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## California Tax Reform Should Include Ending Pay-to-Play

By Paul H. Frankel, Charles J. Moll III & William H. Weissman

On August 3, 2004, the California Performance Review ("CPR") issued its long awaited report to the public. Among its many recommendations was the creation of a California Tax Commission that would consolidate the functions of California's three taxing agencies: the Employment Development Department (payroll taxes), the Franchise Tax Board (income taxes), and the Board of Equalization (property, sales and use and miscellaneous taxes). The focus of the CPR was on tax collection and revenue generation. Although it remains to be seen how, if at all, this recommendation will be implemented, this is a promising step, and we applaud the Governor.

Unfortunately, the CPR failed to specifically address in its recommendations ending pay-to-play, and Legislative proposals to implement CPR's recommendations are not expected before next year. However, several members of the Legislature have made clear that comprehensive tax reform should include separating the tax appeals and adjudication process from the tax collection process. In the past session, two bills were

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introduced in the California Legislature that would have accomplished this by creating a prepayment, independent tax adjudication system modeled on the United States Tax Court. These bills died in the Legislature over the summer and it is unclear what may happen down the road.

While the details of those bills were the subject of significant debate, there was no real opposition to the due process concept that was the true inspiration of the legislation: the right to a full trial on a prepayment basis, a right currently provided by many other states. Greg Turner, General Counsel for the California Taxpayer's Association ("Cal-Tax"), which opposed these two bills, stated that Cal-Tax is "very supportive of consolidation" despite the lack of any discussion of ending pay-to-play. Mr. Turner attributes the CPR's lack of discussion of ending pay-to-play to the Governor's inability to enact any reorganization plan that might require a constitutional amendment. Some people argue that because the California Constitution has an anti-injunction provision, ending pay-to-play would require a constitutional amendment. Nonetheless, he added, "Elimination of pay-to-play? You bet we support it."

The goal of the CPR is to make California a fair and efficient place to conduct business. By ending pay-to-play, all taxpayers would be afforded the opportunity to have a full and independent "day in court." Regardless as to the manner, whether it be by constitutional amendment modifying the anti-injunction rules, or by some other means, ending pay-to-play should be a top priority for the business community. ■

# In *Lanco*, New Jersey Tax Court Offers Thoughtful Response to Burning Question: Physical Presence Is Essential for Nexus[1]

By Paul H. Frankel, Hollis L. Hyans & Amy F. Nogid

*The authors represent Lanco Inc. in this case.*

Few issues in state and local tax practice have been as hotly contested as the issue of whether "economic nexus" — nexus in the absence of physical presence — is permitted under the commerce clause of the U.S. Constitution. New Jersey's Tax Court recently weighed in on the issue, rendering its thoroughly researched and well-reasoned decision in *Lanco.*[2] The *Lanco* court confirmed that physical presence is required under the commerce clause before nexus can be asserted, and it soundly rejected the New Jersey Division of Taxation's position that the mere receipt of revenue purportedly attributable to New Jersey-sourced intangible property is an ample predicate to tax jurisdiction. The New Jersey Tax Court got it right. The division has appealed the tax court's New Jersey Superior Court decision. We expect the appellate division to hear oral argument next year.

## Background

With the advent of electronic commerce and entity isolation strategies related to intangible assets, the question of whether deriving revenue from a particular jurisdiction is constitutionally sufficient to permit that jurisdiction to exert its taxing authority over the out-of-state entity has become a critical question to a growing number of businesses. After the U.S. Supreme Court's decision in *Quill,*[3] the focal point of the economic nexus conundrum has become the commerce clause.[4]

Unfortunately, due in large part to the Supreme Court's resistance to address issues left open by its decision in *Quill*, and to congressional inaction, despite the Court's proffered invitation in *Quill*, states and businesses alike have become emboldened. States have amended their statutes and regulations expanding their tax imposition provisions,[5] while businesses have restructured in reliance upon long-standing interpretations of traditional nexus.

### Commerce Clause

The commerce clause[6] of the U.S. Constitution provides that "Congress shall have Power … to regulate Commerce … among the several states…." In drafting the Constitution, its framers recognized the importance of regulating commerce among the states.[7] In fact, James Madison foretold (in the context of the import-export clause) the situation that continues today, with equal force, in contravention of the commerce clause: [I]t must be foreseen that ways would be found out to load the articles of import and export, during the passage through their jurisdiction, with duties which would fall on the makers of the latter and the consumers of the former. We may be assured by past experience, that such a practice would be introduced by future contrivances; and both by that and a common knowledge of human affairs, that it would nourish unceasing animosities, and not improbably terminate in serious interruptions of the public tranquility."[8]

## Upcoming Conferences

Following is a list of major open conferences through December 31, 2004, in which Morrison & Foerster attorneys will be participating.

**October 2, 2004**
*The Lincoln Institute of Land Policy's National Conference of State Tax Judges*
Chicago
**Speaker**: Craig B. Fields
(cfields@mofo.com)

**October 18, 2004**
*TEI Annual Conference*
New Orleans, Louisiana
**Speaker**: Paul H. Frankel
(pfrankel@mofo.com)

**October 20, 2004**
*Chicago Tax Club Fall Seminar*
Chicago
**Speaker**: Paul H. Frankel
(pfrankel@mofo.com)

**October 21, 2004**
*11th Annual Vanderbilt–Paul J. Hartman SALT Forum*
Nashville
**Speaker**: Paul H. Frankel
(pfrankel@mofo.com)

**October 27, 2004**
*Morrison & Foerster Annual Property Tax Conference*
San Francisco
**Speakers**: Thomas H. Steele, Charles J. Moll III, Peter B. Kanter, Troy M. Van Dongen
**Contact**: Troy Van Dongen
(tvandongen@mofo.com)

**October 29, 2004**
*COST Annual Conference*
St. Petersburg, Florida
**Speaker**: Paul H. Frankel
(pfrankel@mofo.com)

**November 5–7, 2004**
*California Tax Policy Conference*
San Francisco
**Speaker**: Charles J. Moll III
(cmoll@mofo.com)

**December 2–3, 2004**
*Institute on State and Local Taxation at New York University*
New York City
**Co-chair**: Paul H. Frankel
**Panel chairs**: Hollis L. Hyans and Craig B. Fields, Thomas H. Steele
**Contact**: Craig B. Fields
(cfields@mofo.com)

**December 16, 2004**
*TEI New York City Chapter*
New York City
**Speaker**: Paul H. Frankel
(pfrankel@mofo.com)

Justice Marshall correctly understood that the "power to tax involves the power to destroy,"[9] that states would not "respect the interests of others"[10] and that the commerce clause was necessary, "[o]r what should restrain a State from taxing any article passing through it from one State to another, for the purpose of traffic? or from taxing the transportation of articles passing from the State itself to another State, for commercial purposes?"[11]

The commerce clause, whose language only grants powers to Congress, has a long-standing history of having a "negative" or "dormant" power to restrain states from interfering with or discriminating against interstate commerce.

Given the shift from traditional brick-and-mortar retailers to sales activity by entities that have no physical presence in the state of their customers, and the increased prevalence of special-purpose entities whose assets and activities are largely intangible-related, questions related to the nexus of these entities have become commonplace.

