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State & Local Tax Insights

Mitchell A. Newmark and Scott M. Reiber, Co-Editors *Fall 2009*

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California's Treatment of Treasury Function Gross Receipts Before January 1, 2011

By Timothy A. Gustafson

Given California's continuing budget woes, it comes as no surprise that certain tax provisions in California's recent budget agreements have come under fire as corporate handouts that will cost the state billions in lost revenue over the next ten years and beyond.[1] While the pros and cons of elective single-sales-factor apportionment[2] and the sharing of tax credits among members of a combined reporting group[3] are currently under debate, one provision has provoked little controversy thus far. The California Legislature in February 2009 adopted a new definition of "gross receipts" for California sales factor purposes.[4]

Under California Revenue and Taxation Code section 25120,[5] for tax years beginning on or after January 1, 2011, California will define "gross receipts" for sales factor purposes to be the gross amounts realized on the sale or exchange of property, the performance of services, or the use of property or capital in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code. Specifically excluded from the definition are "amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets."

The new legislation provides that taxpayers principally engaged in purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function

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(e.g., a registered broker-dealer) are not performing a treasury function with respect to income so produced. The legislation also specifically excludes from gross receipts the following items: amounts received from hedging transactions involving intangible assets; repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument; the principal amount received under a repurchase agreement or other transaction properly characterized as a loan; proceeds from issuance of the taxpayer's own stock or from sale of treasury stock; damages and other amounts received as the result of litigation; property acquired by an agent on behalf of another; tax refunds and other tax benefit recoveries; pension reversions; contributions to capital (except for sales of securities by securities dealers); income from discharge of indebtedness; and amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code.[6]

While the new legislation attempts to settle a host of gross receipts issues going forward from January 1, 2011, a future effective date nevertheless leaves certain questions unanswered and issues contested at present. One issue at the forefront of a number of appeals currently pending before the California State Board of Equalization ("SBE") and protests presently before the California Franchise Tax Board ("FTB") is the treatment of sales of marketable securities by a corporation's treasury function for California corporate franchise and income tax purposes. The SBE had an opportunity to affirmatively address this issue in December 2008, in *Appeal of Home Depot U.S.A., Inc.*[7]

In *Appeal of Home Depot*, the taxpayer, a leading retailer in the home improvement industry, received business income arising from the redemption of marketable securities. Home Depot's treasury department actively invested and managed the company's cash from its retail operations and monitored the company's investments in short-term financial instruments. While Home Depot had a presence in California through company stores as well as stores of its wholly-owned subsidiaries, the day-to-day management of the investments by its treasury department occurred at the company's headquarters in Atlanta, Georgia. Home Depot's treasury department engaged in these short-term investment activities to ensure the company had sufficient cash to cover its daily working capital needs and to ensure excess cash from the retail operations was appropriately invested. Home Depot filed a claim for refund with the FTB for the taxable year ended January 31, 1999, which requested the gross receipts from its redemption of marketable securities be included in its California sales factor. The FTB denied the claim on the grounds that the inclusion of treasury function gross receipts in the taxpayer's California sales factor denominator would not fairly represent Home Depot's activities in the state. The taxpayer appealed to the SBE.[8]

On appeal, Home Depot argued the FTB had not shown by clear and convincing evidence that including the gross receipts from the redemption of marketable securities in its sales factor resulted in the unfair representation of Home Depot's business activities in California under section 25137.[9] Home Depot claimed that the use of the standard apportionment formula need result in only a "rough approximation" of its business activities in California. Home Depot also contended that inclusion of the gross receipts from its sale of marketable securities in its sales factor resulted in only a 3.27 percent reduction in the income attributable to California for the year under appeal; therefore, by comparison to prior SBE decisions regarding gross receipts, any distortion was too insignificant for any relief under section 25137.[10]

The FTB argued that including the gross receipts generated by Home

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Upcoming 2009–2010 Conferences

The following is a list of conferences through April 2010, in which Morrison & Foerster attorneys will be participating.

OCTOBER 23
Council on State Taxation's (COST) 40th Annual Meeting
Las Vegas, Nevada
Paul H. Frankel

OCTOBER 28
Chicago Tax Club
Rosemont, Illinois
Paul H. Frankel

NOVEMBER 4
Michigan Tax Conference
Novi, Michigan
Paul H. Frankel

NOVEMBER 4-5
State Tax Roundtable for Utilities & Power
Irvine, California
Andres Vallejo

NOVEMBER 9
Tax RAPP
New York, New York
Paul H. Frankel

NOVEMBER 11
NJ Society of Enrolled Agents Meeting, Multi-State Tax Update
Monroe, New Jersey
Mitchell A. Newmark

NOVEMBER 12
Institute for Professionals in Taxation (IPT), Income Tax Symposium
Indian Wells, California
Eric J. Coffill

NOVEMBER 12-14
Annual Meeting of the California Tax Bar and California Tax Policy Conference
San Diego, California
Eric J. Coffill
Hollis L. Hyans
Andres Vallejo
Carley A. Roberts

NOVEMBER 13
TEI, State Tax Day
Hartford, Connecticut
Paul H. Frankel

NOVEMBER 23
California CPA Education Foundation's 2009 Tax Update and Planning Conference
San Francisco, California
Carley A. Roberts

NOVEMBER 24
California CPA Education Foundation's 2009 Tax Update and Planning Conference
Burbank, California
Carley A. Roberts

DECEMBER 1
New Jersey CPAs' State Tax Day
New Jersey
Paul H. Frankel

DECEMBER 9
COST Pacific Southwest Regional State Tax Seminar
San Francisco, California
Thomas H. Steele
Andres Vallejo
Roberta M. Nero
Carley A. Roberts

DECEMBER 10
TEI Holiday Symposium
Paul H. Frankel

DECEMBER 10
COST Pacific Southwest Regional State Tax Seminar
San Jose, California
Thomas H. Steele
Andres Vallejo
Roberta M. Nero
Carley A. Roberts

DECEMBER 15
NYU 28th Institute on State and Local Taxation
New York, New York
Eric J. Coffill
Craig B. Fields
Paul H. Frankel
Hollis L. Hyans

JANUARY 25-27
USC Gould School of Law 2010 Tax Institute
Los Angeles, California
Peter B. Kanter

APRIL 8
MoFo West SALT Update
San Francisco, California

APRIL 15
MoFo East SALT Update
New York, New York

California's Treatment

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Depot's treasury activities in its sales factor was distortive under section 25137. The FTB also denied that there was any "margin of error" that would permit a relatively small amount of distortion. Therefore, the FTB proposed an alternative apportionment formula under *Microsoft* whereby only net receipts from the redemption of marketable securities would be included in Home Depot's sales factor for California apportionment purposes.

On December 18, 2008, after a nearly hour-and-a-half-long oral hearing, the SBE voted 3–2 in favor of the taxpayer and rejected the FTB's use of an alternative apportionment formula under section 25137 to exclude gross receipts generated from the redemption of marketable securities from the sales factor. The SBE held that the FTB failed to carry its burden of proving by clear and convincing evidence that inclusion of these gross receipts resulted in distortion under prior SBE decisions and the California Supreme Court's decision in *Microsoft*. Home Depot successfully argued that any distortion was too insignificant to permit relief under section 25137 as the gross receipts from the sale of its marketable securities was just 6.6 percent of the unitary business's total gross receipts.

