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Tax Policy

Paul H. Frankel, partner in Morrison & Foerster LLP and chairman of the BNA Multistate Tax Advisory Board, is a leading authority on state tax issues. Each year, he and his colleagues prepare this list of important issues in state taxation facing tax practitioners, with a focus on judicial developments. As in past years, nexus continues to be a hotly debated concept. Another hot topic this year was apportionment.

2012 Hot Topics in State Taxation: Nexus, Apportionment Among Most Active Topics This Year

BY PAUL H. FRANKEL, CRAIG B. FIELDS, AND BEE-SEON KEUM

The past year saw marked developments in state tax law. Although participation by the United States Supreme Court was still too limited, many important developments occurred at the state level. Among the most active topics were nexus and apportionment.

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U.S. SUPREME COURT

Goodyear Tires, SA v. Brown

In *Goodyear Tires, SA v. Brown*, the U.S. Supreme Court held that a foreign corporation is not subject to general personal jurisdiction on causes of action not arising out of or related to any contacts between it and the forum state merely because other entities distribute in the forum state products placed in the stream of commerce by the defendant.[1] The foreign subsidiaries of a tire manufacturer were sued in North Carolina by the parents of two boys from North Carolina who died in a bus accident outside of Paris, France. In their complaint, the parents alleged that defective tires manufactured by the foreign subsidiaries caused the deaths. The U.S. Supreme Court reversed the North Carolina courts, concluding that the foreign subsidiaries' connections to North Carolina (*i.e.*, allowing their products to reach North Carolina) fell "far short of the continuous and systematic general business contacts" necessary for North Carolina to "entertain suit against them on claims unrelated to anything that connects them to the State." This case, and *J. McIntyre Machinery Ltd. v. Nicastro* (discussed below), could have significant implications in the state tax world.

J. McIntyre Machinery Ltd. v. Nicastro

In *J. McIntyre Machinery Ltd. v. Nicastro*, the U.S. Supreme Court held that a state cannot exercise, consonant with due process under the U.S. Constitution, *in personam* jurisdiction over a foreign manufacturer solely because the manufacturer targets the United States market for the sale of its product and the prod-

[1] *Goodyear Tires, SA v. Brown*, 131 S. Ct. 2846 (2011).

uct is purchased by a forum state consumer.[2] The New Jersey Supreme Court had held that the foreign manufacturer was subject to jurisdiction in New Jersey under the stream of commerce theory even though the foreign manufacturer had never advertised in, sent goods to, or in any relevant sense targeted New Jersey. Reversing the New Jersey Supreme Court, the U.S. Supreme Court concluded that, because the foreign manufacturer never engaged in any activities in New Jersey that revealed an intent to invoke or benefit from the protection of New Jersey's laws, New Jersey is without power to adjudge the foreign manufacturer's rights and liabilities, and its exercise of jurisdiction would violate due process.

NEXUS

California

In a decision that could have far-reaching implications with the increase of telecommuting (as could *Telebright Corp. Inc. v. Director, Division of Taxation*, discussed below), the California State Board of Equalization (''SBE'') held in *Appeal of Warwick McKinley Inc.* that a Massachusetts corporation had substantial nexus with California for corporate franchise tax purposes because it employed an individual who worked out of her California home.[3] The corporation, which provided marketing and recruiting consulting services, did not conduct any business or maintain any offices in California. The employee's telephone calls and emails were routed through the corporation's headquarters and the employee's clients were located outside of California. The corporation was registered in California for the sole purpose of complying with federal law to provide the employee with worker's compensation insurance. The SBE held that the corporation had a regular, systematic, and substantial connection with, and physical presence within, California due to the employee's activities. The SBE reasoned that, by operating through its California employee, the corporation was afforded substantial benefits and protections by California that enabled the corporation to generate business.

Connecticut

Continuing the trend by states to attempt to attribute nexus, in *Scholastic Book Clubs Inc. v. Commissioner of Revenue Services*, the Connecticut Supreme Court held that Connecticut may constitutionally impose sales and use tax collection responsibilities on an out-of-state book distributor because it had nexus with Connecticut through the activities of local schoolteachers.[4] The distributor, which had no real or personal property or employees in Connecticut, made sales in Connecticut by mailing catalogs to teachers who distributed the catalogs to students, collected the students' orders and payments, and returned them to the distributor. The distributor delivered the ordered products by common carrier. The court determined that the schoolteachers who participated in the distributor's program were representatives of the distributor because the schoolteachers served as the exclusive channel through which the book distributor marketed, sold and delivered its products. Therefore, the court concluded, the schoolteachers' activities provided the requisite nexus under the Commerce Clause to justify imposition of sales and use tax collection responsibilities on the book distributor.