In *National Bellas Hess,*[12] the Illinois Department of Revenue sought to impose a use tax collection obligation on a company lacking physical presence in Illinois, based on its liberal definition of "'[r]etailer maintaining a place of business in this State'" as including "'[e]ngaging in soliciting orders within this State from users by means of catalogues or other advertising, whether such orders are received or accepted within or without this State.'"[13] The Supreme Court cited several of its previously issued decisions concerning *income tax* impositions to support its proposition that, under the due process and commerce clauses (which the Court said were "closely related"),[14] a state is limited to receiving a *quid pro quo.* Thus, the Court referred to *Freeman v. Hewit*,[15] a case decided under the commerce clause, wherein it had stated that "'State taxation falling on interstate commerce … can only be justified as designed to make such commerce bear a *fair share of the cost of the local government whose protection it enjoys.'*" The Court was troubled both by the "virtual welter of complicated obligations" *and* by the fact that Illinois had "no legitimate claim to impose 'a fair share of the cost of local government.'"[16] The Court "decline[d] to obliterate"[17] the distinction between corporations with in-state property and those lacking physical presence.

*Complete Auto Transit*[18] gave the Court another opportunity to clarify the scope and limitations of the commerce clause. Overruling *Spector Motor,*[19] which had held that imposing a tax on the "privilege of doing business" if it applies to purely interstate commerce was impermissible, the Court articulated its four-prong test to determine whether a tax on the in-state portion of interstate activities would be sustained over commerce clause challenges:

*Physical presence is as much a prerequisite to the imposition of income and franchise taxes as it is to use tax collection responsibilities*

- Is the tax applied to an activity with a substantial nexus with the taxing state?
- Is the tax fairly apportioned?
- Is the tax fairly related to the benefits provided to the taxpayer?
- Does the tax discriminate against interstate commerce?

The next Supreme Court case significant to the economic nexus question is, of course, *Quill*.[20] In *Quill*, North Dakota sought to compel an out-of-state mail order seller to collect use tax. While the North Dakota Supreme Court had concluded that "tremendous social, economic, commercial and legal innovations" rendered *Bellas Hess* an anachronism, the U.S. Supreme Court held fast to the physical presence requirement. In fact, even Quill's ownership of diskettes in the state was found not to meet the commerce clause's "substantial nexus" requirement.

Unfortunately, while the *Quill* Court reaffirmed the "bright-line, physical presence requirement," there has been some question as to whether the requirement applies to income and franchise tax matters, given the Court's statements that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes," and "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule."[21] The Court, however, reiterated its position that the formalistic distinctions between direct and indirect impositions be disregarded. Its litany of reasons for continuing to adhere to the bright-line test of *Bellas Hess* and the evils that would occur if it were to depart from the requirement support the conclusion that physical presence is as much a prerequisite to the imposition of income and franchise taxes as it is to use tax collection responsibilities.

It is against this background that *Lanco* came to the New Jersey Tax Court.

### Facts of *Lanco*

The New Jersey Division of Taxation and Lanco stipulated to the following facts:

- Lanco is a trademark protection company incorporated in Delaware;
- Lanco owns certain trademarks, tradenames and service marks;
- Lanco licenses its marks to a sister company, Lane Bryant Inc.;
- Lane Bryant is engaged in the nationwide retail sale of women's clothing and accessories;
- Lane Bryant pays Lanco arm's-length rate royalties;
- Lane Bryant uses Lanco's marks in its business throughout the United States, including New Jersey;
- Lanco conducts all of its licensing activities outside New Jersey;
- Lanco has no office, employees, real property or tangible personal property in New Jersey; and
- Lanco has no agents in the state.

The tax court, therefore, directly and clearly was presented with the question of whether "economic nexus" alone is sufficient under the commerce clause, without any of the factual questions that have muddied the waters in other cases.[22]

*The tax court … directly and clearly was presented with the question of whether "economic nexus" alone is sufficient under the commerce clause*

### Division's Arguments

The division argued that Lanco engaged in ownership and use of its marks in New Jersey for business purposes, sufficient to provide a statutory basis to subject it to the corporation business tax (CBT), and that there were no constitutional impediments to imposition of the tax against Lanco. The division also relied upon its regulation, N.J. Regs. § 18:7-1.9(b), effective as of Nov. 4, 1996, which provides as an example of what constitutes "doing business": "Foreign corporation R holds trademarks that were assigned to it by its parent corporation. R receives fees as a result of licensing those trademarks to certain New Jersey companies for use in New Jersey. R is subject to the corporation business tax on its apportioned income as a result of its trademark licensing activities."

The division argued that this regulation was "consistent with the Legislature's unequivocal intent to include within the CBT those corporations that conduct business in the State by employing intangible property here," and that Lanco "cannot wiggle free by pointing [to] the irrelevant distinction that it draws between tangible and intangible property."[23]

With respect to the commerce clause, the division claimed that all four *Complete Auto* prongs were met: physical presence was not required to establish "substantial nexus"; the CBT only taxed income apportioned to the state; the CBT did not discriminate against intrastate taxation; and Lanco's CBT burden would be fairly related to the services New Jersey provided to Lanco. Specifically, the division argued that *Quill*'s physical presence requirement was an "unnecessarily wooden interpretation of the Constitution … that may have had some surface appeal in past centuries."[24] Further, the division maintained that *stare decisis* played a "decisive role" in *Quill* and that Lanco's exploitation of New Jersey's marketplace distinguished Lanco from Quill.[25] The state's highway system, courts, educated workforce and "host of indirect benefits" entitled New Jersey to "financial recovery."[26]

The division also advocated that *Quill* has no application outside the confines of the sales and use tax area.[27]

**Tax Court's Decision**

The tax court first considered whether the fact that Lanco and Lane Bryant were commonly owned would affect its constitutional analysis. It correctly concluded that their relationship was "not material to the constitutional issue." Courts have consistently recognized the separate business realities of affiliated corporations. The U.S. Claims Court castigated the IRS for failing to do so, stating: "The creation of legal entities that have separate functions under common directors and officers is a familiar and recognized practice in the ordinary conduct of large scale business[es]."[28] The U.S. Supreme Court and the U.S. Tax Court have, time and again, agreed with this proposition.[29]

Whether *Quill*'s physical presence requirement has continuing vitality was next addressed. After scrutinizing the majority opinion in *Quill*, as well as the other opinions rendered in that case, the tax court concluded that "[t]he majority clearly undertook an analysis of the physical presence requirement on its own merits."

There can be no question that the *Quill* Court faced head-on the question of whether *Bellas Hess* remained vital despite the significant technological advances and the burgeoning growth of electronic commerce since it was decided, an argument central to the division's position against Lanco. As the Court itself noted in *Quill*, the basis for the North Dakota Supreme Court's incorrect decision not to follow the physical presence requirement of *Bellas Hess* was that "'the tremendous social, economic, commercial, and legal innovations' of the past quarter-century have rendered it 'obsole[te].'"[30] Quill, in fact, characterized the argument that '"things have changed'" as North Dakota's "major premise."[31] During oral argument in *Quill*, moreover, North Dakota's attorney general urged the Court to overrule *Bellas Hess,* noting that "technological developments, make the world a very different place in 1992 than it was in 1967 when *Bellas Hess* was decided."[32] New Jersey added its voice to North Dakota's argument, claiming, just as it did in *Lanco,* that *Bellas Hess* was "outmoded" and based on "factual assumptions that are not today supportable."[33]

*If physical presence is a constitutional necessity for one, it is illogical that it should not be for both*

Although it found no nexus, the tax court did agree in *dicta* with the division that all four *Complete Auto* tests were met, and concluded that "[a]lthough it is not physically present in the state, Lanco clearly enjoys the same benefits provided to Lane Bryant." In this regard, the tax court missed the mark; Lanco did not receive benefits from New Jersey.

