ca.gov.

California's Pending "Anti-Tax Shelter" Legislation Threatens to Add Substantial Hurdles and Penalties for Tax Planning

By Peter Kanter (PKanter@mofo.com)

Legislation currently pending in California threatens to impose a restrictive economic substance rule and increased penalties on taxpayers. Dubbed the "Anti-Tax Shelter & Tax Avoidance Initiative" by the Franchise Tax Board ("FTB"), Senate Bill 614, 2003-2004 Leg., Reg. Sess. (pending in Cal. Asm. Appropriations Comm. July 10, 2003) ("S.B. 614") which was introduced on May 12, 2003, has recently passed the floor vote in the Senate and is currently in committee in the Assembly.

The bill is aimed at what its supporters have labeled "abusive tax shelters." However, the bill's broad definition of what constitutes an "abusive tax shelter" could surprise many taxpayers. As stated in the FTB's legislative analysis: "Specifically, this bill modifies existing statutes and enhances penalties to mitigate the attractiveness of these shelters to tax preparers, promoters and participants. Finally, the bill provides a chance for participants to avoid enhanced penalties this bill would create, if the participants pay all tax and interest underpaid from using these transactions." The legislation contains several provisions targeting taxpayers that are deemed to have employed abusive tax shelters or engaged in "tax avoidance." It also provides penalties and reporting requirements for tax preparers and advisors who promote the use of tax shelters or assist taxpayers in effecting them. Additionally, the bill provides a "voluntary compliance" program that allows taxpayers to avoid many of the new penalties if the taxpayer files amended returns reversing the tax benefits sought in prior years by use of a tax avoidance transaction, and if the taxpayer waives the right to protect or seek refunds.

Although the bill contains no express definition for "abusive tax shelter," it does provide a codification of the "economic substance doctrine" ("ESD"), which would be used to

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determine whether a taxpayer has engaged in an invalid tax avoidance transaction. The legislation's formulation of the ESD would require taxpayers to meet the most stringent application of that doctrine as it is currently applied by some courts. For example, S.B. 614 would require taxpayers to establish both a "meaningful change in economic position," as well as a "substantial non-tax purpose" to avoid application of the ESD. Moreover, the proposed legislation would not allow a taxpayer to establish a meaningful change in economic position with evidence of favorable non-California income tax benefits, such as foreign tax or estate tax planning.

Several other provisions currently in the bill could threaten not only current and future planning, but planning for prior years as well. For example:

- The bill applies in a number of instances to transactions occurring after January 1, 1999 and thus is retroactive in effect.
- The bill would create a 40% penalty (reduced to 20% if relevant facts were adequately disclosed on the tax return) for understatements from transactions lacking economic substance (or which are overturned under a similar rule of law such as "sham transaction"). The new penalty apparently would apply even if the taxpayer had substantial authority for the transaction, because, as currently drafted, the penalty is a strict liability penalty and can be waived only by approval of senior management at the FTB. The penalty would apply to "determinations" made after January 1, 2004 (which thus could involve transactions that occurred after January 1, 1999).
- The bill would impose for the first time a penalty for failure to file a return disclosing "reportable transactions," which are defined by reference to the federal temporary regulations implementing Internal Revenue Code section 6011.
- The bill would create several reporting requirements and potential penalties for "material advisors" and tax preparers, and it would exclude communications regarding tax shelters between a taxpayer and a federally authorized tax practitioner from the privilege provided by existing confidentiality provisions.
- The bill would extend the statute of limitations for "abusive tax shelters" from four to eight years, and would expand the FTB's authority to issue subpoenas.
- The bill introduces a "voluntary compliance initiative" (effective from January 1, 2004 through March 31, 2004) whereby taxpayers may file amended returns reversing the tax benefits sought in prior years, pay the additional tax and thereby avoid the new penalties and interest contained in the legislation.

If enacted in its current form, S.B. 614 would also threaten taxpayers with penalties for past, present and future tax years.

We will be watching the bill closely and will report on its status in a future issue. If you have any specific questions regarding S.B. 614, please contact Peter Kanter at (415) 268-6005.

W.R. Grace & Co. — Conn. v. Comm'r Revenue

By Paul H. Frankel (PFrankel@mofo.com) & Michael A. Pearl (MPearl@mofo.com)

On July 2, 2003, the Massachusetts Appeals Court affirmed, in major part, the decision of the Appellate Tax Board rejecting the Department of Revenue's attempt to treat as apportionable income the gains from W.R. Grace & Co.'s sale of stock in several subsidiaries held as investments. *W.R. Grace & Co. — Conn. v. Comm'r of Revenue*, No. 00-P-254, 2003 Mass. App. LEXIS 731 (App. Ct. July 2, 2003).