Despite the fact the case was originally designated as a "test" case with 27 other SBE appeals involving the same issue held in abeyance, the SBE did not publish the decision. Accordingly, the decision is not precedential.[11]

What will become of other pending SBE appeals with the gross receipts issue? Subsequent to the SBE's decision in *Appeal of Home Depot*, the FTB has invited a number of corporate taxpayers to participate in a "take it or leave it" streamlined resolution program to resolve pending SBE appeals[12] regarding inclusion of certain treasury receipts in the sales factor.[13] Under the terms of the program, the taxpayer and the FTB both agree to concede a specified portion of the tax in issue, and a closing agreement is then executed by the parties to confirm that agreement. That issue is then concluded (but other issues for that tax year may remain in dispute). The percentage that must be conceded by each party depends upon the percentage of the total sales factor denominator attributed to treasury function gross receipts, based on the table below.

To date, the FTB has not indicated whether it will continue its resolution program or expand the program to include corporate taxpayers currently at protest before the FTB who wish to settle their case (or at least the treasury function gross receipts issue) before the FTB's own Settlement Bureau.

In any event, absent challenges on constitutional or other grounds, the new legislation effectively ends all debate for tax years beginning on or after January 1, 2011, as gross receipts from the sale of marketable securities will be excluded from the sales factor in their entirety for California apportionment purposes once the legislation takes effect. ■

Percentage of Treasury Function Gross Receipts in Sales Factor Denominator	Amount of Tax in Issue Conceded by Taxpayer in Closing Agreement	Amount of Tax in Issue Conceded by FTB in Closing Agreement
Up to 6.6%	25%	75%
More than 6.6%, up to 17.3%	40%	60%
More than 17.3%, up to 27.9%	70%	30%
More than 27.9%, up to 33.9%	85%	15%
More than 33.9%, up to 50%	90%	10%
More than 50%	95%	5%

Reflections on the Current State of "Attributional Nexus": When May a State Use the Presence of an In-State Entity to Claim Jurisdiction over an Out-of-State Seller

By Thomas H. Steele and Kirsten Wolff

(Abridged version of article published in *Major Tax Planning – USC Law School Annual Institute on Federal Taxation*, Matthew Bender, 2009)

The downturn in the national economy has triggered a budgetary crisis for many state governments. Undoubtedly, legislatures will seek increased revenues as part of the solution to the budgetary shortfalls. One politically easy solution is to expand the reach of the state's taxes to sweep in companies that earn income or enjoy other benefits that can be viewed as occurring within the state's boundaries, i.e., by expanding the state's jurisdiction to tax to more out-of-state entities.

In this article, we review controversies involving the limits of "attributional nexus," with an eye toward plotting the lines that currently govern a state's reach to impose its use taxes on an out-of-state seller that has customers but no employees or property within the state. Seventeen years ago, the United States Supreme Court established a "bright-line" standard that required, quite simply, that a taxpayer be physically present (beyond a *de minimis* presence) within the state as a condition for being subject to its taxing regime.[1] Notwithstanding the "bright-line" rule, the battles continue to this day and there is little reason to believe they will be resolved soon.[2]

The question in the cases decided under *Quill* and *Bellas Hess* is: What constitutes physical presence under *Quill*? And in the current world, the particular issue is often: Can the physical presence of a party other than the remote seller be attributed to the remote seller to provide the necessary nexus, and, if so, under what circumstances?

To begin to answer these questions, we first explore the ways in which courts have applied two factors drawn from United States Supreme Court decisions to support the theory of attributional nexus, namely: i) whether an in-state entity is acting "on behalf of" an out-of-state seller, and ii) whether the in-state entity is performing activities in support of the marketing or sales activities of that out-of-state entity.[3] We then outline a list of principles intended to provide guidance in evaluating whether an out-of-state entity may be viewed as physically present within a state by reason of

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1 *See, e.g.*, Jean Ross and Alissa Anderson, *To Have and Have Not: California Corporate Tax Breaks*, St. Tax Notes, July 13, 2009. *But see* Peter L. Faber, *California Legislation Is Solidly Grounded in Tax Policy*, St. Tax Notes, July 27, 2009.

2 Cal. Rev. & Tax. Code §§ 25128, 25128.5.

3 Cal. Rev. & Tax. Code § 23663.

4 *See* SB 15, 3d Ex. Sess. (Cal. 2009).

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

6 Cal. Rev. & Tax. Code § 25120.

7 No. 298683 (Cal. State Bd. of Equalization Dec. 18, 2008), non-precedential letter decision.

8 Home Depot requested (and was subsequently granted) deferral of its appeal pending the resolution of similar legal issues raised before the California Supreme Court in *General Motors Corp. v. Franchise Tax Bd.* ("*General Motors*"), 39 Cal. 4th 773 (2006). On August 17, 2006, the Court issued its opinion in *General Motors* and held that a repurchase agreement is analogous to a secured loan and, therefore, only the interest received with respect to that agreement should be treated as "gross receipts" for purposes of formula apportionment. On August 17, 2006, the Court also issued an opinion in *General Motors'* companion case, *Microsoft Corp. v. Franchise Tax Bd.* ("*Microsoft*"), 39 Cal. 4th 750 (2006), and ruled that, while redemption of marketable securities at maturity generates "gross receipts" that are includible in the apportionment formula, inclusion of such "gross receipts" was distortive for purposes of section 25137 under the particular facts of *Microsoft,* and that an apportionment formula which included only "net receipts" was a reasonable alternative.

9 Section 25137 provides in relevant part:

[I]f the allocation and apportionment provisions of this act do not fairly reflect the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require . . . if reasonable . . . [t]he employment of any . . . method to effectuate an equitable allocation and apportionment of the taxpayer's income.

10 *See, e.g., Appeals of Pacific Telephone and Telegraph Company*, 1978 Cal. Tax LEXIS 91 (State Bd. of Equalization May 4, 1978).

11 The SBE has declared that summary decisions are not citable authority and may not be relied upon or given any consideration as precedent. (*Appeal of Charles W. Fowlks*, No. 86R-0799-RO, 1989 Cal. Tax. LEXIS 32 (State Bd. of Equalization Oct. 31, 1989); *see also* SBE Rule for Tax Appeals No. 5451(d) (Cal. Code Regs. tit. 18, § 5451(d)).)

12 The program aimed to resolve the backlog of cases which had been pending the California Supreme Court's decisions in *Microsoft* and *General Motors* and the SBE's decision in *Appeal of Home Depot*.

13 Under the terms of the program, the FTB requires a taxpayer to remove principal amounts received from repurchase and reverse-repurchase agreements, bank savings accounts, and money market accounts from the sales factor denominator under *General Motors*.

Attributional Nexus

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the activities of a third party that is plainly present in the state.

THE ATTRIBUTIONAL NEXUS TEST

Courts have relied on the United States Supreme Court's decisions in *Scripto, Inc. v. Carson* ("*Scripto*") and *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue* ("*Tyler Pipe*") for the proposition that an out-of-state seller will have nexus by attribution of a third party's in-state activities when: 1) the third party is acting "on behalf of" the out-of-state seller, and 2) the third party's activities are "significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."[4]

While this attributional nexus test is clear in theory, application of the test by the courts has yielded less than fully predictable results. Courts have tended to interpret both factors expansively and have implicitly situated the parts in an inverse relationship to one another. Thus, where the court finds that the in-state entity has a close relationship with the out-of-state seller, either because their business operations are extensively integrated or the in-state entity's actions are substantially controlled by the out-of-state entity, then the court will likely place less emphasis on the degree to which the in-state entity's activities are associated with establishing and maintaining the out-of-state seller's market. On the other hand, where a court determines that the in-state entity's activities are very significantly associated with establishing and maintaining a market for the remote seller, the question regarding the extent to which the in-state entity is acting "on behalf of" the remote seller will be less critical. As a consequence, the court opinions considering nexus often have a certain gestalt quality reflecting a test that apparently turns on all the facts and circumstances rather than a surgical examination of two independent factors. Nonetheless, taking each of the factors in turn provides a useful discipline for making judgments as to the risk that certain activities will result in nexus.

The court opinions considering nexus often have a certain gestalt quality reflecting a test that apparently turns on all the facts and circumstances.