As the *Quill* Court asked North Dakota's attorney general during oral argument, "[w]hy does North Dakota deserve to collect the tax? That's the real—sort of question, I would think. What do you want for nothing?"[34] In response to the attorney general's response that North Dakota "facilitates the transaction" for Quill, and Quill uses "phone lines in our state" and "our roads to deliver their products," and that North Dakota provides "the customer base," Chief Justice William H. Rehnquist responded, "[t]hat's the argument that was rejected in *Bellas Hess* after being so eloquently portrayed by the dissent."[35] Thus, the Court recognized that the amorphous benefits derived by an entity not physically present in a state are not sufficient to warrant collection responsibilities.

Arguably, moreover, a mere collection responsibility (for which many states compensate the collectors) could be based on a state's provision of less substantial benefits than a direct imposition of taxes where the lack of a *quid quo pro* given to entities not physically present becomes obvious.

Next, the tax court addressed the "decisive question" of whether *Quill's* physical presence requirement is limited to situations where a use tax collection responsibility is sought to be imposed, or extends to the imposition of income taxes. Its conclusion that physical presence is just as much a requirement for income taxation as it is for imposing a use tax collection responsibility was premised on:

- the lack of material distinctions between the two under commerce clause nexus principles;
- the pre-*Quill* cases; and
- the post-*Quill* cases.

The tax court pointed out that the benefit of having a clear, bright-line test is the same regardless of the type of tax, and properly recognized that the burden of complying with use tax collection complexities and the burden of having a direct liability to pay a tax are not dissimilar. The court summed up its position: "If physical presence is a constitutional necessity for one, it is illogical that it should not be for both." This conclusion is consistent with the post-*Quill* decisions of the Supreme Court, which strongly suggest that the test applies across-the-board to all taxes.[36]

> *Legitimate means to minimize taxation are, of course the prerogative of any business and perhaps dictate the market-place competition*

Significantly, the court undertook an in-depth analysis of both the pre-*Quill* and the post-*Quill* cases and painstakingly considered articles supportive of limiting *Quill* to use tax situations. Parsing through the decisions that are consistently cited in support of taxing jurisdictions' and the authors' claims that *Quill*'s physical presence requirement is limited to use tax collection responsibility both old — *International Harvester,*[37] *Whitney,*[38] *Curry*[39] — and new — *Geoffrey,*[40] *SYL,*[41] *Truck Renting & Leasing,*[42] *Couchot,*[43] *General Motors*[44] — it debunked each of the shibboleths in turn.

After gratuitously addressing the issue of the retroactivity of the regulation, N.J. Regs. § 18:7-1.9, and concluding that even if physical presence were not a requirement, economic nexus represented a shift in position under New Jersey law and would only be prospective, the court moved on to consider whether the use of tax-minimizing business structures would warrant departure from its legal conclusion, although nothing in the *Lanco* record would support a finding that Lanco was formed for tax purposes. To its credit, the court took a realistic, unjaundiced view of tax planning, so rare these days, recognizing that "[l]egitimate means to minimize taxation are, of course the prerogative of any business and perhaps dictate the market-place competition."

### Looking Forward

Of late, the states are up to their old habits, relentlessly disregarding their borders — the precise evil that the commerce clause was meant to address. New Jersey is the poster child for such behavior. One example is its throwout rule, enacted as part of its Business Tax Reform Act of 2002. It is nothing more than a mechanism to grab income lacking any connection to the state on the basis that other states are not taxing such income.

What is even more distressing is that the states' attempts to tax income that is wholly unconnected to business activity within their borders, contrary to constitutional mandate and Supreme Court precedent, are accomplished under the guise of self-righteousness. Unfortunately, because the Supreme Court has yet to review cases presenting these issues,[45] the states have become more emboldened in their pursuits of taxation of extraterritorial income.

The scholarly decision in *Lanco* provided a welcome respite from the result-oriented decisions that often turn the law and the facts on their head to find a way to tax that which the law does not allow. The American tax landscape has long provided for exemptions and exclusions. Taking advantage of such legislatively prescribed incentives is, as the *Lanco* court understood, neither illegal nor even morally questionable.

Given the significant financial stakes of nexus findings — to both parties — the issues raised by *Lanco* will continue to be litigated throughout the country. Only two avenues exist for resolution — congressional intervention or a decision by the highest court of the land. ■



[1] This article was originally published in the *BNA Tax Management Weekly State Tax Report* and *BNA Tax Management State Tax Library*. The article is reprinted with permission from Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., 1250 23rd Street, N.W., Washington, D.C. 20037 (www.bnatax.com).

[2] *Lanco Inc. v. Director*, Div. of Taxn., 21 N.J. Tax 200 (2003).

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

[4] While issues may likewise exist under the due process clause, this article will not address them.

[5] Often the changes have been characterized as "clarifications" and not the changes that they really are. Legislative and regulatory amendments under the guise of being "mere clarifications" are a troubling practice that appears to be becoming a more frequent occurrence. One would hope that courts will see the ploy for what it usually is — impermissible and unconstitutional retroactive legislation.

[6] U.S. Const. art. I, § 8, cl. 3.

[7] The Federalist Nos. 6, 7, 11, 22 (Alexander Hamilton).

[8] The Federalist No. 42 (James Madison).

[9] *McCulloch v. Maryland*, 17 U.S. 316, 431 (4 Wheat) (1819).

[10] *Brown v. Maryland,* 25 U.S. 419, 440 (12 Wheat) (1827).

[11] *Id*. at 449.

[12] *National Bellas Hess Inc. v. Illinois Dept. of Rev.*, 386 U.S. 753 (1967).

[13] *Id.* at 755 (citation omitted).

[14] *Id.* at 756.

[15] 329 U.S. 249, 253 (1946) (emphasis added).

[16] *National Bellas Hess,* 386 U.S. at 759-60 (citation omitted).

[17] *Id.* at 758.

[18] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

[19] *Spector Motor Svcs. Inc. v. O'Connor*, 340 U.S. 602 (1951).

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

[21] *Quill*, 504 U.S. at 314.

[22] For example, in *Kmart Properties Inc. v. New Mexico Taxn. and Rev. Dept.*, No. 21,140 (N.M. Ct. App. Nov. 27, 2001), *cert. granted,* 40 P.3d 1008 (N.M. 2002), an unpublished decision which cannot be cited as authority under Rule 12-405C of the New Mexico Supreme Court's Rules of Appellate Procedure, the New Mexico Court of Appeals formulated a "functional equivalent" test to physical presence. Given the Supreme Court's avowal of having a bright-line test, the state court of appeals' perversion of the physical presence test was a step in the wrong direction. In *A&F Trademark Inc. v. Tolson*, No. 02-CV-007467 (N.C. Super. Ct. May 22, 2003) (on appeal), the in-state activities of the licensees of the purported taxpayers' intangible property were imputed to the purported taxpayers based in part upon erroneous notions regarding intangible property law. These cases (and others like them) are contrary to the guidance of the Court, grounded in its goal of fostering objective, concrete determinations of nexus.