The Appeals Court agreed with the Board that Massachusetts is constitutionally prohibited from taxing the income derived from Grace's sale of its 54% interest in Herman's Sporting Goods chain and 74% interest in El Torito Restaurants because those operations were not part of Grace's unitary business. The Court noted that (although "Grace exercised some supervision of the subsidiaries, [it was] … the kind of oversight that a parent would typically give to an investment in a subsidiary," and (2) the administrative services provided by Grace on an arm's length basis after they became public companies "did not embody the requisite flow of value to create a unitary business relationship."

[Paul H. Frankel and Michael A. Pearl served as co-counsel for W.R. Grace & Co.] ■

Further, whether another state has thrown back the same receipts does not preclude those same receipts from being thrown out from New Jersey's sales factor, since New Jersey does not consider those receipts as being assigned to the throwback state. N.J. Admin. Code tit. 18, § 7-8.7(e). The Department attempts to justify its position regarding throwback sales by stating that to do otherwise "would mean that New Jersey's tax policy is controlled by the tax policy of other states." However, in connection with the sourcing of non-operational revenue, where the State would recoup additional revenues, the Department stated that the change "brings New Jersey's tax policy into line with the policy of other states." Summary to Regulations, regarding N.J. Admin. Code tit. 18, § 7-8.17.

A few states have dabbled in using "throwout" as a method to enable them to capture "nowhere income." In reality though, there is no "nowhere" income. It is somewhere income, and the fact that sales are related to a state that does not subject the corporation to tax or the corporation is not taxed because it lacks nexus to that state or is protected by P.L. 86-272, does not and should not permit any other state to lay claim on those sales to measure the corporation's presence in that state.

Other states have similarly tried to throw sales out of the denominator of the sales factor, often without explicit statutory authority, and have been rebuffed by the courts. Unlike the New Jersey statute, however, most states appear to limit throwout to situations where the sales that are thrown out have their origin in that state.

Interestingly, the Department apparently has its own misgivings regarding the propriety of its throwout rule, which is understandable considering the fact that New Jersey's throwout provision is not restricted to throwing out sales of tangible personal property shipped from plants or warehouses within the State, but also applies to sales of intangible property where the "taxpayer" has no physical presence in New Jersey. The Department stated in the summary to its regulations that "where a taxpayer believes that application of the throwout rule produces an improper or disproportionate allocation result, the taxpayer should file a return in accordance with the statute and claim a refund, using its proposed apportionment methodology." Further, in situations where the taxpayer had voluntarily come forward (which does not include coming forward under the State's recent amnesty program) and agreed to treat its intangible holding companies as having nexus with the State, the Division has been willing to enter into "neutralization" agreements. The effect of such agreements is to modify the holding company's apportionment percentage (which is often blown out of proportion by the throwout provision) so that the aggregate amount of taxes that will be paid by the intangible holding company and the related payer of intangible expenses approximate the amount of tax that the related payor would have paid had it never deducted any of those expenses.

We applaud the Division's attempt to do the right thing and limit any additional taxes to those that would have been owed without the expense deductions. Clearly, no taxpayer group should be worse off than had it never formed a separate company to hold its intangible property, which can occur due to the throwout rule. In fact, in recent New York State and New York City legislation, the addback provision wisely incorporates that notion. (A.B. 2106, 2003 Leg., 226th Sess. (N.Y. 2003) enacted over Governor Pataki's veto, states in Part U3 amending sections 208(9)(O)(3)(B) - (5)(B) of the New York Tax Law, that "[i]n no event shall the combined tax paid by the taxpayer and its related member or members resulting from the add backs pursuant to clause A of this subparagraph exceed the tax that would

"Interestingly, the Department apparently has its own misgivings regarding the propriety of its throwout rule

have been paid by the taxpayer if no royalty [interest] payments had been made from a related member or members to the taxpayer.")

Alternative Minimum Assessment

The Alternative Minimum Assessment ("AMA") is an alternative method for computing the CBT that targets taxpayers that have economic presence in the State, but do not have entire net income. There are two bases for calculating the AMA: (1) the gross profits method; and (2) the gross receipts method. N.J. Stat. Ann. § 54: 10A-5. However, only taxpayers that have $2 million of gross receipts or $1 million of gross profits are subject to the AMA. *Id.* The thresholds are essentially all or nothing propositions – once you exceed those thresholds by $1, the entire amount of gross receipts or gross profits become subject to tax. The election to use either gross receipts or gross profits is made in the first year that the taxpayer is subject to the AMA, *i.e.*, when the AMA exceeds its CBT liability computed under the traditional entire net income calculation. N.J. Admin. Code tit. 18, § 7-18:1. The method elected must be used for the election year and the subsequent four years. N.J. Stat. Ann. § 54:10A-5a(c). In the fifth year, the taxpayer can change its methodology, but it must continue to use its newly elected method for the following four years. *Id.* The amount of AMA that a taxpayer is required to pay is capped at $5 million or $20 million for an affiliated group of five or more corporations. N.J. Stat. Ann. § 54:10A-5a(d)(1) – (2).