Louisiana

In *Utelcom Inc. & Ucom Inc. v. Bridges*, the Louisiana Court of Appeal held that the Louisiana corporate franchise tax did not apply to two out-of state corporations with limited partner interests in a foreign limited partnership that owned property and did business in Louisiana because the corporations' indirect ownership of capital in Louisiana through the foreign limited partnership did not constitute ''incidents of taxation'' as required under the statute.[5] The corporations themselves did not conduct any business activities in Louisiana, nor did they have employees, property, or bank accounts in Louisiana. The court held that subjecting the corporations to the corporate franchise tax because of their indirect ownership of capital through a limited partnership constituted a prohibited expansion of the scope of the statute.

Maryland

We are happy to report that, in *NIHC Inc. v. Comptroller of the Treasury*, the Circuit Court for Baltimore County reversed the Tax Court and held that the gain from the transfer of a license agreement by NIHC to its parent, N2HC, pursuant to which N2HC licensed the use of intellectual property to its ultimate parent, Nordstrom Inc., is not subject to Maryland taxation.[6] NIHC transferred the license agreement, an appreciated asset, to N2HC and, therefore, had reportable gain under Internal Revenue Code Section 311(b), which it was required to defer for federal income tax purposes. The Comptroller assessed NIHC on the deferred gain. The Circuit Court reversed the Tax Court and held that the deferred gain reported on the federal consolidated return is not included in the Maryland income tax return because, under Maryland's separate company reporting regime, each member of a consolidated group reports its separate company income without regard to consolidation. The case is currently on appeal in the Court of Special Appeals.

In another taxpayer victory, *W.L. Gore & Associates Inc. v. Comptroller of the Treasury*, the Circuit Court for Cecil County reversed the Tax Court and held that two out-of-state subsidiaries that held intellectual property and funds for a parent corporation that did business in Maryland were not subject to corporate income tax in Maryland on their receipts of royalty and interest income.[7] The Circuit Court concluded that the Tax Court erred in finding that the subsidiaries were passive, non-

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

[3] *Appeal of Warwick McKinley Inc.*, No. 489090 (Cal. State Bd. of Eq. Jan. 11, 2012).

[4] *Scholastic Book Clubs Inc. v. Comm'r of Revenue Servs.*, 38 A.3d 1183 (Conn. 2012).

[5] *Utelcom Inc. & Ucom Inc. v. Bridges*, 77 So. 3d 39 (La. Ct. App. 2011).

[6] *NIHC Inc. v. Comptroller of the Treasury*, No. 03–C–10-9151 (Md. Cir. Ct. Dec. 12, 2011).

[7] *W.L. Gore & Associates Inc. v. Comptroller of the Treasury*, No. 07-IN-OO-0084, No. 07-IN-OO-0085, and No. 07-IN-OO-0086 (Md. Tax Ct. Nov. 9, 2010), *rev'd*, *Gore Enterprise Holdings Inc. v. Comptroller of the Treasury*, No. 07-C-10-435

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operational entities that did not have a business existence separate from the parent company.

Minnesota

In *Skagen Designs, Ltd. v. Commissioner of Revenue*, the Minnesota Tax Court held that an out-of-state company that employed ''merchandisers'' in Minnesota was subject to the corporate franchise tax because the activities of the company went beyond the mere solicitation of orders within the meaning of P.L. 86-272.[8] The company, which distributed and sold wristwatches and jewelry to retail stores, employed part time employees (''merchandisers'') who conducted various activities, including the following: re-arranging display cases containing the company's products at retail stores; generating and submitting weekly reports to managers; completing and maintaining detailed floor maps of each retailer's watch department; and conducting training presentations and informational seminars for the retailers' sales associates. The court determined that, taken as a whole, the merchandisers' activities were not *de minimis*, and therefore, the activities created a sufficient nexus between Minnesota and the company.