[23] *Lanco,* Trial Brief of Defendant, Director, Division of Taxation, at 16, 18.

[24] *Id.* at 2.

[25] *Id*. at 33.

[26] *Id.* at 38-40.

[27] *Id.* at 34.

[28] *Merck & Co. v. United States*, 24 Cl. Ct. 73, 88 (1991).

[29] *See, e.g., National Carbide Corp. v. Commissioner*, 336 U.S. 422, 433 (1949) (which rejected an attempt to disregard subsidiaries, and stated that "[u]ndoubtedly the great majority of corporations owned by sole shareholders are 'dummies' in the sense that their policies and day-to-day

activities are determined not as decisions of the corporation but by their owners acting individually"); *Bass v. Commissioner*, 50 T.C. 595, 601 (1968).

[30] *Quill,* 504 U.S. at 301 (citation omitted).

[31] Reply Brief (citation omitted).

[32] *Quill,* 1992 U.S. Trans. LEXIS 189, at *Quill Corp. v. North Carolina,* 504 U.S. 298 (1992) (No. 91-194) at *29 (U.S. Jan. 22, 1992).

[33] Brief Amicus Curiae for the State of New Jersey Supporting Respondent.

[34] *Quill,* 1992 U.S. Trans LEXIS 189 at *28 (U.S. Jan. 22, 1992).

[35] *Id.*

[36] *See, e.g., Allied-Signal Inc. v. Director, Div. of Taxn.,* 504 U.S. 768, 778 (1992) ("The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation at all.").

[37] *International Harvester Co. v. Wisconsin Dept. of Taxn*., 322 U.S. 435 (1944).

[38] *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937).

[39] *Curry v. McCanless*, 307 U.S. 357 (1939).

[40] *Geoffrey Inc. v. South Carolina Tax Comn.*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993).

[41] *Comptroller v. SYL Inc.*, 825 A.2d 399 (Md.), *cert. denied*, 124 S. Ct. 78 (2003).

[42] *Truck Renting and Leasing Assn. v. Commissioners of Revenue*, 746 N.E.2d 143 (Mass. 2001).

[43] *Couchot v. State Lottery Comn.*, 659 N.E.2d 1225 (Ohio), *cert. denied*, 519 U.S. 810 (1996).

[44] *General Motors Corp. v. Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 525 U.S. 1056 (2002).

[45] The Court has rejected invitations to address the economic nexus question outside the use tax area several times. *See, e.g.*, *Geoffrey,* 510 U.S. 992 (1993); *Johnson v. J.C. Penney Natl. Bank*, 531 U.S. 927 (2000); *SYL*, 124 S. Ct. 478 (2003).

# FTB Issues Guidance on Implementing the New California Water's-edge Election Statute

By Eric J. Coffill

## Introduction

On September 30, 2003, the Governor signed Senate Bill (SB) 1061 (Cal. Stats. 2003, Ch. 633), which made significant changes to the California water's-edge election procedures. SB 1061 (the "new legislation") became effective immediately upon enactment, and is operative for taxable years beginning on or after January 1, 2003. On May 3, 2004, the FTB issued FTB Notice 2004-2 (the "Notice"), in which FTB staff explains the implementation of the new legislation. The history, and the basics, of the California water's-edge election are beyond the scope of this article.[1] Instead, this article reviews the highlights of the new legislation as implemented by the Notice.

SB 1061 applies to elections made for taxable years beginning on or after January 1, 2003. However, taxpayers who are currently filing under a water's-edge election in prior years do not have to make a new election under SB 1061. For taxpayers who would have been required to file on a water's-edge basis in their first taxable year beginning on or after January 1, 2003, pursuant to a water's-edge election made in a prior year, the election shall be deemed to have been made under the new provisions. The commencement date of the election made in a prior year continues to be treated as the commencement date under the new procedures.[2]

## Making the Election

The water's-edge election is now a statutory election, instead of an election by contract as under the prior law. Since the time the water's-edge election procedures were first enacted by the California Legislature in 1986, they had required the election to be made by entering into a contract with the FTB. The FTB's bill analyses of SB 1061 explains the 1986 legislation used a contract because it was necessary to justify imposition of the filing requirement of the Domestic Disclosure Spreadsheet ("DDS") and the payment of the water's-edge election fee. However, the repeal of the DDS filing requirement and the fee in 1994 eliminated this original justification for the contract. Accordingly, FTB has now concluded there is no longer any justification for requiring the water's-edge election to be made by contract. For taxable years beginning on or after January 1, 2003, the new legislation provides the election will now be made on the original, timely filed return for the year of the election, and "a written notification of election is filed with the return on a form prescribed by the Franchise Tax

Board."[3] An election will be considered valid under the new legislation if (1) the tax is computed in a manner consistent with a water's-edge election; and (2) the written notification is filed.

Interpreting the new legislation, the FTB Notice states that in order to make a water's-edge election, a corporation must do each of the following:

- Compute its income on a water's-edge basis.
- Use Form 100W, California Corporation Franchise or Income Tax Return–Water's-Edge Filers; and
- Attach the Form 100-WE, Water's-Edge Election, to the timely filed original return (Form 100W) for the year of the election.

The Notice confirms that the election is for an initial term of 84 months and remains in effect, year by year, until terminated by the taxpayer. Corporations which have a valid election for taxable years beginning before January 1, 2003 will continue to file on a water's-edge basis and *will be deemed* to have elected under the new statute for taxable years beginning on or after January 2, 2003. The original commencement date remains in effect.

Interestingly enough, the FTB's Notice does not directly address the "substantial performance" concept previously found only in the FTB regulations, but which was codified in SB 1061.[4] FTB Regulation 25111-1 provides that the election contract shall be considered valid "so long as there has been substantial performance of the requirements for entering into the contract," with "substantial performance" being defined as "'objective evidence' to support the conclusion that an election was intended."[5] This regulation then goes on to provide a non-exclusive list of what constitutes

*The new legislation significantly changed the provisions regarding automatic renewal and termination of the election*

"objective evidence." SB 1061 incorporated this "objective evidence" regulatory principle into the California Revenue and Taxation Code, and provides that pursuant to regulations promulgated by the FTB, the FTB "may accept the filing of other objective evidence that supports the conclusion that a water's-edge election was intended in lieu of notification on the designated form."[6] It remains to be seen whether FTB begins a regulation project on the "objective evidence" standard, and no such project is underway at this time.

### Effect of Different Fiscal Years When Making the Election

The Notice sets forth rules for making the election when taxpayers that are members of the water's-edge group have different fiscal years. In general, the Notice states that each member of the water's-edge group must make the election on its timely filed original return for the taxable year for which the election is being made, and the election becomes effective as of the beginning of the taxable year of the last member of the water's-edge group to file its return and election. The 84-month election period for each member starts from the date that the election becomes effective. Each taxpayer in the electing group must compute its tax on a water's-edge basis for the portion of the taxable year for which the election is effective.