Gross receipts is defined as including receipts from sales of tangible personal property shipped into the State, services performed in the State, rentals from property located in the State, royalties received from the use of patents or copyrights (trademarks, trade names and service marks are not specifically listed) within the State and the catchall, "all other business receipts earned within the State." N.J. Stat. Ann. § 54:10A-5a(a)(5). The Department has explained that gross receipts "is a concept that is related to the receipts fraction numerator." Summary to Regulations. Accordingly, if an item of income is excluded from the tax base it also will be excluded from gross receipts. Gross profits is defined as New Jersey gross receipts, less returns and allowances related to such gross receipts, less the cost of goods sold multiplied by either the taxpayer's allocation factor or receipts factor, at its election. N.J. Stat. Ann. § 54:10A-5(a). The election between utilizing the allocation factor or the receipts factor is a departure from the statutory language. However, the Department, "exercising its authority … to prevent distortion" was apparently sensitive to potential challenges that could have been raised to the provision because using the allocation method generally favors in-state taxpayers. N.J. Admin. Code tit. 18, § 7-18.1.

By providing for gross receipts to be used as one measure for imposing the AMA, the Legislature was attempting to circumvent P.L. 86-272, which protects corporations that sell tangible property from the imposition of net income taxes if their activities fall within limited safe harbors. P.L. 86-272 states that no state "shall have the power to impose … a net income tax." The AMA is not a separate tax. It is merely a separate measure of the CBT.

> *"By providing for gross receipts to be used as one measure for imposing the AMA, the Legislature was attempting to circumvent P.L. 86-272*

Arguably, the CBT is still primarily a net income tax, just as New York State's corporate franchise tax would likely still be considered a net income tax under P.L. 86-272, even though certain of its measures of tax are not net income based, *i.e.*, its tax on capital and subsidiary capital. However, several states which have capital-based alternative impositions have taken the position that P.L. 86-272 only provides a taxpayer protection from imposition of the net income based measure. *See, e.g.*, *Rylander v. B&A Mktg. Co.*, 997 S.W.2d 326 (Tex. App. 1999); *Clairol Inc. v. Pennsylvania*, 518 A.2d 1165 (Pa. 1986). Simply having a separate measure of a single tax should not be viewed as a tax whose measure is not net income based, such as Michigan's Single Business Tax or Washington's Business and Occupation tax. *Gillette Co. v. Michigan Dep't of Treasury*, 497 N.W.2d 595 (Mich. Ct. App. 1993). If New Jersey ultimately is successful in its attempt to avoid P.L. 86-272 protections via the AMA, taxpayers likewise would be at risk of losing the Congressional protection in the many other states that have alternative non-income based taxes, such as New York, Ohio, Indiana, Texas, and Pennsylvania.

Concluding Thoughts

We believe that the BTRA is likely to be the forerunner to similar legislative enactments in other jurisdictions. Indeed, Massachusetts recently enacted its own addback provisions with strikingly similar language. S.B. 1949, 183d Gen. Ct., 2003 Sess., (Mass. 2003). Practitioners should pay careful attention to the BTRA and the results of the inevitable challenges regarding its numerous provisions of dubious constitutionality.

[This article is based on an article that appeared in *State Tax Notes Magazine*, 26 State Tax Notes 131 (July 14, 2003).]

CALIFORNIA COURT OF APPEAL AFFIRMS TAXPAYER VICTORY IN *FARMER BROTHERS*

By Thomas H. Steele (TSteele@mofo.com)

On May 21, 2003, the California Court of Appeal affirmed the judgment of the trial court and struck down as violating the Commerce Clause of the U.S. Constitution, California's restriction of its general dividend received deduction ("DRD") to dividends paid from income previously subject to California tax. *Farmer Bros. Co. v. Franchise Tax Bd.,* 108 Cal. App. 4th 976 (2003). Assuming the ruling holds on appeal, and it should, taxpayers that have been denied the DRD for taxable years prior to 1998 (the final tax year at issue in the litigation) should be entitled to refunds in an amount equal to the California tax they would have saved had the DRD statute (section 24402 of the California Revenue and Taxation Code) been applied without the discriminatory feature. (All subsequent section references are to the California Revenue and Taxation Code.) For taxable years after 1998, the availability of refunds is considerably less clear because the Franchise Tax Board ("FTB") has indicated that it intends to treat section 24402 as void following any final adverse court decision. Thus, litigation or possibly legislation may be required to restore the DRD (even for dividends that previously enjoyed the deduction because they were paid from income that had been taxed by the State).