New Jersey

In *Telebright Corp. Inc. v. Director, Division of Taxation*, the Superior Court, Appellate Division held that an out-of-state software developing company had nexus with New Jersey for Corporation Business Tax (''CBT'') purposes because one of its employees telecommuted full-time from her New Jersey residence.[9] The employee developed and wrote software code from a laptop computer in New Jersey which became a part of a web-based product that the company sold. The Superior Court observed that an employee's creation of computer code in New Jersey for her software developer employer was no different from a foreign manufacturer employing someone to fabricate parts in New Jersey for a product that will be assembled elsewhere.

In *Bis LP Inc. v. Director, Division of Taxation*, the New Jersey Superior Court, Appellate Division held that an out-of-state investment company that held a 99% limited partner interest in a limited partnership doing business in New Jersey which provided outsourcing technology services for its clients did not have sufficient nexus with New Jersey for purposes of the CBT because the investment company was not doing business in New Jersey and was not unitary with the limited partnership.[10] The Superior Court concluded that the investment company lacked nexus with New Jersey because it was not ''integrally related'' with the limited partnership. The investment company was not in the same line of business as the limited partnership, did not substantially overlap with the limited partnership in their officers, did not share offices, operational facilities, technology, or know-how with the limited partnership, and did not control the limited partnership.

(Md. Cir. Ct. Aug. 26, 2011) & *Matter of Future Value Inc.*, No. C-10-434 (Md. Cir. Ct. Sept. 30, 2011).

[8] *Skagen Designs, Ltd. v. Comm'r of Revenue*, No. 8168-R (Minn. Tax Ct. Apr. 23, 2012).

[9] *Telebright Corp. Inc. v. Director, Division of Taxation*, No. A-5096-09T2 (N.J. Super. Ct. App. Div. Mar. 2, 2012).

[10] *Bis LP Inc. v. Director, Division of Taxation*, No. A–1172-09T2 (N.J. Super. Ct. App. Div. Aug. 23, 2011).

New Mexico

In *Matter of Barnesandnoble.com LLC*, the New Mexico Court of Appeals held that an online bookseller had sufficient contacts with New Mexico to establish substantial nexus for purposes of the gross receipts tax because of the in-state use of trademarks.[11] The online bookseller, an out-of-state LLC, sold merchandise through the internet to U.S. customers, including customers in New Mexico. The parent corporation of the online bookseller owned an out-of-state subsidiary that owned and operated retail bookstores physically located in New Mexico. The court concluded that the subsidiary's use of trademarks in the retail bookstores operated in New Mexico established nexus for the online bookseller consistent with the United States Commerce Clause because the retail bookstores strengthened the goodwill behind the trademarks. Furthermore, the court determined that the subsidiary's participation in a multi-retailer gift card program and in a customer loyalty program, while insufficient to create nexus on their own, were cross-marketing activities that enhanced goodwill and helped the online bookseller to establish and maintain a market in New Mexico. Accordingly, the court held that the online bookseller was subject to the gross receipts tax.

Oklahoma

In our recent victory *In the Matter of Scioto Insurance Co.*, the Supreme Court of Oklahoma held that a Vermont insurance company, Scioto, was not subject to Oklahoma's corporate net income tax on payments received by Oldemark LLC, a disregarded entity solely owned by Scioto, under a licensing contract with Wendy's that was not made in Oklahoma and no part of which was to be performed in Oklahoma.[12] Scioto (Oldemark LLC) received income from Wendy's, which sublicensed the use of intellectual property by individual restaurants in Oklahoma owned and operated by franchisees unrelated to Wendy's. The court held that the income that Scioto received from the use of intellectual property in Oklahoma did not create an income tax liability for Scioto because Scioto did not conduct business in Oklahoma and the licensing contract between Scioto and Wendy's was not made in Oklahoma or performed in Oklahoma.

Oregon

In *Ann Sacks Tile & Stone Inc. v. Department of Revenue*, the Oregon Tax Court held that the parent company of a taxpayer had nexus with Oregon on the basis of the activities of its employees, distributors, and authorized service representatives (''ASRs'') in Oregon and, therefore, the taxpayer was required to include the parent company's payroll and sales numbers in its apportionment numerator for its consolidated Oregon corporation excise tax return.[13] The parent company's sales representatives solicited orders from Oregon cus-

[11] *Matter of Protest of Barnesandnoble.com LLC*, No. 31,231 (N.M. Ct. App. Apr. 18, 2012).