### Nonrenewal and Terminating the Election

The new legislation significantly changed the provisions regarding automatic renewal and termination of the election. The prior law provided that a water's-edge election is for an initial term of 84 months, but that the election is automatically renewed each year thereafter for an additional one-year period unless the taxpayer gives written notice of nonrenewal at least 90 days prior to the anniversary date.

Thus, the "rolling" election continued indefinitely if a taxpayer elected water's-edge treatment and did not file a notice of nonrenewal. Under the prior law, a taxpayer wishing to limit the election to the minimum seven-year period had to file a notice of nonrenewal soon after it first made the election — which acted to terminate the election seven years in the future.

SB 1061 changed these renewal and termination provisions, and provides new rules for how the election may be terminated with or without the consent of the FTB. The Notice states that Form 1116, Notice of Nonrenewal of Water's-Edge Contract, is now obsolete, and as of January 1, 2003, there is no need to file a Notice of Nonrenewal.

*Termination Without the FTB's Consent*

SB 1061 provides that a water's-edge election may be terminated without the consent of the FTB after it has been in effect for at least 84 months. The termination must be made on an original, timely filed return (on a non-water's-edge basis) for the first year in which the water's-edge election is to be terminated. To be effective, the termination shall be made by every taxpayer that is a member of the water's-edge group.[7] The Notice states that the effective termination date would be the last day of the taxable year immediately preceding the non-water's-edge filing. However, SB 1061 also includes a provision intended to limit a taxpayer's ability to jump back and forth from year to year between making the election and filing on a worldwide unitary basis. Although the FTB may make exceptions for good cause,[8] the new legislation and the Notice provide that if the taxpayer terminates its water's-edge election, it is required to file on a worldwide basis (i.e., non-water's-edge basis) for at least 84 months before making another water's-edge election (absent the FTB's consent).

*The acquisition of a water's-edge taxpayer no longer automatically "taints" any non-electing affiliates with which it is engaged in a unitary business*

The Notice states that "questions have arisen" regarding the issue of when a taxpayer may terminate the election with the FTB's consent, and the Notice sets forth four specific examples of situations where consent will or will not be required because of the interaction between California Revenue and Taxation Code Sections 25111 and 15113. For instance, in Example 1, a taxpayer had filed a Notice of Nonrenewal and did not file a new contract for year ended 12/31/02, but continued to file on a water's-edge basis "on an original return that contained other objective evidence of an intended water's-edge election." The Notice states this "substantial performance of the requirements for entering into a water's-edge contract" meant a new contract had started as of 1/1/01, so that the taxpayer <u>cannot</u> now terminate the election without the FTB's consent, because the election has not been in effect for seven years. The Notice concludes the taxpayer in this example must obtain the FTB's consent if it wishes to terminate the election at this time.

*Termination with the FTB's Consent*

The new legislation also provides that an election may be terminated prior to its normal expiration date with the consent of the FTB, and provides such a request for termination shall be made at the time and in the manner specified by the FTB. The request may be granted for good cause. For this purpose, "good cause" has the same meaning as specified in Treasury Regulation Section 1.1502-75(c).[9]

The Notice elaborates upon these statutory provisions, and provides that "in general," the request for consent to terminate will be granted "only" if the taxpayer demonstrates that it meets the good cause requirements as provided under Treasury Regulation Section 1.1502-75(c). The Notice also states that consent given by the FTB will not be retroactive. If consent is given, the taxpayer will be required to file on a worldwide basis (i.e., non-water's-edge basis) for at least 84 months before making another water's-edge election (absent consent from the FTB).

The Notice states the request to terminate for good cause must be in writing and must clearly state the reason for the request. A taxpayer must file FTB Form 1117, Request to Terminate Water's-Edge Election, with the FTB no later than the 90th day prior to the due date, including extensions of the return for which the termination would be effective. A taxpayer may withdraw its request at any time before the FTB takes action.

### The New Deemed Election Provisions and Changes in Affiliation

SB 1061 addressed what had been a very serious problem, and a trap for the unwary, under the prior water's-edge election law involving corporate acquisitions. Prior to the new legislation, there were only two methods by which a taxpayer could terminate a water's-edge election prior to the end of the 84-month period. First, a taxpayer could request permission, at any time, from the California FTB to terminate the election, which the FTB could either grant or deny in its discretion, and could impose conditions upon the termination. Second, a taxpayer had a right to timely elect to terminate the election if it was acquired, directly or indirectly, by a non-electing entity that alone or together with its affiliates included in the taxpayer's unitary group was larger, in terms of equity capital, than the taxpayer.

This latter provision frequently gave rise to problems where a nonelecting corporation acquired a corporation which had made the water's-edge election, and both were unitary. *Unless* the acquiring corporation timely terminated the (acquired) election, the acquired company's water's-edge election was automatically binding on the acquiring company for the remaining term of the contract. This provision in the prior law had been the downfall of many a (non-water's-edge electing) unsuspecting corporation which made an acquisition, and then found itself subject to a California water's-edge election for no reason other than the fact a corporation it acquired had made a water's-edge election.

*The FTB has taken another major step toward easing the mechanics of the water's-edge election*

SB 1061 addressed this problem by providing that the acquisition of a water's-edge taxpayer no longer automatically "taints" any non-electing affiliates with which it is engaged in a unitary business. Instead, when two or more taxpayers become unitary under these circumstances, the new legislation provides that the (election or nonelection) status of the larger taxpayer, based on the value of the total "business assets"[10] of the taxpayer and its "component unitary group,"[11] will prevail.[12] According to the FTB, this result is more likely to coincide with a taxpayer's expectations, and would prevent a large unitary group from being unintentionally bound by a water's-edge election when it acquires a smaller water's-edge electing taxpayer.

The Notice summarizes this significant change, and summarizes other current rules regarding changes of affiliation, as follows:

- If one or more electing taxpayer members of a combined reporting group for any reason leave the group, the water's-edge election remains in effect as to the departing taxpayer members and any remaining taxpayer members.[13]

- If electing taxpayers with different election start dates become members of a new group, the election start date of the new group shall be the start date of the taxpayer (and affiliates, if any) whose total business assets are the largest.[14]

- If an electing taxpayer and a non-electing taxpayer become members of a new unitary group, the non-electing taxpayer shall be deemed to have elected *if* the value of the total business assets of the electing taxpayer (and affiliates, if any) is greater than that of the non-electing taxpayer (and affiliates, if any). Otherwise, the election shall *automatically* be terminated at the time the electing members become part of the combined report.[15]

- If two non-electing taxpayers with different termination dates become members of a new group, the termination date, together with any associated restrictions on re-election, of the taxpayer (and affiliates, if any) whose total business assets are the largest shall be the termination date of the new group.[16]

The Notice then proceeds to give four examples of the application of these rules.