This article summarizes the *Farmer Bros.* opinion, describes the effects of the litigation on pending and future refund claims, and outlines some of the theories that might be available to claim a continuing DRD in the face of FTB opposition. Finally, we describe the current status of the pending legislation regarding the insurance company dividend received deduction on the assumption that any legislative fix to the DRD is likely to follow a similar path.

Background of the Litigation

Farmer Bros. Co., a California coffee manufacturer, received dividends from investments in various companies engaged in business in other states as well as, in some cases, in California. Based upon section 24402, Farmer Bros. Co. obtained a deduction in the amount up to 70% of the dividends based on its stock ownership in the payor corporations. (The deduction was available in greater percentages as the stock ownership percentage increased.) However, section 24402 limited the deduction to dividends considered to have been paid from income that had previously been subject to California tax which determination rested upon the dividend payor's relative apportionment factors within the state of California.

Farmer Bros. Co. challenged the limitation placed on the section 24402 deduction as violating the Commerce Clause — citing among other things, that the statute provides a tax benefit based upon the relative presence of the payor in the State in violation of the U.S. Supreme Court's ruling in *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996). The FTB, in turn, countered that the statute does not discriminate against interstate commerce because its purpose is to eliminate double taxation of California income and not to favor in-state commerce. The FTB also argued that the section 24402 scheme, in effect, imposes a "compensatory tax" upon a stream of earnings that originates in other states, and that the imposition of this tax insures that the out-of-state earnings bear a California tax equal to that borne by earnings generated from within the state.

The Court of Appeal Ruling

In holding that the DRD violated the Commerce Clause, the court relied principally upon three authorities: *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996) which struck down a North Carolina "intangibles tax" which taxed "a fraction of the value of corporate stock owned by North Carolina residents inversely proportional to the corporation's exposure to the State's income tax"; *Ceridian Corp. v. Franchise Tax Bd.,* 85 Cal. App. 4th 875 (2000) which struck down a California dividend received deduction for dividends paid by insurance subsidiaries that was closely similar in concept to the DRD at issue in *Farmer Bros.*; and *D.D.I., Inc. v. North Dakota,* 657 N.W.2d 228 (N.D. 2003) which struck down a North Dakota dividends received deduction that apparently mirrored the DRD at issue in *Farmer Bros. Co*. In reliance upon these authorities, the court held:

> We conclude that section 24402 is discriminatory on its face because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California. As a result, the dividends received deduction scheme favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause.

Farmer Bros. Co., 108 Cal. App. 4th at 986-87.

Thereafter, the court went on to conclude that the DRD also violated the "internal consistency doctrine" because, assuming California's DRD was replicated in other states, the combined tax burden of the dividend payor and the dividend recipient would be greater if the payor and recipient operated in different states than the tax burden would be if the payor and recipient did business wholly within a single state.

The Denial of the DRD Cannot Be Justified As a Compensatory Tax

After concluding that the DRD constituted facial discrimination against interstate commerce, the court then rejected the FTB's argument that

> *"It appears that the FTB intends to take the position following a final adverse court decision that section 24402 as a whole is void and no taxpayer may claim the benefits of the deduction*

the discrimination could be justified because the restriction on the DRD operated to compensate for the fact that instate commerce, *i.e.,* dividends qualifying for the DRD, had previously borne a California franchise tax while interstate commerce, *i.e.,* non-qualifying dividends, had been exempt from that tax burden. In doing so, the court noted that the Supreme Court has rejected comparisons under the compensatory tax doctrine based simply upon the fact that out of state earnings had not been subjected to the state's general income tax. Instead, the Supreme Court has required a showing that the in-state commerce has borne some specific burden or paid for some benefit for which the state may fairly ask for analogous compensation from interstate business. Thus, absent compelling proof that the state's income tax could be traced to funding a specific program, which was also utilized by the interstate commerce, the court found that it could not "even begin to make the sorts of qualitative assessments that the compensatory tax doctrine requires." *Id.* (quoting *Fulton,* 516 U.S. 325 at 338). And the court noted the doctrine would be particularly difficult to satisfy, where, as here, the identified tax burden was imposed at a different level of commerce (the payor level) from the level subject to the purported compensatory tax (the payee level).