A court's examination of "whether substantial business activities have been carried on in the taxing state *on the taxpayer's behalf*" is likely to begin with a determination as to whether the two entities are under common ownership, on the theory that an in-state entity is more likely to represent the interests of its out-of-state affiliate if the two entities are commonly owned.[5] However, it is clear that common ownership does not by itself result in attributional nexus.[6] As a corollary, the absence of common ownership is not sufficient to prevent nexus, particularly if the in-state entity is acting on behalf of the out-of-state entity.[7]

Likewise, it does not appear that the in-state entity must actually be viewed as a formal agent of the out-of-state entity under state law to support

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Massachusetts High Court Rejects Retroactive Escheat Regulations

By Hollis L. Hyans and Amy F. Nogid

(Article published in *State Tax Notes*, August 31, 2009)

The Massachusetts Supreme Judicial Court (SJC) recently tackled the thorny question of retroactive application of an amended interpretive regulation in the context of Massachusetts's Abandoned Property Law (APL), and issued a significant victory to Biogen Idec MA, Inc.[1] The court rejected the state treasurer's attempt to narrow the APL's business-to-business exemption by excluding uncashed accounts payable checks through the 2004 amendment of regulations that had been issued contemporaneously with the 2000 APL legislation and that were in effect at the time of Biogen's 2002 amnesty filing.

MASSACHUSETTS APL BACKGROUND

Massachusetts first enacted its APL in 1950.[2] Then-Gov. Paul A. Dever, in his January 4, 1950, message supporting the enactment of the APL, said:

> It is a means which at once will provide substantial revenues to the commonwealth; work a hardship to no one; protect the owners' rights and prevent unjust enrichment of banks, insurers, debtors, companies and individuals who are the recipients of accidental windfall — the windfall of finding in their hands the abandoned property of others.[3]

Substantiating owners' claims to property under the APL was problematic. It was acknowledged that for "years and years, if not decades and decades," holders of abandoned property may not have provided any information identifying the owners of the property remitted.[4] Of the $20 million of property one holder turned over to Massachusetts, only $3.5 million had the names and addresses of the owners; the company had purportedly been instructed by the treasurer's office to mark as "unknown" any amounts when it had incomplete information.[5] Because of lax reporting and enforcement, several fraudulent schemes were undertaken that resulted in the theft of substantial abandoned property money.[6]

While the treasurer's office may have been lax in enforcing reporting requirements, Treasurer Joseph D. Malone, who held that office from 1991 through 1999, was at the same time criticized for "aggressively [seizing] abandoned assets, much of which he eventually transferred to the state's general fund without diligently seeking owners."[7] Businesses were also troubled by what they perceived to be the draconian audits under Malone and, in particular, the focus of contingency auditors on credit balances and the "endless requests for information dating back to a company's founding."[8] Credit balances were viewed as an "attractive target for auditors" that were paid on a contingency fee basis.[9]

When Treasurer Shannon O'Brien took office in 1999, she indicated that more vigorous attempts would be made to reunite property with its owners than were made under Malone, and her office maintained that the APL "should not be about generating money for the state."[10] In response to the concerns of the business community, O'Brien established a task force composed of business associations and lawmakers to review and make recommendations regarding the APL. Massachusetts businesses advocated for the enactment of a business-to-business exemption to provide relief from the Abandoned Property Division's enforcement of the APL "against apparent aged and unresolved

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Escheat Regulations

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business debts reflected in companies' financial records, including uncashed checks."[11] The business-to-business exemption, which exists in some states, is predicated on the notion that abandoned property provisions were intended to protect consumers, and that businesses had the ability to address outstanding issues on their own with their business counterparts.[12] Further, the task force was troubled by the practice of treating as abandoned property checks that were issued between companies but remained uncashed.[13] Common business practice is for a company to simply reissue a check without removing the original check from its books and later to write off the uncashed check, without undertaking the costly step of reconciliation. The task force maintained that a lack of precision in accounting for those transactions should not convert a routine business transaction to an unclaimed property transaction.[14]

The task force, backed by O'Brien, proposed revisions to the APL that were enacted in 2000, including the right to appeal from an audit, the provision of a nine-year limit for filers regarding their liabilities, and as the business community had urged, the exemption for business-to-business credit balances, the question that would be at issue in *Biogen*. The business-to-business exemption provision excluded from the scope of the APL "any outstanding credit balances to a vendor or commercial customer from a vendor resulting from a transaction occurring in the normal and ordinary course of business."[15]

The 2000 legislation also provided for the adoption of an amnesty program and directed the treasurer to conduct "an outreach and publicity program to notify business entities and other holders of abandoned property of their obligations under the General Laws, and the amnesty program."[16] The need for heightened awareness of the state's abandoned property provisions was evident. It was estimated that in 1998 only 3.3 percent of Massachusetts businesses filed the required APL reports.[17] Massachusetts's APL amnesty program followed on the heels of a similar 1999 amnesty program sponsored by the National Association of Unclaimed Property Administrators, in which 40 states had participated; some of those states extended the program through October 31, 2000.[18] Limited lookback and waiver of penalty and interest were the incentives generally offered by the states participating in the 1999 program.[19]

In 2001 O'Brien promulgated regulations that defined credit balances and addressed the scope of the exemption of credit balances from the APL.[20] The definition of credit balances was broad in scope and included "payments to satisfy other obligations between two commercial customers, and may take the form of credits, credit memos, refunds, vouchers, discount points or programs, and other transactions between the parties."[21] The regulations were made applicable to "all prior and current reporting years."

A new treasurer, Timothy Cahill, took office in 2003. On February 12, 2004, he filed emergency regulations to restrict the definition of outstanding credit balances to "outstanding balances that are recorded as current accounts receivable or accounts payable of a holder."[22] The final revised regulations were promulgated on June 18, 2004. Since accounts payable credit balances are eliminated on the issuance of a check, under the amended regulation uncashed or voided business checks would be excluded from the exemption.

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Current California "Strict Liability" Penalty Issues Under Revenue and Taxation Code Sections 19777.5 and 19138

Eric J. Coffill

While California's current $26 billion budget crisis and recent legislative enactments, such as elective single factor sales and unitary credits,[1] have been the most prominent issues on the California tax front, two important and continuing penalty issues should not be overlooked. This article provides a brief update on the current status of both the 2004 so-called "amnesty interest penalty" and the 2008 underpayment penalty, both of which are imposed on a strict liability basis. Continuing, viable issues surround both penalties.

SECTION 19777.5

The amnesty interest penalty found in California Revenue and Taxation Code[2] section 19777.5 was enacted in 2004 as part of a Legislative package (SB 1100) which created tax amnesty programs to be administered by both the California State Board of Equalization (the "SBE") and the California Franchise Tax Board (the "FTB").[3] In general, section 19777.5 imposed a penalty for each taxable year for which amnesty could have been requested (i.e., tax reporting periods beginning before January 1, 2003), for amounts that were due and payable as of March 31, 2005, equal to fifty percent of the accrued interest otherwise due as of that date. The only statutory ground for claiming a refund of the 19777.5 penalty is that it was not "properly computed."[4] The FTB received approximately $3.5 billion in protective claims by March 31, 2005, as a result of taxpayers making protective payments to avoid the penalty for back years. However, it is estimated that only five percent, or $180 million, was "new" revenue, with the balance being accelerated revenue or being refunded to taxpayers.[5]

The FTB continues to take the position that a taxpayer cannot file a protest of the section 19777.5 amnesty penalty before payment and that a post-payment challenge, e.g., a refund claim, only may be based on the ground the penalty was not accurately computed.[6] Similarly, the SBE in its adjudicatory role of reviewing decisions by the FTB on protests and refund claims consistently has taken the position that its jurisdiction to review the amnesty penalty is limited to situations where the penalty is assessed and paid, the taxpayer has filed a timely appeal from a denial of a refund claim, and the taxpayer attempts to show a computational error in the penalty.[7]

Nevertheless, a taxpayer may challenge the constitutionality of section 19777.5. The fact that SB 1100 went into immediate effect and imposed increased interest, retroactively, in the form of a "penalty," raises a number of interesting legal issues. State or federal constitutional challenges may lie on due process, equal protection, retroactivity, and/or ex post facto grounds. However, neither the FTB nor the SBE, as administrative agencies, has the power to refuse to enforce any of the provisions of SB 1100 on the grounds that they are unconstitutional, absent a precedential decision of the California courts.[8] Thus, meaningful challenges to the amnesty interest penalty must take place in the courts rather than before the administrative agencies.