## Conclusion

The process of analyzing whether or not to make a California water's-edge election has never been an easy one, and the election provisions of the new legislation and the Notice will not measurably ease that process. However, the mechanics of the election and the termination processes will certainly be easier. SB 1061 was an FTB-sponsored bill, and to FTB's credit, it has taken another major step toward easing the mechanics of the water's-edge election. While it is inevitable that future glitches will occur in the election and termination process, the new legislation, and Notice 2004-2, provide useful guidance on the new rules. ■

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[1] For an overview of the history and basics of the California water's-edge election, *see* Coffill, "California's New Water's Edge Election Provisions," *State Tax Notes*, Dec. 8, 2003, p. 845. For a more complete history of the original election dating back to 1986, *see* Coffill, "A Kinder, Gentler 'Water's Edge' Election: California Wards Off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package," *State Tax Notes*, Oct. 25, 1993, p. 965.

[2] Cal. Rev. & Tax. Code §§ 23111, subd. (f); 25113, subd. (f).

[3] Cal. Rev. & Tax. Code § 25113.

[4] It is, however, at least indirectly addressed in one example in the Notice, which is discussed below.

[5] Tit. 18, Cal. Code of Regs., § 25111-1, subd. (a)(2).

[6] Cal. Rev. & Tax. Code § 25113(a)(2).

[7] Cal. Rev. & Tax. Code § 23113, subd. (c)(10).

[8] Cal. Rev. & Tax. Code § 23113, subd. (c)(11).

[9] Cal. Rev. & Tax. Code § 23113, subd. (c)(10).

[10] "'Business assets' are assets, including intangible assets, other than stock of a member of the unitary affiliate group, which are used in the conduct of the business of the unitary affiliate group or would produce business income to the unitary affiliate group, if an election were not in place, if the assets were sold. Business assets shall be valued at net book value." Cal. Rev. & Tax. Code § 25113, subd. (c)(6)(A).

[11] "The phrase 'component unitary group' means that portion of a group of corporations that have become members of a new unitary affiliate group that were members of their own respective unitary affiliate group prior to entering the new unitary affiliate group, disregarding any corporations that did not become part of the new unitary group." Cal. Rev. & Tax. Code § 23113, subd. (c)(6)(D).

[12] Cal. Rev. & Tax. Code § 23113, subd. (c)(2).

[13] Cal. Rev. & Tax. Code § 23113, subd. (c)(1).

[14] Cal. Rev. & Tax. Code § 23113, subd. (c)(3).

[15] Cal. Rev. & Tax. Code § 23113, subd. (c)(2).

[16] Cal. Rev. & Tax. Code § 23113, subd. (c)(4).

# Colorado Unitary Case: Victory for the Taxpayer

Craig B. Fields and Behir A. Sabban

*The authors, along with Paul H. Frankel and Roberta Moseley Nero, represent The Kroger Co. in this case.*

Although Colorado adopted its unique combination statute in 1985, there were, to date, no court decisions discussing any of the six tests. (The statute provides six independent tests, three or more of which must be satisfied for the current tax year and the previous two years before combination can be allowed or forced.) The Denver District Court recently addressed one of the six tests and ruled that The Kroger Co. ("Kroger") and certain combined affiliates were not unitary with other subsidiaries (the "Subsidiaries") that had no nexus with Colorado. Kroger Co. v. Fisher, No. 02 CV 6564 (District Court, City and County of Denver, June 10, 2004). Therefore, the Subsidiaries could not be included in the combined Colorado income tax reports.

## Background

Kroger and its combined subsidiaries challenged the Colorado Department of Revenue's forced combination of the Subsidiaries. The Subsidiaries were engaged primarily in the supermarket business in Arizona and had no operations or physical presence in Colorado. Kroger and its combined affiliates operated grocery stores, convenience stores, manufacturing operations and other businesses.

Under 39-22-303(11)(a), C.R.S., three or more of six tests must be satisfied to establish a unitary relationship. The parties agreed that two tests had been satisfied (regarding shared directors and officers) and that three tests had not been satisfied (regarding intercompany sales, services and debt) with respect to the Subsidiaries. The parties disagreed regarding whether the remaining test had been met. The test at issue, which we refer to as the "intellectual property test," looks to whether one entity "substantially uses" the patents, trademarks, service marks, logotypes, trade secrets, copyrights or other proprietary materials ("Intellectual Property") of the other entity.

The Department took the position that the Subsidiaries substantially used Kroger's Intellectual Property because the Subsidiaries sold products that bore trademarks owned by Kroger. While the marks are owned by Kroger, many of the products do not indicate that Kroger is the owner of the marks, as Kroger also sells the products to third parties. These products amounted to less than 1% of the Subsidiaries' total store-keeping units (each distinct configuration of a product has a unique store-keeping unit), and sales of these products produced less than 1% of their total sales.

## The Decision

The court held that the Subsidiaries' sale of products bearing trademarks owned by Kroger does not constitute the use of Kroger's Intellectual Property because in the intellectual property context, "use generally refers to displaying the trademark or logo of another entity pursuant to a licensing or royalty agreement." The Subsidiaries did not license the use of the trademarks, rather they purchased the products and sold the products in their stores. The court correctly observed that a retailer's sale of Coca Cola products would not normally be deemed to be the use of the Coca Cola proprietary brand — it is merely the sale of Coca Cola product.

The court also noted that while intercompany sales are a factor in determining whether or not there is a unitary business, this factor is addressed in another subsection of the unitary statute. Therefore, viewing intercompany sales of product as the use of intellectual property would dilute the intellectual property test.

The court held that even if the sales of the products bearing Kroger's trademarks could be considered a use, the use was not substantial. The court disagreed with the Department's assertion that the mere sale of a single branded product would be a substantial use of intellectual property. As the court concluded, the Department's interpretation would replace the word "substantial" with "any" and this was not the word used by the Legislature.

As the intellectual property test was not satisfied, only two of six criteria of unity were satisfied, and the Department did not have the discretion to force Kroger and its combined affiliates to include the Subsidiaries in their Colorado income tax reports. This decision clarifies an uncharted area of Colorado tax law and holds that the mere purchase of products from a related company will not be double-counted as unitary factors for purposes of the Colorado unitary statute. An appeal is pending with the Colorado Court of Appeals. ■

# California Residency: Intent Not Enough to Change a Taxpayer's Residence

By Carley A. Roberts

For the first time in over 20 years, the California Court of Appeal has issued a published decision interpreting the California residency provisions of Revenue and Taxation Code section 17014. In *Homer E. Nobel et al. v. Franchise Tax Board*,[1] the court addressed whether the taxpayers were residents of California for personal income tax purposes. Despite the taxpayers' clear intent to change their domicile and residence to Colorado, the court held the taxpayers were still California residents. Before addressing the Court of Appeal's decision in *Nobel*, a brief review of California's residency law is instructive.