No Ruling on Remedies

In contrast to the lower court proceeding where the FTB vigorously disputed whether tax refunds were the appropriate remedy, the Court of Appeal proceeding did not involve the question of remedies for the simple reason that the FTB did not appeal that item of the lower court's judgment. The FTB's determination not to appeal apparently may be traced to its realization that the statute of limitations on all of the years at issue in *Farmer Bros.* would be closed before the court's resolution of the case. Thus, while the Supreme Court's decision in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco,* 496 U.S. 18 (1990) provides a theoretical foundation for remedying discrimination either by granting a refund to the interstate commerce that suffered the discrimination or by increasing the tax on the favored intrastate commerce, that choice would not be available in *Farmer Bros.* Because the general statute of limitations had closed for most of the years at issue in the litigation, the FTB acknowledged that it would not be in a position to tax the favored commerce and therefore refunds to the disfavored commerce were appropriate. *See Ceridian Corp. v. Franchise Tax Bd.,* 85 Cal. App. 4th 875 (2000) (where the statute of limitations bars any assessment of additional tax from the favored class of taxpayers, the only permissible remedy is a refund).

Implications for the Future

Based upon the FTB's reaction to the *Ceridian* litigation, it appears that the FTB intends to take the position following a final adverse court decision that section 24402 as a whole is void and no taxpayer may claim the benefits of the deduction. *Cf.* Memorandum from Winston Mah and Dale Isaac, FTB, to General Tax Audit Staff and Multistate Tax Audit Staff (Apr. 26, 2002) (on file with author) (instructing the FTB Audit Staff that no deduction under section 24410 is to be allowed for tax years ending on or after Dec. 1, 1997).

Taxpayers, on the other hand, no doubt will take the position that deduction continues based presumably upon one or more of the following arguments. First, the court's decision in *Farmer Bros.* goes only to the offending restriction on the DRD. By excising the unconstitutional restriction, the statute continues to operate in a manner consistent with legislative intent in eliminating multiple taxation of corporate earnings. *See Kopp v. Fair Political Practices Comm'n*, 11 Cal. 4th 607, 660-61 (1995) (recognizing a court's authority to reform statutes in accord with legislative intent if the legislature would have preferred the reform to the statute as a whole being found unconstitutional). The *Ceridian* court refused to reform section 24410 because the formula used to calculate the deduction required broad substantive changes to operate constitutionally. Given the level of reform required, the court found that rewriting section 24410 would be an "encroachment on the legislative function in violation of the separation of powers doctrine." *Ceridian Corp.*, 85 Cal. App. 4th at 889. By contrast, it appears that section 24410 will operate constitutionally if only the offending subsection is stricken. For this reason, section 24402 may be more amenable to reform than section 24410. Second, the court's reliance upon the internal consistency doctrine demonstrates that the offense of the current DRD is that it effectively seeks to tax income earned in other states. *See Hunt-Wesson, Inc. v. Franchise Tax Bd.,* No. 98-2043, 2000 LEXIS 1010 (U.S. Feb. 22, 2000) (disallowance of an otherwise allowable deduction based upon the amount of out of state income is effectively an extraterritorial tax on the out of state income). This infirmity was also acknowledged by the Superior Court in its opinion in *Farmer Bros.* Given that the infirmity is taxing income beyond California's jurisdiction to tax, the proper remedy is simply to extend the deduction and eliminate the unconstitutional tax. Third, any attempt to disallow the DRD provided by section 24402 also may be viewed as violating the Equal Protection Clause of the U.S. and California Constitutions since dividend paid by legal entities included within a combined report of unitary income will continue to enjoy a full dividend received deduction under section 25106 even though no rational basis exists for distinguishing between the multiple tax burden that arises in that context and the multiple tax that would be imposed by a repeal of section 24402.

Finally, the Legislature may act to reform section 24402 along the same lines being considered for the reform of section 24410. On June 5, 2003, the Assembly passed a bill (A.B. 263, 2003-2004 Leg., Reg. Sess. (Cal. 2003) ("A.B. 263")) amending section 24410 to resolve the uncertainties resulting from the court's decision in *Ceridian*. The bill received a unanimous vote in the Appropriations Committee on June 2, 2003. On June 19, 2003, the bill was referred to the Senate Committee on Revenue and Taxation, and a hearing on the bill was set before the committee on July 9, 2003.

For tax years beginning January 1, 2003, A.B. 263 in its current form provides a deduction to all corporations, whether or not domiciled in California, for 80% of dividends received from insurance companies if at the time of payment the recipient corporation owns 80% or more of each class of stock of the insurance company. For back tax years ending on or after December 1, 1997 but before January 1, 2003, A.B. 263 would provide a deduction equal to 90% of the dividends received from the insurance company. The 80% ownership threshold is the same for back tax years. Since the portion of dividend income eligible for the deduction is not calculated in relation to the insurance corporation's California source income, A.B. 263 seems to avoid the constitutional defects of current section 24410.