[12] *In the Matter of Scioto Insurance Co.*, 2012 OK 41 (Okla. May 1, 2012).

[13] *Ann Sacks Tile & Stone Inc. v. Dep't of Revenue*, No. TC 4879 (Or. Tax Ct. Nov. 29, 2011).

tomers and entered into contracts with local distributors, and its ASRs provided warranty repair work for some of its products to Oregon customers. The parent company also sent employees to Oregon to provide technology assistance and administrative services for one of its subsidiaries.

Tennessee

In *Scholastic Book Clubs Inc. v. Farr*, the Tennessee Court of Appeals held that an out-of-state book distributor had sufficient presence in Tennessee to be subject to sales and use tax collection responsibilities.[14] The distributor had no real property, personal property, or employees located in Tennessee. The distributor made significant sales in Tennessee by mailing catalogs to teachers who distributed the catalogs to students, collected the students' orders and payments, and returned them to the distributor. The distributor delivered the ordered products by common carrier. The court rejected the distributor's constitutional arguments on the basis that the distributor had used the Tennessee schools and teachers to create a ''de facto marketing and distribution mechanism,'' regardless of whether or not the teachers were agents of the distributor. Therefore, the court concluded, the distributor's activities were sufficient to satisfy the substantial nexus requirement and *Quill*'s physical presence standard.

APPORTIONMENT

Illinois

In our *Panhandle Eastern Pipeline Co. & Texas Eastern Trans. Corp. v. Hamer* case, the Illinois Circuit Court held that amounts received for flow-through natural gas transported in pipelines through Illinois on an interstate journey (originating in states other than Illinois and terminating in states other than Illinois but not originating or terminating in Illinois) are not revenue miles ''in'' Illinois. Therefore, such amounts are not included in the numerator of the apportionment factor.[15]

Indiana

In *Miller Brewing Co. v. Department of State Revenue*, the Indiana Tax Court held that sales of beverages prepared for pickup in a neighboring state and delivered to Indiana customers by common carriers were not attributed to Indiana for purposes of the sales factor of the Adjusted Gross Income Tax, where the transportation of the beverages were contracted, arranged, and paid for by the Indiana customers.[16] According to the Department's regulation, sales are not in Indiana if the purchaser picks up the goods at an out-of-state location and brings them back into Indiana in the purchaser's own conveyance. Consequently, under a plain reading of the Indiana code and regulations, the carrier-pickup sales were not Indiana sales and therefore properly excluded from the numerator of the taxpayer's sales factor.

Massachusetts

In *AT&T Corp. v. Commissioner of Revenue*, a telephone company was not required to include receipts from interstate and international calls in the numerator of its Massachusetts sales factor for corporate income tax purposes.[17] Rejecting the Commissioner's position, the Massachusetts Appellate Tax Board held that the company's income-producing activity was the provision of the entire telecommunications network and not each individual call for each of its customers located in Massachusetts. Therefore, the receipts from interstate and international telecommunications services were not Massachusetts sales includable in the numerator of the Massachusetts sales factor.

Michigan

In *Kelly Services Inc. v. Department of Treasury*, the Michigan Court of Appeals held that a corporation properly excluded royalty income from its sales factor under the former Single Business Tax.[18] The corporation, which was in the business of providing temporary staffing services, received royalty income from licensing trademarks, trade names and know-how (the ''intangibles'') to affiliated companies. The court determined that the royalty income was not includable as sales because (1) the corporation retained ownership and control of the intangibles, and (2) the intangibles were not applicable forms of property, being neither stock in trade, included in the corporation's inventory, nor sold to customers.

New Jersey

We are happy to report that the New Jersey Supreme Court held in *Whirlpool Properties Inc. v. Director, Division of Taxation* that, for corporations having a substantial nexus to New Jersey, New Jersey's throwout rule may only apply constitutionally to untaxed receipts attributable to states lacking jurisdiction to tax the corporations either due to insufficient connection with the corporation or similar congressional action such as P. L. 86-272, but not to receipts that are untaxed because a state chooses not to impose an income tax.[19]

On Sept. 7, 2011, the Division issued a Notice explaining the Division's revised audit policy concerning the application of the throwout rule in accordance with the decision in *Whirlpool*.[20] The Notice provides that the Division will not throw out receipts assigned to Nevada, Wyoming and South Dakota because these states do not impose a corporate income tax or a similar busi-

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[14] *Scholastic Book Clubs Inc. v. Farr*, No. M2011-01443-COA-R3-CV (Tenn. Ct. App. Jan. 27, 2012).