Although the penalty was the result of legislation dating to 2004, there is still no definitive California Court of Appeal ruling on the constitutionality of the penalty. Many practitioners expected resolution of the issue in *General Electric Company*, which was filed in February 2006.[9] However, that case involved a prepayment challenge to the penalty, the FTB was (twice) successful on demurrer, and the case

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Strict Liability

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ultimately settled. Currently, there are a number of cases pending in the California courts which challenge the imposition of the 19777.5 penalty,[10] but there is not yet a precedential Court of Appeal decision.

Knowing that several pending court cases involve a challenge to the penalty, the FTB currently allows taxpayers to protect the statute of limitations on a refund claim by filing a request with the FTB to withhold any action on the claim while an audit determination, legislation, or litigation is still pending. Taxpayers who wish to file such protective claims should send a letter to the FTB identifying the tax year, the amount of amnesty penalty paid, and a statement requesting that the FTB hold the claim in abeyance pending the outcome of the litigation.[11]

SECTION 19138

In 2008, SBX1 28[12] added section 19138, which imposed a new penalty, equal to 20% of the understatement of tax, on taxpayers subject to the Corporation Tax Law with understatements of tax in excess of one million dollars in any taxable year.[13] In the words of the FTB, this is a new "strict liability penalty"[14] with no discretion given to the FTB whether to assess or forgo the penalty on such traditional grounds for relief as reasonable cause, substantial authority, or adequate disclosure.[15] For taxpayers included in a combined report, the one million dollar threshold applies to the aggregate amount of tax liability for all taxpayers included in the combined report.[16] For purposes of computing the twenty percent, "understatement of tax" means the amount of tax shown on an original return or shown on an amended return filed on or before the original or extended due date of the return for any taxable year.[17] The penalty applies to taxable years beginning on or after January 1, 2003, for which the statute of limitations on assessments has not expired.[18] However, for any taxable year beginning before January 1, 2008, the amount of tax paid on or before May 31, 2009, and shown on an amended return filed on or before May 31, 2009, was treated as the amount of tax shown on an original return for purposes of section 19138.[19]

For a number of reasons, the new section 19138 penalty should continue to be of interest to all large California corporate taxpayers.

The section 19138 penalty generated much activity at the FTB, which resulted in a December 5, 2008, Interested Parties Meeting, a March 23, 2009, Interested Parties Meeting, issuance of FTB Legal Notice 2009-03 (Mar. 27, 2009), and the penalty having its own dedicated portion of the FTB's website.[20] The FTB reported in June 2009, that, as a result of the May 31st deadline for filing amended returns for the relevant back years, the new penalty resulted in $2.7 billion of revenue, which was significantly higher (i.e., nearly twice) than the FTB's estimate of $1.4 billion.[21]

For a number of reasons, the new section 19138 penalty should continue to be of interest to all large California corporate taxpayers. First, this penalty will continue to be an issue each year in perpetuity unless and until it is repealed by the Legislature or struck down by a court. Accordingly, corporate taxpayers should pay particular attention to possible penalty exposure when filing future returns.

Second, there is pending litigation regarding the constitutionality of the statute. On February 17, 2009, a petition for writ of mandate was filed in *California Taxpayers' Association v. California Franchise Tax Board*,[22] which challenged the constitutionality of section 19138. The petition set forth six causes of action, including claims that: (1) section 19138 is a "tax" (not a penalty) which under Article XIII, section 3, of the California Constitution, must be passed by at least a two-thirds vote of the Legislature, but which passed the Legislature by only a majority vote; (2) the bill (i.e., SBX1 28) was not properly read, printed, and distributed prior to vote, in violation of Article IV, section 8(b), of the California Constitution; (3) the section violates the Excessive Fines Clause of the Eighth Amendment of the U.S. Constitution; (4) the section violates the substantive due process guarantees of the Fourteenth Amendment because it is vague and retroactive; (5) the section violates procedural due process guarantees of the Fourteenth Amendment because it affords no prepayment or postpayment review; (6) the section violates the Commerce Clause of the U.S. Constitution because its practical effect is to discriminate against multistate corporations; and (7) the section violates the Equal Protection Clause of the U.S. Constitution because it arbitrarily discriminates against interstate businesses in favor of intrastate businesses. The petition asked the trial court to issue a writ of mandate commanding the FTB to cease enforcing section 19138, a declaration that section 19138 was unconstitutional, and an injunction prohibiting the FTB from enforcing it. The petition asked that these actions take place before May 31, 2009, to avoid irreparable harm to taxpayers who otherwise would be required to file amended returns by that date to avoid the penalty.[23] Following lively and protracted proceedings, the trial court, in a ruling filed on May 20, 2009, denied the petition for mandate and for other relief. On August 13, 2009, California Taxpayers' Association filed a notice of appeal with the Third District Court of Appeal.[24]

Third, there is possible Legislative action on the penalty statute. Assembly Bill 697 (C. Calderon) was amended on June 1, 2009, to limit the imposition of the section 19138 penalty to taxable years beginning before January 1, 2008 (and after January 1, 2003), and would repeal the penalty provisions on December 1, 2010. The FTB has currently scored AB 697 as having a revenue loss of $580 million in the first year, i.e., 2008-2009—a dramatic change from its prior estimate of a first year revenue loss of only $105 million.[25] AB 697 is currently on the suspense file in the Senate Revenue and Taxation Committee.

Fourth, taxpayers who filed amended returns by May 31, 2009, to avoid the penalty for taxable years beginning before January 1, 2008—and paid approximately $2.7 billion to the FTB during that exercise—should remember to timely file refund claims meeting the requirements of section 19322 seeking a refund of amounts paid on those amended returns. The refund claims should not only seek a refund on the substantive grounds which led to the payments on the amended return, but also should allege the unconstitutionality of the statute, e.g., on all the grounds advanced in the pending *California Taxpayers' Association* appeal. While there are many potential statutes of limitation for filing refund claims, one such statute of particular application is section 19306, which provides in pertinent part that a refund claim can be filed within one year from the date of the overpayment.

"The purpose of a penalty is to deter wilful conduct considered undesirable."[26] Yet twice in the past five years the California Legislature has enacted so-called "penalties" which by their terms retroactively "deter" conduct while generating and accelerating revenue. Both sections 19777.5 and 19138 should be closely watched by practitioners and corporations in hopes that relief is forthcoming from either the courts or the Legislature. ■

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Strict Liability

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[1] *See* Eric J. Coffill and David A. Ziring, *The Income Tax Provisions of California's Fiscal 2009 Budget Act*, St. Tax Notes, Oct. 27, 2008, at 221-26.

[2] All statutory references herein are to the California Revenue and Taxation Code.

[3] For an expanded discussion of the enactment of SB 1100 and the amnesty programs, see Eric J. Coffill and Carley A. Roberts, *California Enacts New FTB and BOE Penalties Affecting Pending Audits, Protests, Appeals, and Settlements*, St. Tax Notes, Aug. 23, 2004, at 601-04.

[4] Section 19777.5(e)(2).