Notably, A.B. 263 includes a provision that effectively repeals section 24410 if the FTB collects less than $15 million in tax in the first 180 days after it goes into effect. As currently proposed, this provision would flatly repeal section 24410, making it appear that there would be no deduction at all if the revenue target is not reached. Given the impact of this provision, it is expected to be the subject of further inquiry and debate. Additionally, the provision as written does not count interest collected towards the $15 million revenue target. Further, the provision does not state if the $15 million figure should be calculated net of any refund claims. The FTB has suggested that it will not process refund claims over that period, so that may partially resolve the issue. In any event, the revenue target provision in A.B. 263 raises significant questions about the future of the bill.

The eventual fate of A.B. 263 is still very much in question. Depending on the resolution of the issues and the success of A.B. 263, the Legislature may consider similar reforms to section 24402.

[Thomas H. Steele is co-counsel for the taxpayer in the *Farmer Bros*. litigation.]

CALIFORNIA AND KANSAS LEGISLATURES PUSH THE LIMITS OF *QUILL*

By Carley A. Roberts (croberts@mofo.com)

As the Internet retailing segment of our economy continues to grow and states search for additional revenues to balance their budgets, states have increasingly focused on ways to collect unpaid use taxes on remote sales. Currently, in most states, the burden of collecting use taxes on remote sales has been imposed on out-of-state sellers only where states can establish nexus under the physical presence standard of *Quill Corp. v. North Dakota*, 504 U.S. 274 (1992) (holding physical presence is required under the Commerce Clause for purposes of determining nexus). Thus, businesses with a physical presence within the state bear the collection burden on in-state sales, while businesses without physical presence escape such burden.

Some states, including California and Kansas, are considering or have enacted legislation that would impose use tax collection obligations on remote sellers by expanding the definition of retailer under their relevant statutory schemes. These statutory provisions raise serious constitutional questions and appear to directly challenge the U.S. Supreme Court's decision in *Quill*.

California Senate Bill 103

Senate Bill 103, 2003-2004 Leg., Reg. Sess. (pending in Cal. Asm. Appropriations Comm. July 8, 2003) ("S.B. 103"), which is currently pending in the California Legislature, represents the Legislature's third attempt to pass an affiliate nexus bill for purposes of the sales and use tax. (A.B. 2412, 1999-2000 Leg., Reg. Sess. (Cal. 2000) ("A.B. 2412"), which contained the identical affiliate nexus provisions of S.B. 103. A.B. 2412 was vetoed by the Governor. A.B. 81, 2001-2002 Leg., Reg. Sess. (Cal. 2001) contained similar affiliate nexus provisions that were amended out.)

The affiliate nexus provisions of S.B. 103 provide that a retailer is engaged in business in California if the retailer is "related," as specified, to a retailer maintaining sales locations in California, provided that the retailer sells similar products under a similar name as the California retailer, or uses facilities or employees of the related California retailer to advertise or promote sales by the retailer to California purchasers.

In pertinent part, S.B. 103 provides:

> For purposes of this section, a retailer is engaged in business in this state, as defined in paragraphs (1) and (2) of subdivision (c), if both of the following conditions exist:
>
> (A) The retailer holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in California or is owned in whole or in substantial part by that retailer, or by a parent or subsidiary thereof. For purposes of this subparagraph, "substantial ownership interest" in an entity means that degree of ownership of equity interest in an entity that is not less than that degree of ownership as specified by Section 78p of Title 15 of the United States Code, or any successor to that statute, with respect to a person other than a director or officer.
>
> (B) The retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to California purchasers.

S.B. 103 also provides that a retailer engaged in business in California would include any retailer having, among other things, any representative or independent contractor operating in California under the retailer's authority for the purpose of servicing or repairing tangible personal property.

The bill states that it is the legislative intent that the above proposed amendments are a "clarification of existing law," which is to be applied prospectively. However, the proposed amendments significantly broaden the definition of the term "retailer engaged in business" under the current applicable law. Section 6203 of the California Revenue and Taxation Code (all subsequent section references are to the California Revenue and Taxation Code) currently defines a "retailer engaged in business" to mean: (1) any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business; (2) any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property; and, (3) with respect to a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state.