The California personal income tax is imposed on the entire taxable income of residents of the state.[2] While residency cases are intensively factual in nature, there are several legal standards under which those facts are to be evaluated. The legal analysis begins with the statute. "Resident" is defined to include: "(1) Every individual who is in the state for other than a temporary or transitory purpose. (2) Every individual domiciled in this state who is outside the state for a temporary or transitory purpose."[3] Any individual who is not a resident is, by process of elimination, a nonresident.[4] Presence within California for more than nine months of a taxable year creates a rebuttable presumption of California residence.[5]

"Residence" and "domicile" are distinct concepts for California tax purposes. "Domicile" denotes the one location with which a person has the most settled and permanent connections and where the person intends to remain.[6] "Residence" denotes any factual place of abode of some permanency, that is, "more than a mere temporary sojourn."[7] A taxpayer may have several residences simultaneously for different purposes, as well as more than one residence for tax purposes. However, a taxpayer may have only one domicile at any given time.[8] A domicile cannot be lost until a new one is acquired.[9]

Regarding domicile, the Court of Appeal has previously defined "domicile" as the "one location with which for legal purposes a person is considered to have the most settled and permanent connection, the place where he intends to remain and to which, whenever he is absent, he has the intention of returning ...."[10] Similarly, FTB Regulation 17014(c) states:

> Domicile has been defined as the place where an individual has his true, fixed, permanent home and principal establishment, and to which place he has whenever he is absent, the intention of returning.... Another definition of "domicile" consistent with the above is the place where an individual has fixed his habitation and has permanent residence without any present intention of permanently removing therefrom.[11]

If an individual is domiciled in California, then he or she remains a resident of California unless he or she is outside California for other than temporary or transitory purposes.[12] Although in every instance the determination of this purpose "will depend to a large extent upon the facts and circumstances of each particular case," it can be stated that an individual is in California for temporary or transitory purposes if he or she is simply passing through on his or her way to another state or country, or is here for a brief rest or vacation, or to complete a particular transaction that will require presence in California for a short period.[13]

Once acquired, a domicile is presumed to continue until it is shown to have changed.[14] In order to change domicile, the California State Board of Equalization has required a showing that a taxpayer (1) left the state without any intention of returning, and (2) was located elsewhere with the intention of remaining there indefinitely.[15] In determining the taxpayer's intent, "the 'acts and declarations of the party must be taken into consideration.'"[16]

In the *Noble* decision, the Court of Appeal echoed many of the long-standing domicile and residency principles discussed above. However, the fact the taxpayers intended to move to another state or the fact they "considered themselves in 'transition' ha[d] no legal significance" according to the Court.

Homer and Stephanie Noble, former residents of Colorado, had been California residents and domiciliaries since 1988. After moving to California, the Nobles continued to own property in Colorado, continued to use Colorado attorneys, accountants and securities brokers, and maintained bank accounts in Colorado. In 1992, the Nobles considered permanently returning to Colorado and began looking for residential property there.

In 1993, Mr. Noble contracted to purchase a 130-acre parcel in Colorado, which included a residence, and the escrow closed on February 25, 1994. However, the Nobles ultimately decided not to move to the 130-acre property and instead treated it as a rental property. In May 1994, Mrs. Noble contracted to purchase a house in Colorado, and escrow closed in June 1994. During July 1994, the Nobles moved part of their household goods to the new house purchased by Mrs. Noble, and the remainder during November 1994.

On March 7, 1994, and March 25, 1994, Mr. Noble sold securities resulting in a net capital gain. Based on a change of residency as of March 1, 1994, the taxpayers filed California Nonresident returns for 1994, reporting the capital gain as nontaxable for purposes of the California income tax. On audit, the Franchise Tax Board concluded the Nobles were domiciled in California, absent for temporary

*The court stated that a "resident's intent to move unsupported by physical acts is not the determinative factor as to whether a taxpayer has changed his or her residence or domicile for tax purposes."*

or transitory purposes, and therefore California residents through July 15, 1994.

The Nobles did not contend they had physically moved to Colorado by March of 1994. To the contrary, during March 1994, the Nobles, among other connections, continued to reside in their California home, which they did not list for sale until June 1994; continued the registration of their vehicles in California; continued their California drivers' licenses; maintained their primary personal checking account and other checking accounts in California; maintained a post office box in California; paid significant amounts for medical and dental care rendered in California; continued a membership in a California club for Mr. Noble; continued to receive cellular phones and credit card statements in California; continued to lease a business office in California for Mr. Noble; and continued to receive Mr. Noble's brokerage statements at his California business mailing address.

However, the Nobles did contend they intended to move to Colorado and the "transition" of their move to Colorado had "progressed far enough" by March 1, 1994, so that their California residency had ended, and their presence in California had become for a "'temporary or transitory' purpose." The stipulated facts showed that during 1993 it was the intention of the Nobles to change their domicile and residence and that of their minor son from California to Colorado, to complete the move to Colorado as soon as possible after the closing of escrow on the 130-acre residential Colorado property, and that the Nobles had spent a substantial amount of time in Colorado between February and July 1994.

Much of the court's analysis focused on the physical acts of the taxpayer for purposes of making the residency determination. Specifically, the court stated that a "resident's intent to move unsupported by physical acts is not the determinative factor as to whether a taxpayer has changed his or her residence or domicile for tax purposes."[17] Continuing, the court stated that "[p]hysical presence in the state has been 'a factor of greater significance than the mental intent or outward formalities of ties to another state."[18]

The court also turned to case law interpreting other California statutes, *i.e.*, other than the income tax statute at issue, involving residency and domicile. "[U]nder the Government Code, a change in residence or domicile requires a 'union of act and intent,' (Gov. Code § 244, subd.(f); *Chambers v. Hathaway* (1921) 187 Cal. 104…) and in that connection, when 'a person actually removes to another place with an intention of remaining there for an indefinite time, and as a place of present domicile, it becomes his place of residence or domicile ….' (*Estate of Weed* (1898) 120 Cal. 634, 639 …)."[19] "'A domicile once acquired is presumed to continue until it is shown to have been changed, and to constitute the new domicile two things are indispensable: First, residence in the new locality, and second, the intention to remain there ….' (*Murphy v. Travelers Ins. Co.* (1949) 92 Cal. App. 2d 582, 587.)" [20] Summarizing these residency principles in its own words, the court stated:

> If one is a resident of the state, that person cannot be in the state for "a temporary or transitory purpose" until that person's acts as well as his or her intent show that he or she has moved out of the state. That one may intend to move from California at some time in the future does not make that person someone who is in California for a temporary or transitory purpose. If it did, every person who contemplates plans for a future would not be taxable as a resident. One is a resident for tax purposes until there are sufficient indicia of an actual change of such residence.[21]

*The court's decision in* Noble *has made it clear that intent alone is insufficient to establish new residency*

The court also emphasized the purpose of the definition of "resident" under section 17014, stating the purpose "'is to include in the category of individuals who are taxable upon their entire net income … all individuals who are physically present in this State enjoying the benefit and protection of its laws and government ….'"[22]

Applying these principles to the Nobles' facts, the court held the "uncontradicted facts establish that no matter what their intention for the future, as of March 1994, appellants had not relinquished either their residence in California, as defined by section 17014, or California domicile, which can be an element of residence under section 17014…. That they considered themselves in 'transition' has no legal significance."[23] Based on the Nobles' continued California contacts, the court also held that such "overwhelming facts of California contacts demonstrate that appellants were, during March of 1994, physically present in this State enjoying the benefit and protection of its laws and government …."[24]

The court's decision in *Noble* has made it clear that intent alone is insufficient to establish new residency. Moreover, intent coupled with physical acts of starting to move or transition to another state is also insufficient to establish new residency. The court was much more focused on whether the taxpayers had relinquished their physical California residence and whether they had affirmatively relocated to another state for purposes of making the residency determination. Nevertheless, the *Noble* decision confirms the long-standing residency principles under California law. ■

[1] 118 Cal. App. 4th 560 (2004).