[15] *Panhandle Eastern Pipeline Co. & Texas Eastern Trans. Corp. v. Hamer*, No. 09 L 051281 (Ill. Cir. Ct. Nov. 2, 2011).

[16] *Miller Brewing Co. v. Dep't of State Revenue*, 955 N.E.2d 865 (Ind. Tax Ct. 2011).

[17] *AT&T Corp. v. Comm'r of Revenue*, C293831 (Ma. App. Tax Bd. June 8, 2011).

[18] *Kelly Servs. Inc. v. Dep't of Treasury*, No. 303736 and 303737 (Mich. Ct. App. Apr. 19, 2012).

[19] *Whirlpool Properties Inc. v. Director, Division of Taxation*, 26 A.3d 446 (N.J. 2011).

[20] Notice: New Jersey Supreme Court Decision in Whirlpool Properties Inc. v. Director (N.J. Div. of Taxn. Sept. 7, 2011).

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ness activity tax. We believe that the Notice improperly interprets the New Jersey Supreme Court's decision.[21]

Oregon

Contrary to the Massachusetts *AT&T* decision discussed above, in *AT&T Corp. & Includible Subsidiaries v. Department of Revenue*, the company was required to include receipts from interstate and international calls in the numerator of its Oregon sales factor for corporate income tax purposes.[22] The Oregon Tax Court looked at each individual call for each of the company's customers in Oregon as the subject of a cost of performance analysis instead of the entire telecommunications network. Furthermore, the Tax Court determined that direct costs included access charges but not all costs incurred to engage in the general business activity with respect to the interstate and international services. Consequently, the receipts from interstate and international calls were includable in the numerator of the sales factor in Oregon.

South Carolina

In *CarMax Auto Superstores West Coast Inc. v. Department of Revenue*, the South Carolina Court of Appeals held that the Administrative Law Court erred by determining that a company had the burden of proving that the Department's alternative apportionment method was not reasonable.[d23] The company, a subsidiary of a retailer of used cars and light trucks, sold used vehicles outside of South Carolina and owned intellectual property during some of the years in issue. The company filed South Carolina returns using the standard apportionment formula. The Department adjusted the apportionment formula to exclude the retail income earned by the company outside South Carolina. Both the company and the Department agreed that the Department bears the initial burden of proving that the standard formula does not fairly represent the company's South Carolina activities. However, the Court of Appeals agreed with the company that the Department also bears the burden of proving that its alternative apportionment formula is reasonable and more fairly represents the company's South Carolina activities.

Virginia

In *Ford Motor Credit Co. v. Chesterfield County*, the Virginia Supreme Court held that Chesterfield County improperly attributed all of the gross receipts from loans that originated in an automotive credit company's Virginia local branch office to that office for purposes of local business, professional and occupational license (''BPOL'') taxes.[24] The company, a subsidiary of Ford Motor Company, was headquartered out-of-state and provided financing for automobile sales and leases. The company's headquarters originated the capital necessary to make the loans, while the Virginia local branch office serviced customers with administrative matters relating to the loans such as changes of address, refinancing, and logging payments. The court determined that the company's local branch did not produce 100% of the gross receipts. Further, because it was impractical or impossible to determine the definite place of business to which gross receipts should be attributed, the court determined that the company's BPOL tax assessment must be calculated using payroll apportionment.

ADDBACK STATUTES AND DENIALS OF DEDUCTIONS

New Jersey

On Feb. 16, 2012, the Division of Taxation issued guidance on the use of intercompany transfer pricing and advance pricing agreements (''APAs'') in the context of intercompany transactions, replacing a previously issued guidance (TAM–2011–17).[25] The guidance explains that Internal Revenue Code Section 482 (''IRC §482'') standards will be utilized when the director examines intercompany transactions and determines whether to adjust the entire net income of a taxpayer. The director will accept an APA with the IRS and third-party pricing studies upon which the APA was based and will make no adjustments to federal taxable income if the taxpayer can demonstrate that it has met the standards of IRC §482. However, the director may challenge their underlying assumptions and interpretations if the ''true earnings'' of the taxpayer on business carried on in New Jersey are not reflected by the terms of the APA. The Division expressed its intent to codify the contents of the guidance in a regulation.