As section 6203 currently exists, an out-of-state retailer is not regarded as having physical presence in California based solely on the fact the retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name. Similarly, an out-of-state retailer is not regarded as having physical presence in California based solely on the fact the retailer uses an independent third party contractor to act under the authority of the retailer in repairing or servicing property sold by the retailer. State Board of Equalization ("SBE") Regulation 1684 specifically states a retailer is not engaged in business in California based solely on its use of a representative or independent contractor in California for purposes of performing warranty or repair services on property sold by the retailer. Cal. Code Regs. tit. 18, § 1684. Contrary to existing law, and the legislative intent language in the bill, which states the amendments are declaratory of existing law, S.B. 103 would establish that an out-of-state retailer is "engaged in business in California" under both of these situations.

Moreover, the bill also appears to conflict with *Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (1994). In that case, the California Court of Appeal addressed the constitutionality of an earlier affiliate nexus provision. The statutory provision under scrutiny in *Current* was subdivision (g) of section 6203, which provided that a "retailer engaged in business in this state" included "any retailer owned or controlled by the same interest which own or control any retailer engaged in business in the same or similar line of business in this state." *Current*, 24 Cal. App. 4th at 412. The court held this provision unconstitutional, finding that Current, which had no employees, inventories, or facilities in California, and had no other contacts with California, did not have nexus with California sufficient to justify the imposition of a use tax collection duty.

Kansas House Bill 2416

In another nexus development, Kansas recently enacted an extremely broad nexus statute that also appears to upset settled constitutional nexus principles. House Bill 2416, 80th Leg., 2003 Res. Sess. (Kan. 2003) ("H.B. 2416") which was signed in May 2003 by the Kansas governor, redefines "retailer doing business in the state" of Kansas for purposes of sales and use taxes. The new definition established under H.B. 2416 includes those retailers having or maintaining permanently or temporarily, directly, or indirectly through a subsidiary, agent or representative, an office, distribution house, sales house, warehouse, or other place of business. Under this definition, the mere presence of a subsidiary in Kansas triggers nexus for the parent, regardless of whether the subsidiary acts in any way to further the parent's business. The language of H.B. 2416 suggests, for example, that every corporate shareholder of IBM (or any other corporation with an office in Kansas) potentially has nexus in Kansas under the statute. The Kansas bill goes further than California's S.B. 103, and also provides new language which requires in-state businesses to collect sales tax on the selling price of items delivered to in-state customers who have ordered such items from out-of-state businesses not registered to do business with Kansas.

Analysis

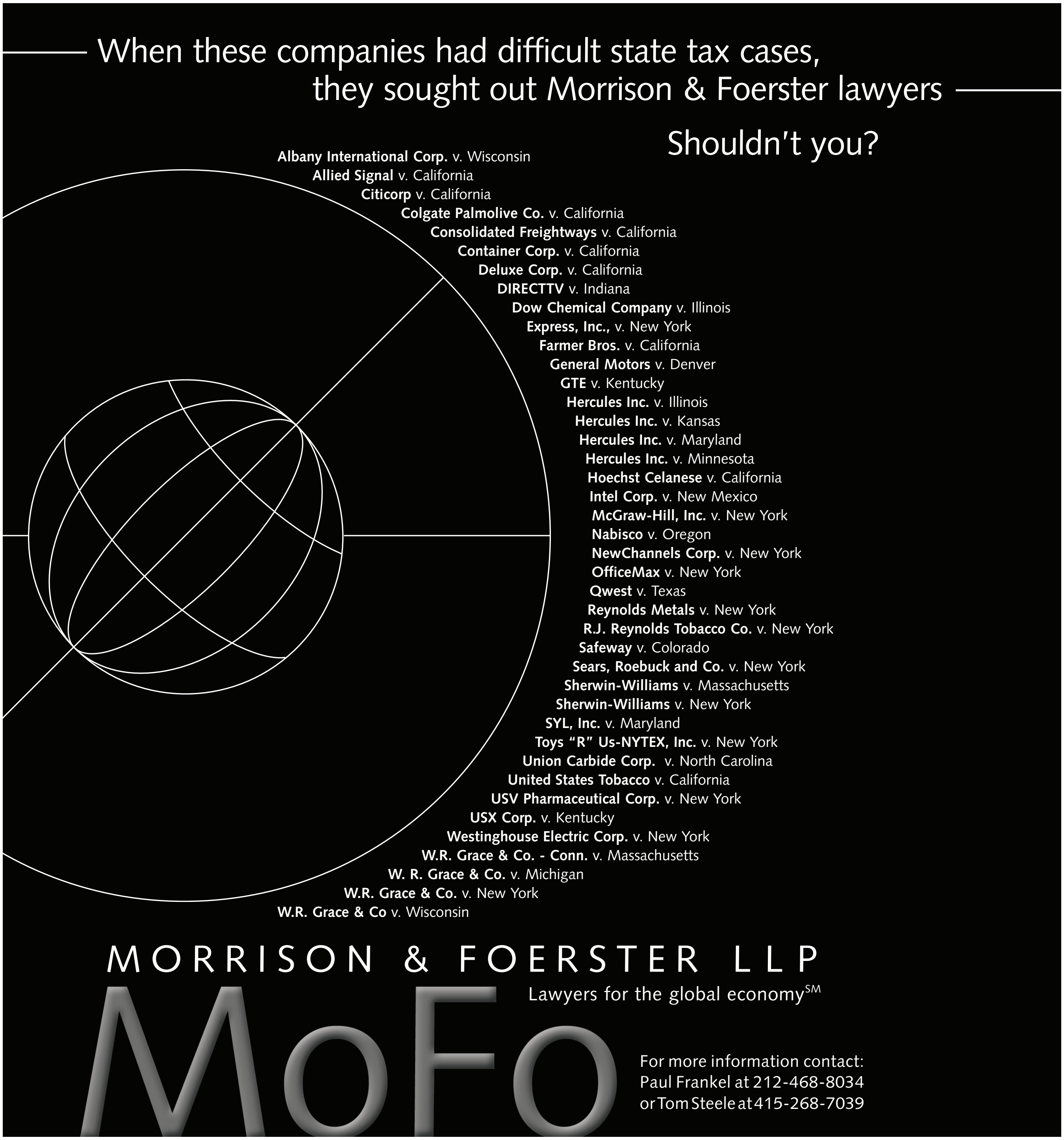
The proposed legislation under California's S.B. 103 and the new legislation under Kansas' H.B. 2416 appear to challenge the Supreme Court's holding in *Quill* and its progeny. In order for a state to constitutionally impose a sales/use tax collection obligation, the state must comply with both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. In *Quill*, the United States Supreme Court made it clear that the Due Process and the Commerce Clause pose distinct limits on the taxing powers of the states. While a state may have the authority to tax a particular taxpayer under the Due Process Clause, imposition of the tax may violate the Commerce Clause. *Quill*, 504 U.S. at 305.