[5] *See* Cal. Franchise Tax Bd., AB 1452 – Bill Analysis, at 11 (Sept. 29, 2008). Of the $3.5 billion in protective claims received by the FTB, about $3 billion was attributable to 109 taxpayers. The FTB in 2005 worked on a "fast-track" timetable to resolve as many amnesty-related refund claims as possible. *See* Cal-Tax, *Cal-Taxletter*, Oct. 14, 2005, at 7.

[6] *See* Cal. Franchise Tax Bd., *Administrative remedies if the post amnesty penalty is miscalculated*, Tax News, June 2006, at 2, *available at* http://www.ftb.ca.gov/professionals/taxnews/0606/0606.pdf.

[7] *See, e.g., Appeal of Virginia M. Harp*, No. 405941, 2009 Cal. Tax LEXIS 160 (State Bd. of Equalization Apr. 15, 2009); *Appeal of Kris Christianson and Carolyn Christianson*, No. 395923, 2009 Cal. Tax LEXIS 147 (State Bd. of Equalization Apr. 15, 2009).

[8] Cal. Const. art. III, § 3.5.

[9] *General Electric Co. and Subsidiaries v. Cal. Franchise Tax Bd.*, No. A115530 (Cal. App. 1st Dist. filed Sept. 15, 2006).

[10] Current pending cases include *Microsoft Corp. v. Cal. Franchise Tax Bd.*, No. CGC08471260 (Super. Ct. S.F. County filed Jan. 22, 2008); *River Garden Retirement Home v. Cal. Franchise Tax Bd.*, No. A123316 (Cal. App. 1st Dist. filed Nov. 6, 2008); and *Shaw v. Cal. Franchise Tax Bd.*, No. BC378829 (Super. Ct. L.A. County filed Oct. 10, 2007).

[11] Cal. Franchise Tax Bd., *The amnesty penalty and protective claims*, Tax News, June 2007, at 2, *available at* http://www.ftb.ca.gov/professionals/taxnews//2007/0607/0607.pdf.

[12] The bill was signed by the Governor on October 1, 2008. For an expanded discussion of the enactment of SBX1 28 and section 19138, *see* Eric J. Coffill and David A. Ziring, *The Income Tax Provisions of California's Fiscal 2009 Budget Act*, St. Tax Notes, Oct. 27, 2008, at 221-26.

[13] Section 19138(a)(1), (b).

[14] Cal. Franchise Tax Bd., SBX1 28–Bill Analysis, at 9 (Sept. 29, 2008).

[15] There are, technically speaking, a few exceptions to the penalty, which are as follows: A refund or credit for any amounts paid to satisfy the new penalty may be allowed only on the grounds that the amount of the penalty was not properly computed by the FTB. Section 19138(e). However, the penalty may not be imposed on any understatement to the extent the understatement is attributable to a change in law that is enacted, promulgated, issued, or becomes final after the earlier of (1) the date the taxpayer files the return for the taxable year for which the change is operative; or (2) the extended due date for the return of the taxpayer for the taxable year for which the change is operative. Section 19138(f)(1). For this purpose, "change of law" means a statutory change or an interpretation of law or rule of law by regulation, legal ruling of counsel under Government Code section 11340.9, or a published federal or California court decision. Section 19138(f)(2). The FTB is directed to implement this latter provision "in a reasonable manner." Section 19138(f)(3). In addition, no penalty will be imposed to the extent the understatement is attributable to the taxpayer's reasonable reliance on written advice of the FTB, but only if the written advice was a Chief Counsel legal ruling issued under section 21012(a)(1). Section 19138(g).

[16] Section 19138(a)(2).

[17] Section 19138(b).

[18] Section 19138(h).

[19] Section 19138(b).

[20] *See* http://www.ftb.ca.gov/businesses/large_corporate_understatement_penalty.shtml.

[21] Cal-Tax, *Cal-Taxletter*, June 19, 2009, at 9.

[22] No. 2009-80000168 (Super. Ct. Sacramento County filed Feb. 17, 2009).

[23] For more information on the case, *see* Jennifer Carr, *California Taxpayer Group Fights New Understatement Penalty*, St. Tax Notes, Mar. 9, 2009, at 785-89.

[24] No. C062791 (Cal. App. 3d Dist. filed Aug. 13, 2009).

[25] Cal. Franchise Tax Bd., AB 697 – Revised Amended Bill Analysis, at 2 (July 7, 2009).

[26] *Fran Corp. v. United States*, 998 F. Supp. 296, 299 n.4 (S.D.N.Y. 1998).

MoFo Attorney News

Morrison & Foerster's State and Local Tax Group would like to welcome the following attorneys to the SALT Group:

- Marjorie S. Elkin joins SALT as Of Counsel in the New York office;
- Timothy A. Gustafson joins SALT as an associate in the Sacramento office;
- Kirsten Wolff joins SALT as an associate in the San Francisco office.

Attributional Nexus

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a finding of attributional nexus.[8] Rather, where the court finds that the out-of-state seller "retained control over many of the significant aspects of the services to be provided by [the in-state entity]," or that the remote seller "relies heavily" on an in-state company to perform critical functions in support of the sale, including, for example, accepting and depositing payment, a court is likely to find that the in-state entity is acting on behalf of the out-of-state entity.[9]

As to the second factor, the courts have found that a wide variety of activities are "significantly associated with the taxpayer's ability to *establish and maintain a market* in this state for the *sales*."[10] For example, the Tennessee Court of Appeals concluded that the various functions performed by an in-state manufacturer for an out-of-state vendor, ranging from "the preparation of price quotes[,] to drawing up blueprints[,] to fabricating the product[,] to arranging for shipment of the product[,] to accepting final payment from the customer," satisfied that standard.[11] Two courts examining Dell's business model have determined that in-state warranty repair services sold by Dell in connection with its remote mail order sales of computers, and provided by a third-party contractor, should be viewed as supporting Dell's efforts to obtain sales in the markets where the warranty repair services are provided.[12]

APPLICATION OF THESE PRINCIPLES TO THE BOOKSELLER CASES

Three cases involving Borders and Barnes & Noble, two booksellers with apparently similar business models, provide a useful opportunity to examine how the courts have determined whether the in-state entity is acting on behalf of the out-of-state entity and whether in-state activities should be viewed as creating or maintaining a market. In those cases, the fundamental facts were the same: each involved stores operating within the state (so-called "brick & mortar" operations) owned by one corporation, and a separately incorporated operation that provided sales over the Internet (and that was not physically present in the state seeking to impose the tax) (the "Internet seller"). In each case, the taxing authorities sought to impose use tax collection over the remote Internet sales operation based upon activities of the brick & mortar stores in the state.[13]

In the *Borders* case, decided by the California Court of Appeal, the in-state retailer: 1) accepted returns from, and provided refunds and exchanges to, the remote seller's customers; 2) issued receipts to its customers with the message "Visit us online at www.Borders.com"; and 3) encouraged its employees to

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> The absence of common ownership may go a long way to establishing that the in-state entity is acting in its own interest and not on behalf of the out-of-state entity and, thus, may be very helpful in avoiding attributional nexus.