Virginia

In our *Wendy's International Inc. v. Department of Taxation* case, the Virginia Circuit Court held that a company was entitled to refunds for intangible expenses paid to an affiliate because an exception to the addback was applicable.[26] The company, a national franchise restaurant chain, licensed intellectual property from its affiliate and sublicensed the intellectual property to restaurants owned by related and unrelated companies. The company deducted the royalties paid to the affiliate from its federal income tax returns. The Virginia statute provides three safe harbor exceptions to the addback, including when ''[a] related member derives at least one-third of its gross revenues from licensing intangible property to parties who are unrelated members'' and the expenses are at arm's length. The court determined that this exception to the addback did not require a direct connection between a related member and an unrelated licensee and, therefore, the exception to the addback applied to the company.

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[21] We note that the throwout rule was repealed in 2008, effective for privilege periods beginning on or after July 1, 2010. L. 2008, c. 120.

[22] *AT&T Corp. & Includible Subsidiaries v. Dep't of Revenue*, No. TC 4814 (Or. Tax Ct. Jan. 12, 2012).

[d23] *CarMax Auto Superstores West Coast Inc. v. Dep't of Revenue*, No. 4953 (S.C. Ct. App. Mar. 14, 2012).

[24] *Ford Motor Credit Co. v. Chesterfield Cty.*, 707 S.E.2d 311 (Va. 2011).

[25] Technical Advisory Memorandum, No. TAM-2012-1 (N.J. Div. of Tax. Feb. 16, 2012).

[26] *Wendy's Int'l Inc. v. Dep't of Tax.*, No. CL09-3757 (Va. Cir. Ct. Mar. 29, 2012).

COMBINED/CONSOLIDATED RETURNS

Indiana

In *AE Outfitters Retail Co. v. Department of State Revenue*, the Indiana Tax Court granted our motion for partial summary judgment and held that the Department was required to apply all of the methodologies provided for in other remedial provisions of the Indiana Code before forcing combination.[27] Therefore, the Department may not force combination unless separate returns result in a distortion of a taxpayer's Indiana income and its Indiana income cannot be fairly reflected through separate accounting, the exclusion or inclusion of one or more factors, the employment of any other reasonable method that would effectuate an equitable allocation and apportionment, or through the use of the Department's IRC Section 482–like powers.

In *Department of State Revenue v. Rent-A-Center East Inc.*, the Indiana Supreme Court reversed and remanded the Tax Court's summary judgment ruling that required the Department to present additional evidence beyond the proposed assessment to defend against a summary judgment motion.[28] The Department asserted that an out-of-state company that operated retail stores throughout the United States, including in Indiana, and paid royalties and strategic assistance fees to two affiliates must file income tax returns on a combined basis with the affiliates. The court stated in this procedural matter that, when properly designated in support of its summary judgment motion, the Department's notice of proposed assessment constitutes a sufficient prima facie showing and that the burden then shifts to the taxpayer to present evidence demonstrating that a genuine issue of material fact exists regarding the asserted tax liability.

New York

In *Matter of Petition of Kellwood Co.*, the New York State Tax Appeals Tribunal ruled that an out-of-state corporation was required to file New York corporate franchise tax returns on a combined basis with one of its wholly-owned non-taxpayer subsidiaries but not with another.[29] The first subsidiary (the ''factoring company'') performed factoring functions for the corporation, which was in the business of supplying apparel to retail stores. The second subsidiary (the ''services company'') provided administrative services to the corporation. The Tribunal concluded that the corporation did not rebut the presumption of distortion with respect to its transactions with the factoring company because it failed to prove that the transactions with the factoring company had economic substance apart from tax considerations. However, the corporation did meet its burden of proving that the transactions with the services company had economic substance and a subjective business purpose.

Under its new combination law which is effective for years beginning in or after 2007, the Division has been attempting to de-combine companies included in combined reports. This is in sharp contrast to its actions under prior law of trying to force combinations in many instances.