[2] Cal. Rev. & Tax. Code § 17041.

[3] Cal. Rev. & Tax. Code § 17014; *see also* Cal. Code Regs. tit. 18, § 17014(a).

[4] Cal. Rev. & Tax. Code § 17015; Cal. Code Regs. tit. 18, § 17014(a).

[5] Cal. Rev. & Tax. Code § 17016; Cal. Code Regs. tit. 18, § 17016.

[6] *Whittell v. Franchise Tax Board*, 231 Cal. App. 2d 278, 284 (1964).

[7] *Id.*; *see also Smith v. Smith*, 45 Cal. 2d 235, 239-40 (1955).

[8] *Whittell*, *supra*, 231 Cal. App. 2d at 284.

[9] *Estate of Phillips*, 269 Cal. App. 2d 656, 659 (1969); *Aldabe v. Aldabe*, 209 Cal. App. 2d 453, 466 (1962).

[10] *Whittell*, *supra*, 231 Cal. App. 2d at 284.

[11] Cal. Code Regs. tit. 18, § 17014(c).

[12] *See* Cal. Code Regs. tit. 18, § 17014(a).

[13] Cal. Code Regs. tit. 18, § 17014(b).

[14] Cal. Code Regs. tit. 18, § 17014(c); *Murphy v. Travelers Ins. Co.*, 92 Cal. App. 2d 582, 587 (1949).

[15] *See Appeal of Terrance and Brenda Harrison*, Cal. St. Bd. of Equal., June 25, 1985, 1985 Cal. Tax LEXIS 106; *see also Estate of Peters*, 124 Cal. App. 75 (1932).

[16] *Appeal of Joe and Gloria Morgan*, Cal. St. Bd. of Equal., July 30, 1985, 1985 Cal. Tax LEXIS 88; *see also Appeal of Harrison*, *supra* (stating "[i]t is the 'intent' of the person that determines domicile"); *Chapman v. Superior Court*, 162 Cal. App. 2d 421, 426 (1958); *Estate of Phillips*, *supra*, 269 Cal. App. 2d at 659.

[17] *Noble, supra,* 118 Cal. App. 4th at 567.

[18] *Id.*, quoting *Whittell, supra*, 231 Cal. App. 2d at 285.

# MoFo SALT Attorney News

## Welcome

Morrison & Foerster's State and Local Tax Group would like to welcome Lorig M. Mushegain as a new attorney to its practice. Lorig joins the New York office as an associate. Immediately prior to joining the group, Lorig was a Multistate Corporate Tax Counsel with the California Franchise Tax Board. She has experience in corporate income and franchise taxes.

Lorig received her B.A. in History from The University of California at San Diego in 1996 and her J.D. from Pepperdine University School of Law in 2000. ■

# Bay Area State & Local Tax Breakfast Meetings

As Chair and Vice Chair of the Taxation Section of the San Francisco Bar Association's Barristers Club, Andres Vallejo and Pilar Sansone have begun holding a series of bimonthly breakfast meetings designed to provide a forum for discussing current developments in state and local tax law, as well as an opportunity for the Bay Area's state and local tax community to meet on a regular basis. The first breakfast meeting, which was held in April, featured a discussion of *Microsoft Corp. v. Franchise Tax Board* and other gross receipts cases, and was presented by the former Chief Counsel of the California Franchise Tax Board. The second meeting, which was held in July, featured a discussion of the California Tax Court proposals, and was presented by Chuck Moll, who is the Chair of the Taxation Section of the Bar Association of California. The third meeting, which was held in September, featured a discussion of the aftermath and current legislative activity surrounding *Ceridian v. Franchise Tax Board*.

If you would like to attend future breakfast meetings, please contact Andres Vallejo (avallejo@mofo.com) or Pilar Sansone (psansone@mofo.com). ■

[19] *Noble* at 568.

[20] *Id.*

[21] *Noble* at 568.

[22] *Noble* at 568, quoting Cal. Code Regs. tit. 18, § 17014.

[23] *Noble* at 569.

[24] *Id.* at 569.

# Cogeneration Facility Entitled To Exemption From New York Gas Import Tax

Craig B. Fields and Roberta Moseley Nero

*The authors, along with Paul H. Frankel, represent Brooklyn Navy Yard Cogeneration Partners, L.P. in this case.*

On September 9, 2004, Administrative Law Judge Brian L. Friedman of the New York State Division of Tax Appeals issued a determination in *Brooklyn Navy Yard Cogeneration Partners, L.P*. The case involved a statutory exemption from the gas import tax (Tax Law Section 189) for "[g]as service sold to a co-generation facility, … or a qualifying facility which is a co-generation facility, as such term is defined by section two hundred one of the Public Utility Regulatory Policies Act of 1978 (Public Law 95-617), and used to generate electricity and/or steam produced by such facility when such electricity or steam is supplied and used by a thermal energy host located at or near the project site."

Brooklyn Navy Yard Cogeneration Partners, L.P (the "Navy Yard") developed, built, owns and operates a cogeneration facility that produces electricity and steam. The primary fuel source utilized by the Navy Yard to produce electricity and steam is natural gas. The Navy Yard sells the electricity and steam that it produces to a regulated utility — Consolidated Edison ("Con Ed") — which in turn sells the electricity and steam to its customers.[1] Unless covered by an exemption, the Navy Yard's purchases of gas service would be subject to the gas import tax.

Judge Friedman concluded that the Navy Yard is "a qualifying facility which is a co-generation facility, as such term is defined by section two hundred one of the Public Utility Regulatory Policies Act of 1978 (Public Law 95-617)."[2] Judge Friedman further concluded that Con Ed is a thermal energy host located at or near the Navy Yard.

The Judge explained that the final question — whether the electricity and steam purchased by Con Ed was "used by" Con Ed — was a question of statutory construction and that since an exemption was involved the Navy Yard was required to prove that its interpretation of the statute is the only reasonable interpretation. Judge Friedman then concluded that the Navy Yard had met this burden by proving Con Ed uses the steam and electricity that it receives from the Navy Yard. Specifically he held that:

> [M]ost States define the term "use" in its taxing statutes as an exercise of any right or power over tangible personal property by the purchaser. Clearly, once the purchaser takes possession of the tangible personal property, it may do one of a number of things to the property including reselling it. Had it been intended by the Legislature to exclude a resale of the steam or electricity from the provisions of the exemption under Tax Law § 189(former[6]), it would have been reasonable to have included the same language as was included in other subdivisions of section 189, to wit, "for its own use or consumption in this state." Since the Legislature did not include this language when it enacted the statute, the Division cannot do so now.

The importance of making a good record before the Administrative Law Judge is clearly illustrated by this case. Judge Friedman noted that the terms of the statute he was required to construe — "thermal energy host," "at or near the project site," and "use" — were not defined terms. The Judge relied heavily upon the testimony of the Navy Yard's witnesses and the other evidence presented, such as photographs, in reaching his conclusions. ■

[1] Con-Ed is the Navy Yard's largest customer; however, electricity and steam are also provided to two other entities. The applicability of the exemption for gas used to produce electricity and steam with respect to those sales was not controverted by the Division.

[2] With the exception of the time period December 1, 1996 through April 9, 1997.

*This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particlar situations.*

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