It is clear from *Quill*, that in order for a state to lawfully impose, under the Commerce Clause, a sales/use tax collection obligation on an out-of-state retailer, that out-of-state retailer must have a "physical presence" in the taxing state. *See also Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967). Under this "physical presence" standard of nexus, the "slightest presence" of an out-of-state retailer with a state is insufficient to permit the state constitutionally to enforce a use tax against the out-of-state company. *Dep't of Revenue v. Share Int'l, Inc.*, 676 So. 2d 1362, 1363 (Fla. 1996); *see also Nat'l Geographic Soc'y v. Cal. Bd. of Equalization,* 430 U.S. 551, 555-56 (1997). Rather, a state may only enforce a use tax collection obligation on an out-of-state retailer if that retailer's activities in the taxing state create a "substantial nexus" with the state. *Share Int'l*, 676 So. 2d at 1363; *see also Nat'l Geographic Soc'y*, 430 U.S. at 555-556; *Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274 (1977).

Most of the out-of-state retailers that would be effected by the proposed California legislation and the new Kansas legislation arguably would have no "physical presence" in state under the *Quill* standard. For example, XYZ Corporation has a brick and mortar location in California. It is subject to the sales tax collection obligation because it is considered to be a "retailer engaged in business" in California under section 6203. XYZ Corporation forms a subsidiary XYZCorp.com. XYZCorp.com has no brick and mortar location in California; it has no employees or officers in California; it does not rent or own any property in California; it does not rely upon its parent for returns, warranty services, or any other services; thus, it has *no* physical presence in California. It sells essentially the same products as XYZ Corporation. XYZCorp.com sells its products via the Internet. Under California's S.B. 103 and Kansas' H.B. 2416, XYZCorp.com would be subject to a use tax collection obligation based solely on its relationship with XYZ Corporation regardless of XYZCorp.com's lack of physical presence in state.

In sum, as state budget deficits continue to grow, combined with the sustained and continued growth of Internet retailing, it is not surprising that states continue to seek ways to collect unpaid use taxes on remote sales. Whether these current attempts to expand state taxing jurisdiction can withstand constitutional scrutiny is yet to be determined. For now, taxpayers should monitor state legislation closely to keep track of these nexus-expanding efforts by the states and be prepared to challenge aggressive nexus states such as Kansas and potentially California. ■

To Our Readers:
As you can see, we have updated the look of Morrison & Foerster's *State & Local Tax Insights*. We have not, however, changed the scope or content of the newsletter and will continue to deliver timely articles and updates regarding state and local tax developments to you on a quarterly basis. We hope that our new look will make the newsletter easier and more enjoyable to read.



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