North Carolina

On June 30, 2011, legislation was signed into law revising the Secretary's authority to redetermine net income, effective for tax years beginning on Jan. 1, 2012.[30] The new law requires the Secretary to make a written request to a corporation to supply within 90 days any information necessary to determine whether the corporation's intercompany transactions have economic substance and fair market value. If the Secretary finds as a fact that a corporation's intercompany transactions lack economic substance or are not at fair market value, the Secretary may add back, eliminate, or otherwise adjust intercompany transactions, and if such adjustments are inadequate to properly reflect net income, the Secretary may require combination.

On Nov. 16, 2011, the Department issued a Directive explaining (1) the Department's current practice with respect to the Secretary's authority to require combined returns for tax beginning before Jan. 1, 2012, and (2) the Secretary's authority to eliminate intercompany transactions and/or require combined returns for tax years beginning on or after Jan. 1, 2012. The Directive provides the conditions under which the Secretary will require a combined return and a list of factors that the Department will consider in determining whether a report by a corporation properly discloses its net income attributable to North Carolina.[31]

GAINS

Alabama

In *In re Kimberly-Clark Corp. & Kimberly-Clark Worldwide Inc. v. Department of Revenue*, on remand from and in compliance with the Alabama Supreme Court's decision, the Court of Civil Appeals reversed its prior decision and held that the gain from the sale of an Alabama mill and timberland by a corporation primarily engaged in the manufacture and sale of paper-related consumer products was nonbusiness income allocable to Alabama.[32] The corporation had sold the mill and timberland pursuant to a change in corporate strategy that shifted focus to the corporation's consumer products rather than its own manufacturing and processing of raw materials. The court determined that the sale of the properties was an extraordinary transaction that represented a divestiture by the corporation of a part of its business rather than a transaction conducted in the regular course of the corporation's business and, therefore, the gain from the sale was properly classified as nonbusiness income. The decision should be helpful for companies asserting that gains constitute nonbusiness income that should be allocated outside Alabama.

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[27] *AE Outfitters Retail Co. v. Dep't of State Revenue*, 957 N.E.2d 221 (Ind. Tax Ct. 2011).

[28] *Dep't of State Revenue v. Rent-A-Center East Inc.*, No. 49S101112-TA-683 (Ind. Mar. 9, 2012).

[29] *Matter of Petition of Kellwood Co.*, DTA No. 820915 (N.Y.S. Tax App. Trib. Sept. 22, 2011).

[30] H.B. 619, S. L. 2011-390.

[31] Directive (N.C. Dep't of Rev. Nov. 16, 2011).

[32] *In re Kimberly-Clark Corp. & Kimberly-Clark Worldwide Inc. v. Dep't of Revenue*, No. 2100803 and No. 2100811 (Ala. Ct. Civ. App. Feb. 17, 2012).

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Michigan

We are happy to report that in *Reynolds Metals Co. v. Department of Treasury*, the Michigan Court of Appeals agreed that the unitary business principle does apply in Michigan. Accordingly, the court held that an out-of-state corporation was not required to include the capital gains from the sale of its interest in a foreign joint venture in its Single Business Tax (''SBT'') base because the corporation did not operate a unitary business with the foreign joint venture.[33] The corporation, which manufactured and distributed aluminum products, held an interest in a joint venture with three unrelated companies for the manufacturing and refining of alumina in Australia. The corporation incurred capital gains when it sold its interest in the foreign joint venture. Affirming the Court of Claims, the Court of Appeals held that the unitary business principle applies to the SBT, a value-added tax, as well as to income-based taxes, and that the corporation was not unitary with the joint venture.

SALES AND USE TAX

California

In our *GMRI Inc. v. California* case, the California State Board of Equalization held that sales tax is not due on gratuities that are included on checks of parties of eight or more customers (called ''large parties'') when the customers of the Red Lobster and Olive Garden restaurants changed the gratuity from the amount specified on the menu.[34]

Indiana

In *Indiana Department of Revenue v. AOL Inc.*, the Indiana Supreme Court held that AOL was liable for use tax on promotional materials sent to Indiana residents from out-of-state producers because AOL purchased the production and mailing of the promotional materials in retail transactions and later used them in Indiana.[35] The service provider hired third-party assembly houses and letter shops to produce and assemble CD-ROM packages containing its client software and promotional materials and mail them from outside Indiana to residents in Indiana. The court rejected the argument that AOL purchased assembly and printing services, determining instead that the sales of the CD-ROM packages were taxable retail transactions that became subject to use tax once the products were used in Indiana.