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refer customers to the remote seller's website.[14] The court concluded that the in-state operation acted on behalf of the out-of-state operation and that these activities were significantly associated with the remote seller's "ability to establish and maintain a market" in California and so created nexus with the out-of-state seller.[15]

In contrast, in the first Barnes & Noble case, *B&N (Cal.)*, the trial court concluded that the brick & mortar store did not act on behalf of the Internet seller. The court focused upon the fact that the brick & mortar company did not control the remote seller.[16] The court also noted that, unlike in the *Borders* case, the sole activity that the brick & mortar store performed for the Internet seller was to distribute coupons for purchases from the Internet seller that had been inserted into the store's shopping bags by a third-party vendor.[17] The court found that this activity was not enough to create an agency relationship, so that the Internet seller did not have nexus with California.[18]

In the second Barnes & Noble case, a U.S. District Court in Louisiana decided that the in-state activities of the brick & mortar store did not establish and maintain a market for the sales of the remote seller.[19] There, the brick & mortar operation and the Internet seller participated in a "membership program," and a gift card program, whereby customers could receive certain discounts and redeem gift cards at the brick & mortar store, with the Internet seller, or at any other participating retailer.[20] However, the court found that these activities did not "produce[] revenue to Online by virtue of sales made or orders taken by the entity that is physically present in the Parish," since the revenue from the programs was simply divided among participating entities on a pro rata basis.[21] The court did not see that it was justified in "treat[ing] Booksellers as acting as a marketing presence for Online," merely because the brick & mortar store filled orders for merchandise from the Internet seller's distribution center, since the brick & mortar store also filled orders from many wholesalers and did not treat the remote Internet seller any differently from those other wholesalers.[22]

Unlike in the *Borders* case, the brick & mortar stores did not refer customers to the remote Internet seller or otherwise promote that entity's business, except in connection with the membership and gift card programs.[23] However, similar to the brick & mortar retailers in *Borders*, Barnes & Noble stores accepted returns of merchandise purchased from the remote Internet seller, treated that merchandise "as if it were its own," and gave it preferential treatment over merchandise purchased from third parties.[24] The court nonetheless distinguished the *Borders* case on this point, on the grounds that the Barnes & Noble stores "initiated the return policy to generate goodwill and to serve the convenience of its customers," implying that the activity was associated with establishing and maintaining the store's own market, not that of the remote Internet seller.[25]

Thus, these cases provide a pointed example of the variety of conclusions courts can reach when deciding attributional nexus questions, even in the face of seemingly parallel facts.

GUIDELINES FOR AVOIDING ATTRIBUTIONAL NEXUS

Because the battle lines continue to shift and because the cases that have recently considered this issue often turn on specific facts, it is difficult to develop any practical rules for avoiding attributional nexus based solely on corporate structure or even operational limits. However, notwithstanding the variation among individual cases, we believe it is possible to establish at least four guidelines that can be used to analyze the risk that an in-state business operation may produce nexus for an out-of-state sales operation.

First, common ownership of a remote seller and an in-state entity, by itself, should not result in attributional nexus.[26] The absence of common ownership may go a long way to establishing that the in-state entity is acting in its own interest and not on behalf of the out-of-state entity and, thus, may be very helpful in avoiding attributional nexus.

Second, contracting with an entity that is plainly not involved in the success of the marketing and sales activity of the out-of-state entity should not result in attributional nexus.[27] This principle will be strongest where the in-state entity is engaged in an obviously unrelated business, for example, where the in-state entity is a professional service provider (e.g., lawyer or accountant),[28] or where the in-state activities provide no meaningful assistance or are, in fact, detrimental to the out-of-state seller's sales.[29]

Because the battle lines continue to shift and because the cases that have recently considered this issue often turn on specific facts, it is difficult to develop any practical rules for avoiding attributional nexus based solely on corporate structure or even operational limits.

Third, as a corollary to this principle, merely placing an advertisement in a local newspaper or other media should not result in nexus over the out-of-state entity that places the advertisement.[30]

Fourth, using a common carrier or similar entity to provide delivery in the state (and even accept payment for the product) should not result in nexus over the out-of-state entity.[31]

Undoubtedly, the operations of many taxpayers will not fit neatly within these guidelines. And, while it is useful to think of these guidelines as providing "safe harbors," the law is probably not yet sufficiently developed to ensure that all courts will adhere to these principles. As a result, at least until the United States Supreme Court weighs in to fully reconcile the holdings of its decisions in *Quill*, *Bellas Hess*, *Scripto*, and *Tyler Pipe*, there will always be a measure of risk that the tax authorities, at least, will construe any substantial relationship with an in-state entity as providing attributional nexus over a remote seller. ■

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1 *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) ("*Quill*") (citing *Nat'l Bellas Hess, Inc. v. Illinois Dep't of Revenue*, 386 U.S. 753 (1967) ("*Bellas Hess*")).

2 Indeed, Dell's recent petition for writ of certiorari with the United States Supreme Court to obtain the Court's guidance on the very issues addressed by this article was denied. *Dell Catalog Sales L.P. v. Taxation & Revenue Dep't*, 199 P.3d 863 (N.M. Ct. App.), *cert. denied*, 189 P.3d 1215 (N.M. 2008), *cert. denied*, 129 S. Ct. 1616 (U.S. Mar. 23, 2009) (No. 08-770) ("*Dell (NM)*").

3 It is worth noting that judicial decisions concerning whether a state has jurisdiction to tax a remote seller often begin by determining whether jurisdiction exists under the state's statutes or regulations. Often the statutory analysis will closely mirror, and effectively substitute for, the constitutional analysis since many state statutes extend the state's jurisdiction to tax to the full limits permitted by the U.S. Constitution or articulate their limit using logic articulated in the court cases discussing the constitutional standards. *Compare* Me. Rev. Stat. Ann. tit. 36 § 1754-B.1.G, *and* Ohio Rev. Code Ann. § 5741.01(I), *with* N.M. Stat. Ann. § 7-9-10.A. Where the constitutional and statutory standards are not identical, and if the state statute is satisfied, the court must then determine whether the constitutional standard is also met because the Commerce Clause and the Due Process

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Attributional Nexus

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Clause requirements must be met in every instance. *See generally Borders Online, LLC v. State Bd. of Equalization*, 129 Cal. App. 4th 1179 (2005) (evaluating the constitutional requirements after determining that the statutory requirements were met).

[4] *Tyler Pipe*, 483 U.S. 232, 250 (1987) (quoting the Washington Supreme Court decision on appeal, 715 P.2d 123, 126 (Wash. 1986)); *Scripto*, 362 U.S. 207, 211 (1960). Although the Court in *Tyler Pipe* found that the out-of-state seller had nexus, the Court nevertheless struck down the tax at issue because it failed the internal consistency standard of the Commerce Clause. *Tyler Pipe*, 483 U.S. at 247-48.

[5] *Arco Bldg. Sys., Inc. v. Chumley,* 209 S.W.3d 63, 74 (Tenn. Ct. App.), *appeal denied*, No. M2004-01872-SC-R11-CV, 2006 Tenn. LEXIS 1002 (Oct. 30, 2006) ("*Arco*") (internal quotation marks omitted; emphasis original); *see generally St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F. Supp. 2d 575, 580-81 (E.D. La. 2007) ("*B&N (La.)*")

[6] *See, e.g.*, *Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (1994) ("*Current, Inc.*"); *see also SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995); *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn.), *cert. denied*, 501 U.S. 1223 (1991).

[7] *See State v. Dell Int'l, Inc.*, 922 So. 2d 1257, 1266 (La. Ct. App.), *reh'g denied*, No. 2004 CA 1702, 2006 La. App. LEXIS 867 (2006) ("*Dell (La.)*").

[8] *Dell (La.)*, 922 So. 2d at 1264.

[9] *Dell (La.)*, 922 So. 2d at 1264, 1266; *Arco*, 209 S.W.3d at 74.

[10] *Tyler Pipe*, 483 U.S. at 250 (emphasis added). The authors are unaware of any decision in which the Supreme Court has articulated a rationale for why the third party's activities must be related to support for sales and marketing activities as opposed to support for other, more general activities of the remote seller in order for those activities to create attributional nexus for sales tax purposes. Nonetheless, this limitation makes sense, given that jurisdictional issues that arise in the context of sales and use taxes are ultimately triggered by sales to the in-state consumer.

[11] *Arco*, 209 S.W.3d at 74.