South Carolina

Online travel companies have been subject to attack around the country on whether they are subject to sales tax collection responsibilities. In *Travelscape, LLC v. Department of Revenue*, the South Carolina Supreme Court held that one such online travel company was liable for sales tax on the gross proceeds received from providing reservations for hotels in South Carolina because it was engaged in the business of furnishing accommodations in South Carolina.[36] The company contracted with hotels for discounted room rates and offered those rates to the public for reservations made on its website, Expedia.com. The company did not pay sales tax on the portion of the fees received from customers that it did not remit to the hotels. The court rejected the company's argument that the fees were derived from services provided and not from the rental charge of the hotel room. The court concluded that the company was in the business of furnishing accommodations within South Carolina because it entered into contracts with hotels in South Carolina, sent employees to South Carolina to negotiate contracts, and book reservations at hotels in South Carolina. Further, the court determined that imposing the sales tax did not violate the Commerce Clause of the U.S. Constitution.

In a Revenue Ruling, the South Carolina Department of Revenue provided that software delivered via the Internet from a seller's laptop to a customer's computer at the customer's location is not subject to sales tax because the software is not delivered by tangible means (such as by tape, diskette or flash drive).[37] Furthermore, the Department ruled that changes made directly to the source code of a customer's software by a software programmer at the customer's location are not subject to sales and use tax because the software programmer has provided a service and no software was sold and delivered.

MISCELLANEOUS

Due Process

Independent Tax Tribunals

In a topic that is near and dear to our hearts, we are happy to report that a number of states have proposed bills and some have enacted legislation that would establish independent tax tribunals. On Dec. 16, 2011, Illinois enacted a law establishing an independent tax tribunal effective July 2013.[38] On April 19, 2012, the Georgia governor signed into law legislation creating the Georgia Tax Tribunal as an independent division within the Office of State Administrative Hearings effective Jan. 1, 2013.[39] On May 16, 2012, the Alabama legislature approved a bill that would create a new Alabama Tax Appeals Commission.[40] However, citing technical errors in the final form of the bill, the Alabama governor announced on May 24, 2012 that he would pocket veto the bill. We hope to see the bill re-introduced and signed by the governor in the not too distant future. On Feb. 6, 2012, a bill was proposed in Oklahoma to establish an independent tax appeals tribunal.[41] On Feb. 28, 2012, a Louisiana representative prefiled a bill creating a new tax court in the Office of the Governor.[42]

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[33] *Reynolds Metals Co. LLC v. Dep't of Treasury*, No. 300001 (Mich. Ct. App. Mar. 20, 2012).
[34] *GMRI Inc. v. California* (Cal. S. Bd. Eq. Nov. 15, 2011).
[35] *Indiana Dep't of Revenue v. AOL Inc.*, 963 N.E.2d 498 (Ind. 2012).
[36] *Travelscape, LLC v. Dep't of Revenue*, 705 S.E.2d 28 (S.C. 2011).
[37] *Revenue Ruling* No. 12-1 (S.C. Dep't of Rev. March 20, 2012).
[38] 35 ILCS 1000/5-5, P.A. 97-636, L. 2011.
[39] Ga. H.B. 100, Act 609, Laws 2012.
[40] Ala. S.B.549.
[41] Okla. S.B. 1297.
[42] La. H.B. 376.

We encourage everybody to do what they can to help expand due process in the state and local tax world.

Nevada

In *Southern California Edison v. District Court*, the Supreme Court of Nevada held that the Department was judicially estopped from requiring a company to challenge a refund claim by filing a petition for judicial review (as opposed to filing a complaint seeking trial de novo), although that was the proper procedure, because the Department had a history of taking inconsistent positions regarding proper procedures. After undergoing administrative procedures at the Department level, the company filed a complaint in the district court seeking trial de novo.[43] The Supreme Court reasoned that the Department had taken "totally inconsistent positions" in quasi-judicial administrative proceedings regarding the proper procedures for a taxpayer challenging the Department's denial of refund claims. Furthermore, the Department admitted that it had specifically informed the company that trial de novo would be available at the trial court level.

[43] *Southern California Edison v. Dist. Ct.*, 255 P.3d 231 (Nev. 2011).

CONCLUSION

There have been many developments in the areas of nexus, combined reporting, apportionment factors, addbacks and denials of deductions. Increased state demand for tax revenues is sure to make the rest of 2012 exciting and interesting.

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