[12] *Dell (La.)*, 922 So. 2d 1257; *Dell (NM)*, 199 P.3d at 872. State tax administrators predictably have taken an even more expansive view of the definition of activities in support of obtaining or maintaining a market. The Kansas Department of Revenue, for example, has concluded local third-party contractors that installed security locks and related equipment sold by an out-of-state seller should be viewed as creating and maintaining the market for the remote seller. Kan. Dep't of Revenue Priv. Ltr. Rul. P-2005-016 (June 20, 2005); *see also, e.g.*, Hearing No. 46,541, Texas Comptroller of Public Accounts (May 10, 2006) (concluding that in-state independent contractors that "perform maintenance and repair services" result in attributional nexus with an out-of-state seller).

[13] *See Borders*, 129 Cal. App. 4th 1179; *Barnesandnoble.com LLC v. State Bd. of Equalization* ("*B&N (Cal.)*"), Cal. Tax Rep. (CCH) ¶ 404-488 (Cal. Super. Ct. Oct. 12, 2007); *B&N (La.)*, 481 F. Supp. 2d at 578-79.

[14] *Borders*, 129 Cal. App. 4th at 1199.

[15] *See Borders*, 129 Cal. App. 4th at 1184, 1190-92, 1199 (citation omitted).

[16] Cal. Tax Rep. (CCH) ¶ 404-488, § III(a).

[17] *Id.* § II.

[18] *Id.* § III(a), (b).

[19] The record in the Louisiana Barnes & Noble case appears to differ slightly from the facts relied upon by the California Superior Court case, discussed above, although both courts reached the same conclusion. The differences in the factual record apparently may be traced to the different years at issue in each decision.

[20] *B&N (La.)*, 481 F. Supp. 2d at 578-79.

[21] *Id.* at 581.

[22] *Id.*

[23] *Id.* at 580.

[24] *Id.* at 582.

[25] *Id.*

[26] *See, e.g.*, *Current, Inc.*, 24 Cal. App. 4th at 385; *see also* Hellerstein & Hellerstein, *Cases and Materials on State and Local Taxation* ¶ 19.02(8)(e) (8th ed. 2005).

[27] *See, e.g.*, Tax Determination No. 08-0128, Wash. Dep't of Revenue (May 14, 2008, released Jan. 28, 2009) (concluding the presence of an in-state entity did not result in attributional nexus, in part because the in-state entity's promotions of sales of products to retailers may have, in fact, reduced the market share of the out-of-state seller by allowing local retailers to compete with the out-of-state entity's sales over the Internet and telephone).

[28] Michigan Dep't of Treasury, Revenue Administrative Bulletin 1999-1, *Use Tax Nexus Standards* ¶ I.6(c) (May 12, 1999).

[29] *See, e.g.*, Tax Determination No. 08-0128, Wash. Dep't of Revenue (May 14, 2008, released Jan. 28, 2009) (finding no attributional nexus in part because the in-state entity's promotions of sales of products to retailers may have, in fact, reduced the market share of the out-of-state seller).

[30] *Current, Inc.*, 24 Cal. App. 4th at 386, 391; *see also In re Laptops Etc. Corp.*, 164 B.R. 506, 521 (Bankr. D. Md. 1993).

[31] *AT&T Commc'ns of Md., Inc. v. Comptroller of the Treasury*, 950 A.2d 86 (Md. 2008) (finding no attributional nexus where common carrier accepted payment from customer for charges by remote information service providers).

Escheat Regulations

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BIOGEN FACTS

Biogen took advantage of the state's amnesty program and filed reports in October 2002, but consistent with the 2001 regulations, did not include its commercial accounts payable credit balances in those reports. Biogen received notification dated September 17, 2003, that it had been selected for audit. The state used a contract auditor, Kelmar Associates LLC, to conduct the audit. Kelmar, which was formed in 2001, sells its abandoned property auditing services to various states, generally on a contingency fee basis. As the president of Kelmar testified:

> We conduct audits in a multi-state environment for a multiple of clients. As a result, the fee structure on that is generally contingency, although it can be different, and that has been found to be really the only way to allocate the cost amongst the states in such a way that not each state is paying an hourly rate or flat fee whereas they may or may not have findings relating to abandoned property for their state.[23]

Four days after Kelmar's first meeting with Biogen, Cahill issued the emergency regulations retroactively adopting a restrictive interpretation of credit balances.

Biogen's audit, which covered 1984 through 2004, was characterized by the New England Legal Foundation and the Associated Industries of Massachusetts as "lengthy, costly and disruptive."[24] Given the lack of detailed records for such an extensive audit period, Kelmar used estimation techniques to generate the $781,000 portion of Biogen's $1.234 million final examination report that related to the new, narrow interpretation of the business-to-business exemption.

Biogen challenged the report administratively. Cahill issued a final decision upholding the final examination report, and Biogen proceeded to challenge the assessment in the superior court. Discovery obtained by Biogen during the superior court proceedings included e-mail correspondence among Treasury officials before the promulgation of the amended regulation, which confirmed that the "prior administration when applying the credit balance exemption extended it to vendor checks when the holder could show that the underlying source of the check was a vendor credit balance" and that the current treasurer could "offer a different interpretation" if the regulations were amended.[25]

The superior court held that O'Brien's original regulations "best comport" with the "apparent intent and purpose" of the 2000 legislation, which was to exempt business-to-business transactions from the APL.[26] The treasurer appealed to the SJC.

SJC OPINION

The SJC concluded that the general deference afforded by courts to an agency's interpretive regulations applied to the original 2001 regulations and not the 2004 amended regulations. The "pivotal threshold question" in the court's view was whether O'Brien had originally interpreted credit balances as including uncashed accounts payable checks as part of her "policy-making discretion."[27] Although Cahill had objected to the admission of the e-mails confirming the earlier internal policy, the court pointed out that Cahill "does not dispute" the substance of the e-mails and held that "'administrative agencies must abide by their own internally promulgated policies.'"[28] The court noted that the 2001 regulations were enacted "contemporaneously" with the statute, were "reasonable," were not the "product of rash, uninformed rulemaking," and that "Treasurer Cahill does not suggest that Treasurer O'Brien failed to engage

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in thoughtful, reasoned deliberation in promulgating the regulations."[29] Having determined that the 2001 original regulations governed, the court did not have to reach the propriety of the attempt of the 2004 regulations to retroactively change the treasurer's administrative position, or Cahill's defense that the 2004 regulations could be applied retroactively because they were "curative."

OBSERVATIONS

The 2001 original regulations and their interpretation by O'Brien are consistent with the purpose of the 2000 legislation to exempt business-to-business credit balances from the scope of the APL. Therefore, the relevant inquiry under the APL should be whether the underlying transaction is a business-to-business transaction. Businesses that attempt to repay outstanding credit balances to their business customers should not be treated differently from businesses that have not attempted to repay those amounts. Although the SJC reached the right result, it held only that the original regulations were properly enacted. The focus of the superior court on the underlying legislative purpose of exempting all business-to-business transactions was correct, as was its realization that the 2004 regulations would "hobble the statute's effectiveness."[30]

Furthermore, although the APL is not a tax imposition, businesses rightfully view unclaimed property remittances as taxation, particularly when the amounts required to be remitted are based on arbitrary estimation techniques used by contingency fee auditors and when the lion's share of the money is deposited in the state's general fund for its general revenue needs. As Justice John Harlan said, "the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source."[31] Retroactive impositions, whether under legislation or regulation, whether they relate to taxes or "quasi-taxes," and whether they are denominated "curative" or "clarifying," should not be countenanced by the courts. As former Massachusetts Gov. Mitt Romney correctly understood in the context of tax impositions: "It is fundamentally unfair to tax people retroactively."[32] That sentiment was echoed by Massachusetts House Minority Leader Bradley H. Jones Jr. (R), who said, "it is wrong for us to surprise taxpayers with an unexpected demand for more money. Fairness and equality are the underpinnings of any good tax code."[33] Fairness and equality should also be the underpinnings of unclaimed property laws, which have become a "tax" of choice used by many state legislatures.

It is also wrong for governments to take money under the guise of uniting that money with its "owner" using questionable estimation techniques that are then applied to scores of years, based on the absence of supporting documentation for years in the distant past and that businesses had no reason to retain.[34] In this case, even if Biogen had retained records regarding those uncashed accounts payable checks, the treasurer's 2001 regulations eliminated the need for that documentation, and a change in regulation in 2004 should not resurrect a need to retain records.

Neither the parties nor the court focused on the fact that Biogen came forward as part of the state's amnesty program. However, the treasurer's attempted retroactive interpretation was all the more egregious because it arose in the context of the state's amnesty program. Although the acknowledged underlying premise of amnesty programs is that there has been noncompliance with reporting and remittance requirements, some states have used unclaimed property amnesty programs as a carrot and then proceeded to try to kill the donkey by the use of contract auditors who not only conjure up assessments but also get to share in the bounty they bring to governments. Contrary to Dever's 1950 statement, the APL can "work a hardship" to businesses that not only undergo onerous and oppressive audits reaching back into the distant past, but whose costs of doing business can increase significantly because of questionable unclaimed property liabilities.

Biogen reveals the ingenuity of the treasurer in devising methods to reopen the abandoned property revenue spigot[35] and highlights the many serious practical problems faced by businesses regarding their unclaimed property obligations around the country. More importantly, the *Biogen* result shows that holders can successfully challenge states' administration of unclaimed property laws. ■

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1 *Biogen Idec MA, Inc. v. Treasurer & Receiver Gen.*, 454 Mass. 174 (2009).

2 Act of 1950, ch. 801, 1950 Mass. Acts 687.

3 Brief of the Appellant, at 10-11, *Biogen Idec MA, Inc. v. Treasurer & Receiver Gen.*, 454 Mass. 174 (2009) ("Brief of the Appellant") (quoting 1950 Sen. Doc. No. 1, at 22 (Message of Gov. Paul A. Dever)).

4 Martin Finucane, *Abandoned Property Turned Over to Treasury Without Names*, Associated Press St. & Loc. Wire, Apr. 4, 2000.

5 *Id.*

6 Ellen J. Silberman, *O'Brien Administration Hit by Treasury Scam*, Boston Herald, Jan. 14, 2000, at 2.

7 Tina Cassidy, *State Treasurer Plans to Shake Up Department*, The Boston Globe, Aug. 9, 1999, at C11.

8 Edward Mason, *Abandoning a Policy*, Boston Business Journal, Nov. 12, 1999, at 1.

9 Cromwell Schubarth, *Businesses Face New Abandoned Property Rules*, Boston Herald, Jan. 28, 2001, at A30.

10 *At the Statehouse — Audit Recommends Treasury Reforms*, Providence J.-Bull., Feb. 9, 2001, at 5C.

11 Brief for New England Legal Foundation and Associated Industries of Massachusetts as Amici Curiae for *Biogen Idec MA, Inc. v. Treasurer & Receiver Gen.*, 454 Mass. 174 (2009) ("Amicus Brief"), at 10.

12 Approximately a dozen states have some form of business-to-business exemption. However, the exemption may be of limited use since, for the benefit to apply, the jurisdiction of the owner's last-known address (the first priority rule under *Texas v. New Jersey*, 379 U.S. 674 (1965)) and the jurisdiction of the holder's corporate domicile (the second priority rule under *Texas v. New Jersey*) must both have the business-to-business exception.

13 Amicus Brief at 10-11.

14 *Id.* at 12.

15 Mass. Gen. Laws ch. 200A, § 5, as added by Act of 2000, ch. 198, § 2, 2000 Mass. Acts 990.

16 Act of 2000, ch. 198, § 4, 2000 Mass. Acts 991.

17 Michael Cohen, *Does That $72,000 Belong to You?* Sunday Telegram (Mass.), July 25, 1999, at A1.

18 As reported in California Assembly Committee on Judiciary, AB 1888 – Bill Analysis (Mar. 28, 2000).

19 AICPA S&L Alert, *Amnesty Program Broadens as States Join Unclaimed Property Voluntary Compliance Program*, The Tax Adviser (Aug. 1999), *available at* http://www.aicpa.org/pubs/taxadv/online/aug1999/alert.htm.

20 960 Mass. Code Regs. 4.00 (2001).

21 *Biogen*, 454 Mass. at 178 (citing 960 Mass. Code Regs. 4.03(13)(b) (2001)).

22 960 Mass. Code Regs. 4.00 (2001).

23 *Informational Hearing: State Controller's Office and Unclaimed Property* (Cal. Sen. Governmental Org. Oct. 22, 2007).

24 Amicus Brief at 16.

25 Brief of Plaintiff-Appellee, at 12, *Biogen Idec MA, Inc. v. Treasurer & Receiver Gen.*, 454 Mass. 174 (2009) (citation omitted).

26 *Biogen Idec MA, Inc. v. Cahill*, No. 06-0198-BLS1, 2007 Mass. Super. LEXIS 68, at *22-23 (Mass. Super. Ct. Feb. 27, 2007).

27 454 Mass. at 184.

28 *Id.* at 186 (quoting *Comm'r of Revenue v. BayBank Middlesex*, 421 Mass. 736, 739 (1996)).

29 454 Mass. at 189.

30 2007 Mass. Super. LEXIS 68, at *23.

31 *Comm'r v. Brown*, 380 U.S. 563, 579-80 (1965) (Harlan, J., concurring opinion).

32 Press release, Massachusetts Executive Dep't (June 10, 2005).

33 *Id.*

34 Despite the laudable goal of returning property to its owners, of the $729 million of property deposited with the state from 1991 through 1998, only $167 million, or about 22 percent, was returned to owners. Cohen, *supra* note 17, at A1. It is surprising that even that much abandoned property made its way back to owners since the law requires only that the treasurer publish "once a week for two consecutive weeks in a newspaper of general circulation." Mass. Gen. Laws ch. 200A, § 8(a). During that time, during the tenure of Malone, purportedly any investigative function to seek out owners of abandoned property "was virtually eliminated." Cohen, *supra* note 17. A state audit report released in 1999 found that unclaimed tangible personal property, including 300 coins wrapped in socks, 1988 Boston Bruins tickets, and war medals, was not inventoried and was languishing in a vault. Ellen J. Silberman, *Treasury Audit Finds Safe Full of Unclaimed Valuables*, Boston Herald, Mar. 10, 1999, at 1.

35 The original APL provided a 14-year dormancy period for intangible assets before the property would be considered abandoned and subject to the APL. However, the legislature has gone to the APL golden goose many times since 1950, steadily decreasing the dormancy period to a mere three years. Act of 1950, ch. 801, 1950 Mass. Acts 687 (14 years); Act of 1975, ch. 608, sec. 4, 1975 Mass. Acts 652 (10 years); Act of 1980, ch. 130, sec. 4, 1980 Mass. Acts 88 (7 years); Act of 1981, ch. 351, sec. 104, 1981 Mass. Acts 438 (5 years); and Act of 1992, ch. 133, sec. 533, 1992 Mass. Acts 570 (3 years), as cited in Brief of the Appellant at 10 n.28. The guise of owner protection is now an apparent afterthought supplanted by budgetary concerns. Having already reduced the dormancy period to an untenably short period, unless the legislature further reduces the dormancy period to an absurdity, that abandoned property spigot closed — at least regarding dormancy periods — in 1992, when the dormancy period for most property was reduced to three years. Act of 2002, ch. 510, 2002 Mass. Acts 1296.

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